Application of Southern California Gas Company (U 904 G) for Authority to: (i) Adjust its Authorized Return on Common Equity, (ii) Adjust its Authorized Embedded Costs of Debt and Preferred Stock, (iii) Decrease its Overall Rate of Return, and (iv) Revise its Gas Rates Accordingly, and for Related Substantive and Procedural Relief.	A.12-04-___ (Filed April 20, 2012)

Exhibit No.: SCG-1

PREPARED DIRECT TESTIMONY OF
ROBERT M. SCHLAX
ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

APRIL 2012

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PREPARED DIRECT TESTIMONY OF

ROBERT M. SCHLAX

ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

I. INTRODUCTION

The purpose of my policy testimony in this state-wide gas and electric utility Cost of Capital ("COC") proceeding is to present and confirm the reasonableness of Southern California Gas Company's ("SoCalGas" or "Company") proposed return on equity ("ROE"), capital structure, and overall rate of return ("ROR") to be applied to SoCalGas' rate base regulated by the California Public Utilities Commission ("Commission") starting in Test Year ("TY") 2013. In addition, I summarize the Company's proposals for an adjusted ratemaking capital structure and Cost of Capital Adjustment Mechanism ("CCM") to replace the Company's existing Market Indexed Capital Adjustment Mechanism ("MICAM").

Viewed as a whole, SoCalGas' comprehensive COC proposal is balanced, reasonable, and appropriate given current market conditions and the significant changes in SoCalGas' operating environment and large capital investment plan. SoCalGas' proposed capital structure, ROE, embedded cost of debt, and overall ROR will enable the Company to raise a significant amount of capital in furtherance of its efforts to maintain a safe, reliable, and modern gas system at reasonable costs to its customers. The requested ROE will incentivize investors to fund, at reasonable rates, the significant increases in gas infrastructure investments required to accommodate customer growth, enhanced pipeline safety standards and the Advanced Metering Infrastructure ("AMI") project.

The Company's COC proposal strives to meet the ROE criteria set out by the United States ("U.S.") Supreme Court, in the *Hope*[1] and *Bluefield*[2] cases, and are reasonable in light of peer-company observations presented in the testimony of expert witness, Dr. Roger Morin. Dr. Morin develops through his independent analysis an ROE recommendation that will serve as a base upon which SoCalGas will develop its full ROE proposal. Witness Michael Foster sponsors the Company's proposed capital structure as the most balanced composite of debt and common equity financing, which will allow SoCalGas to maintain a strong single "A" credit rating. Mr. Foster also sponsors the calculation of the embedded costs of debt and preferred stock. Witness Cheryl Shepherd provides the Company's risk analysis which describes the business and regulatory risks SoCalGas faces as a natural gas utility in California. Lastly, witness Herbert Emmrich sponsors the Company's proposal to implement a CCM in lieu of the current MICAM.

II. SUMMARY OF RECOMMENDATIONS

To support the Company's large expected capital investment program and maintain its single "A" credit rating to obtain adequate funding at reasonable rates, SoCalGas proposes the COC structure shown below:

SoCalGas' Proposed TY 2013 COC Structure

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	5.72%	2.61%
Preferred Stock	2.40%	6.00%	0.14%
Common Equity	52.00%	10.90%	5.67%
Rate of Return (ROR)			**8.42%**

[1] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 391 (1944).
[2] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).

If adopted, this COC structure will decrease the Company's ROR by 0.26%, which will result in a $1.43 million revenue requirement decrease for ratepayers. SoCalGas' currently authorized COC structure is shown below:

Currently Authorized COC Structure

Component	Authorized Capital Ratio	Authorized Cost	Weighted Cost
Long-Term Debt	45.61%	6.96%	3.17%
Preferred Stock	6.39%	4.83%	0.32%
Common Equity	48.00%	10.82%	5.19%
Rate of Return (ROR)			**8.68%**

As shown above, SoCalGas is proposing to lower its long-term debt rate, increase its preferred stock and ROE rates, and adjust its authorized capital structure. SoCalGas' proposed COC structure better reflects current business risks and provides the financial position to enable the Company to access capital markets to finance its large capital investments at beneficial rates in the near and long-term. In addition, SoCalGas requests adoption of its proposed CCM (benchmarked against utility bond yields instead of long-term Treasury yields), which will bring SoCalGas' mechanism more in line with the mechanisms used by the other California Investor Owned Utilities ("IOUs").[3]

III. WHY SOCALGAS IS PARTICIPATING IN THIS PROCEEDING

In Decision ("D") 97-07-054, SoCalGas' 1997 Performance Based Ratemaking ("PBR") decision, the Commission adopted the MICAM, which is benchmarked against the 30-year Treasury bonds. While the other California IOUs have CCMs benchmarked against utility bond indices and have participated in scheduled COC proceedings, SoCalGas has

[3] Southern California Edison Company ("SCE"), San Diego Gas & Electric Company ("SDG&E"), and Pacific Gas and Electric Company ("PG&E").

remained on the MICAM since the adoption in the PBR proceeding. SoCalGas previously attempted to address its MICAM, most recently in a petition for modification of the PBR decision, which was dismissed without prejudice in D.09-07-033. SoCalGas expressed its intent to re-address its MICAM in the next state-wide utility COC proceeding, as stated in its 2012 General Rate Case ("GRC") (A.10-12-006).[4] Because the other California IOUs were directed to file their respective COC Applications in April 2012, SoCalGas is also filing its Application in accordance with its stated intention.[5] SoCalGas believes it is more appropriate to have its COC proposal addressed along with the other IOUs, in a state-wide proceeding instead of on a stand-alone basis.

More importantly, as discussed throughout my testimony, SoCalGas is filing this Application to ensure that its capital structure and ROE are supportive of maintaining a single "A" credit rating, enabling the Company to secure low-cost financing as it enters this period of significant capital investment and transition of the natural gas transmission and distribution industry in California. SoCalGas is projecting to invest $5.0 billion over the next five years related to Commission-mandated projects as well as projects needed to maintain its infrastructure to continue providing the safe and reliable service that SoCalGas is accustomed to providing. Therefore, SoCalGas needs access to the capital markets on an as-needed basis. The Company's overall COC proposal should facilitate this objective.

Since SoCalGas' currently authorized capital structure was approved in 1997 and the industry and capital markets have changed significantly since that time, its current authorized capital structure is at risk of being considered non-competitive when compared to

[4] Mr. Emmrich, who is the CCM witness in this Application, sponsored testimony in the GRC stating SoCalGas' intent to file a COC application.

[5] D.10-01-017 (SDG&E) and D.09-10-016 (PG&E and SCE) granted the utilities' requests to defer the due date of their next COC applications from April 20, 2010 to April 20, 2012.

the other California IOUs for attracting financing for their respective capital investments. In addition, the Company's currently authorized capital structure has not kept pace with other gas and gas services utilities. Therefore, SoCalGas' proposal will better align its overall capital structure with the other gas utilities and supports the Commission's longstanding goal of moderating changes to the ROE.[6]

IV. SUPPORT FOR THE COMPANY'S COMPREHENSIVE PROPOSAL

A. Reasonable ROE

The testimony of Dr. Morin provides an assessment of the risk associated with the Company's equity and determines the investor-required return commensurate with the Company's peer groups. His independent analysis employs the Discounted Cash Flow ("DCF"), Market Risk Premium ("MRP"), and Capital-Asset Pricing Model ("CAPM") methodologies. His analysis results in a proposed 10.50% ROE, which is comprised of a 10.10% level from his quantitative analyses, and a 40 basis point risk premium based on his independent risk analysis of current and historical data. Dr. Morin's recommended 10.50% ROE is the basis upon which the Company applies its own ROE adjustment to reflect additional and prospective business and regulatory risk pressures (described in Ms. Shepherd's testimony), as well as other policy considerations (addressed in this testimony), especially in light of the Company's significant level of anticipated capital spending.

B. Risk Analysis

Ms. Shepherd, in her capacity as Vice-President of Accounting and Finance and longstanding tenure at SoCalGas, observes on a day-to-day basis the numerous factors that affect the Company's earnings and cash flows. Her testimony identifies two major

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[6] *See* D.04-12-047 at 35; D.99-06-057at 50 and 56; D.96-11-060 at 9; D.95-11-062 at 9; D.94-11-076 at 14.

categories of risk – business and regulatory – that subject the Company's expected return to greater risk than the return of a peer group of gas utilities. First, SoCalGas is embarking on a significant capital investment program, at unprecedented levels in the Company's history, associated with the AMI build-out and the anticipated Commission-mandated pipeline safety enhancements. In addition, SoCalGas faces operational risks related to (1) the continued potential of customer bypass by taking service from interstate pipeline companies which are under the jurisdiction of the Federal Energy Regulatory Commission ("FERC"), and (2) the mandates of the South Coast Air Quality Management District's ("SCAQMD") South Coast Air Basin ("SCAB") to eliminate gas combustion in the SCAB. Furthermore, for businesses, California is one of the more litigious and tax-burdensome states in the U.S., and home to some of the most stringent and expensive environmental regulations in the nation.

Investors are also aware of and sensitive to the regulatory risks faced by the Company. These risks exist despite regulatory mechanisms such as revenue decoupling and balancing accounts, which have become the status quo of the California natural gas and gas/electric industries and have already been taken into account by credit rating agencies. This should not be interpreted as SoCalGas being less risky than the other California gas and gas/electric utilities that also have these same mechanisms.

C. Capital Structure and Embedded Costs

In the testimony of Mr. Foster, SoCalGas recommends a new authorized capital structure and how financial risk pressures justify the Company's proposal. Since 1997, the Company has operated under an authorized capital structure comprised of 45.61% long-term debt, 6.39% preferred stock, and 48.00% common equity. To enable continued access to capital markets and to maintain a strong single "A" credit rating, SoCalGas proposes a capital structure of 45.60% long-term debt, 2.40% preferred stock, and 52.00% common equity. Dr. Morin's ROE recommendation is predicated on the assumption that the Commission will approve this recommended capital structure. As Dr. Morin explains, if the Commission adopts a lower common equity ratio than what the Company proposes, then the ROE must be adjusted upward, as a lower common equity ratio implies greater risk and higher capital cost.

SoCalGas believes that maintaining its strong single "A" credit rating is imperative to securing long-term debt at reasonable rates on an as-needed basis to fund the Company's significant capital program. A single "A" rating instills investor confidence in the utility's financial strength. Studies have shown that utilities with an "A" rating tend to achieve the lowest possible COC by steering a course between the revenue increases that would be needed to achieve a rating higher than single "A" and the distress costs associated with ratings below single "A."[7] During times of market stress, firms rated lower than single "A" find that their access to capital is reduced, and end up paying relatively higher rates on what they are able to raise.[8] In previous COC decisions, the Commission has indicated its support of single "A" credit ratings as reasonable,[9] but has resisted attempts to endorse ratings higher than that.[10] Moreover, in the aftermath of the energy crisis, the Commission established that ratepayers benefit from a lower cost of debt, lower transaction costs, and reduced working-capital requirements in its adoption of a single "A" target as the basis for

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[7] *See, e.g.,* Morin, Roger A., New Regulatory Finance, (Vienna, VA: Public Utilities Reports Inc., 2006); Brigham, Gapenski, and Aberwald, "Effects of Capital Structure on Utilities' Cost of Capital and Revenue Requirements," Public Utility Research Center, University of Florida (June 1986).

[8] The Company observed the phenomenon first hand at the height of the financial crisis in 2008, when its BBB-rated parent company, Sempra Energy, sold debt the same week as SoCalGas, but with greater difficulty and at a substantially higher cost.

[9] *See, e.g.,* D.07-12-049 at 43; D.96-11-060 at 10; D.94-11-076 at 15 and 25.

[10] *See, e.g.,* D.92-11-047 at 72-74; D.89-11-068 at Findings of Fact 60-62.

PG&E's ratemaking.[11] Mr. Foster's testimony also includes the supporting schedules of embedded costs of long-term debt and preferred stock.

D. Cost of Capital Adjustment Mechanism

As described in Mr. Emmrich's testimony, SoCalGas has operated under its MICAM since 1997, which is benchmarked to the 30-year Treasury bond yield. The Company attempted twice to suspend its MICAM (in 2002 and 2009) and petitioned the Commission to re-evaluate the appropriateness of the Treasury bond as a benchmark. Although the Commission denied SoCalGas' requests to change the trigger mechanism from Treasury bonds to utility bonds, the Commission did state that the utility bond indices are a more appropriate benchmark to determine when COC adjustments are appropriate.

SoCalGas' MICAM triggered in 2002 and January 2012. In accordance with the MICAM, changes to the authorized ROE and adjustments to the cost of recovery of debt and preferred stock are to be effective the year following the triggering event. For the triggering event which occurred in January 2012, adjustments to SoCalGas' ROE and ROR would become effective in 2013. Since SoCalGas is filing its COC Application for TY 2013, the Company expects the decision from this proceeding will supersede the ROR impact caused by the 2012 MICAM trigger. This proposed change from the current MICAM to a new CCM is more in line with what the other California IOUs have for CCMs, and will allow the Commission to evaluate CCMs on a consistent inter-utility basis.

[11] D.03-12-035 at 41–44 and Appendix C at 11.

V. COST OF CAPITAL TO SUPPORT THE COMPANY'S FINANCING NEEDS

A. Changing Capital Investment Needs and Levels

SoCalGas is entering a period of large capital investment and industry transition that will require SoCalGas to access to the capital markets on a more frequent basis than has been required recently. The Company's operational profile was characterized by standard gas utility service to a steadily growing customer base. Although this business model was characterized by limited external financing needs, SoCalGas' solid financial condition, as reflected in its financial statements and its creditworthiness, ensured access to the capital markets whenever necessary at rates beneficial to ratepayers.

The Company's investment requirements are changing. Starting in 2012, SoCalGas will be implementing its AMI program, which Ms. Shepherd's testimony states will entail approximately $825 million in capital spending over the next six years. In addition, due to the Commission's evaluation of pipeline safety and integrity standards, SoCalGas may be required to fund a $3.1 billion pipeline safety-enhancement capital expenditure program (with $2.4 billion anticipated in the first five years), far exceeding SoCalGas' historical investment requirements. Combined with other capital projects, SoCalGas is expecting to invest $5 billion over the next five years, beginning in 2012, in its natural gas infrastructure. As a result, SoCalGas will need to access the capital markets more frequently than in the past. The proposed COC structure will reduce the impact of such financing on ratepayers over the long term.

In order to follow through on these initiatives, SoCalGas will need to raise new debt over the next several years, regardless of the capital market conditions. SoCalGas also plans to reinvest a substantial portion of its cash flow generated from its operations by delaying or deferring the payment of dividends on its common stock. To enable continued access to the debt capital markets given these new financing requirements while keeping rates reasonable for ratepayers over the long term, the Company recommends adoption of its proposed ROE and capital structure. The overall COC structure is intended to instill investor confidence that SoCalGas not only has the capacity to service its significant new debt obligations, but also the financial wherewithal to cope with the uncertainties posed by changes in its business climate.

B. Maintaining a Strong Credit Rating

The Commission has a long history of supporting credit ratings of gas and electric utilities at single "A" levels, as mentioned earlier. Currently, the Company possesses strong investment-grade credit ratings (A2 by Moody's, A by Standard & Poor's ("S&P"), and A+ by Fitch). In January 2012, S&P rated SoCalGas the 5th strongest gas-distribution utility out of a field of 40 in the U.S., based on credit rating and outlook. Regarding SoCalGas, Moody's writes:

> CPUC's regulatory treatment of natural gas utilities has historically been consistent and stable even during the energy crisis in 2000-2001 when the CPUC was substantially less credit supportive to electrics in the state.[12]

Fitch Ratings echoes this sentiment, saying:

> Fitch considers the California regulatory environment to be constructive and supportive of utility credit. Key features of the regulatory framework include bifurcation of general rate case and cost-of-capital proceedings, forward-looking test years and attrition rate increases, revenue decoupling, and the use of balancing accounts which limit commodity exposure and reduce regulatory lag.[13]

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[12] Moody's Investor Service, *Credit Opinion: Southern California Gas Company* (June 30, 2011).
[13] Fitch Ratings, *Southern California Gas Company* (January 13, 2012).

Equity analysts similarly perceive the Commission as balanced and constructive in its rulings, and they assign a very low likelihood to utility- or investor-adverse behavior on the Commission's part. This view is best summarized by Morningstar:

> Still, the driving force behind [Sempra Energy's] growth outlook and returns remains its best-in-class California utilities, which continue to garner the majority of investment. Both utilities have pending rate cases to be decided later this year, which we expect will be resolved favorably. While the recent tumult may have caused headaches for some investors, we won't be too concerned until we see a noticeable shift in the constructive regulatory environment in California.[14]

Two instances illustrate the advantage of being positively perceived by investors. In November 2008, in the midst of the financial crisis that followed Lehman Brothers' September 2008 bankruptcy, SoCalGas was able to offer and issue $250 million of first mortgage bonds with minimal difficulty, even though other borrowers had to downsize offerings, accept high interest rates to complete transactions, or lacked market access altogether. More recently, the Company's banks have indicated that its 30-year credit spread (i.e., the difference between a borrower's interest rate and the yield on a Treasury bond of similar maturity) has fallen since its last bond offering in 2010, despite financial unrest in Europe and an approximate 1.2 percentage-point decline in the 30-year Treasury yield, both factors that would ordinarily cause credit spreads to increase.

In this proceeding, it is critical that the Commission reinforce today's positive investor perceptions and SoCalGas' capital-market access, especially in light of the Company's changing business profile and considerable financing needs, for investors are still reserving their judgment. One equity analyst puts it this way:

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[14] Morningstar Equity Research, *Sempra's Second-Quarter Earnings Rise 9% and Heavier Pipeline Investments Could Be in Store* (August 10, 2011).

> Three new commissioners were appointed to the CPUC earlier this year and it remains unclear how constructively they may treat the utilities. Following our trip to the West Coast, we believe the CPUC may be balanced in its treatment of the utilities, but this remains uncertain.[15]

Thus, the Commission's approval of SoCalGas' recommended COC structure will directly support SoCalGas' cash flow and credit ratios, which are used in rating agencies' assessment of SoCalGas' financial risk.

C. Parity with Other California IOUs

It is important to note that SoCalGas competes in the same capital markets as the other California IOUs. Therefore, SoCalGas' adopted COC structure must be competitive with the other California IOUs to enable SoCalGas to secure cost-beneficial financing to fund its capital investment projects over the next few years.

Furthermore, as a well-managed utility, evidenced by SoCalGas' ability to weather the financial crisis and maintain its credit ratings during challenging economic conditions in recent years, SoCalGas should be authorized an ROE that is competitive and on par with the other IOUs. As Ms. Shepherd's testimony describes, a comparison of SoCalGas' and SDG&E's (collectively, "SEU's") bond yields shows that the investment community views SEU as having similar level of risks compared to the other IOUs, and should be awarded ROEs at least on par with them. Therefore, in adopting the TY 2013 ROEs for each of the filing California IOUs, SoCalGas requests that the Commission bridge the gap between SoCalGas and the other utilities instead of preserving the differentials which currently exist, between gas and electric service utilities.

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[15] JPMorgan, *CA Investor Tour: CA Regulatory Uncertainty Remains; Resuming Coverage of SRE with a Neutral Rating and a $58 PT* (June 2, 2011).

D. Keeping Financing Rates Low

SoCalGas' large capital program ($5 billion over the next five years) will require the Company to more frequently access the capital markets to raise long-term debt. Such capital is serviced over many years, more likely decades, which means the associated debt-servicing costs will be borne by ratepayers on a long-term basis. Because the resulting authorized COC structure will be inextricably linked with customer rates for years to come, the Commission should therefore assess the long-term customer benefits of SoCalGas' proposed COC structure.

E. Development of 10.90% ROE

Dr. Morin addresses the Company's differential risk profile by examining current and historical market ratios, allowed returns, and betas. In addition, SoCalGas factors the additional and prospective risk pressures and policy considerations described above to support a comprehensive COC proposal. Accordingly, my overall ROE proposal is 10.90%, which starts with Dr. Morin's determination of an ROE of 10.50%, and incorporates an additional 40 basis points adjustment to account for these risk and policy considerations discussed herein. This ROE, along with the proposed COC structure, is prudent and reasonable and will ensure that SoCalGas' financial strength and creditworthiness is maintained during the transformative years ahead while balancing the interests of customers and investors.

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VI. CONCLUSION

I respectfully request that the Commission adopt SoCalGas' proposed TY 2013 COC structure, as summarized below:

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	5.72%	2.61%
Preferred Stock	2.40%	6.00%	0.14%
Common Equity	52.00%	10.90%	5.67%
Rate of Return (ROR)			**8.42%**

The proposed COC structure will enable the Company to comply with the evolving operational safety requirements and maintain its infrastructure to ensure the safe and reliable operation of the Company's gas storage and delivery system. In addition, adoption of the CCM is prudent and will bring SoCalGas in line with the mechanisms used by the other IOUs.

This concludes my prepared direct testimony.

VII. STATEMENT OF QUALIFICATIONS

My name is Robert M. Schlax. I am the Vice President, Controller and Chief Financial Officer ("CFO") and Treasurer of SoCalGas and SDG&E. I joined the Company in 2005 as Vice President and Controller of SoCalGas and SDG&E. In October 2008, I was additionally appointed CFO. In my expanded position, I oversee all of the financial planning and budgeting, energy risk management, financial reporting, debt management, utility accounting and affiliate compliance for SDG&E and SoCalGas.

I have a Bachelor's Degree in Accountancy from the University of Illinois and a Master's Degree in Business Administration from Pepperdine University.

Prior to joining the Company, I served as CFO, Treasurer and Vice President of Finance at Mercury Air Group, Inc. from 2002 to 2005. Prior to 2002, I held various management positions of increasing responsibilities within the accounting and finance departments at Unocal Corporation.

I have previously testified before this Commission.