Company:	Southern California Gas Company (U 904 G)
Proceeding:	2020 Cost of Capital
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SOUTHERN CALIFORNIA GAS COMPANY (U 904 G)

PREPARED REBUTTAL TESTIMONY OF RICARDO GONZALEZ

(AUTHORIZED CAPITAL STRUCTURE)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

August 2019

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SOUTHERN CALIFORNIA GAS COMPANY

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(AUTHORIZED CAPITAL STRUCTURE)

I. INTRODUCTION

My rebuttal testimony addresses capital structure analyses and recommendations contained in the direct testimonies of the following witnesses:

- Mr. Gorman for Energy Producers & Users Coalition, Indicated Shippers, and The Utility Reform Network (EPUC/IS/TURN);[1] and
- Mr. Rothschild for Public Advocates Office (Public Advocates).[2]

I will address the flaws in their capital structure analyses and explain why my authorized capital structure proposal represents a more reasonable and defensible outcome for Southern California Gas Company (SoCalGas) than their proposals.[3]

Table 1 – Summary of Capital Structure Proposals

	Currently Authorized	Proposed		
		SoCalGas[4]	EPUC/IS/TURN[5]	Public Advocates[6]
Long-Term Debt	45.6%	43.6%	47.6%	47.6%
Preferred Equity	2.4%	0.4%	0.4%	0.4%
Common Equity	52.0%	56.0%	52.0%	52.0%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

[1] See Direct Testimony and Exhibits of Michael P. Gorman on behalf of Energy Producers & Users Coalition ("EPUC"), Indicated Shippers, and The Utility Reform Network ("TURN") (August 1, 2019) (Gorman Direct).

[2] See A. Rothschild, Report on the Cost of Capital for Test Year 2020, Redacted Version (August 1, 2019) (Rothschild Direct).

[3] No parties appeared to have contested SoCalGas' embedded cost calculations and proposals.

[4] See Exhibit SCG-02 (Gonzalez), p.1.

[5] See Gorman Direct, p. II-4.

[6] See Rothschild Direct, p. 5.

II. CAPITAL STRUCTURE PROPOSALS

A. Mr. Gorman's Analysis

1. Material flaws in Mr. Gorman's debt ratio analysis

Mr. Gorman argues that SoCalGas' Common Equity ratio should remain unchanged at the currently authorized 52.0%.[7] He, attempts to make a comparison of SoCalGas' adjusted *debt* ratio[8] to a proxy group composed of natural gas, electric, and water utilities as the basis for his proposal. He asserts that SoCalGas adjusted debt ratio of 52.4% is correlated with SoCalGas' current authorized Common Equity ratio of 52.0%. Mr. Gorman argues that this ratio "is reasonably aligned with an A-rated utility company based on industry median adjusted debt ratios."[9] He further contends that SoCalGas' proposed authorized Common Equity ratio of 56.0% would imply an adjusted debt ratio of approximately 48.6%, which "is much lower than the industry median adjusted debt ratio for an A-rated utility."[10] Mr. Gorman claims that "SoCalGas's proposed increased equity ratio will result in an under leveraged utility . . . ."[11]

Mr. Gorman's analysis contains material flaws. First, SoCalGas' adjusted debt ratio is based on actual recorded credit metrics and capital structure, not authorized levels. Therefore, it is not appropriate to compare adjusted debt ratios that are based on authorized capital structures, as authorized capital structures are not used by credit rating agencies to assign a company's credit rating. In fact, the 52.4% adjusted debt

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[7] See Gorman Direct at II-4.

[8] Id. at IX-6 - IX-8.

[9] Id. at IX-7.

[10] Id. at IX-7.

[11] Id. at IX-6.

ratio that Mr. Gorman argues is reasonably aligned with an A-rated utility company is correlated with the year-end actual 2018 Common Equity ratio of 54.92%.[12]

Second, Mr. Gorman's use of electric / gas / water utility adjusted debt ratios as a comparison lacks foundation as a useful or meaningful data set by which to rely on for purposes of evaluating SoCalGas' authorized capital structure. As Dr. Morin explains in his direct testimony,[13] the group of proxy companies were carefully selected based on a number of factors to be utilized in SoCalGas' capital structure and Return on Equity analyses.

The more insightful water utility data would be the recently-adopted Common Equity ratios for the California water utilities, which show that the Commission has adopted higher levels of common equity that more closely align with their actual capital structures. [14] Table 2 shows these recent regulatory outcomes.

Table 2 – Recently Authorized Common Equity Ratios for Regulated California Water Utilities

Utility	Decision	Authorized Common Equity Ratio	Effective Date
Great Oaks Water Co.	D.18-12-002	70.00%	July 1, 2019
Liberty Utilities Corp. (2 entities)	D.18-12-002	57.00%	July 1, 2019
Suburban Water Systems	D.18-12-002	60.00%	January 1, 2019
San Gabriel Valley Water Co.	D.18-12-002	64.46%	January 1, 2019

[12] See Exhibit SCG-02 (Gonzalez), p.13.

[13] See Exhibit SCG-04 (Morin), p. 25.

[14] See D.18-03-035, *mimeo*, p. 22. In D.18-12-002 (issued in A.18-05-001 et al.), the Commission approved a settlement entered into by the water utilities and Public Advocates, which resulted in the adopted Common Equity ratios reproduced in Table 2. Neither the decision nor the attached settlement agreement discusses the water utilities' actual capital structure ratios in relation to their newly-authorized ratios, although the settlement agreement contains ample citations to the testimonies submitted by the parties, which would likely contain that information.

California Water Service Co.	D.18-03-035	53.40%	January 1, 2018
California-American Water Co.	D.18-03-035	55.39%	January 1, 2018
Golden State Water Co.	D.18-03-035	57.00%	January 1, 2018
San Jose Water Co.	D.18-03-035	53.28%	January 1, 2018

I am presenting these data to illustrate that the Commission has adopted Common Equity ratios at or above the ratio that I propose for SoCalGas, which is 56.0%. Further, the Commission has authorized these ratios in light of evidence showing a utility's actual recorded Common Equity ratios, evidence which intervenors in this proceeding largely ignore or discount when evaluating SoCalGas.

2. Mr. Gorman's Tax Cuts and Jobs Act (TCJA) analysis

In his discussion of the tax legislation, Mr. Gorman contends that, "[t]he impact on cash flows, however, is not likely to be significant enough to threaten the credit standing of, or to increase the cost of equity capital for the industry in general on a going forward basis."[15] However, in the previous paragraphs of his testimony, he recognizes,

> Moody's is concerned about short-term cash flow impacts of new tax laws due to the Tax Cuts and Jobs Act ("TCJA") for the regulated utility industry. However, it is looking for regulatory decisions that support the utility's cash flow while the utility transforms to the new federal tax law environment.[16]

He also notes similar concerns from Fitch regarding tax reform:

> The Tax Cuts and Jobs Act signed into law on Dec. 22, 2017 has negative credit implications for U.S. regulated utilities and utility

[15] Gorman Direct at III-9.

[16] Id. at III-8.

> holding companies over the short-to-medium term, according to Fitch Ratings. . .. Absent mitigating strategies on the regulatory front, this is expected to lead to weaker credit metrics and negative rating actions for those issuers that have limited headroom to absorb the leverage creep.[17]

Moody's and Fitch are expecting regulatory commissions to make the necessary adjustments in response to TCJA. One way to achieve this, as S&P explains below, is to allow utilities to make further equity infusions:

> Weaker credit measures from tax reform will likely persist in 2019, reflecting tax-related rate reductions carryovers. However, we expect that some utilities will offset this reduced revenue with further equity infusions or asset sales.[18]

Mr. Gorman's suggestion that on a going forward basis, the credit impacts to utilities will not be impacted in any significant way, does not nullify the impacts of the tax law change to SoCalGas and other regulated utilities in the near term, including the upcoming Cost of Capital cycle (2020 – 2022). SoCalGas maintains that for at least the upcoming cycle, this tax reform represents a negative impact on its credit metrics, and should be taken into consideration when adopting the authorized capital structure for 2020.[19] The excerpt from Fitch seems to corroborate this view. Further, in a recent

[17] Id.

[18] Id. at III-7.

[19] See Exhibit SCG-02 (Gonzalez) at 17-18.

decision on Atmos Energy Corporation Kentucky/Mid-States division's authorized capital structure, the regulatory commission stated:

> Atmos…argues that a higher common equity ratio is characteristic of the current trend for utilities to strengthen the equity portion of their balance sheets in order to counter the impact that the Tax Cuts and Jobs Act has had on financial metrics. Atmos avers that it has intentionally improved its credit metrics through increased equity and decreased reliance on debt financing for more favorable access to capital markets.[20]

The regulatory commission ultimately authorized the utility's requested capital structure after taking this evidence into account.[21]

Lastly, Mr. Gorman asserts, "the S&P Utilities index has outperformed the broader market as measured by the S&P 500 by a significant margin since December 2017 when TCJA was signed into law."[22] First, as shown in Figure 3 of Mr. Gorman's testimony,[23] the S&P Utilities index sharply declined beginning in December 2017 through February 2018, which is arguably due, at least in part, to the stock market's reaction to TCJA. Second, Mr. Gorman links the performance of the S&P Utilities index compared to the broader S&P 500 index since December 2017 directly to changes in tax reform. However, there is no way to isolate the changes in the stock market to any one event or cause. The nature of the stock market is that it reacts in real-time to a

[20] D.2018-00281, p. 32.

[21] See Id. at 35.

[22] Gorman Direct at III-9.

[23] See Id. at III-6.

multitude of events happening worldwide. The enactment of TCJA is just one of many major changes that has impacted the stock market since December 2017.

3. Mr. Gorman does not acknowledge the role of SoCalGas' actual capital structure in maintaining solid credit ratings

Mr. Gorman asserts,

> Ratemaking capital structures should reflect a reasonable cost to customers for allowing a utility to finance its investment in utility infrastructure using an appropriate mix of debt and equity that will maintain a strong investment grade bond rating, and preserve its access to capital. SoCalGas's current ratemaking capital structure that contains a 52% common equity, has successfully met these objectives and at a much lower cost to customers than the increased common equity ratio proposed by SoCalGas witness Folkmann.[24]

While I do not disagree with the first part of Mr. Gorman's statement, I do not think Mr. Gorman draws the proper conclusion from it. Specifically, Mr. Gorman does not appear to take into account that SoCalGas' current "A" credit rating is based on its actual recorded credit metrics and capital structure, *not* its authorized capital structure. This is not to suggest that the utility's authorized capital structure has no relevance to a utility's credit ratings. However, once an authorized capital structure is in place, a utility must actively manage its actual capital structure based on its financial and operational needs. Therefore, it would be an erroneous conclusion to simply state that SoCalGas' solid credit rating has been supported by its 52% authorized Common Equity ratio.

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[24] Id. at IX-5.

SoCalGas has maintained its "A" credit rating since its last Cost of Capital proceeding by maintaining a Common Equity ratio that is above its authorized 52.0%. In fact, SoCalGas' average Common Equity ratio from 2013 through 2018 was 57.15%,[25] well above SoCalGas' currently requested 56.0%. During this time, ratepayers have benefited from the company's strong "A" credit rating and ample access to capital markets at a reasonable cost. However, this benefit has come at a cost to shareholders who were not sufficiently compensated for their investment.

An authorized Common Equity ratio that is lower than the actual Common Equity ratio means that the Common Equity return collected from ratepayers and passed on to shareholders will be lower than a fair market return. In other words, shareholders are not earning a return on the difference between the authorized Common Equity ratio of 52.0% and the actual ratio of 57.15%. As established in the Bluefield and Hope Supreme Court cases, investors in public utilities are entitled to a fair rate of return given the corresponding risks.[26]

Further, Moody's published a matrix of "Debt Ratio Benchmarks,"[27] which it uses along with other indicators as a guideline for assigning a utility's credit rating. The matrix recommends that a utility's debt ratio fall within the range of 35%-45% in order for the company to maintain an "A" credit rating. Assuming the company has little-to-no Preferred Equity, similar to SoCalGas, the resulting Common Equity ratio range for an "A" credit rating would be approximately 55%-65%. This supports SoCalGas' argument

[25] See Exhibit SCG-02 (Gonzalez), Appendix C.

[26] See Exhibit SCG-01 (Folkmann), pp. 2-3.

[27] See Exhibit SCG-02 (Gonzalez) at 10.

that the primary reason it has been able to maintain a strong "A" credit rating since the last Cost of Capital proceeding is that it has held its Common Equity ratio at an average of 57.15%, which is within the "A" range suggested by Moody's. If SoCalGas lowered its actual Common Equity ratio to align with its authorized 52.0%, SoCalGas would risk being downgraded by the rating agencies due to weakened credit metrics. The Moody's matrix suggests that a Common Equity ratio of 52.0% (and corresponding Long-Term Debt ratio of approximately 48%) should be assigned a "Baa" credit rating, one notch below SoCalGas' current "A" rating.

Moody's also recently published an updated credit report for SDG&E which highlights the importance of increasing the Common Equity ratio in order to maintain its current credit ratings:

> Importantly, the Baa1 rating assumes a credit supportive outcome of SDG&E's ongoing 2019 general rate case and cost of capital proceeding where the utility requested an increase in its equity layer to 56% (effective January 2020) from currently 52%. The outcome of these regulatory proceedings will be important for SDG&E's ability to further generate a ratio of CFO pre-W/C to debt that comfortably exceeds 20% on a sustained basis.[28]

Moody's expects SDG&E to maintain its Common Equity level at the requested 56.0% in order to preserve its current credit rating going forward. It is reasonable to assume that Moody's expects the same of SoCalGas.

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[28] Source: "Moody's Investors Service – Rating Action: Moody's affirms San Diego Gas & Electric's ratings; changes outlook to positive from negative," July 29, 2019.

Therefore, I come to the conclusion that Mr. Gorman is not giving due consideration to SoCalGas' actual capital structure data because then he would find support for an increase in SoCalGas' current authorized Common Equity ratio. Instead, Mr. Gorman draws the simple conclusion that SoCalGas has maintained its strong credit rating under a 52.0% *authorized* Common Equity ratio such that an increase would not be required to keep the company's current rating. In my opinion, this is not a correct or well-reasoned approach to developing a capital structure proposal.

B. Mr. Rothschild's Analysis

1. Mr. Rothschild provides no credible analysis to support his proposal

Mr. Rothschild's proposal to keep SoCalGas' authorized Common Equity ratio unchanged at 52.0% is almost exclusively based on Sempra Energy's consolidated capital structure.[29] This is a misplaced basis for establishing a reasonable Common Equity ratio. As explained in the rebuttal testimony of Mr. Folkmann (Exhibit SCG-07), Sempra Energy is a diverse energy holding company with non-regulated affiliates beyond SoCalGas, such that one cannot base a utility's ratemaking capital structure on an evaluation of the holding company's consolidated capital structure.[30]

Aside from his misplaced reliance on the holding company's consolidated capital structure, Mr. Rothschild argues to keep SoCalGas' authorized capital structure unchanged, "because it is closer to the average capital structure ratios of the Electric

[29] See Rothschild Direct at 31-46.

[30] See Exhibit SCG-07 (Folkmann) at 8-10.

Proxy Group. . . ."[31] However, a proxy group comprised of 29 electric utilities[32] is not an appropriate barometer for determining the authorized capital structure of a natural gas utility.

Mr. Rothschild also implies that SoCalGas' proposed authorized capital structure is unjustified because, "[t]he company provides no proof that it would increase SDG&E or SoCalGas' bond rating let alone be worth the associated substantial rate increase. . . ."[33] As I have previously explained, bond ratings are based on actual recorded credit metrics and capital structure, not authorized capital structure. SoCalGas' proposed authorized capital structure would not result in an increased bond rating, but rather benefit ratepayers through an "A" credit rating and fairly compensate shareholders for their investment. The more appropriate view of authorized capital structure is that it should more closely align with a utility's actual capital structure, which is why SoCalGas is proposing an authorized capital structure which includes a Common Equity ratio of 56.0%.

2. Mr. Rothschild's TCJA analysis acknowledges that Common Equity ratio can mitigate adverse impacts from the TCJA, but then fails to apply that conclusion to the appropriate entity

Mr. Rothschild acknowledges that a "significant reduction in the corporate tax rate results in a significant reduction in the important pre-tax coverage and cash flow

[31] Rothschild Direct at 7-8.

[32] See Id. at 8-9.

[33] Id. at 37.

computations used by rating agencies to determine bond ratings."[34] He suggests that, "this reduction can be offset by a real increase in the common equity ratio at the consolidated level."[35] Mr. Rothschild is correct in concluding that an increase in the Common Equity ratio would mitigate the negative impact that a reduction in the corporate tax rate would have on credit metrics by deleveraging the entity and offsetting the reduction in revenues.

However, he once again misses the point when he suggests that the increase in the Common Equity ratio must be made at the consolidated holding company level instead of at the regulated utility subsidiary level.[36] This argument is baseless since credit agencies determine SoCalGas' bond rating based on utility-specific credit metrics and capital structure.

3. Mr. Rothschild acknowledges historical precedent supports using actual capital structures to set authorized capital structures

Mr. Rothschild acknowledges that when determining the optimal capital structure of a regulated utility, "utility commissions often defer to the capital structure on the books of the company."[37] This is aligned with SoCalGas' proposal to the Commission in this proceeding. I've introduced that type of data in this proceeding so that the

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[34] Id. at 45.

[35] Id.

[36] See Id.

[37] Id. at 37.

Commission can make an informed decision in line with its past decision making on adopting authorized capital structures for regulated utilities.

As I explained in my direct testimony, in the last Cost of Capital proceeding (A.12-04-015 et al.), the Commission approved SDG&E's requested Common Equity ratio because it was consistent with its actual Common Equity ratio level.[38] More recently, in the Cost of Capital proceeding for large California water utilities,[39] which I addressed earlier, the utilities requested capital structures that were slightly higher than their average historical capital structures.[40] The Commission adopted the utilities' proposals, stating that their request was not materially different than the recent historical actual capital structures.

Therefore, I come to the conclusion that Mr. Rothschild is not basing his capital structure proposal on the available and relevant data that would support an increase in SoCalGas' current authorized Common Equity ratio. Instead, Mr. Rothschild has undertaken the task of proposing a decrease in the utility's Cost of Capital in this proceeding, and has recommended a capital structure that, combined with his ROE proposal, achieves that result. In my opinion, the Commission has the requisite evidence to adopt a 2020 authorized capital structure that more closely aligns with SoCalGas' actual capital structure experience.

[38] See Exhibit SCG-02 (Gonzalez) at 13-14.

[39] See A.17-04-001 et al.

[40] See Exhibit SCG-02 (Gonzalez) at 14.

III. CONCLUSION

SoCalGas maintains that its requested capital structure is appropriate and promotes the long-term best interests of ratepayers and shareholders alike. Therefore, SoCalGas respectfully requests that the Commission approve its capital structure and embedded cost proposals.

This concludes my prepared rebuttal testimony.