

Application: A.21-08-XXX
Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2022 Cost of Capital
Exhibit No.: SDG&E-01

**PREPARED DIRECT TESTIMONY OF
VALERIE A. BILLE - POLICY OVERVIEW
ON BEHALF OF
SAN DIEGO GAS & ELECTRIC COMPANY**

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



AUGUST 23, 2021

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**PREPARED DIRECT TESTIMONY OF
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I. INTRODUCTION AND SUMMARY OF PROPOSALS

My testimony provides an overview San Diego Gas & Electric Company’s (“SDG&E” or the “Company”) test year (“TY”) 2022 application for a new authorized cost of capital (“COC”) for the Company’s California Public Utilities Commission (“Commission”) operations. I also summarize SDG&E’s right to file a TY 2022 application—given the circumstances surrounding the COVID-19 pandemic—under the Cost of Capital Mechanism (“CCM”) as permitted by Commission decisions and SDG&E’s tariffs.¹ Finally, I present SDG&E’s return on equity (“ROE”) and rate of return (“ROR”) recommendations for TY 2022—and note that SDG&E’s application *will not result in an increase in rates* relative to SDG&E’s current cost of capital.

I am an officer for SDG&E. SDG&E’s operations are principally its electric distribution, gas distribution, and gas transmission businesses, together with the electric generation and the electric and natural gas procurement functions.² SDG&E’s requests in this Application can be placed into five main categories: SDG&E’s (1) right to file an application for TY 2022 under the CCM; (2) authorized ROE; (3) authorized capital structure; (4) cost of debt; and (5) continuation of the CCM. Categories two through four will determine SDG&E’s authorized ROR for 2022

¹ D.08-05-035, pp. 16 and 19, Conclusion of Law 6; *accord* D.13-03-015, p. 7 (finding that “utilities continue to have the right” to file outside of the CCM if meeting the applicable standard); *see also* D.19-12-056, p. 45 (continuing the existing structure of the CCM). *See also* SDG&E electric preliminary statement, Section VII. Cost of Capital Mechanism (CCM) at C.d; SDG&E gas preliminary statement, Section IX. Cost of Capital Mechanism (CCM) at C.d.

² The return on electric transmission is not included since its governing regulatory agency is the Federal Energy Regulatory Commission.

1 until the next cost of capital application is filed and adopted or until the CCM’s adjustment
2 mechanism applies.

3 SDG&E’s proposed ROE and overall ROR is consistent with SDG&E’s unique risks,
4 financial modeling, and economic data demonstrating that the cost of equity for utilities, and
5 SDG&E in particular, has increased during the COVID-19 pandemic despite the decline in
6 interest rates brought on by the federal government’s actions to minimize the pandemic’s
7 economic impacts. It also reflects the Commission’s determination in its 2019 cost of capital
8 decision that SDG&E’s ROE should be “significantly higher” than the national average of
9 authorized electric utility ROEs.³ Yet the Company’s proposals do *not* result in an overall
10 increase in rates compared to SDG&E’s current cost of capital.

11 **II. SDG&E’S RIGHT TO FILE A TEST YEAR 2022 COST OF CAPITAL**
12 **APPLICATION**

13 As detailed in SDG&E’s application and in the testimony of James Coyne (Exhibit
14 SDG&E-04), the COVID-19 pandemic—and the significant fiscal and monetary responses to
15 combat the pandemic’s economic impacts—have resulted in a decline in interest rates. But the
16 cost of equity during the pandemic has increased, driven by increased market volatility,
17 uncertainty, and low interest rates. Utilities’ cost of equity, and SDG&E’s in particular, has risen
18 even more sharply, driven by the increased relative risk associated with utility stocks. Because of
19 this divergence between interest rates and the cost of equity during the pandemic, SDG&E
20 exercises its right under the CCM to file a TY 2022 cost of capital application while proposing to
21 not increase rates compared to its current cost of capital.

³ D.19-12-056, p. 43.

1 **A. The CCM Process Provides Two Methods for An Annual Assessment of**
2 **SDG&E’s Cost of Capital**

3 In 1990, the Commission required SDG&E and other major energy utilities to file annual
4 cost of capital applications.⁴ In 1996, to “streamline” SDG&E’s cost of capital review, the
5 Commission approved the Market Indexed Capital Adjustment Mechanism (“MICAM”). The
6 MICAM permitted SDG&E to file an application every five years (instead of annually), with the
7 MICAM applying to annually assess SDG&E’s cost of capital in the intervening years.⁵

8 In 2008, the Commission established the CCM for SDG&E, Southern California Edison
9 Company, and Pacific Gas & Electric Company (collectively, the “California electric utilities”).⁶
10 Like the MICAM, the CCM’s intent is to “streamline” the cost of capital review.⁷ The CCM
11 requires SDG&E to file a cost of capital application every three years, with the CCM applying in
12 the intervening years to annually assess SDG&E’s cost of capital.⁸

13 The CCM assesses SDG&E’s cost of capital in intervening years through one of two
14 methods—the cost of capital process (alternatively, the “adjustment mechanism”) or the right to
15 file an application under the applicable circumstances. The adjustment mechanism uses interest
16 rates as a proxy for assessing the cost of capital. That is, it ties ROE to interest rates, using
17 changes in utility bond yields to assess whether changes in ROE are warranted.

18 Specifically, the adjustment mechanism assesses whether SDG&E’s cost of capital
19 should be altered based upon changes in a Moody’s utility bond index that is selected based on a

⁴ D.89-01-040.

⁵ D.08-05-035, p. 2.

⁶ D.17-07-005, p. 3. The mechanism was extended to Southern California Edison in 2013. *See* D.13-03-015.

⁷ D.08-05-035, p. 16.

⁸ *Id.* at 15 (“The CCM shall be based on: A full cost of capital application due April 20 of every third year . . .”).

1 utility’s credit rating (A index for utilities rated better than BBB+, Baa index for BBB+ and
2 lower). The applicable Moody’s utility bond index rate average as of September 30 in the year
3 prior to a cost of capital decision is set as the benchmark rate.⁹ That benchmark is then annually
4 compared to the 12-month October through September average of the index.¹⁰

5 In any year where the CCM applies and the difference between the current 12-month
6 October through September average of the applicable Moody’s utility bond index is more than
7 100 points from the benchmark rate, the adjustment mechanism “triggers,” adjusting ROE by
8 one-half of the difference between the benchmark and the Moody’s index rate average for the
9 following year.¹¹ The costs of long-term debt and preferred stock are trued up.¹² By using
10 interest rate changes as a rough proxy to annually assess the cost of equity, the adjustment
11 mechanism “*potentially* replac[es] annual cost of capital proceedings.”¹³

12 Alternatively, SDG&E and the other California electric utilities have the “right to file a
13 cost of capital application outside of the CCM process upon an extraordinary or catastrophic
14 event that materially impacts their respective cost of capital and/or capital structure and affects
15 them differently than the overall financial markets.”¹⁴ The CCM providing the right for a full
16 application is consistent with the fact that the underlying default rule is an annual cost of capital

⁹ D.13-03-015, p. 2; *see generally* Prepared Direct Testimony of Patrick Billings – Cost of Capital Mechanism (August 23, 2021) (“Billings SDG&E-05”), p. PB-10.

¹⁰ D.13-03-015, p. 2.

¹¹ *Id.* at 2-3; D.08-05-035, p. 15.

¹² D.08-05-035, p. 15.

¹³ D.13-03-015, Appendix A, p. 2 (emphasis added).

¹⁴ D.08-05-035, pp. 16 and 19, Conclusion of Law 6; *accord* D.13-03-015, p. 7 (finding that “utilities continue to have the right” to file outside of the CCM if meeting the applicable standard); *see also* D.19-12-056, p. 45 (continuing the existing structure of the CCM).

1 application. While the CCM’s adjustment mechanism provides a potential stand-in for that
2 annual application, SDG&E’s cost of capital is still assessed annually. Because an application
3 provides the Commission and all parties an opportunity for input, adjudication, and a fuller
4 assessment of the cost of capital beyond interest rate changes, it follows that SDG&E has the
5 right to revert to an application to have its cost of capital fully assessed—rather than rely simply
6 on changes in interest rates—when interest rate changes provide an inapt measure of the cost of
7 equity.¹⁵

8 **B. SDG&E Meets the CCM’s Standard for Filing a TY 2022 Application**

9 Under the CCM, SDG&E is currently subject to the Moody’s Baa index. The adjustment
10 mechanism’s measurement period at issue for 2022 spans from October 2020 through September
11 2021. The CCM would likely trigger for SDG&E for 2022, largely driven by the COVID-19
12 pandemic and the federal government’s responses to lessen the economic impacts from the
13 pandemic. In particular, the Moody’s utility bond index yields were extremely low between
14 October 2020-March 2021—the first six months of the applicable measurement period—months
15 that coincide with the height of the COVID-19 pandemic in California. But because the COVID-
16 19 pandemic constitutes an extraordinary event that has materially impacted SDG&E and other
17 utilities’ cost of capital and affected them differently than the overall market based upon the
18 divergence between the cost of debt and the cost of equity and the rise in utilities’ cost of equity
19 relative to the market overall, SDG&E files this application.

¹⁵ See D.13-03-015, Ordering Paragraph 1 and Appendix A, p. 3 (“In the year of cost of capital filings, the CCM would not be used, because the cost of capital proceeding will set new rates for the following year.”).

1 **1. The COVID 19 Pandemic Constitutes an Extraordinary or**
2 **Catastrophic Event**

3 As further detailed in Mr. Coyne’s testimony, that the COVID-19 pandemic constitutes
4 an extraordinary or catastrophic event should be readily apparent. Perhaps the pandemic’s worst
5 health and safety impacts in California were between October 2020 through March 2021—the
6 first six months of the CCM’s measurement period at issue. During that time, the State averaged
7 its highest case counts and hospitalizations during the pandemic, peaking at over 50,000 daily
8 new cases and nearly 23,000 hospitalizations in early January.¹⁶

9 The pandemic, and attempts to mitigate the severe health and safety impacts of the
10 pandemic, has also had significant economic consequences.¹⁷ As the Commission has found,

- 11 • “COVID-19 has been extremely disruptive to all Californians and has had
12 severe economic impacts on many Californians;”¹⁸
- 13 • “COVID-19’s toll on the State’s economy is unrivaled in its speed and
14 breathtaking in its severity;”¹⁹ and
- 15 • “Millions of Californians filed new claims for state unemployment
16 benefits,” and “[b]usinesses—small, medium, and large—faced reductions
17 or closures to their operations because of shelter-in-place orders.”²⁰

18 Even in February 2021, the Commission observed that “California’s economy is still
19 months away from recovery.”²¹ Only on June 15, 2021, with the widespread availability of
20 vaccines, was California able to largely remove many COVID-19 restrictions. But many

¹⁶ COVID19.CA.Gov, *Tracking COVID-19 in California*, available at <https://covid19.ca.gov/state-dashboard/>.

¹⁷ Prepared Direct Testimony of James M. Coyne – Return on Equity (August 23, 2021) (“Coyne SDG&E-04”), p. JMC-06 and JMC-12.

¹⁸ Resolution M-4849 (Feb. 11, 2021) (“Res. M-4849”), p. 3.

¹⁹ D.21-04-015, p. 9.

²⁰ *Id.* at 5-6.

²¹ Res. M-4849, p. 3.

1 businesses remain modified, millions of Californians continue to work from home, and
2 California’s unemployment rate as of May 2021 is 7.9%; well above the state’s 4.3%
3 unemployment rate in February 2020²² and the 5.5% unemployment rate nationwide.²³

4 The COVID-19 pandemic continues to have catastrophic impacts as case numbers have
5 increased again throughout the United States in July-August 2021. New infections again
6 averaged over 140,000 per day on August 17, 2021²⁴—with over 90 percent of California’s
7 population living in areas with “substantial” or “high” transmission.²⁵ Concerns that the
8 increased presence of COVID-19 could slow the global economy, combined with the Federal
9 Reserve’s ongoing actions to increase the money supply to support an economic recovery from
10 the pandemic, have again pushed interest rates lower than they were in spring 2021.²⁶

11 **2. The Cost of Debt Has Decreased While the Cost of Equity Has** 12 **Increased**

13 As noted, the pandemic, and the federal government’s efforts to lessen the significant
14 economic impacts brought about by the pandemic, have, in turn, significantly reduced interest
15 rates.²⁷ Specifically, to counteract the sizeable risk of a severe, prolonged recession—in light of

²² See CA.Gov, *California unemployment rate improves to 7.9% in May 2021* (June 18, 2021), available at <https://edd.ca.gov/newsroom/unemployment-may-2021.htm>;

²³ Bureau of Labor Statistics, *The Employment Situation - July 2021*, available at <https://www.bls.gov/news.release/pdf/empst.pdf>.

²⁴ The New York Times, *Coronavirus in the U.S.: Latest Map and Case Count Updated*, available at <https://www.nytimes.com/interactive/2021/us/covid-cases.html?action=click&module=Top%20Stories&pgtype=Homepage>.

²⁵ San Diego Union Tribune.Com, *California sees small boost in vaccinations but needs much more* (July 29, 2021), available at <https://www.sandiegouniontribune.com/news/california/story/2021-07-29/new-pushes-for-masks-vaccines-highlight-californias-urgent-battle-to-slow-the-coronavirus>.

²⁶ See CNBC.com, *10-year Treasury yield falls below 1.2%, hitting a new five-month low* (July 19, 2021), available at <https://www.cnbc.com/2021/07/19/us-bonds-treasury-yields-start-the-week-lower.html>.

²⁷ Coyne SDG&E-04, p. JMC-06.

1 the economy declining an unprecedented annual rate of 31.4 percent in the second quarter of
2 2020²⁸—Congress has passed approximately \$3 trillion dollars in stimulus measures.²⁹ The
3 Federal Reserve has similarly taken numerous actions—including keeping the overnight federal
4 funds rate near zero (which, in turn, lowers all other interest rates), and conducting ongoing,
5 large scale “quantitative easing,” featuring \$120 billion in ongoing monthly purchases of
6 government and corporate bonds—to significantly increase the money supply and drive down
7 interest rates to facilitate lending and economic activity.³⁰

8 These actions resulted in “[d]ebt yields [being] driven lower by an aggressive and
9 unprecedented level of federal government action designed to support the economy.”³¹ As Mr.
10 Coyne testifies, the “low interest rate environment over the past year has been directly
11 attributable to steps the Federal Reserve has taken to contain the economic effects of COVID-19,
12 including reducing the federal funds rates and taking additional measures to support the U.S.
13 economy and provide liquidity and stability in financial markets.”³²

14 Interest rate movements over the last year also reflect the impact of the pandemic. As
15 noted, during the measurement period, the Moody’s utilities index was at its lowest between
16 November 2020 and March 2021—when California and the United States as a whole
17 experienced the pandemic’s worst health and safety impacts. The index has again trended

²⁸ *Id.* at JMC-11.

²⁹ USASpending.gov, *The Federal Response to COVID-19*, available at <https://www.usaspending.gov/disaster/covid-19>.

³⁰ Coyne SDG&E-04, pp. JMC-16 - JMC-17; JMC-21.

³¹ *Id.* at JMC-06.

³² *Id.* at JMC-27.

1 downwards in July and August 2021 as the “delta” variant has again caused case numbers to rise
2 and renewed concerns about COVID-19’s impact on the economy.³³

3 By contrast, the cost of equity during the pandemic has increased, as “[e]quity investors,
4 responding to increased levels of risk and market volatility, required higher returns.”³⁴ As Mr.
5 Coyne details, volatility in equity markets reached levels not seen since the Great Recession.
6 They remained higher in May 2021 than the market average between 2010-2019.³⁵

7 The federal government multiple stimulus measures have incentivized investors to move
8 from “low yielding bonds into equities, creating upward pressure on valuations and downward
9 pressure on yields for dividend paying companies such as utilities.”³⁶ And higher expected
10 growth, inflation, and interest rates moving forward as the pandemic’s impacts lessen all indicate
11 that the cost of equity will increase going forward.³⁷

12 Utilities, and SDG&E and other California electric utilities in particular, have also been
13 affected differently than the overall market—evidenced both by the underperformance of utility
14 stocks and the increased risks associated with utilities stocks during the measurement period.
15 Although the S&P 500 is up nearly 30% since mid-February 2020, the utility S&P 500 has
16 decreased about five percent during that same time.³⁸ The California electric utilities have even

³³ See CNBC, *10-year Treasury yield drops to 1.15% amid disappointing data, delta variant concerns* (Aug. 2, 2021), available at <https://www.cnbc.com/2021/08/02/us-bonds-treasury-yields-rise-to-start-the-week-ahead-of-pmi-data.html>; CNBC, *10-year Treasury yield falls below 1.2%, hitting a new five-month low* (July 19, 2021), available at <https://www.cnbc.com/2021/07/19/us-bonds-treasury-yields-start-the-week-lower.html>.

³⁴ Coyne SDG&E-04, p. JMC-6.

³⁵ *Id.* at JMC-12.

³⁶ *Id.* at JMC-15.

³⁷ *Id.* at JMC-5.

³⁸ *Id.* at JMC-31.

1 further underperformed the broader utility index, with Sempra Energy down more than 15
2 percent from its mid-February 2020 level.³⁹

3 Utilities are considered riskier relative to the market than they were prior to COVID-19.
4 As Mr. Coyne details, beta coefficients—a measure of risk where 1.0 is the market average and
5 where “higher betas translate to greater risk and higher required equity returns”⁴⁰—have
6 increased substantially for electric and gas utilities, “indicat[ing] that investors have not viewed
7 the utilities sector as a safe-haven during this economic downturn.”⁴¹ Although utilities
8 traditionally were considered safer investments than the market as a whole, as Mr. Coyne
9 testifies, “[u]tilit[ies] company stocks have traded more in-line with the broader market since
10 February 2020 when the COVID-19 pandemic became a concern in financial markets.”⁴²

11 For instance, Value Line’s Beta for the proxy group has increased from 0.56 in January
12 2020 to 0.88 in May 2021; with Sempra Energy’s increasing from 0.70 to 0.95.⁴³ Higher Betas
13 for utilities signal an increase in risk relative to the market. This has caused utilities’ cost of
14 capital to increase more than the overall market, as investors require a higher return for utility
15 stocks to accept those increased risks relative to other stocks.⁴⁴

16 Beyond the general overall market volatility that has made traditionally low-risk stocks
17 such as utilities seem riskier,⁴⁵ part of the concern is investors’ perception of increased risk due

³⁹ *Id.* at JMC-32.

⁴⁰ *Id.* at JMC-30.

⁴¹ *Id.* at JMC-14.

⁴² *Id.* at JMC-13.

⁴³ *Id.* at JMC-14, Figure 3: Beta Coefficients for Proxy Group and Sempra Energy.

⁴⁴ *Id.* at JMC-14.

⁴⁵ *Id.* at JMC-29.

1 to the COVID-19 pandemic’s impact on utilities’ financial health, such as with ongoing
2 disconnection moratoriums. For instance, in California, the Commission has stated that it
3 “appreciate[s] the careful, and tireless efforts of the utilities to protect their employees and
4 customers over this period,”⁴⁶ and noted that utilities have instituted numerous Commission-
5 approved customer service protections during the pandemic. This includes a suspension of:

- 6 • Reconnection fees;
- 7 • Deposits for the establishment of new service and reestablishment of
8 disconnected service;
- 9 • Excessive usage reviews for customers enrolled in CARE and FERA bill
10 assistance programs;
- 11 • Customer removals from CARE or FERA enrollment; and
- 12 • Income verification requirements for CARE or FERA enrollment.⁴⁷

13 As RRA, a segment of S&P states, the longer such moratoriums continue, the more uncertain
14 cost recovery becomes and the longer that the utility must float those costs.⁴⁸ And as Maritza
15 Mekitarian (Exhibit SDG&E-02) and Ari Beer (Exhibit SDG&E-03) testify, the need to cover
16 the costs for those moratoriums have a significant impact on SDG&E’s financial position.⁴⁹

17 In sum, as Mr. Coyne testifies, “[g]iven the uncertainty and volatility that have
18 characterized capital markets since February 2020, and the increase in relative risk to the utility
19 industry (as measured by Beta) compared to the broader market . . . it is reasonable that equity

⁴⁶ Rulemaking 21-02-014, *Order Instituting Rulemaking to Address Energy Utility Customer Bill Debt Accumulated During the COVID-19 Pandemic* (February 11, 2021), p. 3.

⁴⁷ *Id.* at 4-5.

⁴⁸ S&P, RRA Regulatory Focus, *2021 Energy Utility Regulatory Outlook* (Feb. 11, 2021), pp. 2-4.

⁴⁹ Prepared Direct Testimony of Maritz Mekitarian – Authorized Capital Structure (August 23, 2021) (“Mekitarian SDG&E-02”), p. MM-14; Prepared Direct Testimony of Ari Beer – Company Risk (Aug. 23, 2021) (“Beer SDG&E-03”), p. AB-36.

1 investors would require a higher ROE to compensate them for the additional risk associated with
2 owning common stock.”⁵⁰ These “factors drive higher estimates of the cost of equity than those
3 considered by the Commission in 2019.”⁵¹

4 **C. SDG&E Is Exercising Its Right to File an Application to Ensure an Accurate**
5 **Cost of Capital**

6 The costs of debt and equity have thus “moved in opposite directions.”⁵² That is, the
7 steep reduction in debt yields brought on by the federal government and Federal Reserve’s
8 ongoing actions have resulted in interest rates declining. But the cost of equity has increased,
9 driven higher by market volatility, uncertainty, and a perceived increase in utility risks. SDG&E
10 and other utilities’ cost of equity has increased more than the market as a whole, as they are seen
11 riskier relative to the market than they were prior to the pandemic.

12 As Mr. Coyne testifies, the divergence between the costs of debt and equity during the
13 COVID-19 pandemic makes the CCM’s adjustment mechanism an “unreliable measure of the
14 cost of equity capital in these prevailing market conditions.”⁵³ Because the relationship between
15 the cost of equity and the cost of debt has been severed, the adjustment mechanism cannot
16 effectively serve as a proxy to assess SDG&E’s cost of capital based on changes in interest rates
17 during the pandemic.

18 The Commission has previously recognized that the CCM’s adjustment mechanism may
19 not be an appropriate measure of the cost of equity based on a divergence between interest rates
20 and the cost of equity during the last period of extraordinary economic circumstances—the Great

⁵⁰ Coyne SDG&E-04, p. JMC-19.

⁵¹ *Id.* at JMC-5.

⁵² *Id.* at JMC-6

⁵³ *Id.* at JMC-33.

1 Recession. In 2009, the Commission granted a petition for modification (“PFM”) from SCE,
2 PG&E, and the Division of Ratepayer Advocates (“DRA”) (now known as the California Public
3 Advocates Office) to suspend the CCM from applying in 2010 due to a similar divergence
4 between the cost of debt and equity.⁵⁴ Specifically, the CCM was poised to automatically
5 increase SCE and PG&E’s ROE as a “result of dramatic increases in the cost of utility debt that
6 began in September 2008 after the bankruptcy of Lehman Brothers and continued into 2009.”⁵⁵
7 Yet the Commission agreed that this increase in interest rates did not necessarily reflect an
8 increase in the cost of equity, as equity markets “were still showing “significant continued risk
9 aversion by investors.”⁵⁶

10 This divergence between the cost of debt and equity—and overall increase in the cost of
11 equity—has materially impacted SDG&E’s cost of capital and affected SDG&E and other
12 utilities’ differently than the market generally.⁵⁷ SDG&E and other utilities thus have the right to
13 file a cost of capital application in lieu of the CCM’s adjustment mechanism applying during the
14 COVID-19 pandemic.

15 As SDG&E’s ROE must be set commensurate with risks, the fact that the cost of equity
16 for utilities, and SDG&E in particular, has increased during COVID-19 while utility debt yields
17 have decreased indicates that the CCM in these circumstances is an inappropriate measure of
18 SDG&E’s cost of capital. SDG&E and other utilities’ cost of equity has risen more quickly than
19 the overall market, reflected in the significant increase in Beta for utility-related stocks. SDG&E

⁵⁴ D.09-10-016.

⁵⁵ *Id.* at 3.

⁵⁶ *Id.*

⁵⁷ *See id.* at JMC-29.

1 thus brings this application to ensure that the 2022 assessment of its cost of capital reflects the
2 actual market conditions resulting from the extraordinary circumstances of the COVID-19
3 pandemic; while not resulting in an increase in rates.

4 SDG&E requests that the Commission grant its application for TY 2022, and reset the
5 CCM for a new three-year cycle, making SDG&E's next cost of capital application due in April
6 2024 for TY 2025. SDG&E is concurrently filing a motion to establish electric and gas
7 memorandum accounts to preserve the ability to implement the Commission's decision on
8 SDG&E's cost of capital application as of January 1, 2022. As a result of filing this off-cycle
9 application based on the impacts of the COVID-19's pandemic, SDG&E's current cost of capital
10 will remain in effect pending the Commission's decision. These memorandum accounts will
11 record the authorized revenue requirement based on the Company's current cost of capital. Upon
12 a Commission decision, SDG&E will record an entry into the memorandum accounts reflecting
13 that new revenue requirement, and the difference will be implemented in rates.

14 **III. OVERVIEW OF PROPOSALS AND WHY SDG&E'S PROPOSED RATE OF**
15 **RETURN IS NECESSARY WHILE NOT RESULTING IN A RATE INCREASE**

16 For 2022, SDG&E proposes the following cost of capital.

17 **TABLE 1 – PROPOSED 2022 AUTHORIZED COST OF CAPITAL**

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	46%	3.84%	1.77%
Preferred Stock	0%	0%	0%
Common Equity	54%	10.55%	5.70%
ROR	100%	N/A	7.46%

18 The Company's currently authorized cost of capital, as approved in D.19-012-056, is
19 shown below.

1 **TABLE 2 – CURRENTLY AUTHORIZED COST OF CAPITAL**

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.25%	4.59%	2.08%
Preferred Stock	2.75%	6.22%	0.17%
Common Equity	52.00%	10.2%	5.30%
ROR	100%	N/A	7.55%

2
3 If adopted, this will *decrease* the Company’s currently authorized rate of return by 0.09%
4 or nine basis points, which will result in an estimated \$0.17 million (\$0.14 million electric and
5 \$0.03 million gas) revenue requirement *decrease for ratepayers*.

6 SDG&E’s proposals are informed by the Company’s actual capital structure, sound
7 financial modeling, and other qualitative and quantitative analyses from SDG&E and
8 independent sources such as equity analysts and credit rating agencies. The Company’s
9 testimony supports its cost of capital proposals. While this testimony highlights the findings of
10 the Company’s witnesses, each witness sponsors the recommendations in their areas of
11 responsibility.

12 Patrick Billings (Exhibit SDG&E-05) provides SDG&E’s recommendation that the CCM
13 continue and be reset for a new three-year cycle from 2022-2024. As discussed above, the
14 CCM’s adjustment mechanism remains suitable for many economic circumstances, while
15 appropriately providing the right for utilities to file cost of capital applications when warranted,
16 such as during the COVID-19 pandemic.⁵⁸ That said, SDG&E does request three clarifications to
17 the CCM process to address situations that SDG&E has faced during the current CCM cycle:

- 18
- Clarify what index applies to each utility after a cost of capital decision;

⁵⁸ Billings SDG&E-05, p. PAB-9.

- 1 • Specify what Moody’s utility bond index applies when a utility has split
2 credit ratings; and
- 3 • Provide that a utility can switch to a different Moody’s bond index within
4 a CCM cycle if its credit ratings change.⁵⁹

5 Ms. Mekitarian and Mr. Coyne’s testimonies support SDG&E’s proposed capital
6 structure of 54 percent common equity, 46 percent long-term debt, and zero percent preferred
7 stock. As discussed in their respective testimonies, consistent with D.12-12-034, SDG&E’s
8 proposal better aligns SDG&E’s authorized capital structure with its longstanding actual capital
9 structure of 56 percent common equity, and 44 percent long-term debt. The proposal would
10 validate SDG&E’s prudent business decision to maintain a higher actual equity ratio to manage
11 the Company’s above average risks from operating in California; counterbalancing the fact that
12 SDG&E’s credit ratings are at least two notches below where they were prior to 2018 due to
13 perceived wildfire risks.

14 In fact, SDG&E’s proposed capital structure would support further upgrades to SDG&E’s
15 credit ratings. As S&P recently stated, despite ongoing wildfire risks, the ratings agency could
16 raise SDG&E’s rating if SDG&E’s “financial measures are consistently above the upgrade
17 threshold.”⁶⁰ SDG&E’s proposed capital structure also reasonably removes the fictitious preferred
18 equity layer from the Company’s authorized capital structure that lacks any relationship to
19 SDG&E’s actual management of the Company. SDG&E has not had issued preferred stock since
20 1993, redeemed all outstanding shares of preferred stock in 2013, and does not plan to issue this
21 type of financing as it is an inefficient method to raise funds for utility operating companies.⁶¹

⁵⁹ *Id.* at PAB-10.

⁶⁰ S&P, *How are California’s Wildfire Risks Affecting Utility Credit Quality* (Jun. 3, 2021) (“S&P, June 3, 2021”), p. 10.

⁶¹ Mekitarian SDG&E-02, p. MM-7.

1 By having an actual capital structure possessing a higher common equity ratio that its
2 authorized one, SDG&E's investors are buttressing the Company's credit ratings—providing a
3 benefit to ratepayers—without receiving a return on their investment. If SDG&E reduced its
4 actual common equity ratio to its currently authorized one it would harm its credit ratings,
5 resulting in higher borrowing costs. SDG&E's proposed capital structure thus better rewards the
6 Company for the prudent management of its capital structure by moving SDG&E's authorized
7 capital structure closer to its actual one—instead of continuing with a fictitious authorized capital
8 structure that includes preferred equity that the Company does not have.

9 Yet consistent with D.19-12-056, SDG&E is not proposing that its authorized capital
10 structure mirror its actual capital structure. SDG&E's proposal instead strikes a reasonable
11 balance by proposing to replace the Company's preferred equity layer with an increase in both
12 common equity and long-term debt.

13 I provide SDG&E's ROE recommendation and the bases for that proposal, which is
14 supported by the testimony of Mr. Coyne and Ari Beer, as discussed below.

15 **IV. SDG&E'S ROE SHOULD BE SET AT 10.55 PERCENT TO APPROPRIATELY**
16 **REFLECT THE COST OF EQUITY AND SDG&E'S ABOVE-AVERAGE RISKS**

17 SDG&E proposes an eminently supportable ROE of 10.55 percent, given Mr. Coyne's
18 quantitative analysis and the above-average risks that SDG&E faces relative to the proxy group.
19 As noted, SDG&E's return on its rate base must be set at a level that is comparable to the return
20 for other businesses with corresponding risks.⁶² If a utility's return is set too low relative to its

⁶² D.19-12-056, pp. 15-16 (citing *Federal Power Com. v. Hope Natural Gas Co.*, 320 U.S. 591, 601 (1944); *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 (1923)).

1 risks, investors will opt to invest in companies that have the same return with lower risk
2 profiles.⁶³

3 Similarly, a return that is too low puts pressure on SDG&E’s credit ratings.⁶⁴ As the
4 Commission has recognized, a strong investment grade credit rating—which is based on the
5 soundness of the Company as an investment—benefits both the utility and ratepayers.⁶⁵ The
6 riskier that SDGE is considered as an investment, the more expensive it is for the Company to
7 raise capital—because it has to compensate bond and stock holders for that increased risk—
8 through higher interest rates, a higher return on equity or, most likely, both.⁶⁶ Ratepayers
9 ultimately bear these costs.⁶⁷

10 To determine a reasonable return on equity for SDG&E, Mr. Coyne applied the results of
11 four ROE-models (DCF, CAPM, Risk Premium, and Expected Earnings) to a proxy group of 20
12 investment-grade, dividend-paying electric utilities to establish an ROE range.⁶⁸ He found a
13 reasonable range for the proxy group to be 10.5-11.5 percent—before taking SDG&E’s risks into
14 account.

15 Messrs. Coyne and Beer then detail SDG&E’s above-average risks. As both Mr. Coyne
16 and Mr. Beer discuss, a significant, unique risk that SDG&E faces is California’s high propensity

⁶³ Coyne SDG&E-04, pp. JMC-9 – JMC-10.

⁶⁴ See D.19-12-056, p. 16 (finding that ROR must be set at a level to “maintain and support” a utility’s credit rating).

⁶⁵ *Id.* at 7-8.

⁶⁶ See D.03-12-035, p. 42 (“the cost of investment grade debt is considerably less . . . the lower cost of a utility’s debt translates into lower rates, all else being equal.” (citation omitted)).

⁶⁷ See D.12-12-034, p. 9 (as credit ratings are downgraded, it increases “financial risks for common equity holders, thereby requiring greater returns on common equity.”).

⁶⁸ Coyne SDG&E-04, pp. JMC-3 – JMC-04 and JMC-52.

1 for wildfires and accompanying wildfire liability regime. SDG&E in 2018-2019 experienced
2 multiple credit rating downgrades due to catastrophic wildfires in the State—despite SDG&E
3 being repeatedly lauded for its wildfire mitigation efforts and not being the cause of a significant
4 wildfire ignition since 2007. Although Moody’s recently upgraded SDG&E’s credit rating to A3
5 based, in part, on “SDG&E’s track record of effective wildfire risk mitigation practices,”⁶⁹
6 SDG&E’s ratings remain at least two notches below SDG&E’s longstanding A-credit rating by
7 all three credit rating agencies.

8 As S&P recently noted, SDG&E “is viewed as a global leader in wildfire prevention,”⁷⁰
9 “through the implementation of technology and system hardening.”⁷¹ Nevertheless, S&P stated
10 that SDG&E and other California electric utilities continue to face significant risks from the
11 increased likelihood of catastrophic wildfires, inverse condemnation, and the risk of a potential
12 lack of recovery of costs associated with a catastrophic wildfire.⁷²

13 As S&P and Moody’s note, this is partly because “California’s environment remains
14 highly prone to catastrophic wildfires, continuing to pressure utility credit quality.”⁷³ The
15 increased duration of wildfire season and the higher frequency of wildfire-prone conditions has
16 increased the opportunities for a utility’s equipment to be involved in an ignition. As S&P notes,
17 “[d]espite SDG&E’s leadership role in wildfire prevention, we assess the company at the lower

⁶⁹ Moody’s, *Rating Action: Moody’s upgrades San Diego Gas & Electric to A3 from Baa1; outlook stable* (March 30, 2021), p. 1.

⁷⁰ S&P, June 3, 2021 at 8.

⁷¹ S&P, *San Diego Gas & Electric Co.* (July 9, 2021) (“S&P July 9, 2021”), p. 3.

⁷² S&P, June 3, 2021 at 2-3; accord S&P, Regulatory Research Associates (“RRA”), *California Regulatory Review* (Dec. 14, 2020) (“RRA Dec. 14, 2020”), pp. 1-2.

⁷³ S&P, June 3, 2021 at 1; accord Moody’s Investors Service, *San Diego Gas & Electric Company, Update to credit analysis following upgrade to A3* (May 10, 2021) (“Moody’s May 10, 2021”), p. 5.

1 end of the range for excellent business risk profile category” reflecting “the company’s higher
2 wildfire threat compared to utility peers across North America.”⁷⁴

3 SDG&E’s above-average wildfire risk also stems from the state’s legal regime for utility
4 wildfire liability—inverse condemnation’s strict liability combined with doubts regarding cost
5 recovery following SDG&E being permitted cost recovery by FERC but denied cost recovery by
6 the Commission in 2017 for the same conduct in SDG&E’s 2007-caused wildfires.⁷⁵ Although
7 AB 1054’s revisions to the state’s prudence standard and establishment of a wildfire fund with a
8 cap on expenses meaningfully reduces risks, it does not eliminate them.⁷⁶

9 Beyond the still-remaining heightened overall risk of wildfire, rating agencies have
10 repeatedly expressed uncertainty and concerns about AB 1054’s implementation. As S&P has
11 stated, “if the CPUC does not implement AB 1054 in a credit-supportive manner then much of
12 the new law’s credit-supportive elements related to the revised standards of a utility’s reasonable
13 conduct could potentially be negligible.”⁷⁷ Filsinger Energy Partners, an energy advisory firm
14 retained by Governor Newsom’s strike force, estimated that the amount of prudence findings
15 between 2020-2030 would range from 25% to 75% (“Filsinger Report”); in contrast to investors’
16 expectation that FERC would find a utility prudent for the same conduct.⁷⁸

⁷⁴ S&P, *Sempra Energy Unsecured Debt Rating Lowered To 'BBB'; Outlook On Subsidiary SDG&E Revised To Stable* (May 12, 2021), p. 2.

⁷⁵ See Moody’s May 10, 2021, p 6 (noting that it is “important” that AB 1054 revised the state’s prudence standard for wildfire cost recovery to be in line with FERC’s because, “in the case of SDG&E’s 2007 wildfires, while the CPUC denied recovery, the FERC ruled that SDG&E acted prudently and allowed the recovery of the wildfire costs.”).

⁷⁶ S&P July 9, 2021 at 6.

⁷⁷ S&P, June 3, 2021 at 6; accord Moody’s May 10, 2021 at 2 (citing a credit challenge as an “[e]xecution risk in the CPUC’s implementation of the new prudence standards included in the wildfire legislation”).

⁷⁸ See Coyne SDG&E-04, pp. JMC-60 - JMC-63 (discussing the Filsinger Report findings).

1 The long-term risk that the wildfire fund will be exhausted also weighs down SDG&E’s
2 current credit ratings.⁷⁹ And, as RRA noted, inverse condemnation remains in place, making AB
3 1054 an incomplete remedy.⁸⁰ S&P thus recently stated that “because we view the likelihood of a
4 change to California’s interpretation of inverse condemnation as remote, and favorable climate
5 change patterns are also unlikely to emerge for a state with a long history of drought conditions,
6 we are unlikely to raise ratings for utilities with meaningful wildfire-related risks in the near
7 term.”⁸¹ This means that SDG&E’s credit ratings remain significantly below their pre-2018
8 levels based upon credit rating agencies’ assessment of the heightened, ongoing wildfire risks in
9 the state.

10 This ongoing risk is also reflected in investor analysts explicitly pricing Sempra Energy’s
11 (SDG&E’s publicly traded parent corporation) and other California electric utility holding
12 companies’ stock with a “discount”—despite SDG&E’s “superior wildfire mitigation
13 protocols”⁸²—reflecting “lingering risks related to CA’s inverse condemnation policy and highly
14 politicized regulatory environment.”⁸³ And it is reflected in the fact that wildfire insurance
15 premiums continue to rise. This makes it more costly to purchase SDG&E’s \$1.25 billion in
16 insurance that is not covered by the wildfire fund under AB 1054; in addition to shareholders
17 remaining liable to redeem the fund up to a cap equal to 20 percent of the utility’s transmission
18 and distribution equity rate base in situations where FERC finds that the utility was prudent, but

⁷⁹ See S&P, June 3, 2021; Moody’s May 10, 2021.

⁸⁰ See RRA Dec. 14, 2020 at 1 (noting that AB 1054 “does nothing to alter the inverse condemnation policy, thus a substantial risk for PG&E and other utilities in the state remains”).

⁸¹ S&P, June 3, 2021 at 10.

⁸² Evercore ISI, *Sempra Energy* (Jun. 29, 2021), p. 2.

⁸³ Wells Fargo, Equity Research, *Sempra Energy Analysis (SRE)*, *SRE: Analyst Day Previews CapEx Upside in Texas* (Jun. 29, 2021), p. 3.

1 the Commission rules it was not based on the same utility conduct.⁸⁴ Based on these objective
2 costs, Mr. Coyne quantifies the additional risks associated with SDG&E’s wildfire exposure
3 compared to non-California electric utilities and the needed return that shareholders require to
4 bear those risks.⁸⁵

5 Moreover, as Messrs. Beer and Coyne testify, SDG&E faces additional unique risks.

6 They include:

- 7 • “[H]igh political risk and public scrutiny in both San Diego and the state
8 of California,”⁸⁶ including the reaction to PSPS events, that increase
9 political and regulatory contentiousness;⁸⁷
- 10 • Credit challenges from SDG&E’s “[m]aterial capital investment program
11 that will “require incremental debt;”⁸⁸ and
- 12 • The “significant demands that are placed on the California utilities amid
13 many ambitious public policy initiatives”⁸⁹ such as renewable portfolio
14 standards and increased rooftop solar, which increase uncertainty for
15 investors and could result in potential rate pressures or rate shifting.

16 Based on these qualitative and quantitative analyses of SDG&E’s risks, Mr. Coyne states
17 that it would be reasonable for SDG&E’s ROE to be “at the top of the range.”⁹⁰ Similarly, in its
18 2019 decision, the Commission, after “considering the evidence on market conditions, trends,
19 creditworthiness, interest rate forecasts, quantitative financial models, additional risk factors

⁸⁴ See Coyne-SDG&E-04, pp. JMC-60 – JMC-63 (discussing investor expectations that it is likely that there will be circumstances where FERC finds a California utility prudent and the CPUC finds the utility imprudent for the same conduct regarding the cause of a wildfire, based upon past experience and the Filsinger Report).

⁸⁵ *Id.* at JMC-62 – JMC-63.

⁸⁶ Moody’s May 10, 2021 at 5.

⁸⁷ *Id.* at 6.

⁸⁸ *Id.* at 2.

⁸⁹ *Id.* at 10.

⁹⁰ Coyne SDG&E-04, p. JMC-74.

1 including business risk,” implicitly recognized that SDG&E’s above-average risks necessitate an
2 above-average ROE when it “conclude[d] that” SDG&E’s “adopted ROE should be set at the
3 upper end of the just and reasonable range.”⁹¹ It approvingly found that, in setting SDG&E’s
4 ROE at 10.2 percent, that a “10.20% authorized ROE is significantly higher than the 9.60%
5 average ROEs granted to United States electric utilities during 2018.”⁹²

6 RRA likewise recently noted favorably that California’s “recent [ROE] authorizations
7 have been above the industry averages when established,” helping offset the unique, significant
8 risks that SDG&E and other California electric utilities face from inverse condemnation.⁹³ Given
9 that, SDG&E’s ROE proposal of 10.55 percent is certainly reasonable in the unique
10 circumstances of the pandemic; particularly when, combined with the Company’s capital
11 structure proposal, it *does not cause an increase in rates*. SDG&E’s proposal is also consistent
12 with the average ROE request of 10.23 percent from vertically integrated utilities in 2021; well
13 below the highest request of 11.5 percent.⁹⁴

14 By contrast, if the CCM’s adjustment mechanism is allowed to trigger, it would reduce
15 SDG&E’s ROE to around 9.62 percent, near the national average of 9.44 percent authorized
16 average for all electric utility cases in 2020—and even closer to the 9.55 percent 2020 average
17 for vertically integrated utilities.⁹⁵ Even with the COVID-19 pandemic, the average authorized
18 ROE has only moderately declined since the Commission’s 2019 decision. Beyond the reduction

⁹¹ D.19-12-056, pp. 40-41.

⁹² *Id* at 42-43 (citing S&P [RRA] Global Market Intelligence, July 22, 2019 at Table 1).

⁹³ RRA Dec. 14, 2020 at 2.

⁹⁴ S&P, RRA Regulatory Focus, *Major Utility Cases in Progress in the US Quarterly Update on Pending Rate Cases* (Jun. 17, 2021), pp. 2-3.

⁹⁵ S&P, RRA Regulatory Focus, *Major Rate Case Decisions—January-June 2021* (Jul. 27, 2021), p.1.

1 in interest rates not reflecting the cost of equity, allowing the adjustment mechanism to trigger
2 would be inconsistent with the Commission’s 2019 decision finding that SDG&E’s ROE should
3 be set “significantly higher” than the national average of authorized ROEs.⁹⁶

4 As such, the ROE set by the adjustment mechanism would not reflect the financial
5 realities of the COVID-19 pandemic, the Company’s risk profile, or the Commission’s 2019
6 decision finding that SDG&E’s ROE should be set above the national average at the upper end of
7 the range. As demonstrated, given SDG&E’s increased rise in risk relative to the market as
8 reflected in Sempra Energy’s beta, the Company is already a less attractive investment at its
9 current cost of capital. A significant reduction in SDG&E’s ROE will only aggravate this
10 disconnect. Effectively allowing SDG&E’s ROE to be reduced to near the national average
11 would put further pressure on the Company’s credit ratings, threaten investment in SDG&E and
12 other California electric utility stocks that are already discounted and underperforming the
13 broader market, and result in an ROR that would not be just and reasonable in light of the
14 available data. And it would do so at a period when SDG&E is making large capital investments
15 in wildfire mitigation, clean energy, and other state policy goals, putting a further strain on
16 SDG&E’s credit ratings.

17 **V. CONCLUSION**

18 SDG&E brings this application for a TY 2022 cost of capital under the CCM, based upon
19 the COVID-19 pandemic’s extraordinary circumstances resulting in a divergence between
20 lowered utility debt yields and the increased cost of equity for SDG&E and other utilities, while
21 not resulting in a rate increase for customers. SDG&E’s proposed capital structure, ROE, and
22 overall ROR is consistent with financial modeling and other relevant data during the pandemic.

⁹⁶ D.19-12-056, p. 43.

1 It will enable the Company to raise the significant amount of investment required to help meet
2 the State’s ambitious climate change and other environmental goals, mitigate wildfire risks,
3 maintain safe, reliable, and affordable service, and reduce borrowing costs to customers through
4 higher credit ratings. And SDG&E’s proposed ROE is consistent with the Commission’s
5 findings in its 2019 decision that SDG&E’s ROE should be set “significantly higher” than the
6 average of nationwide authorized ROEs.

7 This concludes my prepared direct testimony.

1 **VI. WITNESS QUALIFICATIONS**

2 My name is Valerie Bille. I am Vice President, Chief Accounting Officer, Controller, and
3 Treasurer for SDG&E. My business address is 8330 Century Park Court, San Diego, California
4 92123.

5 In my current position, I am responsible for overseeing the financial planning and
6 budgeting, financial reporting, treasury management, and accounting for SDG&E. I assumed my
7 current position in August 2020. Prior to this, I have served in roles of increasing responsibility
8 at Sempra Energy and SDG&E since November 2014.

9 I received a Bachelor of Science in Business Administration from California State
10 University, San Marcos in 2000. I am a Certified Public Accountant. I began my career with
11 Deloitte & Touche.

12 I have not previously testified before this Commission.