Application: A.22-04-XXX
Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2023 Cost of Capital
Exhibit: SDG&E-05

PREPARED DIRECT TESTIMONY OF

PATRICK BILLINGS - COST OF CAPITAL MECHANISM

ON BEHALF OF

SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

April 20, 2022

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I. INTRODUCTION

My testimony addresses San Diego Gas & Electric Company's ("SDG&E" or "Company") current Cost of Capital Mechanism ("CCM") and proposes that the California Public Utilities Commission ("Commission") continue the current CCM, combined with SDG&E's right to file an application in lieu of the CCM, with three enhancements to the CCM to provide greater clarity and improved efficiency in the interpretation and application of that mechanism. Consistent with SDG&E filing a test year ("TY") 2023 cost of capital ("COC") application, SDG&E proposes that the CCM should be reset for a new three-year cycle, with the next cost of capital application due in April 2025 for a TY 2026 cost of capital.

The current CCM—providing for the interim assessment of SDG&E's cost of capital either through the CCM or SDG&E's right under Decision ("D.") 08-05-035 to file an application in lieu of the CCM in applicable circumstances—with the three proposed enhancements to the adjustment mechanism, should continue to be the basis for return on equity ("ROE") and rate of return ("ROR") assessments between Cost of Capital proceedings. Those enhancements are as follows:

- Apply a utility's median credit rating to choose the applicable Moody's utilities index when a utility has split ratings;
- Allow a utility to change the applicable index when the utility's credit ratings change during CCM years; and
- Specify the CCM Benchmark index and rate applicable for each applicant in the Commission's final decision and what index applies at the time of the decision.

SDG&E has encountered each of these circumstances during the 2020-2022 cost of capital cycle, creating uncertainty as to how the Company should handle these situations. Providing clarification on these three points will improve the CCM process moving forward.

II. CURRENT CCM

A. The CCM's Adoption

Under the CCM, the California energy utilities are required to file Cost of Capital applications every three years. Energy utilities' rate of return components was traditionally addressed in their respective general rate cases.[1] But beginning in 1990, the Commission adjudicated SDG&E's cost of capital on an annual basis.

In 1996, SDG&E was relieved of its requirement to file annual applications, while still having its cost of capital reviewed annually, upon the "adoption of the Market Indexed Capital Adjustment Mechanism ("MICAM")."[2] Although it underwent several modifications, in the last iteration, SDG&E was required to file a complete cost of capital application every five years, with the MICAM applying in the intervening years to assess SDG&E's cost of capital.[3] Under the MICAM, if the difference between the six-month average Aa bond rate and SDG&E's benchmark rate exceeded an off-ramp of 260-basis points, SDG&E had to file a complete cost of capital application in May following that off-ramp event.[4]

In 2008, the Commission adopted the CCM for SDG&E, Southern California Edison Company ("Edison"), and Pacific Gas and Electric Company ("PG&E").[5] In 2013, the

[1] D.08-05-035 at 2.

[2] *Id.* at 2 (citing 66 CPUC 2d 568 at 573 (1996)).

[3] D.08-05-035 at 2 (citing D.05-03-023).

[4] D.08-05-035 at 2 (Off-ramp is a trigger event that suspends the MICAM.).

[5] D.13-03-015 at 2.

Commission reaffirmed the CCM for SDGE, PG&E, and Edison, and applied it to Southern California Gas Company ("SoCalGas").[6] The CCM was subsequently continued in 2017 and 2019.[7]

The CCM assesses changes in the cost of capital ROE solely "based on interest rate changes."[8] The CCM seeks to "streamline" cost of capital applications and reduce the frequency of filings from the default of annual applications,[9] while maintaining "fair and reasonable" ROEs[10] in the intervening years under the premise that changes in interest rates reflect changes in the cost of equity. As the Commission found, the "purpose of an interest rate benchmark is to gauge changes in interest rates *that also indicate changes* in the equity costs of utilities."[11]

Specifically, the CCM ties changes in utility bond rates to changes in ROE, measured under a Moody's utility bond index that is chosen based upon a utility's credit rating (A index for utilities rated better than BBB+, Baa index for BBB+ and lower).[12] The applicable Moody's utility bond index rate yearly average as of September 30 in the year prior to a cost of capital decision is set as the benchmark rate. The benchmark is then compared annually to the 12-month October through September average of the index.[13] In any year where it is determined that the

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[6] *See id.* at 5.

[7] *See* D.19-12-056 at 45 (the "existing CCM shall remain in place for the four applicants in this proceeding"); D.17-07-005 at 5 (setting the CCM to operate in 2018 after accepting a proposed suspension of the mechanism in 2017).

[8] D.08-05-035 at 14.

[9] *See id.* at 7, 16.

[10] *Id.* at 3.

[11] *Id.*, Finding of Fact ("FoF") 16 at 18 (emphasis added).

[12] D.13-03-015 at 2.

[13] *Id.*

CCM should apply and the difference between the current 12-month October through September average of the applicable index exceeds 100 points from the benchmark the CCM "triggers." A utility is required to update long-term debt and preferred equity costs and adjust ROE by one-half of the difference between the benchmark and the current average of the Moody's index rates, effective January 1 of the following year.[14]

Alternatively, the Commission provides that, in lieu of the CCM applying, "utilities have a right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and affects them differently than the overall financial markets."[15]

B. Mechanics of the Current Cost of Capital Mechanism

As noted, the CCM ties ROE to changes in interest rates. It consists of: (1) a benchmark rate; and (2) a deviation range or "dead band" from that benchmark. That dead band determines what amount of movement in bond index rates will trigger the mechanism.

More specifically, the CCM's adjustment mechanism features:

- the most recently adopted authorized capital structure and embedded costs for long-term debt and preferred stock;
- the benchmark index rate as Moody's Utilities Bond Index, based on the utility's credit ratings (for SDG&E, it falls under the Moody's "Baa" Bond Utilities Index);
- a benchmark interest rate representing either: (a) the October through September average of the applicable Moody's Utilities Bond Index from the Test Year ("TY") of the most recently adopted Cost of Capital; or (b) the October through September average following a triggering event and corresponding effective date of an automatic adjustment to the authorized Cost of Capital structure;

[14] D.08-05-035 at 15.

[15] *Id.* at 16 and Conclusion of Law ("CoL") 6 at 19; *accord* D.13-03-015 at 7 (finding that "utilities continue to have the right" to file outside of the CCM if meeting the applicable standard).

- a 100-basis point dead band whereby within plus or minus 100 basis points from the benchmark interest rate, the mechanism will not trigger; and

- an adjustment ratio of 50 percent (*i.e.*, if there is a triggering event and corresponding adjustment to ROE, the ROE will be adjusted by half of the difference between Moody's Utility Bond Index and the benchmark interest rate.).[16]

If the CCM's adjustment mechanism triggers, SDG&E provides notice that the CCM has triggered for the October-September period through an October 15 advice letter filing. If it is determined that the adjustment should be implemented, the adjustment to the authorized ROE—and update of the embedded costs of long-term debt and preferred stock—will result in a revised authorized rate of return to be effective January 1 of the following year.

After triggering to adjust the rate of return, the CCM continues to operate if applicable for that year, with a revised benchmark interest rate equal to the 12-month (October to September) average interest rate that caused the CCM's adjustment mechanism to trigger. The triggering of the adjustment mechanism does not adjust a utility's authorized capital structure (*i.e.*, the ratios).

As noted, since the CCM's adoption in 2008, the Commission alternatively provides that, instead of the CCM applying, a utility has the "right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and impacts it differently than the overall financial markets."[17] This is consistent with the fact that the CCM is a mechanism to relieve the default rule for an annual cost of capital application under D.89-01-040 and the Commission's

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[16] *See* D.08-05-035 at 15.

[17] *Id.* at 16 and COL 6 at 19.

seeming recognition that changes in interest rates will not always reflect changes in the cost of equity. The Commission then adjudicates that application.

III. SDG&E SUPPORTS CONTINUING THE CCM, COMBINED WITH SDG&E's RIGHT TO FILE AN APPLICATION, WITH THREE TECHNICAL ENHANCEMENTS

SDG&E believes that the CCM has largely accomplished the goal of streamlining cost of capital proceedings and maintaining fair and reasonable rates of return when changes in interest rates reflect changes in the cost of equity, while retaining SDG&E's right to file an application instead of the CCM applying when changes in interest rates do not reflect changes in the cost of equity, due to an extraordinary event materially impacting and affecting differently utilities' cost of capital compared to the overall markets. SDG&E agrees with the Commission that when the CCM functions properly, combined with SDG&E's right to file an application under applicable circumstances it: 1) effectively balances the interests of ratepayers and shareholders; 2) reduces the workload requirements and regulatory costs associated with Cost of Capital proceedings; and 3) retains a method to file a cost of capital application in lieu of the CCM applying, as the Commission originally intended in instituting a separate, annual cost of capital proceeding. The CCM process also is viewed positively by various market participants, including rating agencies, in addition to regulatory stakeholders.

SDG&E thus supports the continuation of the CCM combined with SDG&E's right to file an application. With SDG&E filing a TY 2023 cost of capital application, the CCM should be reset for a new three-year cycle, with the next cost of capital application due in April 2025 for a TY 2026 cost of capital. Consistent with prior decisions, the CCM's benchmark for the next cycle should be set on September 30 of the year prior to the test year; here September 30, 2022.[18]

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[18] *See id.* at 16.

Yet SDG&E requests the following three technical enhancements to the CCM's operation to address issues that have arisen for SDG&E during this current CCM cycle.

1. the selection of a CCM benchmark rate index when the utility has split ratings;
2. the approach when SDG&E's credit ratings change during CCM years; and
3. specification of the CCM Benchmark index and rate applicable for each applicant in the Commission's final decision and what index applies at the time of the decision.

SDG&E acknowledges that it proposed several of these enhancements in the 2019 cost of capital application—with the Commission noting their potential merit but declining to adopt those modifications at that time.[19] Yet SDG&E believes these enhancements are even more relevant now; because, as noted, several of these circumstances have arisen for SDG&E during this COC cycle.

A. Specify How to Handle Split Credit Ratings

The applicable CCM index is based on the credit ratings of the utility. But the Commission has never specified what credit rating applies if a utility has different credit ratings from Moody's, S&P, and Fitch. SDG&E currently is split rated with Moody's (A3) one notch higher than S&P and Fitch (BBB+). Moody's rating would qualify SDG&E for the A benchmark rate index, while the S&P and Fitch ratings would qualify SDG&E for the Baa index. It is thus unclear what index would apply to SDG&E under the CCM as defined today.

The Commission should thus address what index applies if a utility faces split ratings. SDG&E proposes that, in the event of split ratings where not all agencies' ratings are at the same level, the median rating should be used in determining the applicable index for the CCM. SDG&E believes this is appropriate because the median rating of the three credit rating agencies

[19] *See* D.19-12-056 at 45.

is known by the financial markets and is therefore reflected in competitive pricing of financial instruments.[20]

B. Clarify What Happens when a Utility Experience's a Credit Ratings Change

SDG&E recommends that the Commission provide that the applicable bond benchmark index can change during a cost of capital cycle if a utility experiences a credit rating change during that period; such as SDG&E experienced in March 2021 when its credit rating was upgraded by Moody's. Such an enhancement would be more consistent with the Commission's goal of accurately having changes in interest rates reflect changes in cost of equity, as it would apply the more applicable index to the utility during the measurement period in question.[21] Applying the appropriate index at that time also better correlates with applicable risks.[22]

Under this enhancement, if a utility experiences a credit rating change it would follow the following framework:

- A ratings upgrade or downgrade that resulted in the median rating changing over the October through September CCM measurement period of any year that affects the applicable Moody's Utilities Bond Index would allow for the utility to update the applicable Moody's Utilities Bond Index;
- The applicable Moody's Utilities Bond Index is based on the company's ratings as of September 30 of that year; and
- Any rating change update will be made through filing an advice letter in October to implement the revised index and benchmark rate for the CCM, to be effective in the following CCM measurement period.

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[20] *See* Appendix A, attached hereto, for an illustration of split ratings and index selection matrix.

[21] *See* D.08-05-035, FoF 16 at 18 ("The purpose of an interest rate benchmark is to gauge change in interest rates that also indicate changes in the equity costs of utilities.").

[22] *Id.* at CoL 10 at 19-20 (adopting utility bond interest rates out of the "desire to use an index that more likely correlates and moves with utility industry risk.").

This index adjustment itself does not cause a CCM adjustment mechanism trigger. Only a CCM adjustment mechanism trigger event would adjust the Cost of Capital.

C. Specify a Utility's Applicable Benchmark Index and Rate in the Decision

In its 2008 and 2013 cost of capital decisions, the Commission specified the applicable benchmark index applicable to each utility. But in D.19-12-056, while ordering the CCM to continue to be in effect through the 2020 Cost of Capital cycle, the Commission's decision did not specify the benchmark rate or benchmark index applicable for each applicant.[23] This caused uncertainty for SDG&E as to what index should apply. Although the 2019 decision found that the previous CCM decisions should apply, those decisions specified that SDG&E should use the Moody's A Rated Utility Index.[24] But that rating did not align with SDG&E's credit ratings at the time of the 2019 Decision.

Specifying the applicable benchmark index and benchmark rate for each application in the decision enhances the efficiency and transparency of the mechanism and its application. Given the Company's credit ratings at the time of filing this testimony, based upon the Commission's precedent, the initial benchmark for SDG&E for a Test Year 2023 would represent the October 2021 through September 2022 average of Moody's Baa Utilities Bond Index, as set on September 30, 2022. If the Company's credit ratings are updated between the time of filing this testimony and the final decision by the Commission, the benchmark index would follow the guidelines proposed in this section.

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23 Applicable index selected using the index selection matrix Appendix A, attached hereto.

24 *See, e.g.*, D.13-03-015, Ordering Paragraph 7 at 10 ("San Diego Gas & Electric Company . . . shall use Moody's long-term A rated utility bond index").

IV. CONCLUSION

SDG&E respectfully requests that the Commission continue the CCM, combined with SDG&E's right to file an application in applicable circumstances, with the proposed three enhancements to the CCM's adjustment mechanism.

This concludes my prepared direct testimony.

V. STATEMENT OF QUALIFICATIONS

My name is Patrick Billings, and my business address is 488 8th Avenue, San Diego, California 92101. I am currently employed by Sempra Energy as Assistant Treasurer. My responsibilities include oversight of capital markets activities, credit ratings and rating agencies, and cash management.

I assumed my current position in June 2019. Prior to this, I have served in roles of increasing responsibility at Sempra since March 2002. These roles included Director of Investor Relations from 2016 until June of 2019 where my responsibilities included developing our investor communication strategy and the communication of Sempra's business strategy and financial projections to the investor community, Director Strategic Projects from 2015 until 2016 where my responsibilities included leading an effort to sell a portion of Sempra's unregulated business to enhance share price valuation, Director of Strategic Planning and Analysis where my responsibilities included evaluating Sempra's investment opportunities and projections of Sempra's financial results for various stakeholders including management, investor communication and credit rating agencies. Additional roles from 2002 until 2012 included Merger and Acquisitions Manager, Business Planning Manager, Financial Planning Manager and a series of roles with increasing responsibility in the Corporate Tax Department. Prior to Sempra I was employed by Deloitte from 1998 to 2002 with my last role being Senior Tax Consultant.

I received a Bachelor of Science in Business Administration from San Diego State University in 1996. I also received a Master of Science in Accounting from San Diego State University in 1998

I have previously submitted testimony before the California Public Utilities Commission.

APPENDIX A

RATINGS TABLE FOR THE CCM INCLUDING INDEX SELECTION

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The following table provides the applicable Moody's Bond Index for each ratings level and the ratings bands for the Cost of Capital Mechanism ("CCM").

Ratings Based Index Selection Table for Cost of Capital Mechanism (CCM) [(i)]

Credit Worthiness	Moody's	Standard & Poor's	Fitch	Applicable Index to be Used for Cost of Capital Mechanism (CCM)
Investment Grade	Aaa	AAA	AAA	Moody's AA Utilities Bond Index (MOODUAA Index) [(ii)]
	Aa1	AA+	AA+	
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Moody's A Utilities Bond Index (MOODUA Index) [(ii)]
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Moody's Baa Utilities Bond Index (MOODUBAA Index) [(ii)]
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	

[(i)] *- Index determined based on the median long-term issuer rating.*

[(ii)] *- D.08-05-035 pg 19, "Moody's Aa utility bond interest rates should be used for those utilities having an AA credit rating or higher, Moody's A utility bond insterest rates should be used for those utilities having an A credit rating, and Moody's Baa utility bond interest rates for utilities having a BBB credit rating".*

Example of selecting the Moody's Utilities Bond Index for a utility with split credit ratings:

For illustrative purposes, suppose SDG&E was rated A3 by Moody's, BBB+ by S&P and BBB by Fitch as of September 30 of a given year. To select the applicable Moody's Utilities Bond Index for the CCM, SDG&E would use the median of the three ratings, or BBB+ by S&P in this example. BBB+ falls in Moody's Baa Utilities Bond Index range in the table above, and that would be the applicable index in the CCM for SDG&E with these hypothetical split ratings.