Company: Southern California Gas Company (U 904 G)
Proceeding: 2023 Cost of Capital
Application: A.22-04-_____
Exhibit: SCG-05

SOUTHERN CALIFORNIA GAS COMPANY (U 904 G)

PREPARED DIRECT TESTIMONY OF PATRICK BILLINGS

(COST OF CAPITAL MECHANISM)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

April 2022

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SOUTHERN CALIFORNIA GAS COMPANY
PREPARED DIRECT TESTIMONY OF PATRICK BILLINGS
(COST OF CAPITAL MECHANISM)

I. INTRODUCTION

My testimony addresses Southern California Gas Company's ("SoCalGas" or "Company") current Cost of Capital Mechanism ("CCM") and proposes that the California Public Utilities Commission ("Commission") continue the current CCM with three enhancements to the CCM process (alternatively, the "adjustment mechanism") to provide greater clarity and improved efficiency in the interpretation and application of the adjustment mechanism. Consistent with SoCalGas filing a test year ("TY") 2023 cost of capital ("COC") application, SoCalGas proposes that the CCM should be reset for a new three-year cycle, with the next cost of capital application due in April 2025 for a TY 2026 cost of capital.

The current CCM—providing for the interim assessment of SoCalGas's cost of capital either through the adjustment mechanism or SoCalGas filing a full application in applicable circumstances with the three proposed enhancements to the adjustment mechanism – should continue to be the basis for return on equity ("ROE") and rate of return ("ROR") assessments between Cost of Capital proceedings. Those enhancements are as follows:

- Applying a utility's median credit rating to choose the applicable Moody's utilities index when a utility has split ratings;
- Allowing a utility to change the applicable index when the utility's credit ratings change during CCM years; and
- 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.

Providing clarification on these three points will improve the CCM process and remove uncertainty surrounding the handling of these situations moving forward.

II. CURRENT CCM

A. The CCM's Adoption

The current CCM was originally adopted by the Commission in 2008 – the Commission adopted the CCM for San Diego Gas & Electric Company ("SDGE"), Southern California Edison Company ("SCE"), and Pacific Gas and Electric Company ("PG&E").[1] The CCM was suspended for 2010 due to the market impacts of the Great Recession of 2008-2009. In its 2013 cost of capital decision, the Commission reaffirmed the CCM for SDGE, PG&E, and SCE, and applied it to SoCalGas (collectively, the California IOUs).[2] The Commission again suspended the CCM for 2017 to avoid the possibility of the CCM triggering upward for that year, based upon interest rate forecasts demonstrating the possibility of an increase in interest rates that could trigger the CCM's adjustment mechanism upward to increase ROE. The Commission again agreed that the potential increase in interest rates did not reflect an increase in the cost of equity.[3] The CCM was subsequently continued in 2017 and 2019.[4]

Unless otherwise authorized or directed, under the CCM, the California IOUs are required to file Cost of Capital applications every three years in April. By way of history leading to the CCM, the California IOUs' rate of return components were traditionally addressed in their respective general rate cases.[5] But beginning in 1990, energy utilities requested—and the Commission set—the cost of capital components and overall rate of return on an annual basis.

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1 Decision (D.) 13-03-015 at 2.

2 D.13-03-015.

3 D.16-02-019.

4 *See* D.19-12-056 at 45 (the "existing CCM shall remain in place for the four applicants in this proceeding"); D.17-07-005 at 5 (setting the CCM to operate in 2018 after accepting a proposed suspension of the mechanism in 2017).

5 D.08-05-035 at 2.

The utilities filed a cost of capital application by May 8 every year, with the Commission deciding rates to go into effect on January 1 of the following year.[6]

The CCM's purpose is to "streamline" processing cost of capital applications and reduce the frequency of filings from the default of annual applications,[7] while using the CCM as a stand-in to assess major energy utilities' cost of capital annually in the intervening years.[8] The CCM provides two methods to assess SoCalGas's cost of capital in interim years.

First, it provides an adjustment mechanism that ties changes in interest rates to changes in ROE, by using a formula to assess a utility's ROE in intervening years based on fluctuations in utility bond rates.[9] The adjustment mechanism automatically recalibrates SoCalGas's authorized ROE and overall ROR upon a triggering of the mechanism, based on significant movements in the bond markets. Second, the CCM alternatively provides SoCalGas and other utilities the "right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and impacts it differently than the overall financial markets"[10] to have their cost of capital assessed in an interim year.

B. Mechanics of the Current Cost of Capital Mechanism

As noted, the current CCM's adjustment mechanism ties ROE to changes in interest rates. It consists of: (1) a benchmark rate; and (2) a deviation range or "dead band" from that benchmark. That dead band determines what amount of movement in bond index rates will trigger the mechanism.

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6 *See* D.89-01-040 at 36 (setting an annual cost of capital schedule).

7 *Id.* at 7.

8 D.08-05-035 at 15-16.

9 *Id.* at 16.

10 *Id.* at 16, 19 (Conclusion of Law (COL) 6).

More specifically, the CCM's adjustment mechanism features:

- the most recently adopted authorized capital structure and embedded costs for long-term debt and preferred stock;

- the benchmark index rate as Moody's Utilities Bond Index, based on the utility's credit ratings (for SoCalGas, it falls under the Moody's "A" Bond Utilities Index);

- a benchmark interest rate representing either: (a) the October through September average of the applicable Moody's Utilities Bond Index from the Test Year ("TY") of the most recently adopted Cost of Capital; or (b) the October through September average following a triggering event and corresponding effective date of an automatic adjustment to the authorized Cost of Capital structure;

- a 100-basis point dead band whereby within plus or minus 100 basis points from the benchmark interest rate, the mechanism will not trigger; and

- an adjustment ratio of 50 percent (*i.e.*, if there is a triggering event and corresponding adjustment to ROE, the ROE will be adjusted by half of the difference between Moody's Utility Bond Index and the benchmark interest rate.).[11]

If the CCM's adjustment mechanism triggers, the adjustment to the authorized ROE—and update of the embedded costs of long-term debt and preferred stock—will result in a revised authorized Rate of Return to be effective January 1 of the following year. SoCalGas makes this change through the advice letter process. The CCM would continue to operate, with a revised benchmark interest rate equal to the 12-month (October to September) average interest rate that caused the CCM's adjustment mechanism to trigger. The triggering of the adjustment mechanism does not automatically adjust a utility's authorized capital structure itself (*i.e.*, the ratios).

As noted, since the CCM's adoption in 2008, the CCM alternatively provides that, instead of the adjustment mechanism applying, a utility has the "right to file a cost of capital

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[11] *See* D.08-05-035 at 15.

application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and impacts it differently than the overall financial markets."[12] This is consistent with the fact that the CCM was a mechanism to relieve the default rule for an annual cost of capital application under D.89-01-040. As the Commission stated in D.13-03-015, while the CCM "streamlin[es] the COC process, the utilities continue to have a right to file" an application under the extraordinary event standard;[13] as the adjustment mechanism only "*potentially* replac[es] annual cost of capital proceedings."[14]

In that 2013 decision, the Commission adopted that, "[i]n the year of cost of capital filings, the CCM would not be used, because the cost of capital proceeding will set new rates for the following year."[15]

III. CCM PROPOSAL

SoCalGas believes that the CCM has largely accomplished the goal of streamlining cost of capital proceedings while retaining the right to file an application in an interim year. SoCalGas thus supports the CCM being continued with the three enhancements requested below.

A. SoCalGas Supports Continuing the CCM

SoCalGas proposes that the CCM be continued, including the following current attributes:

- a three-year application cycle, providing balance between not having a full proceeding every year and having one often enough to review for significant changes;

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12 *Id.* at 16, 19 (COL 6).
13 D.13-03-015 at 7.
14 *Id.* at Appendix A, at 2 (emphasis added).
15 *Id.* at Appendix A, at 3.

- utilize Moody's Utilities Bond Index based on the current company credit ratings as the appropriate benchmark;
- measure a 12-month average of Moody's Utilities bond yields for the period of October 1 through September 30;
- a 100-basis point dead band whereby within plus or minus 100 basis points from the benchmark interest rate, the mechanism will not trigger;
- the 50% adjustment to ROE of total change to utility bond index when CCM is triggered;
- updating the embedded costs of long-term debt and preferred stock when a trigger occurs, to reflect actual August month-end embedded costs in the trigger year and forecasted interest rates for variable long-term debt, new long-term debt, and preferred stock to be issued;
- the current advice letter process to implement trigger provisions, effective January 1 of the following year; and
- Alternatively providing the "right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and impacts them differently than the overall financial markets."[16]

As the Commission has previously found, the mechanism achieves several objectives:

- reduces the time and costs associated with filing and litigating Cost of Capital proposals annually;
- produces objective results based on interest rate changes that eliminate the need for interest rate forecasts (and related forecasting risk);
- does not produce frequent or abrupt changes, while remaining sensitive enough to trigger with meaningful fluctuations in the bond markets;
- retains the right for a utility to file a cost of capital application; and
- provides timely ratemaking information to stakeholders and the financial markets.[17]

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[16] D.08-05-035 at 16, 19 (COL 6).
[17] D.13-03-015 at 7.

SoCalGas agrees with the Commission that the CCM: 1) effectively balances the interests of ratepayers and shareholders; 2) reduces the workload requirements and regulatory costs associated with Cost of Capital proceedings; and 3) retains a method to file a cost of capital application in lieu of the CCM applying, as the Commission originally intended in instituting a separate, annual cost of capital proceeding.

The CCM also is viewed positively by various market participants, including rating agencies, in addition to regulatory stakeholders. It promotes a degree of desired stability, 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; that is, when changes in interest rates diverge from the cost of equity. With SoCalGas filing a TY 2023 cost of capital application, the CCM should be reset for a new three-year cycle, with the next cost of capital application due in April 2025 for a TY 2026 cost of capital. Consistent with prior decisions, the CCM's benchmark for the next cycle should be set on September 30 of the year prior to the test year; thus, for this proceeding, the date would be September 30, 2022.[18]

B. SoCalGas Proposes Three Enhancements to the CCM's Adjustment Mechanism

SoCalGas proposes the following three enhancements to the CCM's adjustment mechanism to address issues that have arisen for SoCalGas during this current CCM cycle.

1. the selection of a CCM benchmark rate index when the utility has split ratings;
2. the approach when SoCalGas's credit ratings change during CCM years; and
3. specification of 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.

[18] *See* D.08-05-035 at 6.

SoCalGas acknowledges that it proposed several of these enhancements in the 2019 cost of capital application—with the Commission noting their potential merit but declining to adopt those modifications at that time.[19] SoCalGas believes these enhancements will provide a clear and efficient application of the mechanism. Each proposal is discussed in turn.

1. Proposed Enhancement on Split Credit Ratings Index Selection

The applicable CCM index is based on the credit ratings of the utility. But the Commission has never specified what credit rating applies if a utility has different credit ratings from Moody's, S&P, and Fitch. As an example, SDGE currently is split rated with Moody's (A3) one notch higher than S&P and Fitch (BBB+). Moody's rating would qualify SDGE for the A benchmark rate index, while the S&P and Fitch ratings would qualify SDGE for the Baa index. It is thus unclear what index would apply to SDGE under the CCM as defined today.

The Commission should thus address what index applies if a utility faces split ratings. In the event of split ratings where not all agencies' ratings are at the same level, the median rating should be used in determining the applicable index for the CCM. SoCalGas believes this is appropriate because the median rating of the three credit rating agencies is known by the financial markets and is therefore reflected in competitive pricing of financial instruments.[20]

2. Proposed Enhancement on Ratings Change During CCM Years

SoCalGas recommends that the Commission provide that the applicable bond benchmark index can change during a cost of capital cycle if a utility experiences a credit rating change during that period. Such an enhancement would be more consistent with the Commission's goal of accurately having changes in interest rates reflect changes in cost of equity, as it would apply

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[19] *See* D.19-12-056 at 45.
[20] *See* Appendix A, attached hereto, for an illustration of split ratings and index selection matrix.

the more applicable index to the utility during the measurement period in question.[21] Applying the appropriate index at that time also better correlates with applicable risks.[22]

Under this enhancement, if a utility experiences a credit rating change it would follow the following framework:

- A ratings upgrade or downgrade that resulted in the median rating changing over the October through September CCM measurement period of any year that affects the applicable Moody's Utilities Bond Index would allow for the utility to update the applicable Moody's Utilities Bond Index;
- The applicable Moody's Utilities Bond Index is based on the company's ratings as of September 30 of that year; and
- Any rating change update will be made through filing an advice letter in October to implement the revised index and benchmark rate for the CCM, to be effective in the following CCM measurement period.

This index adjustment itself does not cause a CCM adjustment mechanism trigger. Only a CCM adjustment mechanism trigger event would adjust the Cost of Capital.

3. Specify the Benchmark Index and Rate in the Final Decision

In its 2008 and 2013 cost of capital decisions, the Commission specified the applicable benchmark index applicable to each utility. But in D.19-12-056, while ordering the CCM to continue to be in effect through the 2020 Cost of Capital cycle, the Commission's decision did not specify the benchmark rate or benchmark index applicable for each applicant.[23]

As stated previously, the CCM's adjustment mechanism is based upon objective bond yield data tied to credit ratings. Specifying the applicable benchmark index and

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21 *See* D.08-05-035 at 18 (Finding of Fact 16) ("The purpose of an interest rate benchmark is to gauge change in interest rates that also indicate changes in the equity costs of utilities.").

22 *Id.* at 19-20 (COL 10) (adopting utility bond interest rates out of the "desire to use an index that more likely correlates and moves with utility industry risk.").

23 Applicable index selected using the index selection matrix Appendix A, attached hereto.

benchmark rate for each application in the decision enhances the efficiency and transparency of the mechanism and its application. Given the Company's credit ratings at the time of filing this testimony, based upon the Commission's precedent, the initial benchmark for SoCalGas for a Test Year 2023 would represent the October 2021 through September 2022 average of Moody's A Utilities Bond Index, as set on September 30, 2022. Per enhancement three, if the Company's credit ratings are updated between the time of filing this testimony and the final decision by the Commission, the benchmark index would follow the guidelines proposed in this section.

IV. CONCLUSION

SoCalGas respectfully requests that the Commission continue the CCM with the proposed three enhancements to the CCM's adjustment mechanism.

This concludes my prepared direct testimony.

V. STATEMENT OF QUALIFICATIONS

My name is Patrick Billings, and my business address is 488 8th Avenue, San Diego, California 92101. I am currently employed by Sempra Energy as Assistant Treasurer. My responsibilities include oversight of capital markets activities, credit ratings and rating agencies, and cash management. I assumed my current position in June 2019.

Prior to this, I have served in roles of increasing responsibility at Sempra since March 2002. These roles included Director of Investor Relations from 2016 until June of 2019 where my responsibilities included developing our investor communication strategy and the communication of Sempra's business strategy and financial projections to the investor community, Director Strategic Projects from 2015 until 2016 where my responsibilities included leading an effort to sell a portion of Sempra's unregulated business to enhance share price valuation, Director of Strategic Planning and Analysis where my responsibilities included evaluating Sempra's investment opportunities and projections of Sempra's financial results for various stakeholders including management, investor communication and credit rating agencies. Additional roles from 2002 until 2012 included Merger and Acquisitions Manager, Business Planning Manager, Financial Planning Manager and a series of roles with increasing responsibility in the Corporate Tax Department. Prior to Sempra I was employed by Deloitte from 1998 to 2002 with my last role being Senior Tax Consultant.

I received a Bachelor of Science in Business Administration from San Diego State University in 1996. I also received a Master's of Science in Accounting from San Diego State University in 1998.

I have previously submitted testimony before the California Public Utilities Commission.

APPENDIX A

RATINGS TABLE FOR THE CCM INCLUDING INDEX SELECTION

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The following table provides the applicable Moody's Bond Index for each ratings level and the ratings bands for the Cost of Capital Mechanism ("CCM").

Ratings Based Index Selection Table for Cost of Capital Mechanism (CCM) [i]

Credit Worthiness	Moody's	Standard & Poor's	Fitch	Applicable Index to be Used for Cost of Capital Mechanism (CCM)
Investment Grade	Aaa	AAA	AAA	Moody's AA Utilities Bond Index (MOODUAA Index) [ii]
	Aa1	AA+	AA+	
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Moody's A Utilities Bond Index (MOODUA Index) [ii]
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Moody's Baa Utilities Bond Index (MOODUBAA Index) [ii]
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	

[i] - *Index determined based on the median long-term issuer rating.*

[ii] - *D.08-05-035 pg 19, "Moody's Aa utility bond interest rates should be used for those utilities having an AA credit rating or higher, Moody's A utility bond insterest rates should be used for those utilities having an A credit rating, and Moody's Baa utility bond interest rates for utilities having a BBB credit rating".*

Example of selecting the Moody's Utilities Bond Index for a utility with split credit ratings:

For illustrative purposes, suppose SoCalGas was rated A3 by Moody's, BBB+ by S&P and BBB by Fitch as of September 30 of a given year. To select the applicable Moody's Utilities Bond Index for the CCM, SoCalGas would use the median of the three ratings, or BBB+ by S&P in this example. BBB+ falls in Moody's Baa Utilities Bond Index range in the table above, and that would be the applicable index in the CCM for SoCalGas with these hypothetical split ratings.