Company:	San Diego Gas & Electric Company (U 902 M)
Proceeding:	2020 Cost of Capital
Application:	A.19-04-017
Exhibit:	SDG&E-08

SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)

PREPARED REBUTTAL TESTIMONY OF MARITZA MEKITARIAN

(AUTHORIZED CAPITAL STRUCTURE)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

August 16, 2019

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I. INTRODUCTION

My rebuttal testimony addresses the direct testimonies of Mr. Rothschild on behalf of the Public Advocates Office ("Cal PA"),[1] Mr. Gorman on behalf of The Utility Reform Network ("TURN"),[2] Mr. O'Donnell on behalf of Federal Executive Agencies ("FEA"),[3] and Dr. Griffing on behalf of Utility Consumers' Action Network ("UCAN") and Protect our Communities ("POC") (collectively "UCAN"),[4] submitted on August 1, 2019, with respect to the proposal for an updated authorized capital structure for San Diego Gas & Electric Company ("SDG&E" or "Company").

Dr. Griffing on behalf of UCAN concludes that SDG&E's embedded cost of long-debt calculation is reasonable.[5] Cal PA, TURN, and FEA also do not contest SDG&E's embedded cost of long-debt calculation. As such, my rebuttal focuses on parties' arguments related to SDG&E's proposed capital structure.

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[1] A. Rothschild, *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 (Rothschild)"). All reference to Mr. Rothschild's testimony are to the redacted version unless otherwise specified.

[2] *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)"). Mr. Gorman only testifies on behalf of TURN regarding SDG&E's application.

[3] *Direct Testimony and Exhibits of Kevin W. O'Donnell, CFA, on behalf of The Federal Executive Agencies* (August 1, 2019) ("FEA Testimony (O'Donnell)").

[4] *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)").

[5] UCAN and POC Testimony (Griffing) at 50:7.

II. CAPITAL STRUCTURE

A. Summary of Intervenors' Capital Structure Recommendations

Mr. Rothschild, Mr. Gorman, Mr. O'Donnell, and Dr. Griffing propose a capital structure for SDG&E of 52% common equity, 48% long-term debt, and 0% preferred equity – largely because it is consistent with SDG&E's currently-authorized equity ratio.[6] The capital structure proposal of SDG&E is contrasted with the intervenors' proposals in Table 1.

Table 1 – Summary of Capital Structure Proposals

	SDG&E	Cal PA	TURN	FEA	UCAN/ POC
Common Equity	56.0%	52.0%	52.0%	52.0%	52.0%
Long-Term Debt	44.0%	48.0%	48.0%	48.0%	48.0%
Preferred Equity	0.0%	0.0%	0.0%	0.0%	0.0%

B. Rebuttal to Intervenor Testimony

1. Intervenors Offer No Support for Replacing Authorized Preferred Equity with Increased Long-Term Debt Rather Than Common Equity

No intervenor disagreed with SDG&E's proposal to eliminate preferred equity from its capital structure. However, while intervenors generally agree with this concept, they propose to add the previously-authorized preferred equity percentage to long-term debt rather than to common equity. Intervenors offer *no* evidence to support their proposal or evidence as to why a capital structure of 52% common equity, 48% debt is currently appropriate for SDG&E. Instead, intervenors simply recommended that SDG&E maintain its authorized common equity ratio

[6] *See* Cal PA Testimony (Rothschild) at 31:8-9; TURN Testimony (Gorman) at Chapter II, Exhibit MPG-3; FEA Testimony (O'Donnell) at 65 (Table 26); UCAN and POC Testimony (Griffing) at 49:7-8.

because it was previously approved by the California Public Utilities Commission ("Commission") and because they contend that it is consistent with that of other utilities.[7]

In so doing, the intervenors cherry-pick a methodology to achieve their desired result. That is, they propose that SDG&E's current authorized common equity ratio remain unchanged from the levels authorized by this Commission in the prior cost of capital proceeding. Yet they propose to change the preferred equity and long-term debt ratios from Decision ("D.") 12-12-034, suggesting shifting 275 basis points from preferred equity to long-term debt without providing any evidence or analysis to justify this as reasonable or appropriate.

Presumably, this reflects the intervenors accepting SDG&E's proposed preferred equity ratio on the basis that SDG&E does not have any preferred equity in its actual recorded capital structure. Yet the intervenors then ignore SDG&E's actual capital structure with regard to common equity. Intervenors thus offer inconsistent and/or unsubstantiated support for their positions. And they seek to increase the amount of financial leverage SDG&E bears compared to its currently authorized capital structure – as the intervenors' proposals would increase SDG&E's debt-to-equity ratio – despite SDG&E suffering from downgraded credit ratings compared to 2012. This cursory justification is without merit and should be rejected in favor of SDG&E's capital structure proposal, for the reasons set forth below.

2. Intervenors Incorrectly Assert that SDG&E's Proposed Capital Structure is not Necessary to Maintain/Restore its Credit Ratings

Intervenors challenge the conclusion that SDG&E's capital structure request is necessary, asserting that Assembly Bill ("AB") 1054[8] alone will increase the Company's credit rating. For

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[7] *See, e.g.*, Cal PA Testimony (Rothschild) at 31; TURN Testimony (Gorman) at VIII-6; FEA Testimony (O'Donnell) at 58:6-10; UCAN and POC Testimony (Griffing) at 49:7-14.

[8] AB 1054, Stats. 2019, Ch. 79.

instance, Dr. Griffing claims that "[a]ccording to the credit rating agencies, it is actions such as the California Legislature passing AB 1054 that will promote the restoration of the SDG&E credit rating."[9] In addition, Mr. O'Donnell states, "SDG&E's bond ratings and stock price seem to have stabilized of late, due in part to AB 1054, which provides some relief from the uncertainty of future wildfire catastrophes."[10]

While SDG&E's credit rating outlooks have improved since the passage of AB 1054, SDG&E's credit ratings remain unchanged.[11] This point was explained in the supplemental testimony of SDG&E witnesses, Bruce Folkmann (Exhibit SDG&E-01-S) and Don Widjaja (Exhibit SDG&E-03-S).[12] Thus, it is clear that the passage of AB 1054 alone will not restore SDG&E's credit rating; SDG&E's proposed capital structure is necessary to support the restoration of the Company's downgraded credit ratings.

Mr. Gorman similarly claims, without evidence, that "SDG&E's proposal to change its common equity ratio . . . is not necessary to support its credit rating and financial integrity. SDG&E's current approved ratemaking capital structure will support credit metric adjusted debt balances that are reasonable and support of SDG&E's bond rating."[13] Mr. Gorman is incorrect and the analysis he presents to support his assertion is flawed. He relies on industry-wide

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[9] UCAN and POC Testimony (Griffing) at 49:23-50:2.

[10] FEA Testimony (O'Donnell) at 55:11-13.

[11] *See, e.g.*, &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"); Moody's, *Rating Action: Moody's affirms San Diego Gas & Electric's ratings; changes outlook to positive from negative*, dated July 29, 2019 ("Moody's July 29 Report"); Fitch Ratings, *Fitch Affirms San Diego Gas & Electric's IDR at 'BBB+'; Outlook Revised to Stable*, dated July 17, 2019.

[12] *Prepared Supplemental Testimony of Bruce Folkmann, Policy* (AB 1054) (August 2019) ("Ex. SDG&E-01-S (Folkmann)") at 5:2-5; *Prepared Supplemental Testimony of Don Widjaja, Company Risk* (AB 1054) (August 2019) ("Ex. SDG&E-03-S (Widjaja)") at 3:9-11.

[13] TURN Testimony (Gorman) at VIII-7:10-13.

information rather than SDG&E-specific analyses. Credit rating agencies regularly provide company-specific information about the credit ratings they assign, including what is necessary to support the current rating as well as factors that could lead to upgrades or downgrades. These publications are a much better source of information than an industry-wide survey.

It is clear from recent credit rating agency publications that SDG&E's proposal to change its common equity ratio *is* necessary to support its credit rating and financial integrity. In fact, Moody's has specified that SDG&E's current credit rating and outlook of "Baa1" and "positive" *assumes* a "credit supportive" outcome in *this* proceeding. Moody's has indicated that it may downgrade SDG&E further if a 56% equity ratio is not approved.

Specifically, in its July 12 report, Moody's stated:

> Importantly, the Baa1 rating assumes a credit supportive outcome of SDG&E's ongoing 2019 general rate case and cost of capital proceeding where the utility requested an increase in its equity layer to 56% (effective January 2020) from currently 52%. The outcome of these regulatory proceedings will be important for SDG&E's ability to further generate a ratio of CFO pre-W/C to debt that comfortably exceeds 20% on a sustained basis.[14]

Moody's reiterated this sentiment on July 29: "The positive outlook assumes . . . credit supportive outcomes of the utility's ongoing regulatory proceedings. These proceedings include its 2019 general rate case and the cost of capital, w[here] a decision [is] anticipated before year-end 2019."[15] Moody's contrasted that, in the "Factors that Could Lead to a Downgrade" section, by stating that "[d]ownward pressure is also likely if SDG&E records credit metrics that are weaker than currently anticipated, for example due to outcomes of pending regulatory

[14] Moody's, Rating Action: *Moody's affirms San Diego Gas & Electric Company's ratings; outlook remains negative*, dated July 12 at 2 ("Moody's July 12 Report").

[15] Moody's July 29 Report at 1.

proceedings that are not credit supportive."[16] On August 2, Moody's listed "regulatory uncertainty with delayed rate case and pending cost of capital proceedings" as one of SDG&E's top "credit challenges," again listing non-credit supportive outcomes in pending regulatory proceedings as possibly leading to downgrades.[17]

By contrast, Mr. Gorman's statement that "SDG&E's current ratemaking capital structure that contains a 52% common equity ratio, has successfully met these objectives [of maintaining a strong investment grade bond rating and preserving access to capital] and at a much lower cost to customers than the increased common equity ratio proposed by SDG&E,"[18] is unsupported and incorrect. SDG&E has maintained its investment grade bond rating and preserved its access to capital by managing its actual capital structure at a higher than authorized common equity ratio of 56%. The credit rating agencies assess the financial risk of SDG&E based on its *actual* capital structure rather than its *authorized* capital structure. That is why it is so important to Moody's and other credit rating agencies that SDG&E's authorized structure is changed to match the Company's actual structure so that SDG&E can continue at its current equity ratio – the one that rating agencies are considering. Otherwise, if SDG&E reduces its actual equity ratio from what it is currently, credit rating agencies will assess SDG&E as being in a weakened financial position relative to now.

These higher than authorized equity levels have improved credit metrics (by reducing debt) with capital provided solely by shareholders, directly benefitting customers. SDG&E's shareholders have not earned a return on the difference between the Company's authorized

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16 *Id*. at 2.

17 Moody's, *San Diego Gas & Electric Company: Update following outlook change to positive*, dated Aug. 2, 2019 at 2.

18 Gorman at VIII-6:12-15.

equity ratio of 52% and its actual equity ratio of 56%. Therefore, ratepayers have benefitted from a higher credit rating at the expense of the shareholders. As such, Mr. Rothschild's statement that SDG&E has provided "no proof" that the Company's proposed capital structure would increase SDG&E's bond rating is far from accurate.[19]

In addition to offering flawed analysis and erroneous conclusions, parties opposed to SDG&E's proposed capital structure ignore the fact that Commission precedent supports setting a utility's authorized capital structures to align with actual ratios. In D.12-12-034, the Commission approved SDG&E's currently authorized capital structure for Test Year 2013 principally because it reflected the Company's actual capital structure at the time.[20] As support for its capital structure finding, it noted that "SDG&E seeks a common equity ratio for its revenue requirement which is the same as its actual common equity ratio."[21] Moreover, a 2017 Report issued by the Commission's Policy & Planning Division states, "[i]n California, a hypothetical capital structure, which is expected to approximate the actual capital structure of the utility over the long run, is used."[22] Consistent with this precedent, the Commission recently adopted common equity ratios for regulated water utilities informed by those utilities' actual ratios.[23]

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

[20] D.12-12-034 at 11 ("utilities should be given some discretion to manage their capitalization with a view towards a balance between shareholders' interest, regulatory requirements, and ratepayers' interest.") (citation omitted).

[21] *Id*.

[22] California Public Utilities Commission, *Utility General Rate Case – A Manual for Regulatory Analysts* (November 13, 2017) at 29, available at https://www.cpuc.ca.gov/uploadedFiles/CPUC_Public_Website/Content/About_Us/Organization/Divisions/Policy_and_Planning/PPD_Work/PPD_Work_Products_(2014_forward)/PPD%20General%20Rate%20Case%20Manual.pdf.

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

As stated in my direct testimony, SDG&E's actual capital structure reflects prudent capital structure management. Given SDG&E's increased business, financial, and regulatory risks, as discussed in the direct and supplemental testimony of Mr. Widjaja (Exhibit SDG&E-03), (Exhibit SDG&E-03-S), a higher common equity layer has allowed SDG&E to maintain its high credit rating (until recent downgrades), limit financial risk, and access the debt markets at reasonable rates – in response to those increased business and regulatory risks. The Company's actual capital structure should therefore be adopted as the Company's authorized capital structure.

It is thus imperative that the Commission approve SDG&E's requested common equity ratio of 56% in order for SDG&E to maintain its credit rating and prevent further downgrades. SDG&E has already been downgraded three notches by Moody's from A1 to Baa1 and two notches by S&P from A to BBB+.[24] Non-investment grade credit ratings begin two notches below SDG&E's current credit ratings. Further downgrades for a lower common equity ratio, as suggested by Moody's, could jeopardize SDG&E's investment grade credit rating, which would adversely impact ratepayers.

3. Mr. Gorman and Dr. Griffing Incorrectly Argue that SDG&E's Proposed Changes to Its Currently Authorized Capital Structure Are Expensive

Mr. Gorman states that "SDG&E's proposal to change its common equity ratio is not cost-effective to customers."[25] Dr. Griffing similarly argues that "SDG&E's proposal increases its common equity ratio, which rewards shareholders, at the expense of both preferred stock and

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24 *See* Moody's July 12 Report at 2; S&P July 30 Report at 1.

25 TURN Testimony (Gorman) at VIII-7:10-11.

long-term debt."[26] These assertions are unfounded. When viewed in isolation, leaving all else unchanged, an increase in a utility's authorized common equity level will increase costs to ratepayers in the short-term. However, this ignores the long-term benefits of achieving and maintaining an optimal credit rating. SDG&E's overall capital structure proposal is consistent with the Commission's desire to adopt capital structures that prudently and proactively support strong credit ratings, which in turn reduces costs to ratepayers.

As stated in Dr. Morin's direct testimony (Exhibit SDG&E-04), a single A bond rating is optimal and cost efficient for ratepayers. He explains that, "[a] single A bond rating generally results in the lowest pre-tax cost of capital for regulated utilities, and therefore the lowest ratepayer burden, especially under adverse conditions . . . [l]ong-term achievement/retention of a single A bond rating is in both a utility's and ratepayers' best interests."[27] As noted in my direct testimony as well as the direct testimony of Dr. Morin, Moody's utility company debt ratio benchmark for a single A bond rating is 35% - 45%, which implies a common equity range of 55% - 65%.[28] SDG&E's proposed common equity ratio of 56% is near the low end of this range. As Dr. Morin states in his rebuttal testimony, "I believe the Company's requested common equity ratio is reasonable as a partial offset to its heightened business risk and a necessary financial metric to regain a single A or above bond rating, which I consider optimal and cost efficient."[29]

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[26] UCAN and POC Testimony (Griffing) at 49:2-4.

[27] *Prepared Direct Testimony of Dr. Roger Morin* (April 2019) ("Ex. SDG&E-04 (Morin)") at 62:17-63:1.

[28] *Prepared Direct Testimony of Maritza Mekitarian, Authorized Capital Structure* (April 2019) ("Ex. SDG&E-02 (Mekitarian)") at 10:3-4; Ex. SDG&E-04 (Morin) at 61:7-9.

[29] *Rebuttal Testimony of Roger A. Morin, Ph.D.* (August 2019) ("Ex. SDG&E-09 (Morin)") at 47:2-5.

Furthermore, the costs of being downgraded from a single A bond rating to BBB can be estimated. Mr. Gorman notes in his direct testimony that the "market-based impact on the utilities moving from a bond rating of A down to BBB would increase their cost of debt by approximately 0.65 percentage points."[30] As stated in my direct testimony, SDG&E plans to issue $600 million of 30-year first mortgage bonds in 2020.[31] So, using Mr. Gorman's own estimates, the additional cost to ratepayers of issuing $600 million of long-term debt at a BBB rating instead of at an A rating is $117 million over the entire 30-year period.[32] As Mr. Rothschild points out, these costs apply to new debt issued.[33] Therefore, these costs would increase and compound each year after 2020 as SDG&E issues additional debt in 2021 and beyond. Moreover, this estimate is conservative because it does not consider the increase in common equity capital costs.

SDG&E's recommended capital structure supports SDG&E's strong credit profile during a period of high capital expenditure outflows and expected continued market volatility. Mr. Gorman and Dr. Griffing make short-term arguments which do not take into consideration the long-term benefits to ratepayers of SDG&E's proposed capital structure.

4. Mr. Rothschild and Mr. O'Donnell Inappropriately Refer to Sempra Energy's Capital Structure

Both Mr. Rothschild and Mr. O'Donnell inappropriately refer to Sempra Energy's capital structure to support their proposal. SDG&E is the applicant in this proceeding, not Sempra Energy. Moreover, as explained in the rebuttal testimony of Mr. Folkman (Exhibit SDG&E-07),

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[30] TURN Testimony (Gorman) at II-8:1-2.

[31] *See* Ex. SDG&E-02 (Mekitarian) at 17:2 and Appendix A.

[32] $600 million times 0.65% is $3.9 million, $3.9 million times 30 years is $117 million.

[33] *See* Cal PA Testimony (Rothschild) at 39:12-13.

Sempra Energy owns non-regulated and international businesses, with different risk profiles and business models.[34] As a diversified energy infrastructure holding company, its capital structure is not relevant to this proceeding. As Dr. Morin explains, the far more relevant metric is the capital structure of the operating utility companies (not the holding companies), where the average capital structure of 53-54% is largely consistent with SDG&E's proposal. In that light, "[t]he slightly higher common equity ratio of SDG&E is not surprising in view of its much higher business risks."[35]

Additionally, Mr. Rothschild erroneously claims that SDG&E's credit rating is entirely dependent on Sempra Energy first increasing its credit rating.[36] This is inaccurate. SDG&E issues its own long-term debt. None of the credit ratings agencies have indicated that this is a factor necessary to upgrade SDG&E's credit ratings. In fact, S&P has assigned Sempra Energy a BBB+ group credit profile ("GCP") and has stated that "the insulating measures at Southern California Gas and SDG&E are sufficient to potentially rate them two notches above the GCP."[37] The fact that SDG&E's credit rating (and that of Southern California Gas Company ("SoCalGas")) is not limited by Sempra Energy's credit rating is further evidenced by the fact that S&P has assigned SoCalGas an A issuer rating, even though Sempra Energy is also the parent company of SoCalGas. Furthermore, SoCalGas has an A1 issuer rating with Moody's, which is three notches above Sempra Energy's issuer rating of Baa1. And SDG&E had an 'A'

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[34] *Prepared Rebuttal Testimony of Bruce A. Folkmann, Policy* (August 2019) ("Ex. SDG&E-07 (Folkmann)") at 18:7-14.

[35] Ex. SDG&E-04 (Morin) at 61:15-62:1.

[36] *See* Cal PA (Rothschild, Confidential Version) at 44.

[37] S&P Global Ratings, *Sempra Energy and Subsidiaries Ratings Affirmed; Outlooks Remain Negative*, dated July, 15, 2019 at 3.

credit rating for 15 years before recent downgrades. Therefore, Sempra Energy's credit ratings are not relevant to setting SDG&E's cost of capital in this proceeding and no increases in Sempra Energy's credit rating are necessary for SDG&E to regain its A bond rating.

5. Mr. Rothschild and Mr. O'Donnell Inappropriately Compare SDG&E's Capital Structure to Utility Holding Companies

Mr. O'Donnell states, "the capital structure of SDG&E must be examined relative to peer companies, relative to the capital structure of its parent holding company, and relative to the equity ratio granted by state regulators across the country."[38] While a comparison to peer companies can be useful, proper peer companies must be used. Mr. Rothschild and Mr. O'Donnell incorrectly compare SDG&E's capital structure to that of the parent companies of SDG&E's proxy group as defined by Dr. Morin,[39] rather than to that of the operating regulated utility companies themselves. Dr. Morin makes this very point.[40] Similarly, as discussed above, the capital structure of Sempra Energy, SDG&E's parent company, is not relevant to the capital structure of its operating regulated utilities. These parent companies, or utility holding companies, manage a wide variety of businesses and are not comparable peer companies of SDG&E.

Mr. O'Donnell also compares SDG&E's capital structure to the average authorized equity ratio granted to utility companies in 2018.[41] Again, this is not an appropriate comparison

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38 FEA Testimony (O'Donnell) at 55:15-18.

39 Ex. SDG&E-04 (Morin), Exhibit RAM-3.

40 Ex. SDG&E-09 (Morin) at 26:4-5.

41 *See* FEA Testimony (O'Donnell) at 56:14 (citing See S&P Global Intelligence, RRA Regulatory Focus, *Major Rate Case Decisions January – June 2019* (Jul. 22, 2019) at 3).

for SDG&E because no consideration is given to the similarity of these companies to SDG&E. That is what a proxy group is for.

Appendix B, Question 5 of my direct testimony shows the authorized and actual capital structure of more appropriate peer companies.[42] The average authorized and actual capital structure of these peer companies is summarized in Table 2 below.

Table 2 – Peer Group Capital Structure Averages

	Current Authorized Common Equity Ratio Average	**2018 Recorded Common Equity Ratio Average**
Non-California Vertically Integrated Utility	51.0%	53.1%
Non-California Non-Vertically Integrated Utility	50.5%	51.6%
California Utility	53.5%	54.6%

Dr. Morin similarly notes that the average authorized capital structure for the utilities in his proxy group is between 53-54%, similar to SDG&E's request here – particularly when SDG&E's increased risks are taken into account.[43] On average, the California utilities have a higher authorized and recorded common equity percentage than utilities outside of California, which is indicative of the recognition that California utilities face increased business and regulatory risks. These increased risks can be partially mitigated by strengthening SDG&E's

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[42] The non-California utility peer group includes the electric and electric and gas operating utility companies from the proxy group identified in Dr. Morin's testimony (Ex. SDG&E-04 (Morin), Exhibit RAM-3). The California utility peer group was obtained from the California Board of Equalization 2018 Capitalization Rate Study. However, Pacific Gas and Electric Company (due to recent wildfires and capital structure waiver request), Southern California Edison Company (due to recent wildfires and capital structure waiver request), private companies (because data is not available), and companies that operate primarily outside of California were excluded.

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

balance sheet via a higher common equity percentage. Further, as explained in my direct testimony, a higher common equity percentage is necessary to mitigate financial risk.[44]

III. CONCLUSION

SDG&E maintains that its requested capital structure is appropriate and promotes the long-term best interests of ratepayers and shareholders alike. Therefore, SDG&E respectfully requests that the Commission approve its proposed capital structure.

This concludes my prepared rebuttal testimony.

[44] Ex. SDG&E-02 (Mekitarian) at 7.