Company: Southern California Gas Company (U 904 G)
Proceeding: 2023 Cost ofCapital
Application: A.22-04-______
Exhibit: SCG-01

SOUTHERN CALIFORNIA GAS COMPANY (U 904 G)

PREPARED DIRECT TESTIMONY OF MIA L. DEMONTIGNY

(POLICY OVERVIEW)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

April 2022

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I. INTRODUCTION

As the officer sponsoring the Test Year 2023 Cost of Capital application for Southern California Gas Company (SoCalGas or the Company), the purpose of my testimony is to present an overview of SoCalGas' proposals. SoCalGas seeks to update its current authorized Cost of Capital to reflect SoCalGas' current business, financial, and regulatory risks, so that the Company can maintain its healthy credit rating, to help to keep borrowing costs low, compete for and attract investment capital, and perform its duties for customers and the public at large in a clean, safe and reliable manner. SoCalGas is filing this Cost of Capital application during a time of significant social, environmental, economic, and geo-political change. The regulatory and political environment has also changed since the Company last filed a Cost of Capital application in 2019. As discussed by the witnesses supporting this Application, although credit rating agencies still express generally positive views about California being a credit-supportive jurisdiction, there are significant current issues that are generating negative outlooks and credit downgrades for California's energy investor-owned utilities (IOUs).

Since the 2019 Cost of Capital decision, there have been significant changes on many fronts from a macro perspective: a global pandemic, mounting inflation concerns, a global shift toward decarbonization, and Russia's invasion of Ukraine. These issues and their relationship and impact on one another generally elevate uncertainty in today's capital markets. For example, Russia's invasion of Ukraine has emphasized the importance of national energy independence, impacting energy commodity prices and potentially slowing the global transition to decarbonization.[1] These types of global impacts could have a heightened impact in California where decarbonization goals are some of the most ambitious in the United States. Given these significant uncertainties and volatility in the macroeconomic environment, establishing a rate of return commensurate with the risks utilities face would promote stability and attract needed investment in California energy infrastructure.

In addition, for SoCalGas (a gas-only utility and the largest local gas distribution company in the country), the regulatory and political environment has become increasingly uncertain, particularly over the last few years, creating unique risks relative to other California IOUs and utilities in other jurisdictions. Based on these changing circumstances, SoCalGas seeks to update its current authorized Cost of Capital to address increased business, financial, and regulatory risks that are further described in Exhibit SCG-03 (Deana Ng).

As the Commission articulated when approving SoCalGas' Test Year 2020 authorized Cost of Capital:

> The legal standard for setting a fair rate of return has been established by the United States Supreme Court in the Bluefield and Hope cases. The Bluefield decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public and sets forth parameters to assess a reasonable return. Such a return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should be reasonably sufficient to ensure confidence in

[1] S&P Global, *Accelerating Energy Transition After Ukraine Crisis Poses Tough Balancing Act* (April 1, 2022), *available at:* https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/accelerating-energy-transition-after-ukraine-crisis-poses-tough-balancing-act-69637250.

> the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties.
>
> The Hope decision reinforces the Bluefield decision and emphasizes that such returns should be sufficient to cover capital costs of the business. The capital cost of business includes debt service and equity dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.[2]

SoCalGas' Test Year 2023 Cost of Capital proposal represents a fair Rate of Return, and is supported by data, sound financial modeling, information from credit rating agencies, and qualitative and quantitative analyses from witnesses. Therefore, SoCalGas respectfully requests that the Commission adopt SoCalGas' Test Year 2023 Cost of Capital as proposed. SoCalGas also requests that the Commission extend its current Cost of Capital Mechanism, with some focused enhancements.

II. OVERVIEW OF PROPOSALS

A. Authorized Cost of Capital for Test Year 2023

The following presents SoCalGas' proposed Test Year 2023 Cost of Capital and its currently authorized Cost of Capital.

[2] Decision (D.) 19-12-056, *mimeo,* pp. 15-16, 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 1 – PROPOSED

Test Year 2023			
Component	**Capital Ratio**	**Cost**	**Weighted Cost**
Long-Term Debt	45.60%	3.89%	1.77%
Preferred Equity	0.40%	6.00%	0.02%
Common Equity	54.00%	10.75%	5.81%
Rate of Return (ROR)	100.00%		**7.60%**

TABLE 2 – CURRENTLY AUTHORIZED[3]

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	4.23%	1.93%
Preferred Equity	2.40%	6.00%	0.14%
Common Equity	52.00%	10.05%	5.23%
Rate of Return (ROR)	100.00%		7.30%

The proposed authorized Rate of Return (ROR) of 7.60% represents a 30-basis point (*i.e.*, 0.30%) increase from the current ROR of 7.30%.

I anticipate that some of the California IOUs filing applications concurrently with SoCalGas may request differing Cost of Capital increases, particularly due to the differences in risks faced by those California IOUs, such as wildfire cost recovery risk. While SoCalGas is somewhat exposed to contagion risk associated with wildfire issues, SoCalGas has its own unique set of risks as the sole gas-only IOU in this proceeding and as the largest gas-only utility

3 D.19-12-056 at p. 55 (Ordering Paragraph 5).

in California, and in the United States. California's ambitious climate goals, including a desire to shift away from fossil fuels, have accelerated significantly over the last few years, creating increased uncertainty around the future role of the natural gas system in California, more so than in other parts of the country. This uncertainty, combined with other risk factors, ultimately led to SoCalGas' credit rating being downgraded from A1 to A2 in 2020.[4] SoCalGas' Test Year 2023 Cost of Capital is an increase over the current Cost of Capital, to account for the increased risks that California IOUs, and SoCalGas specifically, face relative to utilities in other jurisdictions. The increase is also attributable to SoCalGas' authorized capital structure proposal, which is designed to reflect SoCalGas' average actual recorded capital structure experience over the past five years. SoCalGas' Cost of Capital should be at an appropriate level relative to the other California IOUs, as it must continue to attract investor capital through a strong and competitive Rate of Return in this less stable financial and regulatory environment, compared to that which existed when SoCalGas filed its last Cost of Capital application in 2019.

B. Cost of Capital Mechanism (CCM)

SoCalGas also requests that the Commission extend its current CCM, which functions to provide interim assessments of SoCalGas' authorized cost of capital between proceedings based on material bond rate fluctuations. The CCM allows for either adjustments through the mechanism or through the filing of an application under certain circumstances. The CCM is viewed positively by the Commission as well as the financial markets, as it allows for efficient use of Company and Commission resources, provides stability through a multi-year authorized rate of return, and offers flexibility to reassess when there are material bond rate fluctuations. In

[4] Source: Moody's, "Rating Action: Moody's downgrades Southern California Gas Company to A2 from A1; stable outlook" (May 29, 2020).

order to provide clear and efficient application of the mechanism, SoCalGas proposes focused enhancements to the current CCM.

III. LIST OF SUPPORTING TESTIMONIES

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

- **Exhibit SCG-01, Policy Overview (witness: Mia DeMontigny)**. My testimony provides an overview of SoCalGas' Cost of Capital proposals for the Test Year 2023 and the period until the Cost of Capital is next updated by application. I provide a brief summary of the primary proposals and their underlying support, as contained in the testimonies of the following witnesses.
- **Exhibit SCG-02, Authorized Capital Structure and Embedded Cost of Debt and Preferred Equity (witness: Shirley Arazi)**. Ms. Arazi presents SoCalGas' authorized capital structure proposal, including evidence of SoCalGas' historical recorded capital structure levels. As Ms. Arazi sets forth in her testimony, SoCalGas has relied on Common Equity relative to Long-Term Debt and Preferred Equity over the past five years, which has helped SoCalGas manage the financial risk of being over-leveraged. SoCalGas proposes an updated authorized capital structure comprised of 45.60% Long-Term Debt, 0.40% Preferred Equity, and 54.00% Common Equity. Ms. Arazi also performs and presents an embedded cost analysis for Long-Term Debt and Preferred Equity, which are applied to the capital ratios to yield a weighted cost of Long-Term Debt and Preferred Equity.
- **Exhibit SCG-03, Company Risk (witness: Deana Ng)**. Ms. Ng describes SoCalGas' business, financial, and regulatory risks, operating as a regulated, gas-only

utility in California. Her testimony provides justification and additional qualitative support for SoCalGas' Return on Equity proposal presented in Exhibit SCG-04 (Coyne), and authorized capital structure proposal presented in Exhibit SCG-02 (Arazi). Ms. Ng supports her analysis with official company disclosures and information from three prominent rating agencies: Moody's, Standard and Poor's (S&P), and Fitch. SoCalGas faces unique risks as a gas-only utility operating in California and in today's political and regulatory climate, in which some lawmakers, policymakers, and constituents are signaling for the end of natural gas as an energy resource. Ms. Ng explains that these risks should be appropriately reflected in SoCalGas' authorized Cost of Capital.

- **Exhibit SCG-04, Return on Equity (witness: James M. Coyne)**. Mr. Coyne is an expert specializing in regulatory and litigation support, financial advisory services, energy market strategies, market assessment, and capital market analyses and is SoCalGas' Return on Equity (ROE) witness in the Test Year 2023 Cost of Capital proceeding. Through his modeling and evaluation of financial and economic data for proxy group companies, as well as his consideration of the Company's risks and proposed capital structure, Mr. Coyne presents his findings and analyses, and recommends an authorized ROE of 10.75%.

- **Exhibit SCG-05, Cost of Capital Mechanism (witness: Patrick Billings)**. Mr. Billings presents SoCalGas' Cost of Capital Mechanism proposal, including the historical performance of the CCM and SoCalGas' credit ratings, the benefits of continuing the mechanism for the upcoming Cost of Capital cycle, and proposed enhancements to the current CCM. These enhancements include: (1) applying a utility's median credit rating to choose the applicable Moody's utilities index when a utility has split ratings, (2) allowing a utility to change the applicable index when the utility's credit ratings change during CCM years, and (3) specifying the CCM Benchmark index and rate applicable for each applicant in the Commission's final decision and what index applies at the time of the decision.

IV. KEY THEMES UNDERLYING THE COST OF CAPITAL PROPOSALS

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

A. Return on Equity (ROE)

First, in terms of Mr. Coyne's ROE analysis and ROE recommendation of 10.75%, I have confidence that the Commission will find his analysis credible and well-supported, based on his experience and expertise in the field of finance and his extensive regulatory experience on Cost of Capital matters. While he is one of several expert witnesses who may be testifying for parties in this proceeding, I believe the Commission will find his determination of proxy groups, application of financial modeling and analysis of the results, and understanding of market data and investor expectations, as probative and reliable. As an introduction to his analysis for SoCalGas' ROE, Mr. Coyne provides the following insights:

> The ratemaking process is premised on the principle that, in order for investors and companies to commit the capital needed to provide safe and reliable utility services, the utility must have the opportunity to recover invested capital and the market-required return on that capital. Because utility operations are capital-intensive, regulatory decisions should enable the utility to attract capital on

favorable terms. The financial community carefully monitors the current and expected financial condition of utility companies as well as the regulatory environment in which they operate. In that respect, the regulatory environment is one of the most important factors considered by both debt and equity investors in their assessments of risk. It is therefore essential that the ROE authorized in this proceeding takes into consideration the current and expected capital market conditions that SoCalGas faces, as well as investors' expectations and requirements regarding both risks and returns. A reasonable ROE is required both for continued capital investment by SoCalGas and to maintain confidence in California's regulatory environment among credit rating agencies and investors.[5]

Mr. Coyne's recommended 10.75% ROE represents a reasonable outcome based on the range he has computed through his modeling efforts, and in light of the business, financial, and regulatory risks that SoCalGas will carry in the upcoming Cost of Capital cycle.

B. Capital Structure

In terms of SoCalGas' authorized capital structure, the Company's proposal is closely aligned with its actual average capital structure experience over the past five years. From 2017 to 2021, SoCalGas' recorded capital structure ratios were as follows:[6]

Recorded	2017	2018	2019	2020	2021	2017-2021 Average	Proposed 2023
Long-Term Debt	43.47%	44.80%	44.50%	48.05%	46.65%	45.49%	**45.60%**
Preferred Equity	0.31%	0.28%	0.25%	0.22%	0.21%	0.25%	**0.40%**
Common Equity	56.22%	54.92%	55.25%	51.73%	53.14%	54.25%	**54.00%**

5 *See* Exhibit SCG-04 (Coyne) at 9.

6 *See* Exhibit SCG-02 (Arazi) at. 7, 15, 17, and Appendix C (figures are rounded to the hundredth decimal point. If percentages do not sum to 100.00%, it is due to rounding).

The higher-than-authorized average Common Equity level relative to Long-Term Debt and Preferred Equity have provided SoCalGas with increased capital sourced from shareholders, reduced financial risk, and the ability to maintain strong credit metrics throughout the Cost of Capital period, directly benefiting ratepayers and shareholders. The Commission has adopted utility authorized capital structures based on actual capital structure levels.[7] Therefore, SoCalGas proposes a Test Year authorized capital structure that is more aligned with its actual average capital structure ratios over the past five years, and one which the Company can manage and maintain throughout the next Cost of Capital cycle.

C. Company Risk

In terms of SoCalGas' discussion of business, financial, and regulatory risk, Ms. Ng's analysis is supported by SoCalGas' most recent 10-K Annual Report for the year ended December 31, 2021, which represents the company's official disclosures to the United States Securities and Exchange Commission, the investment community, and the public at large. In addition, Ms. Ng references information and recent actions from three major rating agencies (Moody's, S&P, and Fitch) to provide market-sourced support for SoCalGas' risk assessment. As Ms. Ng explains, capital markets determine the price of investor capital based on the riskiness of the investee in relation to other investees. Because investors have a broad array of investment options, a utility such as SoCalGas must compete for and attract private funds by offering potential investors the opportunity to earn a return on investment that is equal to the potential returns offered by other investments of comparable risk. A strong Cost of Capital (and Rate of

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7 *See Id.* at 13-14.

Return) positions the utility to attract that capital.[8]

Changes in the California regulatory and political environment, as well as events that have occurred since the last Cost of Capital structure was adopted, have contributed to increased uncertainty, risk, and challenges for the California IOUs, and for SoCalGas, as California's and the nation's largest gas-only utility. Among the primary risk drivers contributing to the current instability is the current political climate, where some California lawmakers, public officials, and policymakers are promoting the significant reduction or elimination of natural gas, and thus the ability for SoCalGas to retain the use of its existing infrastructure or invest in new infrastructure, in furtherance of service and system reliability, is increasingly uncertain. This uncertainty poses a business risk to SoCalGas' planned capital projects, which are estimated at approximately $9.8 billion over the next five years (2022 – 2026). Furthermore, the 2015 Aliso Canyon well leak incident created litigation, insurance, and operational risks for SoCalGas. This additional risk disproportionally impacts SoCalGas relative to its peer group and the other California IOUs.

These risks underscore the need for a strong and competitive Cost of Capital in the upcoming cycle, so that SoCalGas can attract the necessary capital to fund its planned capital projects which focus on safety and reliability. Further, I anticipate that the market would view the proposed changes to SoCalGas' cost of capital positively and would support the perception of California as a credit supportive jurisdiction relative to other states.

D. Cost of Capital Mechanism (CCM)

Mr. Billings' testimony supports SoCalGas' position that retaining the CCM for the upcoming Cost of Capital cycle will continue to provide the same benefits that the CCM provided since it was adopted. As Mr. Billings discusses, the Commission recognized the

[8] *See* Exhibit SCG-03 (Ng) at 2-4.

benefits of the CCM when adopting it for California IOUs in the 2013 Cost of Capital (Phase 2) proceeding, which was upheld in the 2020 Cost of Capital proceeding:[9]

> This CCM streamlines the major energy utilities' COC process while providing greater predictability of the utilities' COC by eliminating the use of interest rate forecasts and disputes concerning interest rate levels and trends, as well as uncertainties associated with conflicting perceptions of financial markets and the return requirements of investors. Hence, shareholders and ratepayers alike share the burden and benefits of market changes, while eliminating the burden of annual COC applications. The CCM also enables the utilities, interested parties, and Commission staff to reduce and reallocate their respective workload requirements for litigating annual COC proceedings.[10]

Mr. Billings also explains that market participants have indicated their preference for the automatic rate-setting mechanism, since it provides greater clarity and transparency in understanding changes to a utility's ROE while also preserving the default right to file a cost of capital application when the adjustment mechanism is not an accurate measurement of changes in the cost of equity. This in turn promotes a degree of stability; and financial markets generally respond favorably to stability.[11]

SoCalGas believes the CCM would be more effective and appropriate for the upcoming Cost of Capital cycle, given current conditions, if the focused enhancements proposed by Mr. Billings are made to address the recent instability of utility credit ratings.

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9 D.13-03-015 at 6. "The CCM has provided certainty for its customers and investors, and avoided the use of scarce Commission resources to litigate the utilities' COC. The CCM has also maintained a fair and reasonable COC while reducing the time and costs to the Commission and all parties associated with annual COC proceedings."

10 D.13-03-015 at 7.

11 *See* Exhibit SCG-05 (Billings) at 7.

V. CONCLUSION

SoCalGas respectfully asks the Commission to adopt its proposed Test Year 2023 Cost of Capital, with a finding that it represents a reasonable outcome supported by the evidence. In addition, SoCalGas requests that the Commission reset and extend applicability of its current CCM, with the focused enhancements being proposed, so that the mechanism can more appropriately and effectively regulate SoCalGas' authorized Cost of Capital until the next application is filed.

This concludes my prepared direct testimony.

VI. WITNESS QUALIFICATIONS

My name is Mia L. DeMontigny. I am Chief Financial Officer and Controller for SoCalGas. My business address is 555 West Fifth Street, Los Angeles, CA 90013.

In my current position, I am responsible for overseeing the financial planning and budgeting, accounting and financial reporting, treasury management, and gas procurement for SoCalGas. I am a Certified Public Accountant. After I received my Bachelor of Commerce Degree in Accountancy from Concordia University in 1994, I began my professional career.

My experience in the utility industry began in 1998. From 1994 to 2013, I was employed in public accounting at Price Waterhouse (Canada from 1994 to 1998) and PriceWaterhouseCoopers, LLP (United States from 1998 to 2013). From 2013 to 2015, I was employed as the U.S. Assistant Controller for National Grid. I joined Sempra Energy in 2015 and have been in my current position at SoCalGas since 2019.

I have previously testified before the Commission.