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**SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED DIRECT TESTIMONY OF MARITZA MEKITARIAN
AUTHORIZED CAPITAL STRUCTURE**

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



APRIL 2019

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**PREPARED DIRECT TESTIMONY OF
MARITZA MEKITARIAN
AUTHORIZED CAPITAL STRUCTURE**

I. INTRODUCTION

My testimony presents the proposals of San Diego Gas & Electric Company (“SDG&E” or “Company”) regarding the adoption of an updated authorized capital structure and embedded cost of debt in support of the Company’s California Public Utilities Commission (“CPUC” or “Commission”) regulated operations in Test Year 2020. The capital structure refers to the capital ratios of three components: (1) common equity; (2) long-term debt; and (3) preferred stock (if applicable). The capital ratios, in conjunction with the embedded costs associated with the three components, determine the weighted-average cost of capital or authorized rate of return. Table 1 below shows SDG&E’s proposed capital structure and embedded costs for Test Year 2020.

Table 1 – Proposed Capital Structure and Embedded Costs

	Proposed Capital Structure	Proposed Embedded Costs
Common Equity	56.00%	14.3% ¹
Long-Term Debt	44.00%	4.59% ²
Preferred Stock	0.00%	0.00%

¹ Please refer to the Prepared Direct Testimony of Bruce A. Folkmann, Policy Overview (April 2019) (“Ex. SDG&E-01 (Folkmann)”) who summarizes the return on equity recommendations from the Prepared Direct Testimony of Roger A. Morin, Ph.D., Return on Equity (April 2019) (“Ex. SDG&E-04 (Morin)”), Prepared Direct Testimony of John J. Reed and James M. Coyne, Wildfire Risk Premium (April 2019) (“Ex. SDG&E-05, Ch. 1 (Reed/Coyne)”), and Prepared Direct Testimony of Todd A. Shipman, CFA, Wildfire Risk Premium (April 2019) (“Ex. SDG&E-05, Ch. 2 (Shipman)”) and provides SDG&E’s overall ROE proposal.

² See Appendix A for the derivation of the embedded cost of debt proposal.

1 My testimony addresses SDG&E's proposed capital structure and embedded cost of debt,
2 as well as the treatment of customer deposits.

3 **II. OVERVIEW OF CAPITAL STRUCTURE**

4 Capital structure consists of common equity, long-term debt, and preferred stock. As the
5 Commission has found, capital structure is one component of determining a fair and reasonable
6 return on equity ("ROE") and authorized rate of return ("ROR").³ The Commission assesses
7 capital structure in conjunction with ROE and the embedded costs of debt and preferred stock
8 because the Commission's goal is to maintain long-term rate of return stability by considering
9 ROE and capital structure together.⁴ The Company's authorized ROR is determined by applying
10 the Company's ROE and embedded costs of debt and preferred stock (not applicable here) to its
11 authorized capital structure.

12 The equity component of a utility's authorized ratemaking capital structure represents the
13 amount of capital covered by shareholders. The common equity ratio reflects how a company is
14 financing its cash needs and shows the percentage of assets on which the shareholders have a
15 claim. The higher the common equity ratio, the more the shareholders have at stake and the
16 more they would require in return. A low common equity ratio indicates higher financial risk.

17 Long-term debt represents a measurement of a company's financial leverage. A high
18 debt ratio increases the risk of debt repayment to lenders and, other things being equal, will result
19 in higher costs of capital over the long-term. Conversely, a low debt ratio is not preferred as it
20 does not take advantage of a tax-deductible source of financing that is lower in cost than equity.

³ Decision ("D.") 08-05-035 at 7-8.

⁴ *Id.*

1 Preferred stock is a source of capital that is issued in shares, like common equity, but
2 comes with preferential treatment for dividends. Due to the preferred treatment on dividends,
3 preferred stock generally has a lower cost than common equity. Credit rating agencies, like
4 Standard & Poor's ("S&P"), generally treat preferred stock as a hybrid of debt and equity,
5 assigning a percentage of equity content in accordance with the security's features.

6 An optimal capital structure is one that supports a strong credit rating, lowering
7 borrowing costs for the utility and ratepayers. This generally involves a blend of debt and
8 equity. Debt is generally less expensive than equity, due to its tax advantage and lower risk. But
9 a high debt ratio increases financial risks because it means that a company has been aggressive in
10 financing its growth with debt. A company that is highly leveraged with fixed costs requires a
11 higher return on both debt and equity for investors – as the earnings available to shareholders
12 become more volatile and secondary to debt payments. As the Commission has stated,
13 “[b]ecause the level of financial risk that the utilities face is determined in part by the proportion
14 of their debt to permanent capital, or leverage, we must ensure that the utilities’ adopted equity
15 ratios are sufficient to maintain reasonable credit ratings and to attract capital.”⁵ SDG&E’s
16 proposed capital structure is necessary to manage financial risk as a result of recent downgrades
17 SDG&E has experienced, which is discussed in greater detail in the testimony of Bruce MacNeil
18 (Exhibit SDG&E-06).

19 **III. PROPOSED CAPITAL STRUCTURE**

20 SDG&E proposes a capital structure comprised of 56.00% common equity, 44.00% debt,
21 and 0% preferred stock – a change from the Company’s currently authorized capital structure of
22 52.00% common equity, 45.25% debt, and 2.75% preferred stock. The current authorized capital

⁵ See D.12-12-034 at 5.

1 structure was established in D.12-12-034. It has not changed in seven years. The proposed
2 authorized capital structure would increase common equity from 52.00% to 56.00%, while
3 decreasing long-term debt from 45.25% to 44.00%, and preferred stock from 2.75% to 0%.
4 Table 2 below compares the proposed capital structure with the currently authorized capital
5 structure.

6 **Table 2 – Current Authorized Capital Structure and Proposed Capital Structure**

	Current Authorized	2020 Proposed
Common Equity	52.00%	56.00%
Long-Term Debt	45.25%	44.00%
Preferred Stock	2.75%	0.00%

7
8 SDG&E proposes this change for two primary reasons: (1) to reflect the Company’s more
9 recent actual (recorded) capital structure since 2013; and (2) to help SDG&E manage financial
10 risks and improve its credit ratings – given the recent rating agency downgrades due to a
11 perceived inability to recover potential catastrophic wildfire liability costs.

12 **A. SDG&E’s Proposal Tracks the Company’s Recorded Capital Structure**

13 The Company’s recommended change in capital structure to increase common equity and
14 decrease long-term debt and preferred stock is designed to reflect SDG&E’s actual (recorded)
15 capital structure. SDG&E’s proposal is consistent with Commission precedent of adopting a
16 utility’s actual capital structure as its authorized structure. In fact, the Company’s currently
17 authorized capital structure reflects the fact that the Commission adopted SDG&E’s actual
18 capital structure in the last Cost of Capital (“COC”) decision, D.12-12-034.⁶ The Commission

⁶ See *id.* at 11.

likewise recently adopted common equity ratios for regulated water utilities that reflected those utilities' actual ratios.⁷ Having the authorized capital structure mirror the recorded capital structure helps limit any divergence between actual and recorded ROR.

SDG&E's actual capital structure has changed since the 2012 COC Commission decision.⁸ Since 2013, SDG&E's average recorded (actual) capital structure has been more heavily weighted towards common equity than its authorized structure. When compared to the authorized capital structure, the 2018 recorded capital structure had a common equity ratio that was 415 basis points higher than the authorized ratio of 52.00%, a long-term debt ratio that was 140 basis points lower than the authorized ratio of 45.25%, and a preferred stock ratio that was 275 basis points lower than the authorized ratio of 2.75%. Table 3 below, and discussed in Appendix B, shows SDG&E's actual recorded capital structure from 2013 through 2018.

Table 3 – SDG&E's Historical Capital Structure

	2013	2014	2015	2016	2017	2018	Current Authorized
Common Equity	53.39%	54.44%	57.55%	57.21%	55.61%	56.15%	52.00%
Long-Term Debt	46.61%	45.56%	42.45%	42.79%	44.39%	43.85%	45.25%
Preferred Stock	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2.75%

The Company has retained earnings in common equity to balance the capital structure above SDG&E's authorized common equity ratio of 52%. In fact, as shown in Table 3 above, on

⁷ See D.18-03-035 at 22.

⁸ See D.17-07-005 at 12, Q.4 (“How has the utility’s recorded capital structure changed since the 2013 Cost of Capital application? How has the recorded capital structure compared to authorized capital structure over this time period?”).

1 a rounded basis, SDG&E has been operating at or above a 56% equity percentage since 2015,
2 with a 56.2% five-year historical average. These higher than authorized equity levels have
3 improved credit metrics (by reducing debt) with capital provided solely by shareholders, directly
4 benefitting customers and shareholders.

5 For the preferred stock component of the capital structure, SDG&E recommends
6 reducing it from 2.75% to 0%. This too reflects SDG&E's actual capital structure. SDG&E has
7 not issued preferred stock since 1993, redeemed all issued and outstanding shares of its preferred
8 stock in 2013, and does not plan to issue this type of financing in the near future. A significant
9 divergence exists in the relative financing costs between preferred stock and long-term debt that
10 makes the latter a more cost-effective means of financing the Company's business. Despite a
11 downward trend in bond rates, the relative cost of preferred stock has increased significantly in
12 recent years. The preferred stock market has been challenged by a shrinking buyer base that has
13 severely limited demand for traditional institutional utility preferred stock. And the relative cost
14 of preferred stock has risen sharply. By contrast, SDG&E has been successful at issuing debt at
15 low bond rates to fund its large capital investment plan, further supporting reducing the preferred
16 stock component.

17 SDG&E's actual capital structure reflects prudent capital structure management.
18 SDG&E's historically strong credit rating is a result of that effective and proactive management.
19 As discussed in the testimony of Don Widjaja (Exhibit SDG&E-03), SDG&E faces significantly
20 increased business, financial, and regulatory risks. A higher common equity layer has allowed
21 SDG&E to maintain its high credit rating (until recent downgrades) and issue over \$2 billion of
22 long-term debt since the last COC proceeding. As discussed further below, the higher common
23 equity ratio has helped SDG&E limit financial risk and access the debt markets at reasonable

1 rates – in response to those increased business and regulatory risks. The Company’s actual
2 capital structure should therefore be adopted as the Company’s authorized capital structure.

3 **B. The Proposed Capital Structure Helps the Company Manage its Financial**
4 **Risks and is Credit Supportive**

5 In addition to being consistent with the Company’s actual capital structure, SDG&E’s
6 capital structure recommendation is consistent with the goal of keeping the Company’s capital
7 costs reasonable – relative to the costs associated with the authorized ratios – to help maintain its
8 credit rating. It is in the interest of ratepayers to preserve SDG&E’s credit profile and maintain a
9 strong balance sheet to support planned infrastructure growth. SDG&E’s proposal protects the
10 Company from:

- 11 • The increased business risk of potentially unrecoverable catastrophic
12 wildfire liability costs;
- 13 • Deteriorating credit ratings as a result of that business risk; and
- 14 • Other factors that may increase the Company’s debt.

15 **1. SDG&E’s Proposed Authorized Capital Structure Reflects the Need**
16 **to Reduce Financial Risks to Respond to Lowered Credit Ratings**

17 As discussed in Mr. Widjaja’s testimony, financial risk – a function of the amount of debt
18 in a utility’s capital structure – is the uncertainty arising from increased reliance on debt
19 financing and the associated fixed obligation payments required of debt. As the Commission has
20 recognized, financial risk increases with debt leverage.⁹ A rising debt-equity ratio implies that a
21 company has growing fixed obligations to holders of securities that have precedence to revenues.
22 As that obligation increases, more revenues must be committed to these payments, thus
23 increasing risk to the company’s initial debt holders. Similarly, the larger the revenues

⁹ See D.12-12-034 at 5.

1 committed to fixed obligation payments, the greater the financial risk exposure to the common
2 stockholders, as they are entitled only to revenues available after all fixed obligation payments
3 are satisfied.

4 A prudent financial manager takes proactive steps to manage and mitigate financial risk.
5 SDG&E’s current risks support its proposed capital structure. As Dr. Morin has discussed, lower
6 financial risks should be used to offset higher business risks.¹⁰ Dr. Morin continues that
7 “SDG&E’s capital structure should be more conservative than that of its peers in order to
8 partially compensate for its higher business risks.”¹¹ He concludes that it “is clear from these
9 multiple perspectives that SDG&E’s 56% common equity ratio is barely adequate given its very
10 high business risks.”¹²

11 The major credit rating agencies likewise commonly employ several key metrics to
12 quantify financial risk, such as funds from operations (“FFO”) as a percent of total debt and debt
13 as a percentage of total capital. Together with their assessment of business risk and regulatory
14 framework, the major credit rating agencies use these financial metrics to determine the credit
15 ratings they assign. Credit metric guidance provided by the credit rating agencies is an
16 invaluable guide to help determine the appropriate use of debt. The Commission has recognized
17 that “maintain[ing] investment-grade creditworthiness” is an “important component[s] of the
18 *Hope* and *Bluefield* decisions.”¹³

¹⁰ Ex. SDG&E-04 (Morin) at 63.

¹¹ *Id.*

¹² *Id.*

¹³ D.12-12-034 at 37 (alteration in original).

1 The FFO-to-Total Debt ratio measures funds from operations as a percent of total debt. It
2 indicates how much of its debt a company could retire with annual cash from operations, where a
3 higher figure indicates a stronger ability to retire its debt, and thus lower financial risk. In its
4 most recent credit opinion¹⁴ of SDG&E, Moody's specified a lower bound adjusted FFO-to-
5 Total Debt ratio of 24% for SDG&E to avoid further downgrades from its current Baa1 rating.
6 Per the same credit opinion, Moody's calculated adjusted FFO-to-Total Debt for SDG&E as of
7 December 2018 of 25%.¹⁵ Therefore, in order for SDG&E to maintain a strong adjusted FFO-to-
8 Total Debt ratio, additional debt issuances to fund the business will need to be countered with a
9 higher equity ratio.

10 In addition to FFO-to-Total Debt metric, credit rating agencies also employ Debt-to-Total
11 Capital in assessing financial risk. Moody's Rating Methodology for Regulated Electric and Gas
12 Utilities¹⁶ explains their approach to assessing credit risk for regulated electric and gas utilities
13 globally. The report provides a detailed rating grid which can be used as a reference tool to
14 approximate credit profiles within the regulated electric and gas sector. Table 4 below replicates
15 Moody's Debt Ratio benchmarks presented in the report.

¹⁴ Moody's Investors Service, Credit Opinion – San Diego Gas and Electric (March 14, 2019) at 1.

¹⁵ *Id.*

¹⁶ Moody's Investors Service, Rating Methodology for Regulated Electric and Gas Utilities (June 23, 2017).

Table 4 – Moody’s Debt Ratio Benchmarks

Bond Rating	Debt / Capital ¹⁷
Aaa	< 25%
Aa	25% - 35%
A	35% - 45%
Baa	45% - 55%
Ba	55% - 65%
B	65% - 75%
Caa	≥75%

Table 4 above suggests that for SDG&E to return to a strong single “A” bond rating, it must maintain a debt ratio in the range of 35%-45%. This is consistent with SDG&E’s actual/proposed debt ratio of 44.00%, and further supports the Commission’s adoption of SDG&E’s actual capital structure as its authorized structure. As Dr. Morin states, “[f]or a single A bond rating, which I consider optimal and cost efficient for ratepayers, the debt ratio range is 35%-45%, implying a common equity ratio range of 55%-65%. The Company’s proposed common equity ratio is almost at the bottom of this range, notwithstanding the fact that its business risk far exceeds that of its peers.”¹⁸ By contrast, debt utilization beyond the levels indicated by the target credit metrics defined above would put downward pressure on SDG&E’s credit rating.

As Messrs. Widjaja and MacNeil describe, SDG&E’s credit profile has recently been degraded several notches and placed on negative watch due primarily to business and regulatory

¹⁷ Ratios shown are for companies that Moody’s has identified to have a standard risk profile.

¹⁸ *Accord Ex. SDG&E-04 (Morin)* at 62.

1 risks – namely concerns that the Company will be unable to recover costs from a catastrophic
2 wildfire due to strict liability from the legal doctrine of inverse condemnation when combined
3 with the Commission’s disparate reasonableness review standard that fails to take that strict
4 liability into account. The Company’s placement on “negative outlook” by credit rating agencies
5 because of the business risks of potentially unrecovered catastrophic wildfires costs will be
6 further exacerbated if the Company takes on additional financial risks, in the form of additional
7 debt to fund its robust capital program and increased debt equivalence related to Power Purchase
8 Agreements (“PPA”) and Resource Adequacy (“RA”) obligations. This additional debt and debt
9 equivalence must be countered with a higher common equity ratio. This is discussed further in
10 the following section of my testimony.

11 **2. SDG&E Faces Increased Financial Risks**

12 **a. Debt Equivalence Related to Power Purchase Agreements**

13 Debt equivalence is a concept used by credit rating agencies to describe the financial risk
14 resulting from signing long-term contracts, such as PPAs. Although PPAs are not reported on a
15 utility’s balance sheet as debt, credit-rating agencies treat the utility’s commitments under PPAs
16 as debt-like financial obligations. Those agencies consider the fixed financial obligations
17 resulting from long-term PPAs to be debt or debt equivalence due to the financial risk inherent in
18 such multi-year contracts. Credit-rating agencies incorporate debt equivalency in their credit
19 analysis.

20 There are various reasons why SDG&E must enter into additional PPAs. When
21 SDG&E’s energy demand exceeds output from its own generation, the Company will procure
22 energy through PPAs with third parties. On February 21, 2019, the Commission voted to
23 approve a three-year forward local RA procurement requirement for all Load Serving Entities
24 (“LSEs”) applicable for the 2020 RA compliance year. RA is a compliance program to ensure

1 LSEs procure sufficient capacity to meet their share of peak load. Capacity is procured through
2 PPAs, ownership of generation resources, or capacity (RA-only) contracts. To increase certainty
3 and stability for necessary resources, the Commission finds an appropriate balance with a 100%
4 procurement requirement for year 1 and 2 and 50% procurement requirement of year 3
5 applicable for the 2020 RA compliance year. This is a significant change from the prior RA
6 procurement requirement which was 100% for year 1 and zero thereafter. In order for SDG&E
7 to comply with the additional RA standards, SDG&E will need to enter into additional PPAs.

8 Additionally, as discussed in Mr. Widjaja’s testimony, the Renewables Portfolio Standard
9 (“RPS”) – referring to the procurement of electricity from renewable sources – has increased in
10 California to 60% of total procurement by 2030, and 100% by 2045.¹⁹ This is one of the most
11 ambitious plans in the country.²⁰ To meet these standards, SDG&E will continue entering into
12 additional long-term PPAs. As renewable PPAs represent a growing component of the
13 Company’s overall energy portfolio, SDG&E expects the corresponding debt equivalence figure
14 to continue to grow for the foreseeable future.

15 Since PPAs represent a growing component of the Company’s overall energy portfolio,
16 these agreements will continue to negatively impact SDG&E’s credit profile and must be
17 appropriately factored into the authorized capital structure.

18

¹⁹ Cal. Pub. Utils. Code § 399.11(a).

²⁰ Lawrence Berkeley National Laboratory, *U.S. Renewables Portfolio Standards, 2017 Annual Status Report* (July 2017), available at <http://eta-publications.lbl.gov/sites/default/files/2017-annual-rps-summary-report.pdf>.

1 The Commission is cognizant of the risks associated with debt equivalence, which are
2 spelled out in detail in a 2017 Report issued by the Commission’s Policy & Planning Division.²¹
3 As the Commission has recognized, debt equivalence impacts utility credit ratings and must be
4 balanced in both the adopted capital structures and ROEs.²² SDG&E’s proposed capital structure
5 and ROE are intended to comprehensively manage the impact of these circumstances and should
6 therefore be considered reasonable.

7 **b. Negative Impact from Tax Reform**

8 The Tax Cuts and Jobs Act (“TCJA”) of 2017 will also likely have a negative impact on
9 utility credit ratings. As S&P explains:

10 The impact of tax reform on utilities is likely to be negative to varying degrees
11 depending on a company’s tax position going into 2018, how its regulators react,
12 and how the company reacts in turn. It is negative for credit quality because the
13 combination of a lower tax rate and the loss of stimulus provisions related to
14 bonus depreciation or full expensing of capital spending will create headwinds in
15 operating cash-flow generation capabilities as customer rates are lowered in
16 response to the new tax code...Regulators must also recognize that tax reform is a
17 strain on utility credit quality and we expect companies to request stronger capital
18 structures and other means to offset some of the negative impact.²³

19 For the first time in its history, Moody’s downgraded the outlook on the U.S. regulated
20 utility sector to “negative,” citing lower cash flows and higher debt levels as federal tax reform

²¹ California Public Utilities Commission, *An Introduction to Debt Equivalency* (August 4, 2017),
available at
[http://www.cpuc.ca.gov/uploadedfiles/cpuc_public_website/content/about_us/organization/divisions/policy_and_planning/ppd_work/ppd_work_products_\(2014_forward\)/ppd%20-%20intro%20to%20debt%20equivalency\(1\).pdf](http://www.cpuc.ca.gov/uploadedfiles/cpuc_public_website/content/about_us/organization/divisions/policy_and_planning/ppd_work/ppd_work_products_(2014_forward)/ppd%20-%20intro%20to%20debt%20equivalency(1).pdf).

²² D.12-12-034 at 29 (The Commission’s goal in considering debt equivalence is to “provide reasonable confidence in the utilities’ financial soundness, to maintain and support investment-grade credit ratings, and provide utilities the ability to raise money necessary for the proper discharge of their public duty.”).

²³ S&P Global Ratings, U.S. Tax Reform: For Utilities’ Credit Quality, Challenges Abound (January 24, 2018) at 5.

1 and increased capital spending continued to weigh on the sector.²⁴ This follows a January 2018
2 downgrade by Moody's of the ratings outlook on 25 U.S. utilities, which cited weaker cash flows
3 due to tax reform. Moody's stated the following:

4 Tax reform is credit negative for US regulated utilities because the lower 21%
5 statutory tax rate reduces cash collected from customers, while the bonus
6 depreciation reduces tax deferrals, all else being equal. Moody's calculates that
7 the recent changes in tax laws will dilute a utility's ratio of cash flow before
8 changes in working capital to debt by approximately 150-250 basis points on
9 average, depending to some extent on the size of the company's capital
10 expenditure programs. From a leverage perspective, Moody's estimates that debt
11 to total capitalization ratios will increase, based on the lower value of deferred tax
12 liabilities.²⁵

13 Generally, less cashflow from customer rates will result in lower credit ratios and
14 potentially lower credit metrics. Overall, the negative impact of the TCJA from a cash flow
15 perspective is a reduction in revenue requirement, with no reduction in the cost of both equity
16 and debt capital. Allowing the utility a higher equity ratio helps restore some of that lost cash
17 flow. This industry-wide impact further necessitates SDG&E's proposed capital structure to
18 offset the loss of certain benefits, such as bonus depreciation, and less cashflow from customer
19 rates.

20 c. Elevated Levels of Capital Investment

21 As filed in our 2019 General Rate Case ("GRC")²⁶ and the Wildfire Risk Mitigation
22 Plan,²⁷ SDG&E has proposed significant capital investments to support modernizing

²⁴ Moody's Investors Service, Regulated Utilities – US, 2019 Outlook Shifts to Negative Due to Weaker Cash Flows, Continued High Leverage (June 18, 2018) at 1.

²⁵ Moody's Investors Service, Moody's Changes Outlook on 25 Regulated Utilities Primarily Impacted by Tax Reform (January 19, 2018) at 1.

²⁶ See Application ("A.") 17-10-007.

²⁷ See Rulemaking ("R.") 18-10-007, San Diego Gas & Electric Company's Wildfire Mitigation Plan (February 6, 2019).

1 transmission and distribution infrastructure, along with fire hardening measures to protect against
2 extreme weather events and support public safety. These investments support the State’s energy
3 and environmental policies, such as reducing greenhouse gas emissions, enabling access to
4 renewable energy, and reinforcing SDG&E’s commitment to provide safe and reliable service to
5 its customers.

6 Furthermore, Calpine has exercised its put option that requires SDG&E to purchase Otay
7 Mesa Energy Center (“OMEC”), a 605 MW power plant, for \$280 million, subject to
8 adjustments, on or before October 3, 2019.²⁸ This elevated level of capital investment will
9 require substantial funding, both internally and externally. SDG&E may fund its capital
10 investments through a combination of debt issuances, internally generated cash flow, and
11 retained earnings by suspending its dividend payments. The elevated level of capital investment
12 will create additional financial risk if funded at the Company’s current authorized capital
13 structure. Therefore, SDG&E recommends that its proposed capital structure be adopted so that
14 SDG&E has ready access to capital at a reasonable cost to fund its robust capital investment
15 program.

16 In short, a higher equity ratio is necessary to mitigate the increased investment risks
17 SDG&E faces and prevent further downgrades in its credit rating. SDG&E believes that its
18 actual capital structure reflects a prudent policy to manage debt levels so that SDG&E remains at

²⁸ In October 2018, SDG&E and OMEC LLC signed a resource adequacy capacity agreement for a term that would commence at the expiration of the current tolling agreement in October 2019 and end in August 2024, under which Calpine would not exercise the put option as part of the agreement. However, the agreement was contingent upon receiving final and non-appealable approval from the CPUC before the expiration of the put option on April 1, 2019. *See* Resolution E-4981. In March 2019, Protect Our Communities (“POC”) filed a request with the CPUC to rehear its resolution which approved the agreement. As a result, Calpine has exercised its put option requiring SDG&E to purchase the plant. *See* R.01-10-024.

1 investment-grade credit levels, protecting against short-term fluctuations and disruptions to
2 credit markets and the business environment. SDG&E recommends that the Commission realign
3 the capital structure by increasing the common equity ratio to reflect its actual capital structure
4 and help lower financial risks, thus mitigating the credit rating agencies' belief that SDG&E is
5 now a riskier investment.

6 **IV. EMBEDDED COST OF DEBT AND PREFERRED STOCK RECOMMENDATIONS**

7 The embedded cost of debt represents all the costs associated with the issuance and
8 servicing of debt, expressed as a percentage of the net proceeds received from debt issuances.

9 The embedded cost of preferred stock represents all the costs associated with the issuance and
10 servicing of that stock, expressed as a percentage of the net proceeds received from preferred
11 stock issuances. Table 5 below summarizes the currently authorized and the forecasted
12 embedded costs of long-term debt and preferred stock for SDG&E.

13 **Table 5 – Embedded Cost of Debt and Preferred Stock**

	Current Authorized	2020 Forecast
Long-Term Debt	4.59%	4.59%
Preferred Stock	6.22%	0.00%

14 SDG&E's forecasted embedded cost of long-term debt is 4.59%. This represents no
15 change in the Company's currently authorized amount.²⁹ This forecast accounts for \$2 billion of
16 low interest long-term debt that SDG&E has issued since the last COC proceeding was
17 conducted in 2012. Consistent with previous COC proceedings, SDG&E recommends setting
18 the authorized cost of debt equal to the forecasted embedded cost of debt during Test Year 2020.
19

²⁹ The derivation of this figure is contained in Appendix A.

1 As a result of the Company's robust capital investment program discussed above, the
2 Company plans to raise \$675 million in 2019 and \$600 million in 2020 of new long-term debt.

3 The embedded cost of debt calculations use the March 2019 IHS Markit Global Insight
4 forecast of the 30-year Treasury bond yield for 2019 and 2020, plus a forecast of the SDG&E-
5 specific credit spread of 1.51%. This is the current trading level of SDG&E's most recently
6 issued 30-year bond of 131 basis points, plus a new issuance concession of 20 basis points.³⁰

7 As explained above, SDG&E no longer uses preferred stock as a source of financing.
8 SDG&E redeemed all issued and outstanding shares of its preferred stock in 2013 and does not
9 anticipate issuing any preferred stock in the foreseeable future, as reflected in its actual capital
10 structure. As such, SDG&E puts forth an embedded cost of preferred stock of 0%.

11 Historically, the Commission has directed that "[t]he latest available interest rate forecast
12 should be used to determine embedded long-term debt and preferred stock costs in ROE
13 proceedings."³¹ Accordingly, during the course of this proceeding, SDG&E will submit an
14 embedded cost update that will reflect the latest IHS Markit Global Insight forecast, as well as
15 any changes to the Company's debt forecast that may take place between the preparation of this
16 testimony and the submittal of the update.

17 **V. CUSTOMER DEPOSITS**

18 Customer Deposits are funds collected from customers for security against non-payment
19 that will be returned to those same customers or used as a credit against their bills in the event of
20 non-payment. SDG&E pays interest at the Federal Reserve published prime non-financial 3-
21 month commercial paper rate on these balances.

³⁰ New issue concession is the difference between the spread at which new bonds are issued and the spread at which corresponding bonds of the same issuer are traded in the secondary market.

³¹ D.07-12-049 at 56, Conclusion of Law 33.

1 Consistent with SDG&E’s position in its GRC proceeding,³² Customer Deposits should
2 continue to be excluded from working cash, consistent with CPUC Standard Practice (“SP”) U-
3 16, which provides that interest-bearing accounts are excluded from working cash.³³

4 The Commission has stated its preference for consistency under SP U-16, noting that “we
5 presume that ratemaking treatment consistent with SP U-16 should be deemed reasonable,
6 especially where there are no special circumstances that justify a deviation.”³⁴ SDG&E has
7 always treated Customer Deposits as interest-bearing accounts that are excluded from working
8 cash; an approach that has been accepted in prior SDG&E GRC proceedings. As there are no
9 such special circumstances here, there is no need to make changes to SDG&E’s long-standing
10 treatment. Including ratepayer money (Customer Deposits) in working cash would be
11 inconsistent with the fact that substantially larger amounts of shareholder-provided balances such
12 as net balancing account under collections that receive the same interest rate are excluded from
13 working cash and rate base. There is no logical reason to exclude one interest-bearing account
14 (Customer Deposits) from SP U-16’s application without also providing the same treatment for
15 other interest-bearing accounts.

16 Moreover, because Customer Deposits are monies returned to customers, it is not
17 appropriate to be treated as a source of long-term financing. Long-term financing provides a
18 static, dependable source of funds with known maturity dates. By contrast, the Customer
19 Deposit balance can increase or decrease, depending upon the economy and building demand.

³² A.17-10-007, Reply Brief of Southern California Gas Company and San Diego Gas & Electric Company in the Test Year 2019 General Rate Case (October 12, 2018) at 427.

³³ California Public Utilities Commission, Determination of Working Cash Allowance, Standard Practice U-16 at 1-8 (“This account represents monies advanced by the customer as security for the payment of utility bills. Only noninterest-bearing customer deposits are to be considered.”).

³⁴ D.14-08-032 at 628.

1 These balances are not permanent in nature and thus lack the same characteristics as long-term
2 financing.

3 Financial principles also provide that short-term assets should be financed with short-
4 term liabilities and long-term assets should be financed with long-term liabilities. Customer
5 Deposits are short-term and refunded after 12 months. Therefore, Customer Deposits should not
6 be used to finance long-term assets, such as rate base assets, and should not be treated as a source
7 of long-term financing.

8 Moreover, the Commission has stated that “balancing accounts and customer deposits
9 should both earn the short term debt rate.”³⁵ Since the Commission has stated that customer
10 deposits should earn a short-term debt rate, the Commission has effectively distinguished this
11 short-term liability from long-term liabilities, which receive long-term rates of return.

12 Based on the foregoing, Customer Deposits should continue to be excluded from the
13 Company’s working cash, consistent with SP U-16.

14 **VI. CONCLUSION**

15 SDG&E seeks a Test Year 2020 authorized capital structure of 56% equity, 44% long-
16 term debt, and 0% preferred stock. The proposed capital structure reflects SDG&E’s actual
17 capital structure and the increase in the equity ratio is necessary to mitigate financial risk.

18 SDG&E also seeks a Test Year 2020 embedded cost of debt and preferred stock of 4.59%
19 and 0%, respectively. These reflect the forecasted embedded costs for the 2020 test year.

20 SDG&E’s proposals put forth herein are reasonable and should be adopted.

21 In addition, Customer Deposits should continue to be excluded from working cash
22 because these accounts are interest-bearing, consistent with SP U-16. Also, these deposits

³⁵ *Id.* at 630.

1 | should not be treated as a source of long-term financing because they lack the characteristics of
2 | permanent financing sources.

3 | SDG&E respectfully requests the Commission adopts these recommendations beginning
4 | for the 2020 test year.

5 | This concludes my prepared direct testimony.

1 **VII. STATEMENT OF QUALIFICATIONS**

2 My name is Maritza Mekitarian. I am employed by SDG&E as the Financial and
3 Business Planning Manager. My business address is 8330 Century Park Court, San Diego,
4 California 92123.

5 I received a Bachelor of Science in Business Administration with Accounting emphasis
6 from San Diego State University and am a Certified Public Accountant in the state of California.
7 I have been employed by SDG&E and Sempra Energy since 2000. In addition to my current
8 position, I have held various Accounting and Finance positions within the organization,
9 including Financial Accounting Manager and Capital Planning & Analysis Manager.

10 In my current role, I am responsible for the development of SDG&E's financial plan and
11 numerous treasury related functions.

12 I have not previously testified before this Commission.

Appendix A

SDG&E Embedded Cost of Debt Test Year 2020

Appendix A
San Diego Gas & Electric Company
Embedded Cost of Debt
Test Year 2020
(in Thousands)

Line Number	Description	A Principal	B Total Discount and Expense	C Net Proceeds (A - B)	D Annual Interest Payment	E Total Amortization	F Effective Rate [(D + E) ÷ C]
1	SERIES VV (CV2004A)	43,615	1,509	42,106	2,562	51	
2	SERIES WW (CV2004B)	40,000	1,385	38,615	2,350	47	
3	SERIES XX (CV2004C)	35,000	1,213	33,787	2,056	41	
4	SERIES YY (CV2004D)	24,000	832	23,168	1,410	28	
5	SERIES ZZ (CV2004E)	33,650	1,166	32,484	1,977	40	
6	SERIES AAA (CV2004F)	75,000	3,089	71,911	3,000	89	
7	SERIES BBB	250,000	3,005	246,995	13,375	100	
8	SERIES DDD	250,000	3,547	246,454	15,000	177	
9	SERIES FFF	250,000	3,336	246,664	15,313	111	
10	SERIES GGG	300,000	4,438	295,562	18,000	148	
11	SERIES HHH	250,000	2,822	247,178	13,375	94	
12	SERIES III	500,000	10,559	489,441	22,500	352	
13	SERIES JJJ	350,000	4,571	345,429	10,500	457	
14	SERIES LLL	250,000	2,990	247,010	9,875	100	
15	SERIES MMM	250,000	3,867	246,133	10,750	129	
16	SERIES NNN	450,000	3,742	446,258	16,200	376	
17	SERIES PPP	48,469	665	47,804	928	97	
18	SERIES QQQ	500,000	5,904	494,096	12,500	590	
19	SERIES RRR	400,000	5,822	394,178	15,000	194	
20	SERIES SSS	400,000	5,838	394,162	16,600	195	
21	Amortization of call premiums	-	3,281	(3,281)	-	1,665	
22	First mortgage bonds	4,699,734	73,583	4,626,151	203,271	5,080	4.50%
23	Amortization of call premiums	-	560	(560)	-	257	
24	Unsecured bonds	-	560	(560)	-	257	
25	Other expense and amortization	-	-	-	375	-	
26	December 31, 2018 total long-term debt	4,699,734	74,144	4,625,590	203,646	5,337	4.52%
27	Change in interest and amortization in 2019	-	(1,084)	1,084	241	(302)	-
28	Forecasted debt to be issued in 2019:	675,000	7,287	667,713	31,500	243	-
29	December 31, 2019 total long-term debt	5,374,734	80,346	5,294,388	235,387	5,277	4.55%
30	Change in interest and amortization in 2020	-	(838)	838	120	(403)	-
31	Forecasted debt to be issued in 2020:	600,000	6,542	593,458	29,575	218	-
32	December 31, 2020 total long-term debt	5,974,734	86,050	5,888,684	265,082	5,092	4.59%
33	Forecasted 2020 Embedded Cost of Long-Term Debt						4.59%

San Diego Gas & Electric Company
Issuance Cost Summary
Taxable First Mortgage Bonds
(in Dollars)

30 Year Bond Issuance	2019	2020
Principal issued	675,000,000	600,000,000
Up-front issuance fees		
Underwriter ⁽¹⁾	5,906,250	5,250,000
Legal	203,970	208,333
Printing	16,318	16,667
Rating agency ⁽²⁾	891,000	792,000
Trustee	28,352	28,958
Auditor	45,883	46,865
CPUC	149,804	153,008
SEC	45,200	46,167
Total up-front cost	<u>7,286,776</u>	<u>6,541,998</u>

(1) Based on 87.5 basis points of principal issued

(2) Based on 13.2 basis points of principal issued

**San Diego Gas & Electric Company
Proposed Debt Capital Markets Issuance
2019 & 2020 Projected Activity**

SDG&E Issued Bond Trading Spread ⁽¹⁾	1.31%
New Issuance Concession	0.20%
Indicative New Issuance Credit Spread	<u>1.51%</u>
2019 Issue Year	
Global Insight Treasury Forecast - March 2019	<u>3.16%</u>
Estimated Coupon	<u>4.67%</u>
2020 Issue Year	
Global Insight Treasury Forecast - March 2019	<u>3.42%</u>
Estimated Coupon	<u>4.93%</u>

(1) Pricing information for Series SSS as of 4/2/2019. During the course of this proceeding, SDG&E will submit an update with the most recent market data.

Appendix B

Response to D.17-07-005, Questions 4 and 5

Appendix B

Response to D.17-07-005, Questions 4 and 5

Question 4.

How has the utility's recorded capital structure changed since the 2013 Cost of Capital application? How has the recorded capital structure compared to authorized capital structure over this time period? D.17-07-005 at 12.

Response.

Since 2013, SDG&E's average recorded (actual) capital structure has been more heavily weighted towards common equity than its authorized structure. *See* page 5 and table 3 of this testimony.

Question 5.

How does the utility's current capital structure compare to other utilities nationally and to other California utilities? Include separate comparisons for vertically integrated and non-vertically integrated utilities. D.17-07-005 at 12.

Response.

SDG&E used the proxy group identified in Dr. Morin's testimony (Ex. SDG&E-04) to represent the non-California utilities proxy group. The California utilities proxy group was obtained from the California Board of Equalization 2018 Capitalization Rate Study. From this group we excluded Pacific Gas and Electric Company, Southern California Edison Company, private companies, and companies that operate primarily outside of California.

As shown in the tables below, the non-California utility average authorized common equity percentages for vertically and non-vertically integrated companies in the proxy group is 51% and 50.5%, respectively. In comparison to the authorized amounts, the recorded common equity percentages for vertically and non-vertically integrated non-California utilities is 53.1% and 51.6%, respectively.

Current Authorized and 2018 Recorded Capital Structure of Proxy Group (Vertically Integrated) ⁽¹⁾

No.	Parent Company and Operating Utilities ⁽²⁾	State(s)	Authorized Common Equity Ratio ⁽³⁾	Recorded Common Equity Ratio ⁽⁴⁾	Vertically Integrated (Y/N)
1	Alliant Energy: Interstate Power and Light Company Wisconsin Power and Light Company	IA	49.0% ⁽⁵⁾	52.4%	Y
		WI	52.0%	53.9%	Y
2	Ameren Corp.: Union Electric Company / Ameren Missouri	MO	51.8%	52.1%	Y
3	Black Hills: Black Hills Colorado Electric, Inc. Black Hills Power Inc. / Black Hills Energy South Dakota Cheyenne Light, Fuel and Power Company	CO	52.4%	53.0%	Y
		SD, WY, MT	53.3%	54.3%	Y
		WY	54.0%	53.0%	Y
4	CMS Energy Corp.: Consumers Energy Company	MI	40.9%	50.1%	Y
5	Consolidated Edison Inc.: Consolidated Edison Company of New York, Inc.	NY	48.0%	47.7%	Y
6	Dominion Energy: Virginia Electric and Power Company / Dominion Energy Virginia	VA, NC	51.4%	52.8%	Y
7	DTE Energy: DTE Electric Company	MI	50.0% ⁽⁶⁾	51.0%	Y
8	Duke Energy: Duke Energy Carolinas, LLC Duke Energy Florida, LLC Duke Energy Indiana, LLC Duke Energy Ohio, Inc. ⁽⁸⁾ Duke Energy Progress, LLC	NC, SC	52.5% ⁽⁷⁾	51.6%	Y
		FL	46.7%	45.4%	Y
		IN	44.4%	53.4%	Y
		OH, KY	50.8% ⁽⁹⁾	61.4%	Y
		NC, SC	52.5% ⁽⁷⁾	50.7%	Y
9	Eversource Energy: NSTAR Electric Company ⁽¹⁰⁾	MA	53.3%	55.5%	Y
10	Fortis: Tucson Electric Power Company UNS Electric, Inc.	AZ	50.0%	53.0%	Y
		AZ	52.8%	55.5%	Y
11	MGE Energy: Madison Gas and Electric Company	WI	56.1%	52.4%	Y
12	NorthWestern Corp.: NorthWestern Energy	SD, MT, NE	48.0% ⁽¹¹⁾	48.0%	Y
13	Public Service Enterprise: Public Service Electric and Gas Company	NJ	54.0%	54.3%	Y
14	WEC Energy Group: Upper Michigan Energy Resources Corporation Wisconsin Electric Power Company / We Energies Wisconsin Public Service Corporation	MI	50.5%	54.5%	Y
		WI, MI	51.9%	55.8%	Y
		WI	50.5%	57.4%	Y
15	Xcel Energy Inc.: Northern States Power Company - MN Northern States Power Company - WI Public Service Company of Colorado Southwestern Public Service Company	MN, ND, SD	52.5%	53.0%	Y
		WI, MI	51.5%	53.9%	Y
		CO	56.0% ⁽¹²⁾	55.8%	Y
		TX, NM	51.0%	54.4%	Y
Average			51.0%	53.1%	Y

⁽¹⁾ Preferred stock is a minimal component of the capital structure of the proxy group so only the common equity component is shown

⁽²⁾ Selection of electric and electric and gas operating utilities based on Parent company proxy group from Dr. Morin's ROE testimony (Exhibit RAM-3) excluding Sempra

⁽³⁾ Authorized common equity ratio per S&P Global unless otherwise noted

⁽⁴⁾ 2018 recorded common equity ratio based on 2018 10-K or most recently filed 2018 FERC Form 3-Q. Total capitalization excludes short-term debt and capital leases

⁽⁵⁾ This is the authorized common equity ratio for the company's retail electric operations. The authorized common equity ratio for the company's gas operations is 51.0%

⁽⁶⁾ Authorized common equity ratio per U-18255

⁽⁷⁾ Average authorized common equity ratio in NC and SC

⁽⁸⁾ Includes Duke Energy Kentucky, Inc. which has an authorized common equity ratio of 49.3% and 50.8% for its electric and gas operations, respectively, and operates in KY

⁽⁹⁾ This is the authorized common equity ratio for the company's electric operations. The authorized common equity ratio for the company's gas operations is 53.3%

⁽¹⁰⁾ Includes Western Massachusetts Electric Company which has an authorized common equity ratio of 54.5% and operates in MA

⁽¹¹⁾ This is the authorized common equity ratio for the company's electric delivery operations. The authorized common equity ratio for the company's gas operations is 46.8%

⁽¹²⁾ This is the authorized common equity ratio for the company's electric operations. The authorized common equity ratio for the company's gas operations is 54.6%

Current Authorized and 2018 Recorded Capital Structure of Proxy Group (Non-Vertically Integrated) ⁽¹⁾

No.	Parent Company and Operating Utilities ⁽²⁾	State(s)	Authorized Common Equity Ratio ⁽³⁾	Recorded Common Equity Ratio ⁽⁴⁾	Vertically Integrated (Y/N)
1	Ameren Corp.: Ameren Illinois Company	IL	50.0%	52.5%	N
2	Consolidated Edison Inc.: Orange and Rockland Utilities, Inc. ⁽⁵⁾	NY, NJ	48.0%	48.5%	N
3	Eversource Energy: Connecticut Light and Power Company Public Service Company of New Hampshire	CT NH	53.0% 52.4%	55.5% 47.5%	N N
4	Exelon Corp: Atlantic City Electric Company Baltimore Gas and Electric Company Commonwealth Edison Company Delmarva Power & Light Company PECO Energy Company Potomac Electric Power Company	NJ MD IL DE, MD PA DC, MD	50.5% 51.9% 47.1% 50.5% 53.4% 50.4%	48.7% 53.8% 55.2% 50.2% 53.9% 50.3%	N N N N N N
5	Fortis: Central Hudson Gas & Electric Corporation	NY	48.0%	51.0%	N
Average			50.5%	51.6%	N

⁽¹⁾ Preferred stock is a minimal component of the capital structure of the proxy group so only the common equity component is shown

⁽²⁾ Selection of electric and electric and gas operating utilities based on Parent company proxy group from Dr. Morin's ROE testimony (Exhibit RAM-3) excluding Sempra

⁽³⁾ Authorized common equity ratio per S&P Global

⁽⁴⁾ 2018 recorded common equity ratio based on 2018 10-K or most recently filed 2018 FERC Form 3-Q. Total capitalization excludes short-term debt and capital leases

⁽⁵⁾ Includes Rockland Electric Company which has an authorized common equity ratio of 49.7% and operates in NJ

As shown in the table below, the California utility average authorized and recorded common equity percentage is 53.5% and 54.6%, respectively. 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 risk, including from the application of the legal doctrine of inverse condemnation to wildfire liabilities. These increased business and regulatory risk can be partially mitigated by strengthening SDG&E's balance sheet via a higher common equity percentage.

Current Authorized and 2018 Recorded Capital Structure of California Utilities ⁽¹⁾

No.	Parent Company and Operating Utilities ⁽²⁾	State(s)	Authorized Common Equity Ratio ⁽³⁾	Recorded Common Equity Ratio ⁽⁴⁾	Vertically Integrated (Y/N)
1	American States Water Company: Golden State Water Company	CA	55.0%	61.0%	Y
2	PPW Holdings LLC: PacifiCorp	CA, ID, OR, UT, WA, WY	52.0%	52.8%	Y
3	Sempra Energy: Southern California Gas Company	CA	52.0%	54.9% ⁽⁵⁾	N
4	Southwest Gas Holdings Inc.: Southwest Gas Corporation	AZ, CA, NV	55.0%	49.5%	N
Average			53.5%	54.6%	

⁽¹⁾ Preferred stock is a minimal component of the capital structure of these companies so only the common equity component is shown

⁽²⁾ Selection based on gas, electric, and water companies per the California Board of Equalization 2018 Capitalization Rate Study (page 1); excludes SCE, PG&E, private companies, and companies that operate primarily outside of California

⁽³⁾ Authorized common equity per the California Board of Equalization 2018 Capitalization Rate Study (page 1)

⁽⁴⁾ 2018 recorded common equity ratio based on 2018 10-K unless otherwise noted. Total capitalization excludes short-term debt and capital leases

⁽⁵⁾ This represents the company's actual ratemaking common equity ratio