Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2020 Cost of Capital
Application: A.19-04-017
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SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)

PREPARED REBUTTAL TESTIMONY OF BRUCE A. FOLKMANN

(POLICY OVERVIEW)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

August 16, 2019

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SAN DIEGO GAS AND ELECTRIC COMPANY
PREPARED REBUTTAL TESTIMONY OF BRUCE A. FOLKMANN
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I. INTRODUCTION

My rebuttal testimony on behalf of San Diego Gas & Electric Company ("SDG&E" or the "Company") addresses the direct testimony of intervenors submitted on August 1, 2019, including the testimony of witnesses on behalf of the California Public Advocates Office ("Cal PA"), the Environmental Defense Fund ("EDF"), the Federal Executive Agencies ("FEA"), the Utility Consumers' Action Network and Protect Our Communities (collectively, "UCAN"), and the Utility Reform Network ("TURN"). My testimony addresses: (1) the intervenors' return on equity ("ROE") proposals in relation to SDG&E's risks; (2) EDF's recommendation for separate gas and electric ROEs; and (3) the intervenors' capital structure proposals.

In brief, intervenors' arguments suffer from the same fatal flaw. They imagine that SDG&E's risks are equivalent to – or less than – other investor-owned utilities ("utilities") nationwide. They seek to set the Company's ROE as if SDG&E faces below-average risks compared to the Company's peers. But this framing ignores all evidence to the contrary – namely the exceptional threat that SDG&E and other California utilities face from, among other things, the state's catastrophic wildfire liability regime of inverse condemnation and outlier prudency review. This liability combination has resulted in multiple credit rating downgrades and an increased cost of equity for the Company. SDG&E's cost of capital must reflect these threats – or risk further credit downgrades and insufficient investment to meet California's ambitious policy goals. Attempts to lower the Company's current ROE and place it well beneath the national average would do exactly that.

1 **II. SDG&E'S ROE MUST REFLECT ITS UNIQUE, ABOVE-AVERAGE RISKS**

2 **A. Intervenors Inexplicably Recommend A Below-Average ROE Despite Their**
3 **Acknowledgement That SDG&E Faces Significant Risks**

4 Intervenors correctly note that a company's ROE must be set commensurate with risks.[1]
5 That is, the greater the risk, the greater the return required.[2] Otherwise, it will become difficult
6 for a utility to access capital, forcing a company to rely more on debt financing, putting greater
7 pressure on a company's credit rating, and increasing costs to ratepayers.[3]

8 SDG&E's cost of capital proposals reflect the fact that SDG&E and other California
9 utilities face unique risks that are not shared by utilities outside the state. Moody's recently
10 summarized a primary driver of that risk – California's wildfire liability regime. As the rating
11 agency stated:

12 • Wildfires have grown larger and more damaging in California for multiple reasons,
13 including climate change and population growth in fire prone areas;

14 • California utilities are "particularly vulnerable to the financial impact of utility-
15 related wildfires because under California's inverse condemnation law, utilities are
16 held liable for wildfire damages [that can reach tens of billions of dollars] if their
17 equipment is found to be the source of ignition or somehow caused the fire,
18 regardless of fault or the reasonableness of their conduct;"

19 • Although, in theory, utilities can pass these costs along to ratepayers if the
20 Commission finds that the utility demonstrated that it behaved prudently, in practice
21 the Commission's first precedent was to deny SDG&E recovery of wildfire costs that
22 it incurred in 2007 (compared to the Federal Energy Regulatory Commission
23 ("FERC") granting full recovery on the same facts), throwing "into doubt the ability

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1 *Direct Testimony and Exhibits of Michael P. Gorman on behalf of Energy Producers & Users Coalition ("EPUC"), Indicated Shippers, and the Utility Reform Network ("TURN")* (August 1, 2019) ("TURN Testimony (Gorman)") at VIII-11:28-31; *Direct Testimony and Exhibits of Kevin W. O'Donnell, CFA, on behalf of the Federal Executive Agencies* (August 1, 2019) ("FEA Testimony (O'Donnell)") at 16:5-10.

2 *Prepared Direct Testimony of Marlon F. Griffing, Ph.D., Cost of Capital on behalf of Utility Consumers' Action Network and Protect Our Communities Foundation* (August 1, 2019) ("UCAN and POC Testimony ("Griffing")") at 8:20-21.

3 *See Prepared Direct Testimony of Dr. Roger Morin* (April 2019) ("Ex. SDG&E-04 (Morin)") at 5-7.

> of utilities in the state to recover wildfire costs and rais[ing] questions about how incurring such costs would affect their financial stability." [4]

As a result, SDG&E has faced multiple credit rating downgrades and an increased cost of equity in the last two years – for example, with Standard & Poor's ("S&P") downgrading SDG&E from an 'A' rating to 'BBB+ – even without the Company experiencing any significant wildfires during this time. Most intervenors concede these increased risks. For instance, Kevin O'Donnell, on behalf of FEA, states that inverse condemnation "does make an investment in a [California utility] more risky, as a whole, than an investment in a utility that operates in a state without such liability risk."[5]

Intervenors further largely acknowledge the precipitous drop in SDG&E's credit rating in the last year (at least two notches each by all three relevant credit rating agencies), as a result of these risks. For example, Michael Gorman, on behalf of TURN,[6] states that:

- SDG&E and other California utilities have faced credit rating downgrades as a result of "wildfire risk unique to California,"[7]
- A "Baa utility bond, as opposed to an A-rated utility bond [under Moody's ratings framework];" is "more risky"[8] and
- The "change in bond rating" for California utilities "is a directly observable metric to gauge the increased cost of capital that reflects this increased cost recovery risk to California utilities."[9]

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4 Moody's, *FAQ on the credit implications of California's new wildfire law,* dated August 6, 2019 ("Moody's Aug. 6 Report") at 2.

5 FEA Testimony (O'Donnell) at 41:14-16; *accord id.* at 57:15-16 ("I understand and accept the fact that SDG&E has a higher level of risk due to inverse condemnation and the ongoing threat of wildfires").

6 While Mr. Gorman also testifies on behalf of EPUC and IS, with regards to SDG&E his testimony is solely on behalf of TURN.

7 TURN Testimony (Gorman) at V-10:4-7.

8 *Id.* at V-11:1-6.

9 *Id.* at V-10:11-13.

Because of these threats, Mr. Gorman acknowledges that an ROE wildfire risk premium is appropriate.[10]

And multiple intervenors likewise concede that the heightened risk for California utilities is similarly reflected in equity markets. As Mr. O'Donnell admits, the stock of SDG&E's parent company, the more diversified, Sempra Energy, is "still in the shadow of inverse condemnation."[11] Richard McCann on behalf of EDF states that "ROEs for all three [California] utilities' market valuation have diverged some [from] the U.S. average over the last year and a half" compared to utility holding companies nationwide, with the stock of Sempra Energy discounted 40 basis points[12] – indicating an even larger impact on SDG&E.[13] The investors' acknowledge that Sempra Energy's .75 beta is significantly higher than the average of the intervenors' proxy group.[14]

Yet, in making their ROE proposals, the intervenors overwhelmingly treat SDG&E and other California utilities as adequately represented by the national proxy group. Intervenors

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[10] *Id.* at II-5:9-10.

[11] FEA Testimony (O'Donnell) at 64:17-18.

[12] *Prepared Direct Testimony of Richard McCann, Ph.D. on Authorized Cost of Capital for Utility Operations for 2020 on behalf of the Environmental Defense Fund* (August 1, 2109) ("EDF Testimony (McCann)") at 14.

[13] *See* FEA Testimony (O'Donnell) at 60:4-6 (stating that some of Sempra's "earnings growth is coming from expected earnings growth from recent acquisitions, such as the Oncor purchase, and have little to do with utility regulation in California"); S&P Global Ratings, *San Diego Gas & Electric Co. Ratings Affirmed, Outlook Revised to Stable from Negative*, dated July 30, 2019 ("S&P July 30 Report") at 2 ("Sempra [Energy] is a large company that operates other significant and well-run businesses beyond its California utilities); Fitch Ratings, *Fitch Affirms Sempra, SDG&E, SoCalGas and Oncor; SDG&E's Outlook Remains Negative,* dated April 19, 2019 ("Fitch April 19 Report") at 1 ("Sempra's exposure to catastrophic wildfire risk in California is alleviated by the diverse source of its earnings including those from Oncor, Cameron liquefied natural gas (LNG) and growing non-electric rate base in California").

[14] *See* TURN Testimony (Gorman) at VIII-34:5-6 (average proxy group beta is .59); FEA Testimony (O'Donnell) at 63:11-13 (average proxy group beta is .58).

1 essentially argue that ROEs are trending lower nationally, so ROEs should also be set lower
2 here, consistent with that trend.[15] Some go so far as to not even discuss risk – let alone wildfire
3 liability risk – ignoring that ROE must be set commensurate with risks.[16]
4 In fact, the intervenors go further still. With perhaps the notable exception of TURN,
5 they all propose to set SDG&E's ROE well *below* the national ROE average of 9.6%-9.8% for
6 2018-2019 – in effect asserting that California utilities are *less* risky than other utilities
7 nationwide.[17] For example:

8-9
- Dr. Marlon Griffing for UCAN admits that his recommendation of 9.15% would put SDG&E "among the low end of ROEs for U.S. electric operating companies;"[18]

10-11
- Mr. O'Donnell repeatedly states that SDG&E is riskier than national utilities – before proposing an ROE for SDG&E of 9.5% that is below the national average;[19]

12-16
- Mr. Gorman's suggested wildfire premium of .65% barely puts his ROE recommendation of 9.65% at the low end of the national average – in effect contending that California's wildfire liability regime barely results in average risks – with a "base" ROE recommendation of 9.0% that is well below the national average.[20]

[15] *See, e.g.*, FEA Testimony (O'Donnell) at 32-33.

[16] *See, e.g.*, *Rebuttal Testimony of Roger A. Morin, Ph.D.* (August 2019) ("Ex. SDG&E-09 (Morin)") at 25:5-11; *see also* Decision ("D.")12-12-034 at 28 ("We also consider additional risk factors not specifically included in the financial models.").

[17] *See* Ex. SDG&E-09 (Morin) at 4:5-7 (stating that the "zone of currently authorized ROEs" for vertically integrated utilities in the United States in 2018 and 2019 is 9.6%-9.8%) (citing S&P Global Intelligence, RRA Regulatory Focus *Major Rate Case Decisions January-June 2019* (Jul. 22, 2019)).

[18] UCAN and POC Testimony (Griffing) at 47:7-8; *see id.* at 46:20-21 (pointing out that the current average authorized ROE for vertically integrated utilities is 9.71%); *see also* Ex. SDG&E-09 (Morin) at 36:16-19 (noting how Rothschild's ROE proposal would result in one of the lowest ROEs in the country for a utility that is one of the riskiest).

[19] *Compare* FEA Testimony (O'Donnell) at 64:7-9 (Table 25) (proposing a 9.5% ROE), *with* TURN Testimony (Gorman) at II-3:12-13 (asserting the industry authorized ROE for 2019 is "about 9.6%").

[20] *Compare* TURN Testimony (Gorman) at II-Ex. MPG-3 (proposing an ROE for SDG&E of 9.65%), *with* TURN Testimony (Gorman) at V-10:13-V-11:1 (Table 10) (seemingly attempting to disavow his proposed .65% wildfire risk premium).

Even if there has been a slight decline in national average ROEs since 2012,[21] not only do intervenors' below-average ROE proposals ignore all recent evidence from credit rating agencies and other sources demonstrating how California utilities are far from average, but they are also inconsistent with the intervenors' own testimony. For example, Mr. Gorman asserts that the national ROE average has been sufficient to support "strong investment grade bond ratings" for utilities nationwide;[22] purportedly evidenced by the fact that utility industry credit ratings have improved over the last eight years despite a declining ROE average.[23] Yet here, as Mr. Gorman acknowledges, California utilities face the exact opposite situation – precipitously declining credit ratings over the last year despite stable, above average ROEs. This situation underscores the unique risk for SDG&E and other California utilities and the need to set ROE commensurate with SDG&E's above-average threat profile. It also shows the fallacy of intervenors' proposals to set SDG&E's ROE at the bottom end of the national ROE range, which would could cause further damage to SDG&E's credit rating.

B. Intervenors' Arguments About Prudency Review and Wildfire Insurance Ignores that ROE is Set Based on Investor Expectations

Certain intervenors attempt to justify their below average ROE proposals by asserting that catastrophic wildfire liability risk is simply a matter of prudent utility conduct.[24] But this

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[21] *Compare* S&P Global Intelligence, RRA Regulatory Focus, *Major Rate Case Decisions January – December 2018* (Jan. 31, 2019) ("S&P Jan. 31 Report") at 6 (noting that the average ROE set in 2012 for composite gas and electric was 10.09%) *with* Ex. SDG&E-09 (Morin) at 6:22-7:1 (national average from 2018-2019 is 9.6-9.8%).

[22] TURN Testimony (Gorman) at II-3:18-23.

[23] *Id.* at II-3-4 (Table 7).

[24] *See, e.g.*, *id.* at V-8-9; *Prepared Direct Testimony of Karl Richard Pavlovic on Behalf of Utility Consumers' Action Network and Protect Our Communities Foundation, Cost of Capital* (August 1, 2019) ("UCAN Testimony (Pavlovic)") at 7.

1 misses the point. The cost of equity is determined by investors' *future* expectations.[25] A return
2 must be sufficient for investors to believe that the return is worth the risk.[26] And, as Moody's
3 noted, the Commission's complete denial of the Company's 2007 wildfire cost recovery
4 heightened risks for investors, who subsequently assumed that the Commission would routinely
5 deny wildfire cost recovery regardless of the circumstances; particularly given that FERC
6 granted SDG&E recovery on the same facts.[27]

7 Intervenors miss this nuance by focusing on the fact that utilities are disallowed recovery
8 from ratepayers for costs found attributable to "imprudent conduct." But, as Moody's notes, this
9 is *not* the standard that has been applied by the Commission.[28] Instead, as Mr. Gorman admits,
10 under the Commission's existing standard, the "'burden rests heavily upon a utility to prove . . .
11 that it is entitled to the requested rate relief.'"[29] In other words, a utility must demonstrate that it
12 acted prudently.

13 Elsewhere in the country, particularly at FERC, the prudency standard is not applied in
14 such a draconian fashion.[30] So even assuming utilities in other states face the same wildfire risk
15 (despite smaller populations and less expensive real estate), it is this application of a differing

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[25] *See* Ex. SDG&E-09 (Morin) at 22:6-10 ("Cost of capital models, including the CAPM, are prospective (i.e. forward-looking) in nature and must take into account current market expectations for the future because investors price securities on the basis of long-term expectations, including interest rates . . . stock prices are based on investor expectations.") (citation omitted).

[26] *Id.* at 30:6-7 (it is the "most basic financial theory" that "the higher the risk, the higher the expected return").

[27] *See* Moody's, *San Diego Gas & Electric Company, Update following outlook change to positive*, dated Aug. 2, 2019 ("Moody's Aug. 2 Report") at 5; *see also Prepared Supplemental Testimony of Concentric Energy Advisors, Wildfire Risk Premium,* Chapter 1 (Aug. 2019) ("Ex. SDG&E-05-S (Concentric) Ch. 1") at 9:-10:11.

[28] Moody's Aug. 6 Report at 4.

[29] TURN Testimony (Gorman) at IV-13:11-13 (citing D.14-06-007 at 31).

[30] *See* Moody's Aug. 2 Report at 5.

1 legal standard – in combination with inverse condemnation automatically shifting costs to
2 utilities (meaning that a utility has to potentially attempt to recover far greater costs through
3 prudency review) – that reasonably led investors and credit rating agencies to see California
4 utilities as uniquely risky compared to peers who are subject to a negligence standard and a more
5 favorable prudency review. [31]

6 The evidence of this impact is most apparent with SDG&E. SDG&E is widely acclaimed
7 for its "track record of effective wildfire mitigation."[32] The Company has made "significant
8 investments" to "mitigate and prevent" wildfire risks.[33] SDG&E has not been involved in any
9 significant utility-related wildfires in 2017 or 2018. Indeed, SDG&E has not been involved in a
10 significant wildfire since 2007. Nevertheless, the Company's credit has still been downgraded
11 multiple notches due to California's wildfire liability regime, laying bare the claim that recent
12 credit downgrades or the increased cost of equity is simply a reflection of utility imprudence or
13 negligence in recent wildfires.

14 Nor is SDG&E's quantification of the risk of catastrophic wildfire liability an attempt to
15 obtain insurance,[34] or cost recovery prior to wildfire liability arising.[35] Again, the cost of equity
16 is judged by measuring investor expectations.[36] Because investors make investment choices
17 based upon risk and reward, return on equity is based on risk profile. By definition, all risks
18 involve uncertainty about the future. To take one intervenor's line of reasoning to its logical

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[31] *Compare* EDF Testimony (McCann) at 24.

[32] Moody's Aug. 2 Report at 1.

[33] *Id.* at 5.

[34] TURN Testimony (Gorman) at II-1:11-II-2:2.

[35] UCAN Testimony (Pavlovic) at 9; TURN Testimony (Gorman) at V-6:3-5.

[36] *See* Ex. SDG&E-09 (Morin) at 45:4-5 & n. 57.

conclusion, setting ROE would be prohibited because all risks are based upon potential future events that may not occur or may eventually be recovered in rates.[37] An event may not come to pass, but that does not mean that it is not a threat. Quantifying the additional risk that catastrophic wildfire liability places on investors is merely a component of ensuring that SDG&E's ROE is commensurate with risks.

C. SDG&E Continues to Face Above-Average Wildfire Liability Risks Following Assembly Bill 1054

Some intervenors justify their below-average ROE proposals by stating that any wildfire liability risks were "fully mitigate[d]" by Assembly Bill ("AB") 1054.[38] As described in my supplemental testimony, credit rating agencies have made clear that is far from the case.[39] Instead, as Mr. Pavlovic admits, although rating agencies removed SDG&E from negative watch, AB 1054 left SDG&E's "downgraded credit ratings unchanged."[40] As Moody's specified, AB 1054 was not a "comprehensive solution" for utility wildfire risks.[41] Credit rating agencies continue to see heightened threats for California utilities for several reasons. SDG&E and other California utilities face the fear that AB 1054 will not be implemented as hoped-for, primarily with regard to:

- How the Commission will implement the new prudence review standard – namely whether the agency will apply the standard in the same manner as FERC or make it relatively easy for intervenors to shift the burden back to the utility;[42] and

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[37] *See* UCAN Testimony (Pavlovic) at 9:7-14.

[38] TURN Testimony (Gorman) at V-1:14-16.

[39] *See Prepared Supplemental Testimony of Bruce Folkmann, Policy (AB 1054)* (August 2019) ("Ex. SDG&E-01-S (Folkmann)") at 4-13.

[40] UCAN Testimony (Pavlovic) at 12:14-17.

[41] Moody's Aug. 6 Report at 2.

[42] Moody's Aug. 2 Report at 5 ("The application of this revised prudency standard by the CPUC in a credit supportive manner would likely strengthen our view of the credit supportiveness of the

1 2 - How long the wildfire fund remains solvent – and with it, the cap on potential utility liability.[43]

3 California utilities also continue to face increased long-term wildfire liability risks that AB 1054
4 does not resolve; principally from the increased frequency and severity of wildfires due to
5 climate change and population growth and the continuing applicability of inverse
6 condemnation.[44]

7 **D. SDG&E Still Faces Increased Non-Wildfire Risks**

8 And, as Moody's recently underscored, SDG&E still bears increased risks outside of
9 wildfire liability. Despite finding that the Company faces an improved regulatory framework
10 because of AB 1054, the ratings agency only gave the Company a 'Baa' in its metrics for the
11 "Consistently and Predictability of Regulation" and "Timeliness of Recovery of Operating and
12 Capital Costs" to reflect the "high political risk and public scrutiny in California."[45] As Moody's
13 stated:

14 15 16 17 18 19 20
> SDG&E's credit also incorporates our view that utilities in California tend to receive a higher level of scrutiny and attention from both the media and the public, such that issues can quickly become contentious. Our analysis considers the significant demands that are placed on the California utilities, including many ambitious public policy initiatives that are implemented through utility operations. Examples include the state's Renewable Portfolio Standard and Senate Bill 100 (passed last year) that

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regulatory environment in California. However, this is likely to take some time as it remains to be seen how challenging it will be for the intervenors to create serious doubt, an undefined term and subject to the CPUC's interpretation."); S&P July 30 Report at 2 ("If the [C]ommission does not implement AB 1054 in a credit-supportive manner then much of the new law's credit-supportive elements related to the revised standards of a utility's reasonable conduct could potentially be negligible.").

43 S&P July 30 Report at 1-2 (noting that, if the wildfire fund is exhausted, SDG&E "loses the credit benefit of using the [wildfire] fund as a source of liquidity and more importantly loses the credit protection of the liability cap," leaving only the revised prudence standard).

44 *See, e.g.*, *id.*; Moody's Aug. 6 Report at 2.

45 *Id.* at 9.

require load serving entities to procure 60% of their total energy sales from renewables by 2030 and 100% by 2045, respectively.[46]

The ratings agency further specified that its current (downgraded) ranking of Baa1 "*assumes* a credit supportive outcome" in SDG&E's general rate case and this cost of capital proceeding – suggesting that the agency would consider negative action if SDG&E faces poor results here and in other regulatory matters.[47]

Intervenors attempt to argue that these risks are long-standing in nature. Mr. McCann asserts that many of SDG&E's cited risks "have existed since before the previous cost of capital decision in 2012"[48] and therefore these risks "are already priced into the base average ROE for the market basket of utilities used for comparison and no additional adjustments are appropriate."[49] Mr. Gorman similarly states that risks such as those presented by competition, Net Energy Metering ("NEM"), and the Renewable Portfolio Standard ("RPS"), are not new and there is no indication there these risks require higher equity returns.[50] Both EDF and TURN further assert that the cited non-wildfire risks are borne by ratepayers with little to no exposure to shareholders.[51]

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[46] *Id.* at 6-7; *see also Prepared Direct Testimony of Don Widjaja, Company Risk* (April 2019) ("Ex. SDG&E-03 (Widjaja)") at 23:6-16 (discussing RPS standards).

[47] *See* Moody's, *Rating Action: Moody's affirms San Diego Gas & Electric Company's ratings; outlook remains negative* (July 12, 2019) ("Moody's July 12 Report") at 2 (specifying that the rating agency's assumption is, in part, predicated upon SDG&E being granted a 56% common equity ratio) (emphasis added).

[48] EDF Testimony (McCann) at 25.

[49] *Id.* at 24.

[50] *See* TURN Testimony (Gorman) at IV-20:3-5, IV-22:9-11, IV-24:20-22.

[51] *See, e.g.*, *id.* at IV-22:11-15; EDF Testimony (McCann) at 23.

Even ignoring for the moment that most intervenors here do not argue for a "base average ROE for the market"[52] such as was purportedly granted in 2012, and instead propose below-average ROEs, the suggestion by EDF and TURN that the risks described by SDG&E have remained static since 2012 is erroneous. Since the last Cost of Capital proceeding, these risks have only increased. For example, Senate Bill ("SB") 350 and SB 100 establish aggressive new clean energy, clean air and greenhouse gas reduction goals for 2030 and beyond.

In addition, the implications of the state's policy favoring customer choice are apparent today in a way that they were not for SDG&E in 2012. SDG&E did not have Community Choice Aggregators ("CCAs") in its service territory in 2012; it now has one operating CCA and several other communities actively exploring the option. The largest of these, the City of San Diego, represents approximately 40% of SDG&E's current bundled load. In addition, the legislature recently approved an expansion of the Direct Access ("DA") program. Likewise, reliance on distributed energy resources ("DERs") has increased dramatically in the period since 2012 – from about 130 cumulative megawatts ("MW") of NEM in 2012 to over 995 cumulative MW in 2018. This figure only continues to grow. Procuring to meet the State's new mandates in a departing load environment presents an exponentially increased risk compared to what existed in 2012.

Messrs. Gorman and McCann's narrow focus on short-term cost recovery risk misses the larger point. The risk is not primarily related to cost recovery; it arises from the undermining of the traditional utility business model. The energy sector is in a period of fundamental and significant change; the basic utility service model will likely undergo more change in the next ten years than has been seen in the last 100.

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[52] *See* EDF Testimony (McCann) at 24.

California is at the cutting edge of this transformation. It has embraced customer choice, aggressive clean energy goals, grid modernization, and resource diversification goals. At the same time, the state is implementing its statewide Integrated Resource Planning framework and changing its Resource Adequacy program to add multi-year procurement requirements and a central buyer framework. The speed and scale of this change creates uncertainty[53] – compounded by the perception, acknowledged by the Commission, that there is no overarching strategy guiding this evolution. As noted in the agency's Staff White Paper, *Consumer and Retail Choice, the Role of the Utility, and an Evolving Regulatory Framework*, "California may well be on the path towards a competitive market for consumer electric services, but is moving in that direction without a coherent plan to deal with all the associated challenges that competition poses, ranging from renewable procurement rules to reliability requirements and consumer protection."[54]

While California has long been a change leader, the widescale transformation occurring now represents a fundamental shift. There can be no question that investors' uncertainty regarding a future in which the state is revisiting "long held assumptions in their regulatory frameworks and examin[ing] the role of the electric utility at the center of this system," has a material impact on their perception of SDG&E's risk profile.[55] Risks, such as load departure due to CCA and DA, and increased reliance on DERs, pose a fundamental change to the incumbent regulated utility business model. Mr. Gorman's statement that "SDG&E may be correct that

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[53] *See* Moody's Aug. 2 Report at 6-7.

[54] California Public Utilities Commission Staff White Paper, *Consumer and Retail Choice, the Role of the Utility, and an Evolving Regulatory Framework* (May 2017), at 3. *Available at:* http://www.ourenergypolicy.org/wp-content/uploads/2017/05/Retail-Choice-White-Paper-5-8-17.pdf.

[55] *See id.* at 3.

1 growth in NEM impacts 'affordability' for non-participating customers"[56] substantiating S&P's
2 finding that rate pressures are an additional risk to California utilities.[57]
3 Without a clear long-term strategy for transitioning to this new model, there are
4 significant long-term business and financial risks from stranded assets in the absence of an
5 optimal way to downsize SDG&E's portfolio to support the integration of CCAs. Although the
6 state has taken positive steps to resolve challenges associated with increased load departure, such
7 as revising the Power Charge Indifference Adjustment ("PCIA") formula, there remains
8 ambiguity concerning the long-term viability of the current utility business model. There is thus
9 more uncertainty than ever with respect to the future role of California utilities, increasing the
10 risks that credit agencies and others see for SDG&E.
11 In short, as S&P states, the Company's business risks continue to be "at the higher end of
12 the range,"[58] leaving SDG&E credit rating well below its former 'A' rating. AB 1054 may have
13 arrested the fall of the Company's credit ratings. But it did not restore them.
14 As such, Mr. Gorman's assertion that, in the last adjudicated cost of capital proceeding
15 (D.12-12-034), the Commission awarded "authorized ROE for the California utilities that
16 reasonably aligned with the industry average"[59] in 2012 is irrelevant and misleading in today's
17 risk environment. Putting aside the fact that intervenors here largely propose ROEs below the
18 national average,

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56 TURN Testimony (Gorman) at IV-22:14-15.

57 *See Prepared Supplemental Testimony of Concentric Energy Advisors, Wildfire Risk Premium,* Chapter 2 (Aug. 2019) ("Ex. SDG&E-05-S (Concentric) Ch. 2") at 5:1-3, n.4 (citing S&P Global Ratings, *Credit FAQ: The Looming California Wildfire Season Prompts an Examination of Investor-Owned Utilities' Risks*, dated June 7, 2019 at 3).

58 S&P July 30 Report at 2.

59 *See* TURN Testimony (Gorman) at II-3:6-8.

- In D.12-12-034, with SDG&E having an S&P 'A' credit rating, the Commission placed SDG&E's ROE above the 2012 national average (10.30% vs. 10.09%);[60]
- Many of the risks cited in D.12-12-034 that justified the Company's ROE at that time have only increased;[61] and
- Those risks have been joined by the overarching threat from catastrophic wildfire liability.

Mr. Gorman's contention that the catastrophic wildfire liability risk is the same as was considered by the Commission in 2012 cannot be taken seriously.[62] It is belied by the Commission explicitly stating in D.12-12-034 that it did not consider wildfire liability a risk that needed to be compensated through a higher ROE because "none of the credit agencies reporting on the creditworthiness of either SCE or SDG&E mentioned any risks associated with wildfires."[63]

This is obviously the exact opposite situation from the present. As the testimony in this case makes clear, credit rating agencies have been acutely focused on this issue since 2018. This reflected in SDG&E's multiple downgrades; for example S&P changing the A credit rating the Company had for 15 years prior to the 2017 and 2018 wildfires to 'BBB+.' So if SDG&E was considered near average risk with an 'A' rating in 2012, it is self-evidently riskier now at 'BBB+,' indicating that the Company's ROE must be adjusted upward for its unique risk.

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60 *Compare* D.12-12-034 at 40 (setting SDG&E's ROE at 10.30%), *with* S&P's Jan. 31 Report at 6 (noting that the average ROE set in 2012 for composite gas and electric was 10.09%). Concededly, the Commission stated in D.12-12-034 that it believed it was setting SDG&E's ROE "slightly below the 10.36% average ROEs granted United State electric utilities during the first six months of 2012". *Id.* at 40.

61 *See, e.g.*, Moody's Aug. 2 Report at 6 ("Our analysis considers the significant demands that are placed on the California utilities, including many ambitious public policy initiatives that are implemented through utility operations.").

62 *See* TURN Testimony (Gorman) at II-1-2; *accord* EDF Testimony (McCann) at 25.

63 D.12-12-034 at 30.

Reducing SDG&E's ROE below its current 10.20%[64] (which is still within the range of ROEs granted for 2018-2019[65]), would send exactly the wrong signal to credit agencies and equity markets.[66]

III. SDG&E SHOULD CONTINUE TO BE GRANTED A SINGLE ROE BASED UPON THE COMPANY'S COMMENSURATE RISKS

EDF's proposal to establish separate ROEs for SDG&E's gas and electric operations should likewise be rejected. The proposal is inconsistent with the Commission's longstanding precedent in favor of setting a single ROE for major gas and electric companies.[67] No other party argues to apply separate ROEs to SDG&E, and EDF does not specify how that difference should be decided.[68]

Again, as described by Dr. Morin, ROE is set by placing a Company's return commensurate with its risks, based upon investor expectations. Investors invest in SDG&E. In so doing, they seek returns from the Company as a whole, based on the Company's relative risk. They do not determine what portion of the Company their funds are invested in. The Commission should continue to follow its past practice to set a Company-wide ROE based upon the Company's risk portfolio. It has ample other opportunities to set policy priorities.

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[64] *See* D.17-07-005 at 7 (reducing SDG&E's ROE from 10.30% to 10.20% pursuant to a joint petition for modification).

[65] *See* S&P's Jan. 31 Report at 11-14.

[66] *See* Moody's July 12 Report at 2 (noting that SDG&E's current Baa1 rating "assumes a credit supportive outcome" of the Company's cost of capital proceeding).

[67] *See* D.12-12-034 at 40; D.99-06-057 at 64 (citing D.93-12-022 at 43).

[68] *See* Kjensli, *Report on the Cost of Capital Test Year 2020* on behalf of the Public Advocates Office, California Public Utilities Commission (August 1, 2019) ("Cal PA Testimony (Kjensli)") at 4:17-21 (stating that the CPUC should put off addressing a single ROE for SDG&E's gas and electric assets until the next cost of capital proceeding); *see also* S&P's Jan. 31 Report at 1 (noting that the average ROE granted nationally to electric and gas companies was nearly identical in 2018).

1 **IV. SDG&E'S CAPITAL STRUCTURE PROPOSAL IS CRITICAL TO THE**
2 **COMPANY'S CREDIT RATING**

3 Finally, intervenors similarly incorrectly state – without evidence – that SDG&E's capital
4 structure proposal is "not necessary to support [the Company's] credit rating and financial
5 integrity."[69] Instead, as detailed in Maritza Mekitarian's rebuttal testimony, Moody's has
6 expressly specified that its current credit rating for SDG&E is predicated on the assumption that
7 SDG&E will receive a 56% equity ratio.[70] The rating agency added that there could be negative
8 pressure on the Company's credit rating if SDG&E's capital structure is reduced.[71] Dr. Morin
9 likewise notes that:

10 - The average capital structure of the utilities in his proxy group is around 53%-54%;[72]
11 - A 55%-65% common equity ratio is ideal for a utility to obtain an 'A' credit rating;[73]
12 and
13 - "It is sound business practice to offset in part the high relative business risk of
14 SDG&E by lowering its financial risk, that is, targeting a higher common equity
15 ratio."[74]

16 SDG&E's proposed capital structure reflects its actual capital structure.[75] As Mr.
17 Rothschild on behalf of Cal PA acknowledges, regulatory commissions often set authorized

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[69] TURN Testimony (Gorman) at VIII-7:10-11.

[70] *Prepared Rebuttal Testimony of Maritza Mekitarian, Authorized Capital Structure* (August 2019) ("Ex. SDG&E-08 (Mekitarian)") at 5:8-17 (citing Moody's July 12 Report)

[71] Moody's, *Rating Action: Moody's affirms San Diego Gas & Electric's ratings; changes outlook to positive from negative*, dated July 29, 2019 at 2 ("Moody's July 29 Report").

[72] Ex. SDG&E-09 (Morin) at 26:6-7.

[73] Ex. SDG&E-04 (Morin) at 61:7-9.

[74] Ex. SDG&E-09 (Morin) at 46:18-19.

[75] Ex. SDG&E-08 (Mekitarian) at 6:9-11.

capital structure based upon the utility's actual ratio.[76] That is because, as the Commission has previously found, "utilities should be given some discretion to manage their capitalization with a view towards a balance between shareholders' interest, regulatory requirements, and ratepayers' interest."[77] The Commission thus recently granted a group of water utilities their actual capital structure ratios up to 57% equity.[78]

Mr. Rothschild's focus on Sempra Energy's capital structure is similarly misplaced. As discussed, Sempra Energy is a diversified holding company that owns several regulated and non-regulated subsidiaries. Sempra Energy's consolidated capital structure and financials are comprised of all its subsidiaries – including not only the two Commission-regulated utility subsidiaries (Southern California Gas Company ("SoCalGas") and SDG&E) – but also out-of-state and international subsidiaries that are not regulated by this Commission and do not impact the operations of SDG&E (or SoCalGas). The various subsidiaries owned by Sempra Energy have different risk profiles and business models. As such, Sempra Energy's consolidated risk profile is very different than any one of its subsidiaries. As Dr. Morin explains, the far more relevant metric is the capital structure of operating utility companies.[79] And, as noted earlier, SDG&E's capital structure proposal is consistent with those of Dr. Morin's proxy group – particularly once the Company's higher risks are taken into consideration.[80]

SDG&E believes strongly in operating with its current actual capital structure to counterbalance its higher regulatory and business risks. Without this common equity ratio,

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[76] Cal PA Testimony (Rothschild) at 37.

[77] D.12-12-034 at 11 (citation omitted).

[78] D.18-03-035 at 22-23.

[79] Ex. SDG&E-09 (Morin) at 26:4-5.

[80] *Id.* at 26:7

ratepayers may face higher costs through a credit rating that stays at its currently depressed level – or perhaps goes even lower. The Company's authorized capital structure should thus be set to reflect its currently operating actual one.

V. CONCLUSION

In 2012, with an 'A' credit rating, the Commission set SDG&E's ROE at slightly above the national average for that year at 10.30%, with a 52% common equity ratio. The same risks that were present in 2012 have only intensified. And those risks have been joined by the significant threat that SDG&E faces from California's wildfire liability regime – reflected in the Company's multiple credit downgrades since 2018.

Yet Intervenors nearly all inexplicably assert that SDG&E's ROE should be set well below the national average. In other words, the intervenors ignore reality. At an absolute minimum, the Company's ROE should not be lowered from its current position – given SDG&E's increased risks compared to 2012-2017 and the fact that SDG&E's current ROE remains within the range of ROEs granted in 2018-2019. To not increase SDG&E's ROE and instead set it lower than it is currently – or to not increase the Company's capital structure to reflect SDG&E's actual response to increased business risks – would ignore the perverse effect those actions would have on the Company's already lowered credit rating and ability to raise capital. The Company's ROE request of 12.38% is eminently justified by its significantly higher risks. Therefore, SDG&E respectfully requests that the Commission approve the Company's proposals.

This concludes my prepared rebuttal testimony.