Application: A.21-08-013 (consolidated)
Witness: Valerie A. Bille
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PREPARED OPENING TESTIMONY OF

VALERIE A. BILLE

SDG&E POSITION REGARDING SCOPING MEMO PHASE ONE QUESTIONS

ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

JANUARY 18, 2022

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SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED OPENING TESTIMONY OF VALERIE A. BILLE
SDG&E POSITION REGARDING SCOPING MEMO PHASE ONE QUESTIONS

I. INTRODUCTION

This testimony addresses the two questions raised in the Assigned Commissioner's December 24, 2021 Scoping Memorandum and Ruling ("Scoping Memo") regarding the consolidated 2022 cost of capital applications of San Diego Gas & Electric Company ("SDG&E"), Pacific Gas and Electric Company ("PG&E"), and Southern California Edison Company ("SCE") (collectively, the "Utilities"). The Scoping Memo limited this proceeding to the cost of capital for 2022 (with the Utilities regularly scheduled applications due in April 2022), and established a first phase to consider the following two issues:

1. Are there extraordinary circumstances that warrant a departure from the CCM for 2022?; and

2. If so, should the Commission leave the cost of capital components at pre-2022 levels for the year 2022, or open a second phase to consider alternative cost of capital proposals for the year 2022?[1]

The California Public Utilities Commission ("Commission") should find that extraordinary circumstances justify suspending the CCM's formula adjustment mechanism ("CCM Adjustment Mechanism") for 2022 and leave SDG&E's cost of capital components at the pre-2022 cost of capital levels that the Commission already approved for 2022 in Decision ("D.") 19-12-056 (the "2019 Decision"). As further detailed in James Coyne's "Extraordinary Circumstances"[2] testimony, the COVID-19 pandemic—and the significant Federal Government

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[1] Scoping Memo at 7; *see id.* at 3.

[2] *See* Prepared Opening Testimony of James M. Coyne – Extraordinary Circumstances (January 18, 2022) ("SDG&E-07 (Coyne)"), JMC-2 – JMC-3.

and Federal Reserve responses to combat the pandemic's economic impacts—constitute extraordinary circumstances that warrant suspending the CCM.

The CCM is based on a presumed correlation between changes in interest rates and changes in the required return on equity ("ROE").[3] But that linkage did not exist during the CCM measurement period at issue (October 1, 2020-September 30, 2021) ("Measurement Period").

The pandemic—and the federal policies to minimize the economic impacts of the pandemic—resulted in a decline in interest rates. Yet the cost of equity—particularly for SDG&E and other utilities—has not decreased, evidenced by the increased relative risk associated with utility stocks as measured by beta and the Utilities' underperformance relative to the S&P Utility 500 and overall market.[4] Because the CCM's Adjustment Mechanism would not result in just and reasonable rates due to the divergence between interest rates and the cost of equity, it should be suspended.

Moreover, it is now evident that the low-interest rate environment during the Measurement Period was temporary—resulting from the Federal Reserve's extensive policies to minimize the pandemic's impacts. As the Federal Reserve is now raising interest rates due to increased economic activity and inflation, the CCM Measurement Period would not produce an accurate cost of capital for 2022.

In suspending the CCM, the Commission should find a second phase unnecessary and leave SDG&E's cost of capital components at their current levels for 2022. Although SDG&E filed an application to set a new cost of capital for 2022-2024, given that the Scoping Memo limits this proceeding to 2022, the increasingly evident temporary nature of the interest rate

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[3] *See* D.08-05-035, at 14, 15 n.20, and 20, Ordering Paragraph ("OP") 2.

[4] SDG&E-07 (Coyne), JMC-14 – JMC-15.

environment during the pandemic, and the fact that the Commission will imminently conduct a full cost of capital assessment beginning in April 2022 for 2023, the suspension of the CCM, maintenance of SDG&E's current cost of capital for 2022, and a full cost of capital proceeding for 2023 as presented in the Scoping Memo should be adopted.

In the 2019 Decision, the Commission already found SDG&E cost of capital components just and reasonable for 2022, subject to the CCM. As the CCM should not apply here due to the extraordinary circumstances arising from the pandemic, the 2022 rates that the Commission has already approved should continue—particularly because SDG&E continues to possess similar credit ratings and faces the same (if not increased) risks that existed at the time of the 2019 Decision.[5]

By contrast, setting the appropriate cost of capital is a complex undertaking. It is inefficient to simultaneously conduct a prolonged, phase two cost of capital proceeding for 2022 when the Scoping Memo specifies that the Commission will imminently conduct a full cost of capital proceeding for 2023 based upon April 2022 applications.[6] A phase two proceeding would likely not get decided until the end of the year, creating additional uncertainty for investors who must invest based upon 2022 expectations. Accordingly, the Commission should maintain SDG&E's current cost of capital and then determine the appropriate cost of capital in a full, robust 2023 proceeding beginning in April 2022 as economic conditions further stabilize.

[5] D.19-12-056 at 42-43.

[6] *See* Scoping Memo at 8-9 (specifying that a phase two for 2022 would not consider all issues as it would be inefficient to conduct two full cost of capital proceedings in consecutive years).

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II. THE COVID-19 PANDEMIC HAS RESULTED IN EXTRAORDINARY CIRCUMSTANCES THAT JUSTIFY SUSPENDING THE CCM

3 The CCM's Adjustment Mechanism's basic premise—that changes in interest rates can
4 serve as a rough proxy for changes in the cost of equity to remove the need to assess the cost of
5 capital—does not apply here. The COVID-19 pandemic—and government response to lower
6 interest rates to combat the pandemic's economic impacts— has resulted in a temporary,
7 artificially low interest rate environment featuring a divergence between interest rates and the
8 cost of equity. As further detailed in Mr. Coyne's testimony, a suspension of the CCM is thus
9 appropriate because the CCM does not provide a reasonable assessment of the cost of capital for
10 2022.[7] If the COVID-19 pandemic does not constitute extraordinary circumstances, it is difficult
11 to imagine when the "extraordinary circumstances" contemplated in D.08-03-035 would exist.

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A. The CCM Is a Proxy for a Full Cost of Capital Proceeding Based on the Presumed Relationship Between Interest Rates and the Cost of Capital

14 In 2008, the Commission established the CCM, relieving the burden of annual cost of
15 capital applications for the Utilities (the "2008 Decision").[8] The 2008 Decision requires SDG&E
16 to file a cost of capital application every three years, with the CCM applying in the intervening
17 years to assess SDG&E's cost of capital through one of two methods—the CCM "Adjustment
18 Mechanism" or SDG&E's right to file an application in extraordinary circumstances.[9]

19 The Adjustment Mechanism assumes a positive relationship between interest rates and
20 the cost of equity, with interest rate changes serving as a rough proxy for changes to the Utilities'

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[7] SDG&E-07 (Coyne), Sections II and III.

[8] D.08-035-035 at 15-16.

[9] *Id.* at 20, OP 1.

1 ROE in an effort to "streamline" the cost of capital process.[10] Specifically, it measures SDG&E's
2 cost of capital by tying changes in ROE to changes in a Moody's utility bond index that is
3 selected based on a utility's credit rating (A index for utilities rated better than BBB+, Baa index
4 for BBB+ and lower).[11] The applicable Moody's bond index rate during a cost of capital test year
5 is established as the benchmark.[12]

6 That benchmark is then annually compared to the 12-month October through September
7 index average.[13] In any year where the CCM's Adjustment Mechanism applies and the difference
8 between the current 12-month October through September average of the applicable Moody's
9 utility bond index and benchmark is more than 100 points, the adjustment mechanism "triggers,"
10 adjusting ROE by one-half of the difference between the benchmark and the Moody's index rate
11 average, while the costs of long-term debt and preferred stock are trued up.[14]

12 Alternatively, the 2008 Decision provides utilities the "right to file a cost of capital
13 application outside of the CCM process upon an extraordinary or catastrophic event that
14 materially impacts their overall respective cost of capital and/or capital structure and affects
15 them differently than the financial markets."[15] The longstanding right for utilities to file an

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[10] *Id.* at 16 (finding that the "CCM also enables the utilities, interested parties, and Commission staff to reduce and reallocate their respective workload requirements for litigating annual cost of capital proceedings."); *see* D.13-03-015, Appendix A, p. 2 (finding that the CCM "potentially replaces annual cost of capital proceedings.").

[11] D.08-05-035 at 15 and 21, OP 1e (stating that the Adjustment Mechanism, if applicable, alters ROE by one-half of the change in the cost of debt as measured by an average change in the index that is applicable to that Utility).

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

[13] *Id.*; D.08-05-035 at 21, OP 2.

[14] D. 13-03-015 at 2-3; D.08-05-035 at 15.

[15] D.08-03-035 at 19, Conclusion of Law ("CoL") 6; *id.* at 16.

application is consistent with the Commission's underlying default rule for an annual cost of capital application—and a recognition that the CCM's Adjustment Mechanism is a stand-in for the Commission's ultimate authority to set an appropriate cost of capital and ensure that the cost of capital meets constitutional standards.[16]

B. The COVID-19 Pandemic Has Had Extraordinary Health and Economic Impacts

That the COVID-19 pandemic constitutes an extraordinary or catastrophic event should be readily apparent. On March 4, 2020, Governor Newsom declared a state of emergency in response to the first known COVID-19 cases in California.[17] On March 11, 2020, the World Health Organization characterized COVID-19 as a pandemic.[18]

The pandemic—and attempts to mitigate the severe health and safety impacts of the pandemic—have had significant economic consequences.[19] As the Commission has found,

- "COVID-19 has been extremely disruptive to all Californians and has had severe economic impacts on many Californians;"[20]
- "COVID-19's toll on the State's economy is unrivaled in its speed and breathtaking in its severity;"[21] and

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[16] *See* D.19-12-056 at 15-16 (citing *Federal Power Com. v. Hope Nat'l Gas Co.,* 320 U.S. 591, 601 (1944); *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 (1923)) (reiterating longstanding Supreme Court precedent that the return must be commensurate to businesses with corresponding risks).

[17] Executive Department, State of California, Proclamation of a State of Emergency (March 4, 2020), available at https://www.gov.ca.gov/wp-content/uploads/2020/03/3.4.20-Coronavirus-SOE-Proclamation.pdf.

[18] World Health Organization, *WHO Director-General's opening remarks at the media briefing on COVID-19* (March 11, 2020), available at https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020

[19] SDG&E-07 (Coyne), JMC-2 – JMC-3.

[20] Resolution M-4849 (February 11, 2021) ("Res. M-4849"), p. 3.

[21] D.21-04-015 at 9.

- "Millions of Californians filed new claims for state unemployment benefits," and "[b]usinesses—small, medium, and large—faced reductions or closures to their operations because of shelter-in-place orders."[22]

On March 19, 2020, Governor Newsom ordered Californians to stay at home except to meet essential needs.[23] Stay-at-home orders remained in effect in various regions of California throughout 2020 and into the start of 2021.[24] Perhaps the pandemic's worst health and safety impacts in California were between October 2020 through March 2021—the first six months of the CCM's Measurement Period. During that time, the State averaged its highest hospitalizations during the pandemic, peaking at over 50,000 daily new cases and nearly 23,000 hospitalizations in early January 2021.[25]

Although on August 28, 2020, California implemented the "Blueprint for a Safer Economy," framework for reopening businesses and other activities,[26] as of February 4, 2021, 99.9 percent of California's population remained in the most restrictive tier of the state's economic reopening plan.[27] That same month, the Commission observed that "California's economy is still months away from recovery."[28] In May 2021, California's unemployment rate

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[22] *Id.* at 5-6.

[23] Executive Department, State of California, Executive Order N-33-20 (March 19, 2020), available at https://www.gov.ca.gov/wp-content/uploads/2020/03/3.19.20-attested-EO-N-33-20-COVID-19-HEALTH-ORDER.pdf

[24] Res. M-4849.

[25] COVID19.CA.Gov, *Tracking COVID-19 in California,* available at https://covid19.ca.gov/state-dashboard/.

[26] COVID19.CA.Gov, available at https://covid19.ca.gov/safely-reopening/; *see also* Res. M-4849.

[27] Res. M-4849.

[28] *Id.* at 3.

1 was 7.9%; above both the 5.8% unemployment rate nationwide[29] and the state's 4.3%
2 unemployment rate in February 2020.[30]
3 On June 15, 2021, Governor Newsom rescinded the executive orders that put into place
4 the Stay at Home Order and Blueprint for a Safer Economy.[31] But public health orders regarding
5 COVID-19 issued by the California Department of Public Health and Cal/OSHA remain in
6 place.[32] As of September 2021, California's unemployment rate remained at 7.5 percent, above
7 the national average of 4.8 percent.[33] A study conducted October 12, 2021 to October 31, 2021
8 by the Public Policy Institute of California found that 49 percent of Californians said that they or
9 someone in their household worked from home between October 2020 and October 2021.[34]
10 The impacts of COVID-19 unfortunately continue to be felt, with cases in California
11 rising above 15,000 new cases on August 23, 2021, with the "delta" variant, and over 77,000

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29 Bureau of Labor Statistics, *The Employment Situation - May 2021*, available at https://www.bls.gov/opub/ted/2021/number-of-unemployed-decreased-by-496000-to-9-3-million-in-may-2021.htm.

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

31 COVID19.CA.Gov, Past Restrictions, available at https://covid19.ca.gov/safely-reopening/#past-restrictions.

32 California Department of Public Health, State Public Health Officer Order of June 11, 2021 (June 11, 2021), available at https://www.cdph.ca.gov/Programs/CID/DCDC/Pages/COVID-19/Order-of-the-State-Public-Health-Officer-Beyond-Blueprint.aspx.

33 CA.Gov, Employment Development Department, California's September 2021 unemployment rate holds at 7.5 percent (October 22, 2021), available at https://edd.ca.gov/newsroom/unemployment-september-2021.htm.

34 Public Policy Institute of California, PPIC Statewide Survey: Californians and Their Economic Well-Being (October 2021), available at https://www.ppic.org/publication/ppic-statewide-survey-californians-and-their-economic-well-being-november-2021/.

1 new cases on December 29, 2021, with the "omicron" variant.[35] As of January 7, 2022,

2 California had reported over 5,600,000 cases and more than 76,000 deaths.[36]

3 **C. The Pandemic, and Federal Government Actions to Mitigate the Pandemic,**
4 **Have Kept Interest Rates Low**

5 The pandemic, and the federal government's efforts to lessen the significant economic
6 impacts brought about by the pandemic, have, in turn, significantly reduced interest rates during
7 the CCM Measurement Period. Concerns that COVID-19 could slow the global economy
8 repeatedly pushed rates lower.[37] And to counteract the sizeable risk of a severe, prolonged
9 recession—given the economy declining an unprecedented annual rate of 31.4 percent in the
10 second quarter of 2020, with U.S. gross domestic product declining by 3.5 percent overall in
11 2020[38]—the federal government took significant actions to minimize economic impacts.

12 Congress enacted about $4.5 trillion in stimulus measures.[39] The Federal Reserve
13 likewise took numerous steps to reduce interest rates and increase the money supply to facilitate
14 lending, including:

15 - Keeping the overnight federal funds rate (which, in turn lowers all other interest rates)
16 from March 2020 until the present at the lowest level of zero to .25 percent;[40]

17 - Engaging in "quantitative easing," announcing in March 2020 that it would purchase
18 at least $500 billion of Treasury securities and $200 billion of mortgage-backed

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

36 *Id.*

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

38 Associated Press, US economy shrank 3.5% in 2020 after growing 4% last quarter (January 28, 2021), available at https://apnews.com/article/us-economy-shrink-in-2020-b59f9be06dcf1da924f64afde2ce094c.

39 *See* SDG&E-07 (Coyne), JMC-5.

40 *See* The New York Times, Fed Shifts to Inflation Battle, Winding Down Pandemic Support (December 15, 2021), available at https://www.nytimes.com/2021/12/15/business/economy/inflation-fed-fomc-meeting-december-2021.html (the Federal Reserve currently intends to raise the federal funds rate three times in 2022).

securities over ensuing months to support critical market functioning during the period of economic hardship caused by the pandemic;[41] and

- Purchasing from December 2020 through November 2021 at least $80 billion per month of Treasury securities and at least $40 billion per month of mortgage-backed securities to support the flow of credit to households and businesses during the pandemic.[42]

Federal Reserve assets roughly doubled from December 2019 to the end of 2020, rising from around $4 trillion to around $8 trillion. And the overall money supply in the U.S. economy increased from roughly $15.5 trillion at the beginning of March 2020 to $19.7 trillion a year later.[43] As Mr. Coyne testifies, the "low interest rate environment has been directly attributable to temporary steps the Federal Reserve has taken to contain the economic effects of COVID-19, including reducing the federal funds rates and taking additional measures to support the U.S. economy and provide liquidity and stability in financial markets."[44] These Federal Reserve's actions resulted in "[d]ebt yields [being] driven lower by an aggressive and unprecedent level of federal government action designed to support the economy."[45]

This is reflected in interest rate movement during the pandemic. As Mr. Coyne testifies, in March 2020, for the first time on record, the yield on a 10-year treasury bond dropped below

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[41] Federal Reserve Board Press Release, Federal Reserve issues FOMC statement (March 15, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm.

[42] CNBC, Fed will aggressively dial back its bond buying, sees three rate hikes next year (December 15, 2020), available at https://www.cnbc.com/2021/12/15/fed-will-aggressively-dial-back-its-monthly-bond-buying-sees-three-rate-hikes-next-year.html.

[43] FRED, Economic Data, Source: Board of Governors of the Federal Reserve System (US), available at https://fred.stlouisfed.org/series/WM2NS.

[44] SDG&E-07 (Coyne), JMC-20.

[45] *Id.*

one percent.[46] It stayed below one percent for the remainder of 2020,[47] and remained at historically low levels throughout 2021.[48]

D. The Cost of Equity Diverged from the Cost of Debt

In contrast to this low interest rate environment, the cost of equity increased, as, "[e]quity investors, responding to increased levels of risk and market volatility, required higher returns."[49] As Mr. Coyne details, volatility in equity markets reached levels not seen since the Great Recession, and remained higher in May 2021 then the market average between 2010-2019.[50] The federal government's multiple stimulus measures incentivized investors to move from low yielding bonds into equities "creating upward pressure on valuations and downward pressure on yields for dividend paying companies such as utilities."[51]

And higher expected growth, inflation, and interest rates moving forward as the pandemic's impacts lessen all indicate that the cost of equity will further increase.[52] This divergence between the cost of debt and equity—and overall increase in the cost of equity—has materially impacted SDG&E and other utilities' cost of capital.[53]

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[46] FRED, Economic Data, Source: Board of Governors of the Federal Reserve System (US), available at https://fred.stlouisfed.org/series/DGS10.

[47] U.S. Department of the Treasury, available at https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2020.

[48] SDG&E-07 (Coyne), JMC-6.

[49] *Id.* at JMC-20.

[50] *Id.* at JMC-7 – JMC-8.

[51] *Id.* at JMC-5 – JMC-6.

[52] *Id.* at JMC-14 – JMC-15.

[53] *See id.* at JMC-10.

Utilities, and SDG&E in particular, have also been impacted differently than the overall market—evidenced both by the underperformance of utility stocks and the increased risks associated with such stocks, as measured by beta (discussed below). From February 2020 to June 2021, the S&P 500 increased nearly 30 percent in value. Yet the Utility S&P 500 decreased about five percent during that same time. And the California electric utilities underperformed the broader utility index even further, with Sempra Energy (SDG&E's parent company) down more than 15 percent from its mid-February 2020 level in June 2021,[54] more than 20 percent on September 30, 2021 (the end of the measurement period), and over 10 percent on December 31, 2021.[55]

SDG&E and other utilities are also considered riskier relative to the market than they were prior to COVID-19. As Mr. Coyne details, beta coefficients—a measure of risk where 1.0 is the market average and where higher betas translate to greater risk and higher required equity returns[56]—have increased substantially for electric and gas utilities, indicating that "[i]nvestors have not viewed the utilities sector as a safe-haven during" this economic downturn.[57] Although utilities traditionally were considered safer investments than the market as a whole, as Mr. Coyne testifies, "[u]tilit[ies] company stocks have traded more in-line with the broader market since February 2020 when the COVID-19 pandemic became a concern in financial markets."[58]

For instance, Value Line's beta for a representative group of utilities has increased from 0.56 in January 2020 to around 0.88 in June 2021 and 0.89 in December 2021; with Sempra

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[54] *Id.* at JMC-11 – JMC-12, and Figure 5.

[55] *Id.*

[56] *Id.* at JMC-8 – JMC-10.

[57] *Id.* at JMC-9.

[58] *Id.* at JMC-8.

1 Energy's increasing from 0.70 to 0.95 and 1.00 for those same time periods.[59] Higher betas for
2 utilities signal an increase in risk relative to the market, demonstrating that utilities' cost of
3 equity has risen more substantially than the market as a whole, as investors require a higher
4 return for utility stocks to accept those increased risks relative to other stocks.[60]
5 Beyond the general overall market volatility that has made traditionally low-risk stocks
6 such as utilities seem riskier, part of the concern is investors' perception of increased risk due to
7 the COVID-19 pandemic's impact on utilities' financial health, such as with disconnection
8 moratoriums. For instance, in California, the Commission has stated that it "appreciate[s] the
9 careful, and tireless efforts of the utilities to protect their employees and customers over this
10 period,"[61] and noted that utilities have instituted numerous Commission-approved customer
11 service protections during the pandemic, including a disconnection moratorium.[62] As RRA, a
12 segment of S&P has stated, the longer such moratoriums continued, the more uncertain cost
13 recovery became and the longer that the utility had to float those costs.[63]
14 As Mr. Coyne testifies,"[g]iven the uncertainty and volatility that have characterized
15 capital markets since February 2020, the increase in relative risk to the utility industry (as
16 measured by beta) compared to the broader market . . . it is reasonable that equity investors
17 would require a higher ROE to compensate them for the additional risk associated with owning

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[59] SDG&E-07 (Coyne), JMC-9, Figure 3: Beta Coefficients for Proxy Group and Sempra Energy.

[60] *Id.* at JMC-10.

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

[62] Res. M-4842; *see also* Executive Department, State of California, Executive Order N-42-20 (April 2, 2020), available at https://www.gov.ca.gov/wp-content/uploads/2020/04/4.2.20-EO-N-42-20.pdf. AB 135 ends the moratorium for most customers on January 31, 2022.

[63] S&P, RRA Regulatory Focus, *2021 Energy Utility Regulatory Outlook*, (February 11, 2021) at 2-4.

1 common stock."[64] These "factors drive higher estimates of the cost of equity than those
2 considered by the Commission in 2019."[65]
3 The costs of debt and equity have thus diverged. That is, the steep reduction in debt
4 yields brought on by the Federal Government and Federal Reserve's ongoing actions have
5 resulted in interest rates declining. But the cost of equity has increased, driven higher by market
6 volatility, uncertainty, and a perceived increase in SDG&E and other utilities' risks relative to
7 the market, as demonstrated by the increase in beta.

8 9 **E. The Low Interest Rate Environment Was Temporary to the Pandemic and the Federal Reserve's Actions**

10 Moreover, low interest rates during the CCM Measurement Period seem unique to that
11 phase of the pandemic due to the federal government's actions and not indicative of the 2022
12 economic environment, further supporting suspension. Specifically, in November 2021, the
13 Federal Reserve began tightening its pandemic-induced loose monetary policy (meaning where
14 the Federal Reserve allows cash to build up in the banking system to lower interest rates and
15 facilitate lending) in response to increased economic activity and inflation by tapering
16 quantitative easing, with the goal of increasing interest rates.[66] In December, the Federal Reserve
17 accelerated that tapering process, announcing that it would buy $60 billion of Treasuries and
18 Mortgage-based securities each month starting in January 2022—half the level of the Federal

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64 SDG&E-07(Coyne) at JMC-20.

65 *Id.* at JMC-10.

66 *See* CNBC, Fed will aggressively dial back its bond buying, sees three rate hikes next year (December 15, 2020), available at https://www.cnbc.com/2021/12/15/fed-will-aggressively-dial-back-its-monthly-bond-buying-sees-three-rate-hikes-next-year.html.

Reserve's purchases prior to the November taper and $30 billion less than it bought in December.[67]

The Federal Reserve likewise announced that it will begin raising interest rates, forecasting three rate increases in 2022 and two each in 2023 and 2024.[68] Sustained inflation (the Consumer Price Index climbed 7 percent for 2021) is leading to increased expectations, however, that the Federal Reserve will move even faster and enact four rate increases this year.[69] Because the CCM Adjustment Mechanism would be based on the Measurement Period's low interest rate environment resulting from the Federal Reserve's significant actions that do not reflect economic conditions going forward, it would result in a poor forecast of SDG&E's cost of capital for 2022.

F. A Suspension of the CCM is Consistent with Past Precedent and Appropriate Given the Pandemic

In creating the CCM, the Commission recognized there would be extraordinary circumstances that would justify a departure from the CCM Adjustment Mechanism.[70] The CCM Adjustment Mechanism's purpose is to "gauge changes in interest rates that also indicate changes in the equity costs for utilities."[71] But because the relationship between the cost of equity and interest rates during the pandemic has collapsed—and the interest rate changes were transitory—the adjustment mechanism cannot effectively serve as a proxy to assess SDG&E's cost of capital for 2022.

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[67] *Id.*

[68] *Id.* (discussing how the Federal Reserve has stated it would likely not increase rates at the same time it is buying bonds, as the two moves would work at cross purposes). *See* SDG&E-07 (Coyne) at JMC-7.

[69] The New York Times, Consumer Prices Popped again in December (January 12, 2022) available at https://www.nytimes.com/2022/01/12/business/economy/cpi-inflation-december-2021.html.

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

[71] *Id.* at 12 and 18, Findings of Fact ("FoF") 16.

The Commission has previously recognized that the CCM's Adjustment Mechanism may not be an appropriate measure of the cost of equity based on a divergence between interest rates and the cost of equity during the last period of extraordinary economic circumstances—the Great Recession. In 2009, the Commission granted a petition for modification to suspend the CCM from applying in 2010 due to a similar divergence between the cost of debt and equity, based on the Commission finding that "dramatic increases in the cost of utility debt that began in September 2008 after the bankruptcy of Lehman Brothers and continued into 2009" did not necessarily reflect an increase in the cost of equity."[72]

A similar divergence between interest rates and the cost of equity exists here. Given the extraordinary circumstances of the pandemic, the divergence between low interest rates brought on by Congress and the Federal Reserve's temporary, pandemic-specific response and the cost of equity, and the increased risk as measured by beta and underperformance of the Utilities relative to the market, the CCM Adjustment Mechanism's Measurement Period does not constitute a reasonable proxy for SDG&E's 2022 cost of capital.

III. THE COMMISSION SHOULD LEAVE THE COST OF CAPITAL COMPONENTS AT PRE-2022 LEVELS FOR 2022

Given the increasingly evident temporary nature of the interest rate environment that existed during the Measurement Period and the fact that the Commission will conduct a full cost of capital assessment beginning in April 2022 for 2023, the Commission should suspend the CCM and "leave the cost of capital components as they are at pre-2022 levels for the year 2022"[73] rather than have a 2022 phase two proceeding. As noted in the Scoping Memo, "D.08-

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[72] D.09-10-016 at 3.

[73] Scoping Memo at 3.

05-035 does not prescribe a particular process or outcome when off-cycle outcome when applications are filed."[74] The Commission retains the discretion, consistent with constitutional standards, to determine appropriate rates. And the Commission's 2019 Decision found SDG&E's current cost of capital just and reasonable 2020 through 2022 unless the CCM's Adjustment Mechanism applies.[75]

That is, as the Commission in the 2019 Decision has already found SDG&E's current cost of capital is just and reasonable subject to the CCM—and the CCM should not apply as it would not produce a reasonable outcome here for the reasons discussed above—the Commission should find that the 2019 Decision's determinations remain valid. The temporary nature of the low interest rate economic conditions during the Measurement Period also supports leaving in place SDG&E's current cost of capital—particularly because, under the Scoping Memo, the Commission will adjudicate a full cost of capital decision for test year 2023 based on April 2022 applications when economic conditions have perhaps further stabilized.[76]

Finally, the Commission's findings in the 2019 Decision support applying SDG&E's current cost of capital—as it remains consistent with SDG&E's current risks, credit ratings, and the nationwide authorized ROE average.[77] In setting SDG&E's ROE at 10.20 percent, the Commission in the 2019 Decision, after "considering the evidence on market conditions, trends,

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[74] *Id.* at 8.

[75] D.19-12-056 at 55, OP 3, 7; D.08-05-035 at 20, OP 1(a). *See also* D.19-12-056 at 55, OP 4 (ordering SDG&E to file a Tier 2 Advice Letter to set its preferred equity ratio; that advice letter was subsequently adopted setting SDG&E's preferred equity ratio at 6.22 percent); Joint Stipulation of Fact (January 10, 2022) at 2.

[76] *See* Scoping Memo at 7; *see generally* SDG&E-07 (Coyne) at JMC-6 ("The economy remains in a tenuous phase of the business cycle.").

[77] D.19-12-056 at 43.

creditworthiness, interest rate forecasts, quantitative financial models, additional risk factors including business risk:"[78]

- "[C]onclude[d] that" SDG&E's "adopted ROE should be set at the upper end of the just and reasonable range;"[79]
- Observed approvingly that SDG&E's "10.20% authorized ROE is significantly higher than the 9.60% average ROEs granted to United States electric utilities during 2018."[80] and
- Found that SDG&E's 10.20% authorized ROE was necessary "to assure confidence in the financial soundness of the utility and to maintain investment grade credit ratings."[81]

Although Moody's recently upgraded SDG&E's credit rating to A3 based, in part, on "SDG&E's track record of effective wildfire risk mitigation practices,"[82] SDG&E's credit ratings from S&P and Fitch remain the same (BBB+) as they were at the time of the 2019 Decision.[83] S&P and Moody's reiterated in 2021 that SDG&E and the other Utilities continue to face significant risks from the increased likelihood of catastrophic wildfires in California, inverse condemnation strict liability for utility-caused wildfires, and the threat of a potential lack of recovery of costs associated with a catastrophic wildfire.[84]

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[78] *Id.* at 42.

[79] *Id.*

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

[81] *Id.* at 42-43.

[82] Moody's, "Rating Action: Moody's upgrades San Diego Gas & Electric to A3 from Baa1; outlook stable," at 1 (Mar. 30, 2021).

[83] 2019 Decision at 51, FoF 32 ("SDG&E has an investment grade rating of BBB+ from S&P").

[84] S&P, "How are California's Wildfire Risks Affecting Credit Quality?" (Jun. 3, 2021), pp. 2-3; *accord* Moody's Investors Service, "San Diego Gas & Electric Company, Update to credit analysis following upgrade to A3," (May 10, 2021), p. 5. Regulatory Research Associates ("RRA"), "California Regulatory Review," (Dec. 14, 2020) at. 1-2.

1 As S&P recently determined, "[d]espite SDG&E's leadership role in wildfire prevention,
2 we assess the company at the lower end of the range for excellent business risk profile category"
3 reflecting "the company's higher wildfire threat compared to utility peers across North
4 America."[85] S&P later added that "because we view the likelihood of a change to California's
5 interpretation of inverse condemnation as remote, and favorable climate change patterns are also
6 unlikely to emerge for a state with a long history of drought conditions, we are unlikely to raise
7 ratings for utilities with meaningful wildfire-related risks in the near term."[86] As such, SDG&E
8 continues to suffer from the same downgraded credit ratings (at least two notches below where
9 they were in 2018 from all three credit rating agencies) despite being repeatedly lauded for its
10 wildfire mitigation efforts and not being the cause of a significant wildfire since 2007.[87]
11 SDG&E's current cost of capital also remains consistent with the Commission's
12 observation in the 2019 Decision that SDG&E's ROE should be "significantly higher" than the
13 nationwide authorized ROE average.[88] The national 2020 authorized average ROE for vertically
14 integrated electric utilities was 9.55 percent and 9.44 percent for January-June 2021;[89] compared
15 to 9.60 percent in 2018 (the year cited in the 2019 decision).[90] That is, even with the COVID-19

[85] S&P, "Sempra Energy Unsecured Debt Rating Lowered To 'BBB'; Outlook on Subsidiary SDG&E Revised to Stable" (May 12, 2021) at 2.

[86] S&P, "How are California's Wildfire Risks Affecting Utility Credit Quality" (Jun. 3, 2021) at 10.

[87] *See* Prepared Direct Testimony of Air Beer – Company Risk (August 23, 2021) at AB-24.

[88] D.19-12-056 at 42.

[89] RRA Regulatory Focus, "Major Rate Case Decisions—January-December 2020" (Feb. 2, 2021), at 1; RRA Regulatory Focus, "Major Rate Case Decisions—January-June 2021" (Jul. 27, 2021), at 1. At the time of the filing of this testimony, the RRA report for the full 2021 year was not yet available.

[90] D.19-12-056 at 42-43.

pandemic, the average authorized electric utility ROE nationwide have only moderately declined.

The CCM Adjustment Mechanism, by contrast, would reduce SDG&E's ROE by 58 basis points[91]—a much larger reduction in ROE than the one that has taken place in the national authorized electric utility average since the 2019 Decision—reducing SDG&E's ROE to around that average. Even at SDG&E's current ROE, Sempra Energy's beta has significantly increased, its stock has underperformed both the S&P 500 and S&P Utility 500, and investor analysts have explicitly priced Sempra Energy's stock at a "discount"—despite SDG&E's "superior wildfire mitigation protocols"[92]—reflecting "lingering risks related to [California's] inverse condemnation policy and highly politicized regulatory environment."[93] Applying the CCM Adjustment Mechanism would only exacerbate these impacts and be contrary to prior Commission findings.

The Commission should thus suspend the CCM and apply SDG&E's current cost of capital to 2022 rather than litigate the issue in a phase two proceeding. Setting the cost of capital is a complex undertaking. Now that the Scoping Memo has established that such a fulsome proceeding will be conducted for all four applicable utilities for test year 2023 with the "imminent" filing of applications within five months beginning in April 2022,[94] it is not prudent to consider SDG&E's cost of capital for 2022 in a simultaneous phase two that does not consider

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[91] SDG&E Compliance Filing (November 8, 2021) at 5.

[92] Evercore ISI, "Sempra Energy" (Jun. 29, 2021), at 2.

[93] Wells Fargo, Equity Research, Sempre Energy Analysis (SRE), SRE: Analyst Day Previews CapEx Upside in Texas (Jun. 29, 2021), p. 3.

[94] Scoping Memo at 8.

all cost of capital issues.[95] The Scoping Memo noted that it is "[s]ignificantly more efficient" to avoid having two fully litigated cost of capital proceedings in consecutive years.[96] An elongated, simultaneous proceeding where the 2022 cost of capital would be set at the end of this year (even if the proceeding only considers the cost of capital components) also provides less value to investors and other stakeholders who must invest based upon expectations.

That said, the pandemic—and the resulting low-interest rate environment due to federal government and Federal Reserve actions to combat the economic impacts of the pandemic—constitutes extraordinary, exigent circumstances that warrant suspending the CCM. The Commission should thus leave in place SDG&E's current cost of capital that the Commission has already approved for 2022 and then turn to setting the cost of capital in a full proceeding beginning in April 2022; allowing the Commission to determine SDG&E's cost of capital for 2023-2025 as economic conditions from the pandemic stabilize.

IV. CONCLUSION

The extraordinary circumstances of the COVID-19 pandemic—and the federal government's aggressive, temporary response to lower interest rates to minimize the economic impacts from the pandemic—renders the CCM Adjustment Mechanism an inadequate measure of SDG&E's 2022 cost of capital given the decoupling of interest rates and the cost of equity. The Commission should suspend the CCM and leave SDG&E's current cost of capital in place. The Commission has already found that cost of capital reasonable and the bases for the Commission findings in the 2019 Decision still apply today. The Commission can then analyze

[95] *See, e.g.*, *id.* (noting that the Commission has found a three-year cycle ideal holding a full capital of capital proceeding); *id.* at 9 (deferring consideration of issues such as a "blended ROE" to 2023 test year).

[96] *Id.*

SDG&E's cost of capital in a full proceeding for 2023 based on SDG&E's April 2022 application.

This concludes my prepared opening testimony.

V. WITNESS QUALIFICATIONS

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

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

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

I have not previously testified before this Commission.