

Company: Southern California Gas Company (U 904 G)
Proceeding: 2020 Cost of Capital
Application: A.19-04-XXX
Exhibit: SCG-01

SOUTHERN CALIFORNIA GAS COMPANY (U 904 G)
PREPARED DIRECT TESTIMONY OF BRUCE A. FOLKMANN
(POLICY OVERVIEW)

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

April 2019

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1 As the Commission articulated when approving SoCalGas' Test Year 2013
2 authorized Cost of Capital:

3 The legal standard for setting a fair rate of return has been established
4 by the United States Supreme Court in the Bluefield and Hope cases.

5 The Bluefield decision states that a utility is entitled to earn a return upon
6 the value of its property employed for the convenience of the public and
7 sets forth parameters to assess a reasonable return. Such a return
8 should be equal to that generally being made at the same time and in
9 the same general part of the country on investments in other business
10 undertakings attended by corresponding risks and uncertainties. That
11 return should be reasonably sufficient to ensure confidence in the
12 financial soundness of the utility, and adequate, under efficient
13 management, to maintain and support its credit and to enable it to raise
14 the money necessary for the proper discharge of its public duties.

15 The Hope decision reinforces the Bluefield decision and emphasizes
16 that such returns should be sufficient to cover operating expenses and
17 capital costs of the business. The capital cost of business includes debt
18 service and stock dividends. The return should also be commensurate
19 with returns available on alternative investments of comparable risks.
20 However, in applying these parameters, we must not lose sight of our

1 duty to utility ratepayers to protect them from unreasonable risks
2 including risks of imprudent management.¹

3 SoCalGas' Test Year 2020 Cost of Capital proposal represents a fair Rate of
4 Return, and is supported by data, sound financial modeling, information from the rating
5 agencies, and qualitative and quantitative analyses from witnesses. Therefore, I
6 respectfully request the Commission to adopt SoCalGas' Test Year 2020 Cost of
7 Capital as proposed. I also request that the Commission extend SoCalGas' current
8 Cost of Capital Mechanism, with some focused modifications.

9 **II. OVERVIEW OF PROPOSALS**

10 **A. Authorized Cost of Capital for Test Year 2020**

11 The following present SoCalGas' proposed Test Year 2020 Cost of Capital and
12 its currently authorized Cost of Capital.

13 **TABLE 1 – PROPOSED**

Test Year 2020			
Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	43.60%	4.23%	1.84%
Preferred Equity	0.40%	6.00%	0.02%
Common Equity	56.00%	10.70%	5.99%
Rate of Return (ROR)	100.00%		7.85%

14
15

¹ D.12-12-034, *mimeo*, pp. 17-18, *citing* Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia, 262 U.S. 679 (1923).

TABLE 2 – CURRENTLY AUTHORIZED

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	4.33%	1.97%
Preferred Equity	2.40%	6.00%	0.14%
Common Equity	52.00%	10.05%	5.23%
Rate of Return (ROR)	100.00%		7.34%

The proposed authorized Rate of Return of 7.85% represents a 51 basis point (*i.e.*, 0.51%) increase from the current 7.34%. This increase, if adopted, would equate to an increase in overall transportation revenues of \$40.14 million for 2020 (or 1.3%). A typical residential customer using 34 therms of gas per month will see a \$0.46 monthly bill increase in 2020 (or 1.1%).

I expect the California IOUs filing applications at the same time as SoCalGas will request higher Cost of Capital increases, particularly in response to the significant risks associated with wildfire cost recovery. SoCalGas is not immune from the risks that the electric utilities bear, as credit rating agencies have warned. However, currently SoCalGas' credit rating has not been downgraded due to this specific risk. SoCalGas' Test Year 2020 Cost of Capital is nonetheless an increase over the current Cost of Capital, to account for the increased risks that California IOUs face relative to utilities in other jurisdictions, and for risks SoCalGas faces as a gas-only utility. The increase is also attributable to SoCalGas' authorized capital structure proposal, which is designed to reflect SoCalGas' actual capital structure experience. SoCalGas' Cost of Capital should not trail too far behind the other California IOUs, as SoCalGas must continue to attract investor capital through a strong and competitive Rate of Return in this less stable financial and regulatory environment, compared to the environment which existed when SoCalGas last filed its application in 2012.

1 **B. Cost of Capital Mechanism (CCM)**

2 SoCalGas is also requesting that the Commission extend its current CCM, which
3 functions to automatically adjust the authorized Cost of Capital based on material bond
4 rate fluctuations. The CCM is viewed positively both by the Commission and the
5 financial markets, as it provides a number of benefits. However, based on the
6 assessment of recent rating agency information, the current environment in which
7 SoCalGas is operating, with the more recent concerns being expressed on all California
8 IOUs, SoCalGas proposes focused modifications to the current CCM, most notably, a
9 narrowing of the “dead band” to account for the decrease in market stability relative to
10 when the last Cost of Capital was adopted.

11 **III. LIST OF SUPPORTING TESTIMONIES**

12 SoCalGas’ Cost of Capital application is accompanied by prepared direct
13 testimonies from five witnesses, as summarized below:

- 14 • **Exhibit SCG-01, Policy Overview (witness: Bruce Folkmann).** My testimony
15 provides an overview of SoCalGas’ Cost of Capital proposals for the Test Year
16 2020 and the period until the Cost of Capital is next updated by application. I
17 provide a brief summary of the primary proposals and their underlying support,
18 as contained in the testimonies of the following witnesses.

- 19 • **Exhibit SCG-02, Authorized Capital Structure (witness: Ricardo Gonzalez).**
20 Mr. Gonzalez presents SoCalGas’ authorized capital structure proposal. Mr.
21 Gonzalez presents evidence of SoCalGas’ actual capital structure levels since
22 the last Cost of Capital was adopted for Test Year 2013. As he shows,
23 SoCalGas has relied increasingly on Common Equity relative to Long-Term Debt

1 and Preferred Equity, which has helped SoCalGas manage the financial risk of
2 being over-leveraged. SoCalGas is proposing an updated authorized capital
3 structure comprised of 43.60% Long-Term Debt, 0.40% Preferred Equity, and
4 56.00% Common Equity. Mr. Gonzalez also performs and presents an
5 embedded cost analysis for Long-Term Debt and Preferred Equity, which gets
6 applied to the capital ratios to yield a weighted cost of Long-Term Debt and
7 Preferred Equity. Finally, this testimony addresses an issue that was litigated in
8 the pending SoCalGas Test Year 2019 General Rate Case (GRC) regarding the
9 ratemaking treatment of customer deposits, but which may become an issue in
10 this Cost of Capital proceeding.

- 11 • **Exhibit SCG-03, Company Risk (witness: Jesse Aragon).** Mr. Aragon
12 describes SoCalGas' business, financial, and regulatory risk, operating as a
13 regulated, gas-only utility in California. His testimony provides justification and
14 additional qualitative support for SoCalGas' Return on Equity proposal presented
15 in Exhibit SCG-04 (Morin), and authorized capital structure proposal presented in
16 Exhibit SCG-02 (Gonzalez). Mr. Aragon supports his analysis with official
17 company disclosures and information from three prominent rating agencies:
18 Moody's, Standard and Poor's, and Fitch. SoCalGas faces increased risk as a
19 California IOU, due in large part to the market's reaction to the negative
20 outcomes for Pacific Gas and Electric Company (PG&E), Southern California
21 Edison Company (SCE), and SDG&E with respect to California's application of
22 inverse condemnation, and its impact on wildfire cost recovery. Further,
23 SoCalGas faces unique risks as a gas-only utility operating in today's political

1 and regulatory climate, in which some lawmakers, policymakers, and
2 constituents are signaling for the end of natural gas as an energy resource. Mr.
3 Aragon explains that these risks should be appropriately reflected in SoCalGas'
4 authorized Cost of Capital.

- 5 • **Exhibit SCG-04, Return on Equity (witness: Dr. Roger Morin).** Dr. Morin is
6 an expert and scholar in the field of finance and was SoCalGas' Return on Equity
7 (ROE) witness in the Test Year 2013 Cost of Capital proceeding. Through his
8 modeling and evaluation of financial and economic data for proxy group
9 companies, as well as his consideration of the company's risks and proposed
10 capital structure, Dr. Morin presents his findings and analyses, and recommends
11 an authorized ROE of 10.70%. He also addresses why flotation costs should be
12 factored into a utility company's authorized ROE.²

- 13 • **Exhibit SCG-05, Cost of Capital Mechanism (witness: Bruce MacNeil).** Mr.
14 MacNeil presents SoCalGas' Cost of Capital Mechanism analysis and proposal.
15 Mr. MacNeil describes how the CCM works, how it has performed since being
16 adopted, and the benefits of continuing the mechanism for the upcoming Cost of
17 Capital cycle. His testimony also presents the history of SoCalGas' credit ratings
18 since the last Cost of Capital was decided, the factors that have led to recent
19 ratings actions, and the proposed modifications to the current CCM to make the
20 mechanism more appropriate and functional based on the changing credit ratings

² Flotation costs are very similar to the closing costs on a home mortgage. In the case of issues of new equity, flotation costs represent the discounts that must be provided to place the new securities. See Exhibit SCG-04 (Morin), p. 53.

1 landscape. He describes four modifications/clarifications to the current CCM that
2 would achieve that result: (1) narrowing of the current dead band from 100 basis
3 points to 50 basis points, (2) clarifying the selection of the CCM's benchmark
4 index when the utility has split ratings, (3) clarify the approach that should be
5 taken in the event SoCalGas' current credit rating changes during the CCM
6 years, and (4) clarification of guidance with respect to utilities with non-
7 investment grade ratings.

8 **IV. KEY THEMES UNDERLYING THE COST OF CAPITAL PROPOSALS**

9 I have reviewed the testimonies being presented by SoCalGas. The witnesses
10 are responsible for sponsoring, explaining, and defending their qualitative and
11 quantitative analyses and their ultimate proposals. However, I would like to highlight
12 several elements of their testimonies which merit attention.

13 **A. Return on Equity (ROE)**

14 First, in terms of Dr. Morin's ROE analysis and ROE recommendation of 10.70%,
15 I have confidence that the Commission will find his analysis as credible and well-
16 supported, based on his experience and expertise in the field of finance and his
17 extensive regulatory experience on Cost of Capital matters. While he is one of several
18 expert witnesses who may be testifying for parties in this proceeding, I believe the
19 Commission will find his determination of proxy groups, application of financial modeling
20 and analysis of the results, and understanding of market data and investor expectations,
21 as probative and reliable. As an introduction to his analysis for SoCalGas' ROE, Dr.
22 Morin's provides the following insights:

1 If a utility is authorized a ROE below the level required by equity
2 investors, the utility or its parent will find it difficult to access equity
3 capital. Investors will not provide equity capital at the current market
4 price if the earnable return on equity is below the level they require given
5 the risks of an equity investment in the utility.³

6 . . .

7 As a company relies more on debt financing, its capital structure
8 becomes more leveraged. Because debt payments are a fixed financial
9 obligation to the utility, and income available to common equity is
10 subordinate to fixed charges, this decreases the operating income
11 available for dividend and earnings growth. Consequently, equity
12 investors face greater uncertainty about future dividends and earnings
13 from the company. As a result, the company's equity becomes a riskier
14 investment. The risk of default on a company's bonds also increases,
15 making the utility's debt a riskier investment. This increases the cost to
16 the utility from both debt and equity financing and increases the
17 possibility a company will not have access to the capital markets for its
18 outside financing needs.⁴

19 . . .

20 SCG must secure outside funds from capital markets to finance required
21 utility plant and equipment investments irrespective of capital market

³ See Exhibit SCG-04 (Morin) at 7.

⁴ See Id. at 7-8.

1 conditions, interest rate conditions and the quality consciousness of
2 market participants. Thus, rate relief requirements and supportive
3 regulatory treatment, including approval of my recommended ROE, are
4 essential.⁵

5 Dr. Morin's recommended 10.70% ROE represents a reasonable outcome based
6 on the range he has computed through his modeling efforts, and in light of the business,
7 financial, and regulatory risks that SoCalGas will carry in the upcoming Cost of Capital
8 cycle.

9 **B. Capital Structure**

10 In terms of SoCalGas' authorized capital structure, the company's proposal is
11 closely aligned with its actual capital structure experience since the last Cost of Capital
12 case was adopted. From 2013 to 2018, SoCalGas' recorded capital structure ratios
13 were as follows:⁶

Recorded	2013	2014	2015	2016	2017	2018	2013-2018 Average	Proposed 2020
Long-Term Debt	35.52%	40.61%	44.31%	46.11%	43.47%	44.80%	42.47%	43.60%
Preferred Equity	0.55%	0.46%	0.38%	0.33%	0.31%	0.28%	0.38%	0.40%
Common Equity	63.94%	58.93%	55.31%	53.56%	56.22%	54.92%	57.15%	56.00%

14 These higher-than-authorized Common Equity levels relative to Long-Term Debt
15 and Preferred Equity have provided SoCalGas with increased capital sourced from

⁵ See Id. at 8.

⁶ See Exhibit SCG-02 (Gonzalez), pp. 5, 12, 13, and Appendix C (figures are rounded to the hundredth decimal point. If percentages do not sum to 100.00%, it is due to rounding).

1 | shareholders, have reduced financial risk, and have improved credit metrics (by
2 | reducing debt) throughout this period, directly benefitting ratepayers and shareholders.
3 | The Commission has adopted utility authorized capital structures based on actual
4 | capital structure levels.⁷ Therefore, SoCalGas is proposing a Test Year authorized
5 | capital structure that is more aligned with its actual capital structure ratios, and one
6 | which the company can manage and maintain throughout the next Cost of Capital cycle.

7 | **C. Company Risk**

8 | In terms of SoCalGas' discussion of business, financial, and regulatory risk, Mr.
9 | Aragon's analysis is supported by SoCalGas' most recent 10-K Annual Report, which
10 | represents the company's official disclosures to the Securities and Exchange
11 | Commission, the investment community, and the public at large. In addition, Mr.
12 | Aragon references information and recent actions from three major rating agencies
13 | (Moody's, S&P, and Fitch) to provide market-sourced support for SoCalGas' risk
14 | assessment.

15 | As Mr. Aragon explains, capital markets determine the price of investor capital
16 | based on the riskiness to the borrower in relation to other borrowers. Because investors
17 | have a significant array of investment options, a utility such as SoCalGas must compete
18 | for and attract private funds by offering potential investors with the opportunity of
19 | earning a return on investment that is equal to the potential returns offered by other
20 | investments of comparable risk. A strong Cost of Capital (and Rate of Return) positions
21 | the utility to attract that capital.⁸

⁷ See Id. at 13-14.

⁸ See Exhibit SCG-03 (Aragon), pp. 2-3.

1 Changes in the California regulatory and political environment, as well as events
2 that have occurred since the last Cost of Capital was adopted, have contributed to
3 increased uncertainty, risk, and challenges for the California IOUs, and for SoCalGas,
4 as the state's largest gas-only utility and largest local distribution company in the nation.
5 Among the primary risk drivers contributing to the current instability is California's
6 application of inverse condemnation on utilities, which has significantly impacted the
7 electric utilities' ability to recover substantial wildfire-related costs. While this risk has
8 resulted in recent credit downgrades for PG&E, SCE, and SDG&E, SoCalGas is also
9 subject to this same risk, which may impact its credit rating.

10 In addition, in the current political climate, where some California lawmakers,
11 public officials, and policymakers are promoting the significant reduction or elimination
12 of natural gas, the ability for SoCalGas to retain the use of its existing infrastructure or
13 invest in new infrastructure, in furtherance of service and system reliability, is
14 increasingly uncertain. This uncertainty poses a business risk to SoCalGas' planned
15 capital projects, which are estimated at approximately \$6.1 to \$6.8 billion over the next
16 five years (2019 – 2023). Furthermore, the 2015 Aliso Canyon well leak incident has
17 created new litigation, insurance, and operational risks for SoCalGas that did not exist in
18 2013. This additional risk disproportionately impacts SoCalGas relative to its peer group
19 and the other California IOUs.

20 These risks underscore the need for a strong and competitive Cost of Capital in
21 the upcoming cycle, so that SoCalGas can attract the necessary capital to fund its
22 planned capital projects. Further, I anticipate that the market will respond positively to
23 the Commission's adoption of SoCalGas' proposed Cost of Capital, which will promote

1 market stability and will help to restore the perception of California as a credit supportive
2 jurisdiction relative to other states.

3 **D. Cost of Capital Mechanism (CCM)**

4 Mr. MacNeil (Assistant Treasurer for Sempra Energy responsible for oversight of
5 capital market activities, credit ratings and rating agencies) provides a fresh and
6 credible review of the CCM in light of recent bond market history, rating downgrades at
7 other California IOUs (including SDG&E), and future uncertainties around SoCalGas'
8 credit ratings. Overall, SoCalGas believes that retaining the CCM for the upcoming
9 Cost of Capital cycle will continue to provide the same benefits that the CCM provided
10 since it was adopted. As Mr. MacNeil discusses, the Commission recognized the
11 benefits of the CCM when it adopted it for the California IOUs in the last Cost of Capital
12 (Phase 2) proceeding:

13 This CCM streamlines the major energy utilities' COC process while
14 providing greater predictability of the utilities' COC by eliminating the use
15 of interest rate forecasts and disputes concerning interest rate levels and
16 trends, as well as uncertainties associated with conflicting perceptions
17 of financial markets and the return requirements of investors. Hence,
18 shareholders and ratepayers alike share the burden and benefits of
19 market changes, while eliminating the burden of annual COC
20 applications. The CCM also enables the utilities, interested parties, and
21 Commission staff to reduce and reallocate their respective workload
22 requirements for litigating annual COC proceedings.⁹

⁹ See Exhibit SCG-05 (MacNeil), p. 3.

1 Mr. MacNeil also explains that credit rating agencies and banks have indicated
2 their preference for the automatic rate-setting mechanism, since it provides greater
3 clarity and transparency in understanding changes to a utility's ROE compared to the
4 uncertainty of trying to predict the outcome of litigation. This in turn promotes a degree
5 of stability; and, financial markets generally respond favorably to stability.¹⁰

6 The current CCM is fundamentally simple in its construction and consists of (i) a
7 benchmark interest rate (based on Moody's "A" Utility Bond Index) and (ii) a 100 basis
8 point dead band from that benchmark, which determines whether the CCM will trigger.
9 If bond rates fluctuate in either direction beyond the dead band, the CCM will
10 automatically trigger, thereby causing several components of the authorized Cost of
11 Capital to become adjusted (*i.e.*, the ROE, embedded costs of Long-Term Debt and
12 Preferred Stock), and an updated Cost of Capital (and Rate of Return) will become
13 effective on January 1 of the following year.

14 SoCalGas believes the CCM would be more effective and appropriate for the
15 upcoming Cost of Capital cycle, given current conditions, if the dead band is narrowed
16 to 50 basis points, and a few focused clarifications are made to address the recent
17 instability of utility credit ratings.

18 **V. CONCLUSION**

19 SoCalGas respectfully asks the Commission to adopt its proposed Test Year
20 2020 Cost of Capital, with a finding that it represents a reasonable outcome supported
21 by the evidence. In addition, SoCalGas requests that the Commission reset and extend
22 applicability of its current CCM, with the focused modifications being proposed, so that

¹⁰ See *Id.*

1 the mechanism can more appropriately and effectively regulate SoCalGas' authorized
2 Cost of Capital until the next application is filed.

3 This concludes my prepared direct testimony.

1 **VI. WITNESS QUALIFICATIONS**

2 My name is Bruce A. Folkmann. I am Vice President, Controller, Chief Financial
3 Officer, Chief Accounting Officer, and Treasurer for SoCalGas and SDG&E. My
4 business address is 8330 Century Park Court, San Diego, CA 92123.

5 In my current position, I am responsible for overseeing the financial planning and
6 budgeting, energy risk management, financial reporting, and treasury management for
7 SDG&E and SoCalGas.

8 I graduated summa cum laude from the University of Houston Honors College,
9 receiving degrees in Accounting and Finance. I am a Certified Public Accountant. I
10 began my career with Arthur Andersen and a large multinational corporation. In 2005, I
11 joined Sempra Energy and have held positions of increasing responsibility in Sempra
12 Energy businesses since that time.

13 I have previously testified before the Commission.