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Proceeding: 2023 Cost of Capital
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SOUTHERN CALIFORNIA GAS COMPANY (U 904 G)

PREPARED REBUTTAL TESTIMONY OF SHIRLEY ARAZI

(AUTHORIZED CAPITAL STRUCTURE AND EMBEDDED COST OF DEBT AND PREFERRED EQUITY)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

August 2022

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I. INTRODUCTION

My prepared direct testimony provided a forecast of Southern California Gas Company's (SoCalGas or the Company) embedded costs of long-term debt[1] and preferred stock for test year 2023, proposing an embedded cost of debt and preferred equity of 3.89%[2] and 6.00%, respectively. I also recommended an authorized capital structure of 45.60% long-term debt, 0.40% preferred equity, and 54.00% common equity, which is credit supportive, more consistent with SoCalGas's historical capital structure, and reflects the ongoing rise in common equity ratios of comparable utilities.

My rebuttal testimony on behalf of SoCalGas addresses the direct testimony of intervenors submitted on August 8, 2022, specifically, the testimony of witnesses on behalf of the Public Advocates Office (Cal Advocates); Energy Producers & Users Coalition (EPUC), Indicated Shippers (IS), and The Utility Reform Network (TURN) (jointly, EPUC/IS/TURN); and Protect Our Communities Foundation (PCF). Rather than supporting SoCalGas's well-reasoned capital structure proposal or even proposing to maintain SoCalGas's current authorized capital structure, Cal Advocates and EPUC/IS/TURN instead suggest increasing SoCalGas's long-term debt ratio from its current authorized. My rebuttal testimony explains that Cal Advocates and EPUC/IS/TURN's alternate proposals to shift 200 basis points of the preferred equity ratio to the long-term debt ratio while maintaining the current authorized common equity ratio are misguided and should be rejected, as it would increase the Company's financial

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[1] The terms "debt" and "long-term debt" are used interchangeably, unless specifically noted otherwise.
[2] To be updated in a late-filed exhibit (cost of debt) on September 14, 2022.

leverage and have an unfavorable impact on credit metrics. The topics of embedded costs of debt and preferred equity calculations were largely uncontested,[3] therefore this rebuttal testimony only briefly addresses PCF's comments regarding embedded cost of debt. In summary, I will address the flaws in intervenors' capital structure proposals and explain why my authorized capital structure and embedded cost proposals represent a more appropriate outcome for SoCalGas to support a strong credit profile for efficient access to debt and equity markets.

II. CAPITAL STRUCTURE

A. Summary of Intervenors' Capital Structure Recommendations

Cal Advocates and EPUC/IS/TURN recommend long-term debt ratios of 47.60%,[4] which would shift 200 basis points of SoCalGas's currently authorized preferred equity ratio to long-term debt, thereby increasing SoCalGas's financial leverage. The capital structure proposal of SoCalGas is contrasted with the intervenors' proposals in Table 1. No party contested SoCalGas's proposal regarding the cost of preferred equity.

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[3] No specific proposals regarding SoCalGas's embedded cost of debt and preferred equity calculations were provided by intervenors, except by PCF which recommends that "current interest rate should be used to estimate future interest rates." (Direct Testimony of Mark E. Ellis (Exhibit PCF-01) at 30-32).

[4] Direct Testimony of J. Randall Woolridge (Exhibit Cal Adv-01) at 6; Direct Testimony of Michael P. Gorman (Exhibit EPUC/IS/TURN-1) at I-3, IX-10.

TABLE 1 – SUMMARY OF CAPITAL STRUCTURE PROPOSALS

Capital Structure Component	Current Authorized[5]	SoCalGas Proposed[6]	Cal Advocates[7]	EPUC/IS/ TURN[8]
Long-Term Debt	45.60%	45.60%	47.60%	47.60%
Preferred Equity	2.40%	0.40%	0.40%	0.40%
Common Equity	52.00%	54.00%	52.00%	52.00%
Total	100.00%	100.00%	100.00%	100.00%

B. Intervenors' Capital Structure Proposals Do Not Provide Credible Analysis or Support Maintaining an "A" Credit Rating and Should Not Be Adopted

The requests and supporting testimony of Cal Advocates and EPUC/IS/TURN regarding SoCalGas's authorized capital structure are inadequate and unreasonable for several reasons. The capital structure proposals of Cal Advocates and EPUC/IS/TURN ignore SoCalGas's actual recorded capital structure and do not support SoCalGas's ability to maintain its "A" credit rating, which is important for a reasonable cost of debt that is included in customer rates. Additionally, Cal Advocates' arguments disputing SoCalGas's capital structure proposal isolate a single component of the overall cost of capital and do not appear to consider the entire cost of capital calculation. Lastly, Cal Advocates and PCF suggest altering the capital structure calculation in various ways that are inappropriate for multiple reasons, as discussed below.

1. Credit Quality is Not Considered in Intervenors' Capital Structure Proposals

Cal Advocates and EPUC/IS/TURN ignore several important factors when each making their capital structure recommendation for a 47.60% long-term debt ratio. First, the historical

5 Decision (D.)19-12-056 at 2.
6 Direct Testimony of Shirley Arazi (Exhibit SCG-02) at 1-2.
7 Direct Testimony of J. Randall Woolridge (Exhibit Cal Adv-01) at 6.
8 Direct Testimony of Michael P. Gorman (Exhibit EPUC/IS/TURN-1) at II-3, IX-10.

recorded 5-year average long-term debt ratio for SoCalGas is approximately 45.49%.[9] SoCalGas proposes an authorized ratio of 45.60%, which more closely aligns with the historical average. Second, the authorized capital structure adopted by the Commission should be credit supportive. SoCalGas manages its actual capitalization to support maintenance of its current "A" credit rating, which results in lower borrowing costs for the utility and ultimately, ratepayers.

As explained in my direct testimony,[10] although long-term debt is generally less expensive than common or preferred equity, there are limits to how much of the capital structure should be comprised of debt due to the effects an elevated long-term debt ratio has on the company's financial risk and credit profile. The more a company utilizes debt, with a rising debt-equity ratio, the greater the financial risk to both stockholders and debt holders and ultimate risk of heightened costs to ratepayers. The Commission has recognized in past decisions that, "as long-term debt ratios are increased, credit ratings tend to be downgraded which results in increased financial risks for common equity holders, thereby requiring greater returns on common equity."[11]

Degradation of SoCalGas's credit metrics could result in a credit rating downgrade. In 2020, Moody's downgraded SoCalGas's credit rating from A1 to A2, partially due to the increased debt ratio in SoCalGas' actual capital structure in recent years.[12] Moody's guidance[13] provides a target debt ratio of 35-45% for regulated gas and electric utilities to maintain an "A" credit rating.[14] Conversely, Cal Advocates and EPUC/IS/TURN suggest a 47.60% ratio, which falls under the Baa range of Moody's guidance. Mr. Ellis, representing PCF, similarly

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[9] Direct Testimony of Shirley Arazi (Exhibit SCG-02) at 5.
[10] *Id.* at 6-7.
[11] D.12-12-034 at 8-9.
[12] Direct Testimony of Shirley Arazi (Exhibit SCG-02) at 6-8.
[13] Moody's, "Rating Methodology for Regulated Electric and Gas Utilities," (June 23, 2017).
[14] *Id.* at 11.

recognizes the notion that a reasonable balance between authorized capital structure and return on equity (ROE) is needed in order to maintain a favorable credit rating, "for any given credit rating … the level of debt that can be accommodated in the capital structure will vary with ROE."[15,16] A lower credit rating, such as Baa, would likely lead to higher costs of long-term debt for future issuances, which would be included in future authorized embedded cost of debt requests. As such, Cal Advocates' and EPUC/IS/TURN's respective proposals would effectively increase long-term debt costs for customers over time, and thus do not merit adoption.

Additionally, EPUC/IS/TURN incorrectly asserts that SoCalGas's authorized common equity ratio should continue to reflect 52.00% because the Company's historical capital structure used for ratemaking purposes has supported strong credit metrics and is currently supporting a "Stable" outlook for the Company.[17] While I agree with Mr. Gorman that the historical recorded average capital structure should be a key consideration when setting the authorized capital structure, I disagree that this should result in maintaining SoCalGas's current authorized common equity ratio of 52.00%. Mr. Gorman does not appear to take into account that SoCalGas's 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 its 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 to support its credit quality. Therefore, it would be erroneous to simply state that SoCalGas's "A" credit rating has been supported only by its 52.00% authorized common equity ratio.

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[15] Direct Testimony of Mark E. Ellis (Exhibit PCF-01) at 26.

[16] Yet it is perplexing that Mr. Ellis then suggests an excessively low ROE of 5.35%, which is further examined in Mr. Coyne's rebuttal testimony (Exhibit SCG-08 at 5.)

[17] Direct Testimony of Michael P. Gorman (Exhibit EPUC/IS/TURN-1) at IX-6.

Moreover, SoCalGas has preserved its "A" credit rating by maintaining an actual common equity ratio that is above its authorized 52.00%. Over the last five years, SoCalGas's actual average common equity ratio is 54.25%, which is 225 basis points higher than its current authorized common equity ratio of 52.00%. This means that SoCalGas has been operating with a significantly higher actual common equity ratio and significantly lower preferred equity ratio[18] compared to authorized levels in order to support maintaining our "A" credit rating. During this time, ratepayers have benefited from the company's "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 will result in an effective common equity return that is lower than a fair market return. In other words, shareholders are not earning a return on the 225-basis point difference between the authorized common equity ratio of 52.00% and the actual average ratio of 54.25%. As established in the *Bluefield* and *Hope* Supreme Court cases,[19] public utility investors are entitled to a fair rate of return given the corresponding risks.

Furthermore, in its latest credit report for San Diego Gas & Electric Company (SDG&E), Moody's assumes a constructive outcome in the pending 2023 Cost of Capital and expresses the importance of a strong common equity ratio for maintaining credit ratings, "an increase in the utility's allowed equity layer to 54% (as requested) would be credit supportive because it would contribute to stronger credit metrics."[20] Therefore, it is my conclusion that Mr. Gorman and Dr.

[18] SoCalGas's currently authorized preferred equity ratio is 2.40% compared to its five-year historical average ratio of 0.25%.

[19] D.19-12-056 at 15-16 (citing *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 601 (1944); *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679, 692 (1923)).

[20] "Moody's Investors Service – Credit Opinion: San Diego Gas & Electric Company" (June 23, 2022).

Woolridge are not giving due consideration to credit quality and the reliance of credit ratings on SoCalGas's actual capital structure.

2. Capital Structure Components Should Not Be Determined in Isolation, But Assessed as a Whole, Along with Other Cost of Capital Components

Cal Advocates also advances certain capital structure proposals that are arbitrary and erroneous and should be excluded from the Commission's consideration when setting SoCalGas's authorized cost of capital. While consideration should be given to each cost of capital component, the overall compilation of the components together establishing a fair and reasonable authorized rate of return is the standard as established by the *Bluefield* and *Hope* decisions.[21] When viewing the impact of increasing the common equity ratio in isolation, intervenors miss the full picture of SoCalGas's proposal. An increase in a utility's authorized common equity level when viewed in isolation (leaving all else unchanged) will increase costs to ratepayers. But this ignores the lower cost of debt and long-term benefits of maintaining an "A" credit rating, which reduces long-term borrowing costs for ratepayers. As described further below, setting authorized cost of capital components in isolation from one another can easily lead to an unreasonable and imbalanced rate of return.

Cal Advocates' capital structure proposal would increase SoCalGas's debt-to-equity ratio, setting SoCalGas's common equity ratio at 52.00% and long-term debt ratio at 47.60%, with little-to-no meaningful support as to why its proposal is fair or reasonable. Dr. Woolridge cites Cal Advocates' common equity proposal of 52.00% is "to be more reflective of the capital structures of other publicly held electric and gas companies."[22] This proposal would set one

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[21] D.19-12-056 at 15-16 (citing *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 601 (1944); *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679, 692 (1923)).

[22] Direct Testimony of J. Randall Woolridge (Exhibit Cal Adv-01) at 5.

component of the authorized rate of return in isolation from the other components in order to be in line with other electric and gas companies nationwide, where risk profiles and jurisdictions differ. Further, maintaining SoCalGas's 52.00% current authorized common equity ratio would disregard the Company's average historical capital structure, trend of increasing common equity ratios for peer utilities, and SoCalGas's higher-than-average risk profile, as described in Ms. Ng's direct testimony.[23]

As discussed in my direct testimony[24], I agree that consideration for authorized common equity ratios of comparable natural gas utilities is appropriate. However, I disagree that this should be the only consideration, and also have reservation with Dr. Woolridge's suggestion that electric companies or utility holding companies would be comparable with SoCalGas.[25] SoCalGas has identified an appropriate group of proxy companies based on a rigorous screening process described by Mr. Coyne.[26] Using the latest S&P Global data, I estimate the 5-year average authorized common equity ratio for SoCalGas's proxy group to be 54.1%[27] which closely aligns with SoCalGas's proposal of 54.0%. Additionally, a trend of increasing authorized common equity ratios continues to be apparent for comparable natural gas companies when comparing each of the 10-year (53.6%), 5-year (54.1%), and 3-year (54.8%) averages.[28] This trend, again, supports an increase of SoCalGas's authorized common equity ratio to 54.00%, in-line with that of our proxy group. Furthermore, Regulatory Research Associates

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23 Direct Testimony of Deana Ng (Exhibit SCG-03)

24 Direct Testimony of Shirley Arazi (Exhibit SCG-02) at 16.

25 The rebuttal testimony of Ms. DeMontigny further addresses Cal Advocates' use of holding companies in their analysis (SCG Exhibit-06 at 6-8).

26 Direct Testimony of Mr. Coyne (Exhibit SCG-04) at 30-32.

27 S&P Global Rate Case History (Past Rate Cases) Data downloaded August 16, 2022 for Natural Gas Distribution utilities. Five-year average reflects SoCalGas's proxy group for 2017-YTD 2022.

28 *Id.* The ten-, five-, and three-year averages reflect SoCalGas's proxy group authorized common equity ratios for 2012-, 2017-, and 2019-YTD 2022, respectively.

(RRA) remarks on a similar trend nationwide, stating that authorized "equity ratios have generally increased over the last several years."[29] As discussed in my direct testimony,[30] in addition to authorized capital structures of comparable natural gas utilities, the Commission should also consider the utility's actual historical recorded capital structure, risk profile, and whether the proposal is credit supportive when establishing the authorized capital structure.

3. Cal Advocates Proposal to Alter the Basis of the Capital Structure's Components Should be Disregarded

While it does not appear that Cal Advocates' capital structure proposal considers short term debt, Cal Advocates' testimony suggests that short-term debt be considered when calculating total capitalization.[31] Cal Advocates also suggests that the utilities' authorized capital structure should be based on the actual capital structure of the holding company (e.g. Sempra) rather than the operating company,[32] which is addressed in the rebuttal testimony of Ms. DeMontigny.[33] In the following discussion, I describe why altering the current methodology to calculate capital structure should not be adopted by the Commission.

Cal Advocates' assertion that short-term debt should be included as part of total capitalization when calculating the authorized capital structure is inappropriate. Historically, the Commission has appropriately excluded short-term debt from the authorized capital structure of the California utilities, stating, "[f]or the purposes of this proceeding, the capital structures of the applicants are comprised of distributions of long-term debt, preferred equity, and common equity."[34] Further, the decision clarifies that "[d]ebt due within one year, short-term debt, is

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[29] RRA, Major Energy Rate Case Decisions in the US—January-June 2022, (July 27, 2022) at 7.
[30] Direct Testimony of Shirley Arazi (Exhibit SCG-02).
[31] Direct Testimony of J. Randall Woolridge (Exhibit Cal Adv-01) at 28.
[32] *Id.*
[33] Rebuttal Testimony of Mia DeMontigny (Exhibit SCG-06) at 6-8.
[34] D.19-12-056 at 6.

excluded."[35] Additionally, the authorized rate of return set by this proceeding is ultimately applied to the utility's rate base (or its in-service capital assets). These capital assets have lives longer than one year, with many having a useful life of 30 years or more. Long-lived assets should be funded with a combination of long-term debt and equity and receive a rate of return. Conversely, short-term expenses, such as operations and maintenance expenses, should be funded primarily with short-term debt to align with the short-term nature of these costs. The introduction of short-term debt financing into long-term financing horizons needlessly mismatches asset financing time spans with the assets' useful lives, increases financial risk and raises the risk of negative reactions by both credit rating agencies and investors. As such, it would not be appropriate to include short-term debt as part of total capitalization when considering the appropriate authorized capital structure.

III. EMBEDDED COST OF LONG-TERM DEBT AND PREFERRED EQUITY

A. Summary of Intervenors' Embedded Cost of Long-Term Debt and Preferred Equity Recommendations

No intervenor made specific cost of debt or preferred equity recommendations for SoCalGas as summarized in Table 2 below. However, Mr. Ellis nonetheless commented that the current interest rate should be used to estimate future interest rates, arguing that historically Global Insight forecasts have exceeded the actual yield.[36] The proposals for embedded costs of debt and preferred equity of SoCalGas are included in Table 2.

[35] *Id.,* n.2.
[36] Direct Testimony of Mark E. Ellis (Exhibit PCF-01) at 30-32.

TABLE 2 – SUMMARY OF EMBEDDED COSTS PROPOSALS

Embedded Cost Component	Current Authorized[37]	SoCalGas Proposed[38]	Intervenor Proposed
Long-Term Debt	4.23%	3.89%	n/a
Preferred Equity	6.00%	6.00%	n/a

B. SoCalGas's Long-Standing Methodology For Calculating Embedded Cost Is Reasonable and Should Be Adopted By The Commission

As described in my prepared direct testimony, SoCalGas uses the same cost of debt calculation the Commission has previously adopted, proposing an embedded cost of long-term debt of 3.89%, which is a 34-basis point reduction from the currently authorized embedded cost of debt.[39] Consistent with previous cost of capital proceedings, SoCalGas recommends setting the authorized cost of debt equal to the forecasted embedded cost of debt at the end of the 2023 test year. The derivation of the embedded cost of debt includes the actual historical costs associated with the issuance and servicing of past long-term debt issuances currently outstanding. The forecast component only includes expected debt issuance costs for the current year (2022) where issuances may not have yet occurred, and the test year (2023).[40] Therefore, the makeup of SoCalGas's embedded cost of debt proposal[41] mainly consists of historical embedded costs and a smaller forecast component only containing the remaining 2022 issuance costs (if all issuances have not yet been made), and costs for the test year.

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37 D.19-12-056 at 2.

38 Direct Testimony of Shirley Arazi (Exhibit SCG-02) at 3, 12.

39 *Id.*

40 The embedded cost of debt will be updated in a late-filed exhibit on September 14, 2022 which will refresh any actual issuances that occurred in 2022 and updated interest rate forecasts through the 2023 test year.

41 Based on SoCalGas's embedded cost of long-term debt proposal of 3.89%, approximately 3.64% is comprised of embedded costs for issuances that took place before August 2022 and the remaining 0.25% is comprised of embedded costs for forecasted long-term debt issuances for the remainder of 2022 and 2023.

Consistent with long standing practice, SoCalGas uses the April 2022 IHS Markit Global Insight forecast of the 30-year treasury bond yield plus an estimated SoCalGas-specific credit spread. Subsequent cost of capital proceedings will update the authorized cost of debt to incorporate the actual embedded cost of debt that occurred during the 2023 Cost of Capital cycle. The Commission has found SoCalGas's methodology for calculating embedded cost of debt to be reasonable in past cost of capital decisions, including the current 2019 decision.[42]

Taking into consideration the discussion above, Mr. Ellis's arguments regarding the impact SoCalGas's forecasted debt issuances have on the calculation of our embedded cost of debt proposal is unfounded, as well as his criticism on SoCalGas's use of Global Insight as the source for forecasted treasury bond yields:

> From 2014 through 2021, Global Insight's one-year forward 30-year Treasury yield has exceeded the actual yield by 0.8%. Because the Sempra Utilities' embedded cost of debt forecasts rely on a source, Global Insight, whose forecasts have systematically overestimated actual interest rates, the Sempra Utilities' embedded cost of debt forecasts have systematically overestimated their actual costs of debt.[43]

The Commission has previously addressed similar issues in SoCalGas's 2019 GRC decision (D.19-09-051), where the Commission found as a conclusion of law, "Global Insight escalation rates are specific to the utility industry and reflect SDG&E's and SoCalGas's inflationary cost increases…"[44] The CPUC's 2019 GRC decision also noted: "We reviewed the forecast and do not have objections to the methodology utilized by SoCalGas and using

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[42] D.19-12-056 at 15.
[43] Direct Testimony of Mark E. Ellis (Exhibit PCF-01) at 31.
[44] D.19-09-051 at 761 (COL 307).

information from Global Insight's regional forecast",[45] and, "[i]t was not shown through evidence that Global Insight's forecasts are frequently incorrect by large margins for other periods or that their methodology is intrinsically flawed. Forecasting is not an exact science and there will be times that a forecast will be incorrect."[46]

The Commission should continue to find SoCalGas's methodology, including the use of Global Insights' forecasted treasury rates, to be reasonable and adopt SoCalGas's embedded cost of long-term debt and preferred equity proposals.

IV. 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 of debt[47] and preferred equity proposals.

This concludes my prepared rebuttal testimony.

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[45] *Id.* at 665.
[46] *Id.* at 667.
[47] Subject to the late-filed exhibit (cost of debt) scheduled to be submitted on September 14, 2022.