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Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2022 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

AUGUST 23, 2021

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PREPARED DIRECT TESTIMONY OF PATRICK BILLINGS ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY

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 with three enhancements to the CCM process (alternatively, the "adjustment mechanism") to provide greater clarity and improved efficiency in the interpretation and application of the adjustment mechanism. Consistent with SDG&E filing a test year ("TY") 2022 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 2024 for a TY 2025 cost of capital.

The current CCM—providing for the interim assessment of SDG&E's cost of capital either through the adjustment mechanism or SDG&E filing a full application 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:

- Applying a utility's median credit rating to choose the applicable Moody's utilities index when a utility has split ratings;
- Allowing a utility to change the applicable index when the utility's credit ratings change during CCM years; and
- Specifying 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 this CCM process 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

Unless otherwise authorized or directed, under the CCM, the California energy utilities are required to file Cost of Capital applications every three years. By way of history leading to the CCM, energy utilities' rate of return components was traditionally addressed in their respective general rate cases.[1] But beginning in 1990, energy utilities requested—and the Commission set—the cost of capital components and overall rate of return on an annual basis. The utilities filed a cost of capital application by May 8 every year, with the Commission deciding rates to go into effect on January 1 of the following year.[2]

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")."[3] Like the CCM, the MICAM lessened the burden on the Commission and interested parties in litigating a contested cost of capital application every year. 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.[4] Under the MICAM, if the difference

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1 Decision ("D.") 08-05-035, p. 2.

2 *See* D.89-01-040, p. 36 (setting an annual cost of capital schedule).

3 D.08-05-035, p. 2 (citing 66 CPUC 2d 568 at 573 (1996)).

4 D.08-05-035, p. 2 (citing D.05-03-023).

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.[5] SDG&E nonetheless actively participated in cost of capital proceedings in 2003, 2005, 2006, and 2008 that fell on non-application years for SDG&E where the MICAM applied.[6]

In 2008, the Commission adopted the CCM for SDG&E, Southern California Edison Company ("Edison"), and Pacific Gas and Electric Company ("PG&E").[7] As with the MICAM, the CCM's purpose is to "streamline" processing cost of capital applications and reduce the frequency of filings from the default of annual applications,[8] while using the CCM as a stand-in to assess major energy utilities' cost of capital annually in the intervening years.[9] The CCM provides two methods to assess SDG&E's cost of capital in interim years.

First, it provides an adjustment mechanism that ties changes in interest rates to changes in ROE, by using a formula to assess a utility's ROE in intervening years based on fluctuations in utility bond rates.[10] The adjustment mechanism automatically recalibrates SDG&E's authorized ROE and overall ROR on SDG&E jurisdictional operations upon a triggering of the mechanism, based on significant movements in the bond markets. Or second, the CCM alternatively provides SDG&E and other utilities 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

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

[6] *Id.* at 6.

[7] D.13-03-015, p. 2.

[8] *See id.* at 7.

[9] *See* D.08-05-035, pp. 15-16.

[10] *Id.* at 16.

of capital and/or capital structure and impacts it differently than the overall financial markets"[11] to have their cost of capital assessed in an interim year.

In 2009, the Commission approved a petition for modification ("PFM") from SCE, PG&E, and the Division of Ratepayer Advocates ("DRA") (now known as the California Public Advocates Office) that suspended the CCM for 2010 to avoid it from triggering upwards, based on the Commission approving the PFM's contention that the Lehman Brothers bankruptcy and resulting financial crisis that precipitated the Great Recession of 2008-2009 caused a divergence between the cost of debt and equity. The financial crisis resulted in a significant rise in interest rates that the Commission agreed did not translate to a concurrent rise in the cost of equity.[12]

In its 2013 cost of capital decision, the Commission reaffirmed the CCM for SDGE, PG&E, and Edison, and applied it to Southern California Gas Company ("SoCalGas").[13] In 2016, the Commission again suspended the CCM for 2017 to avoid the possibility of the CCM triggering upward for that year, based upon interest rate forecasts demonstrating the possibility of an increase in interest rates that could trigger the CCM's adjustment mechanism upward to increase ROE. The Commission again agreed that the potential increase in interest rates did not reflect an increase in the cost of equity.[14] The CCM was subsequently continued in 2017 and 2019.[15]

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[11] *Id.* at 16 and Conclusion of Law ("COL") 6, p. 19.

[12] D.09-10-016, p. 3.

[13] *See* D.13-03-015.

[14] D.16-02-019.

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

B. Mechanics of the Current Cost of Capital Mechanism

As noted, the current CCM's adjustment mechanism 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[16] 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;
- 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.).[17]

If the CCM's adjustment mechanism does trigger, 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. SDG&E makes

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[16] Applicable Moody's utilities index would be adjusted for a change in utility's credit rating, index selection matrix provided in Appendix A, attached hereto.

[17] *See* D.08-05-035, p. 15.

this change through the advice letter process. The CCM would continue to operate, 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 automatically adjust a utility's authorized capital structure itself (*i.e.*, the ratios).

As noted, since the CCM's adoption in 2008, the CCM alternatively provides that, instead of the adjustment mechanism 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."[18] This is consistent with the fact that the CCM (and MICAM before it) was a mechanism to relieve the default rule for an annual cost of capital application under D.89-01-040. As the Commission stated in D.13-03-015, while the CCM "streamlin[es] the COC process, the utilities continue to have a right to file" an application under the extraordinary event standard;[19] as the adjustment mechanism only "*potentially* replac[es] annual cost of capital proceedings."[20]

In that 2013 decision, the Commission adopted that, "[i]n 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."[21] Notably, in that proceeding, SDG&E jettisoned an initial proposal to voluntarily suspend the CCM if the yield on single-A utility bonds moved by more than 250

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[18] *Id.* at 16 and COL 6, p. 19.

[19] D.13-03-015, p. 7.

[20] *Id.* at Appendix A, p. 2 (emphasis added).

[21] *Id.* at Appendix A, p. 3.

basis points from the benchmark rate in favor of an application, "acknowledging that the current CCM [already] allows utilities to file a COC application outside of the current CCM process."[22] The Division of Ratepayer Advocates similarly noted that SDG&E's initial proposal was "redundant and unnecessary as D.08-05-035 already includes a provision for utilities to file a cost of capital application outside of the CCM process."[23]

As noted, the Commission has also suspended the CCM's adjustment mechanism at times where it agreed that changes in interest rates did not reflect changes in the cost of equity. For example, during the Great Recession, the Commission granted a petition for modification to suspend the CCM for 2010 based upon a "result of dramatic increases in the cost of utility debt that began in September 2008 after the bankruptcy of Lehman Brothers and continued into 2009." [24] The Commission accepted that it did not necessarily reflect an increase in the cost of equity, as equity markets were still showing "significant continued risk aversion by investors."[25] Similarly, the Commission suspended the CCM in 2017 when it "agree[d] with Petitioners that holding the cost of capital constant at this time is reasonable" given the possibility that the CCM would trigger based on forecasts showing the potential for "slight increase in interest rates over time."[26]

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22 *Id.* at 5.

23 A.12-04-015 et al, *Report on The Cost of Capital for Test Year 2013, Phase 2: Adjustment Mechanism* (November 30, 2021) ("Exhibit DRA-03"), pp. 9-10.

24 D.09-10-016, p. 3.

25 *Id.*

26 D.16-02-019, p. 3.

III. CCM PROPOSAL

SDG&E believes that the CCM has largely accomplished the goal of streamlining cost of capital proceedings while retaining the right to file an application in an interim year. SDG&E thus supports the CCM being continued with the three enhancements requested below.

A. SDG&E Supports Continuing the CCM

SDG&E proposes that the CCM be continued, including the following current attributes:

- a three-year application cycle, providing balance between not having a full proceeding every year and having one often enough to review for significant changes;
- utilize Moody's Utilities Bond Index based on the current company credit ratings as the appropriate benchmark;
- measure a 12-month average of Moody's Utilities bond yields for the period of October 1 through September 30;
- a 100 basis point dead band whereby within plus or minus 100 basis points from the benchmark interest rate, the mechanism will not trigger;
- the 50% adjustment to ROE of total change to utility bond index when CCM is triggered;
- updating the embedded costs of long-term debt and preferred stock when a trigger occurs, to reflect actual August month-end embedded costs in the trigger year and forecasted interest rates for variable long-term debt, new long-term debt, and preferred stock[27] to be issued;
- the current advice letter process to implement trigger provisions, effective January 1 of the following year; and
- Alternatively providing 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

[27] *See* Prepared Direct Testimony of Maritz Mekitarian – Authorized Capital Structure (August 23, 2021) ("Mekitarian SDG&E-02"), pp. MM-6 - MM-7 (explaining that SDG&E does not expect to issue any new preferred stock in the upcoming COC cycle.)

structure and impacts them differently than the overall financial markets."[28]

As the Commission has previously found, the mechanism achieves several objectives:

- reduces the time and costs associated with filing and litigating Cost of Capital proposals annually;
- produces objective results based on interest rate changes that eliminate the need for interest rate forecasts (and related forecasting risk);
- does not produce frequent or abrupt changes, while remaining sensitive enough to trigger with meaningful fluctuations in the bond markets;
- retains the right for a utility to file a cost of capital application; and
- provides timely ratemaking information to stakeholders and the financial markets.[29]

SDG&E agrees with the Commission that the CCM: 1) effectively balances the interests of shareholders and ratepayers; 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 also seems to be viewed positively by various market participants in addition to regulatory stakeholders. It promotes a degree of desired stability, while also preserving the default right to file a cost of capital application when the adjustment mechanism is not an accurate measurement of changes in the cost of equity; that is, when changes in interest rates diverge from the cost of equity. With SDG&E filing a TY 2022 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 2024 for a TY 2025 cost of capital. Consistent with prior decisions, the CCM's benchmark

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[28] D.08-05-035 p. 16 and COL 6, p. 19.

[29] D.13-03-015, p. 7.

for the next cycle should be set on September 30 of the year prior to the test year; here September 30, 2021.[30]

B. SDG&E Proposes Three Enhancements to the CCM's Adjustment Mechanism

SDG&E proposes the following three enhancements to the CCM's adjustment mechanism 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.[31] 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. SDG&E believes these enhancements will provide a clear and efficient application of the mechanism. Each proposal is discussed in turn.

1. Proposed Enhancement on Split Credit Ratings Index Selection

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

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30 *See* D.08-05-035, p. 6.

31 *See* D.19-12-056, p 45.

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. 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 is known by the financial markets and is therefore reflected in competitive pricing of financial instruments.[32]

2. Proposed Enhancement on Ratings Change During CCM Years

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.[33] Applying the appropriate index at that time also better correlates with applicable risks.[34]

Under this enhancement, if a utility experiences a credit rating change it will 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

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

[33] *See* D.08-05-035, Finding of Fact 16, p. 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.").

[34] *Id.* at COL 10, pp. 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.").

- 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.

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.

3. Specify the benchmark index and rate in the final 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.[35] 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 (Moodua).[36] But that rating did not align with SDG&E's credit ratings at the time of the 2019 decision.

As stated previously, the CCM's adjustment mechanism is based upon objective bond yield data tied to credit ratings. 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

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[35] Applicable index selected using the index selection matrix Appendix A, attached hereto.

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

the time of filing this testimony, based upon the Commission's precedent, the initial benchmark for SDG&E for a Test Year 2022 would represent the October 2020 through September 2021 average of Moody's Baa Utilities Bond Index, as set on September 30, 2021. Per enhancement three, 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.

IV. CONCLUSION

SDG&E respectfully requests that the Commission continue the CCM 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's of Science in Accounting from San Diego State University in 1998.

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 A- 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.