Company: Southern California Gas Company (U 904 G)
Proceeding: Test Year 2026 Cost of Capital
Application: A.25-03-XXX
Exhibit: SCG-01

CHAPTER 1

PREPARED DIRECT TESTIMONY OF

SARA P. MIJARES

ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

(POLICY OVERVIEW AND COMPANY RISK)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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PREPARED DIRECT TESTIMONY OF SARA P. MIJARES
ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

I. INTRODUCTION AND SUMMARY OF PROPOSALS

My testimony provides an overview of Southern California Gas Company's (SoCalGas or Company) test year (TY) 2026 application for a newly authorized cost of capital (COC) for its operations regulated by the California Public Utilities Commission (Commission), including detailing how SoCalGas's above-average risk profile compared to utilities outside California informs the Company's cost of capital proposals.

At this critical time when the Commission exercises its various levers to promote the affordability of utility service, it must consider the direct link between affordability and the financial health of the utility. The Commission has an opportunity to help maintain customer affordability[1] by supporting strong sustainable utility financial health, which reduces costs of financing. Financially stable utilities with strong credit metrics and stable revenues are better able to keep borrowing costs low, manage operational costs and invest in infrastructure to help keep utility services safe, reliable, and affordable. This relationship between prioritizing financial health and customer affordability forms a cycle that benefits both the utility and the customers it serves.

For SoCalGas (a gas-only utility and the largest gas distribution company in the country[2]), the regulatory and political environment has become increasingly uncertain, creating unique risks relative to other California investor-owned utilities (IOUs) and utilities in other

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1 SoCalGas is currently in the top quartile lowest average bill, 2020-2023 American Gas Association: Top 50 IOU's by Total Customers.

2 By number of customers and revenues per American Gas Association (AGA) Statistics Database *2023 Rankings by Companies*.

jurisdictions. Furthermore, with the current relative instability of capital markets, utilities, their investors, and their customers face risks related to market fluctuations, regulatory changes, increasing climate events, and needs for infrastructure development. Setting an appropriate authorized rate of return for SoCalGas is critical to reflect the actual cost of capital that utilities face here in California.

It is imperative that SoCalGas be able to raise capital at reasonable rates. Energy utilities are in a capital-intensive industry where they build and maintain critical infrastructure. The costs necessary to support such critical infrastructure investments are collected through customer rates over long periods of time (i.e., over the life of the asset), consistent with ratemaking principles. However, investments are being made now and thus SoCalGas must attract capital to help finance safe, reliable, and affordable investments.

Investors and creditors continue to closely follow California's regulatory environment, and the following table highlights some of SoCalGas's unique risks (described later in the testimony) and the potential negative impacts on cash flows, balance sheet health and credit metrics, resulting in increased costs to customers:

TABLE 1 – SOCALGAS UNIQUE RISKS SUMMARY

	Key Unique Risks for SoCalGas	**Evidence**	**Impacts to customers**
Financial Risks	- Sustained higher interest costs due to (1) increased interest rates beyond other utilities that have equivalent or lower credit ratings and (2) extended regulatory lag (described below)	- 30-year first mortgage bonds have traded 10-15 basis points higher than peers with similar ratings or notch below[3]	- Approximately $5.1 million incremental annual borrowing costs on $3.4 billion issued 2022-2024 (based on 15bps)
	- Increased uncertainty around California's regulatory environment, including affordability concerns	- S&P downgraded SoCalGas's credit rating in January 2025[4], potentially resulting in future higher interest costs	
Regulatory Risks	- Sustained elevated undercollected regulatory account balances	- Undercollected regulatory account balances increased from approximately $318 million in 2019 to $852 million as of December 31, 2024	- TIMP: approximately $18 million of interest expense from January 2023 to June 2024 (filed in November 2022)
	- Regulatory lag: Increased risk in timely recovery of costs	- 2024 GRC decision was adopted 12 months later than anticipated in the updated Rate Case Plan and 12 months into the test year - DIMP Tier 3 Advice Letter 6224-G submitted in November 2023 and no resolution has been issued as of this application	- 2024 GRC: ~$11 million in interest expense resulting from the delay - DIMP Tier 3 AL: approximately $5 million in interest expense annually
Business Risks	- Energy transition, including natural gas sentiment	- Removal of new business line extension allowances - 5% discounts to Gas LDC multiple on 2026e SoCalGas EPS[5]	

As the Commission noted in the 2023 Cost of Capital decision, Decision (D.) 22-12-031, "an authorized ROE has risk when it does not adequately compensate a utility for the risk that

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3 Peers with credit rating(s) one notch lower than SoCalGas at Moody's.

4 S&P Global Ratings, *Research Update: Sempra Outlook Revised to Negative, Ratings Affirmed; Southern California Gas Downgraded, Outlook Stable* (January 9, 2025), *available at:* https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/13372819.

5 Source: Morgan Stanley, *Regulated & Diversified Utilities/IPPs/North America: Monthly Meter Reading* (January 27, 2025) at 74.

investors must assume."[6] The Commission went on to acknowledge the utilities' concern "that a lower ROE could potentially harm their credit profile and increase the cost of capital during a time when they need to spend substantial amounts on capital investment projects," but determined that the concern was "without merit."[7] Recent investor comments and SoCalGas's credit downgrade in January 2025[8] demonstrate that the Company's concern was and is still warranted. Specifically, investor and creditor sentiment regarding California's regulatory and policy environment is increasingly negative, translating into credit downgrade(s), higher relative risk for investment, and ultimately higher borrowing costs that flow to utility customers. S&P stated: "Furthermore, we expect the company to operate with negative discretionary cash flow throughout our forecast period, indicative of external funding needs. To account for this weakening of financial performance, we revised downward our comparable ratings analysis modifier to neutral from positive, which lowers SoCalGas's stand-alone credit profile and ratings."[9] Downgrades of SoCalGas's credit rating may lead to investors viewing the company as riskier (i.e. requiring a higher return on equity to invest), and increased borrowing costs (i.e. higher cost of debt).

While this testimony highlights the findings of the Company's witnesses, each witness sponsors the recommendations in their areas of responsibility. My testimony also, in conjunction with the testimony of Joshua Nowak, details SoCalGas's above-average risk compared to utilities outside of California and why it supports the Company's requests. The Company's

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[6] D.22-12-031 at 30.

[7] *Id.* at 31.

[8] Source: S&P Global Ratings, *Research Update: Sempra Outlook Revised to Negative, Ratings Affirmed; Southern California Gas Downgraded, Outlook Stabl*e (January 9, 2025).

[9] *Id.*

various testimonies support its cost of capital proposal, which should be authorized by the Commission.

II. SOCALGAS'S PROPOSED RATE OF RETURN IS FAIR, REASONABLE, AND JUSTIFIED

The authorized cost of capital for a regulated utility should represent a fair Rate of Return (ROR) that supports investor confidence in the financial soundness of the utility and helps maintain and support credit worthiness to effectively manage and operate utility business, which also results in maintaining affordability. Specifically, as the Commission articulated when approving SoCalGas's Test Year 2023 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 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.[10]

As such, for TY 2026, SoCalGas proposes the following cost of capital.

[10] D.22-12-031 at 15-16 (citing *Fed. Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591 (1944) [*Hope*]; *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923) [*Bluefield*].

TABLE 2 – PROPOSED TY 2026 AUTHORIZED COST OF CAPITAL

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	5.02%	2.29%
Preferred Stock	2.40%	6.00%	0.14%
Common Equity	52.00%	11.00%	5.72%
Rate of Return (ROR)	100.00%	N/A	8.15%

The Company's currently authorized cost of capital, as set in the 2023 COC Phase 1 Decision, D.22-12-031, and last modified in 2023 COC Phase 2 Decision, D.24-10-008, and Advice Letter 6404-G, is shown below.

TABLE 3 – CURRENTLY AUTHORIZED COST OF CAPITAL

Component	Capital Ratio	Cost	Weighted Cost
Long-Term Debt	45.60%	4.63%	2.11%
Preferred Stock	2.40%	6.00%	0.14%
Common Equity	52.00%	10.08%	5.24%
Rate of Return (ROR)	100.00%	N/A	7.49%

If adopted, SoCalGas's proposals will increase the Company's currently authorized rate of return by 0.66%, which will result in an estimated $117 million (2.1%) increase for 2026.[11]

The Company's financial risk profile, its relationship between debt and equity, and the need to balance financial stability, risk, return on investment, and customer affordability is critical in understanding SoCalGas's overall cost of capital proposal. SoCalGas's requests are

[11] Revenue requirement impact calculated using an imputed 2026 rate base from the 2024 General Rate Case (GRC). The adopted post-test year (PTY) mechanism did not authorize a specific rate base for the 2025-2027 PTY period. SoCalGas's revenue requirement impact is illustrative and will be updated as a result of the final outcome of this proceeding.

informed by the Company's actual capital structure, sound financial modeling, capital market data, independent sources such as equity analysts, credit rating agencies, other state utility commissions' cost of capital authorizations, and other qualitative and quantitative analyses from SoCalGas.

As such, SoCalGas respectfully requests that the Commission adopt SoCalGas's proposed Test Year 2026 Cost of Capital.

III. SOCALGAS'S ROE SHOULD BE SET AT 11.00% TO APPROPRIATELY REFLECT THE COST OF EQUITY AND THE COMPANY'S ABOVE-AVERAGE RISKS, ENABLING SOCALGAS TO ATTRACT CAPITAL ON FAVORABLE TERMS

Mr. Nowak provides SoCalGas's ROE proposal of 11.00%. Mr. Nowak's recommendation is well-supported, considering that his quantitative analysis shows an ROE range of 10.25% to 11.25%, the current and sustained high-interest rate environment, the increase in ROEs nationwide, and the above-average risks that SoCalGas faces relative to the proxy group as detailed here and in Mr. Nowak's testimony. One such risk is uncertainty of regulatory decisions. For example, SoCalGas's significantly delayed Test Year 2024 GRC Final Decision created increased challenges to plan for and implement business activities responsive to authorized funding for 2024 and into 2025, amid an external environment of persistent inflation, increasingly complex regulation and general uncertainty. SoCalGas has, as a result, experienced increased risk. Investors and analysts have correspondingly expressed concerns regarding the regulatory environment. For example, Guggenheim addressed the increased risk of operating in California throughout their January 2025 Sector Outlook:[12]

[12] Source: Guggenheim, *'25 Utilities Outlook: Incremental Investors and Marginal Buyers, If You Are Still There, Step Up and Meet the New GARP Sector - Utilities* (January 23, 2025).

- Ongoing regulatory challenges and bill pressure concerns, unfavorable 2024 case rulings (Cost of Capital, SRE CA GRC, Wildfire Cost Recovery). We have concerns around the goal seeking optics of decision making, multiple modifications to proposed decisions and lack of consistency in case schedules.[13]
- A turbulent 2024 regulatory cycle shifts our view on CA to a more cautious stance in 2025; 2025 proceedings could present risks including from the cost of capital discussions. From a high level, the core regulatory mechanisms have been favorable in CA (separate cost of capital mechanism, multiyear plans, revenue decoupling), but CPUC decisions have been inconsistent and optically arbitrary at times.[14]
- 2024 CPUC track record showed mixed outcomes, disallowances and optics of goal seeking to alleviate bills. In 2025 we see risks from the cost of capital proceeding.[15]

SoCalGas invests in infrastructure needed for the safe, reliable and affordable delivery of energy while balancing the investments necessary to meet operational and customer needs and California's ambitious decarbonization mandates. SoCalGas finances these investments by either issuing long term debt or using equity. Both methods have costs: the Company pays interest to creditors for debt issued, or it pays dividends to equity shareholders. Because capital markets are competitive, investors will only choose to invest with SoCalGas to fund critical projects (e.g.,

[13] *Id.* at 45.

[14] *Id.* at 55 (emphasis omitted).

[15] *Id.*

critical safety and reliability programs) if SoCalGas presents a reasonable return on those investments relative to the Company's risks.

The Commission recently reiterated, the "legal standard for setting the fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases"[16] and that return must thus be set at a level that is comparable to the return for other businesses with corresponding risks.[17] The Commission also stated that, the "issue of affordability as it relates to the cost of capital is subsumed under the *Hope* and *Bluefield* standards. Consideration of affordability beyond the *Hope* and *Bluefield* standards risk undermining them."[18]

That is, if the ROE is set too low it harms the customers in addition to the utility, as investors will invest in other companies that have the same return with lower risk profiles,[19] thus diminishing SoCalGas's ability to attract capital with the most cost-effective terms. Specifically, setting an ROE artificially low can lead to increased financial leverage and/or credit rating downgrades, raising costs for customers.[20] As the Commission has recognized, a strong investment grade credit rating—which is based on the soundness of the Company as an investment—benefits both the utility and ratepayers.[21]

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16 D.24-10-008 at 30 (citation omitted).

17 *Id.*

18 *Id.*

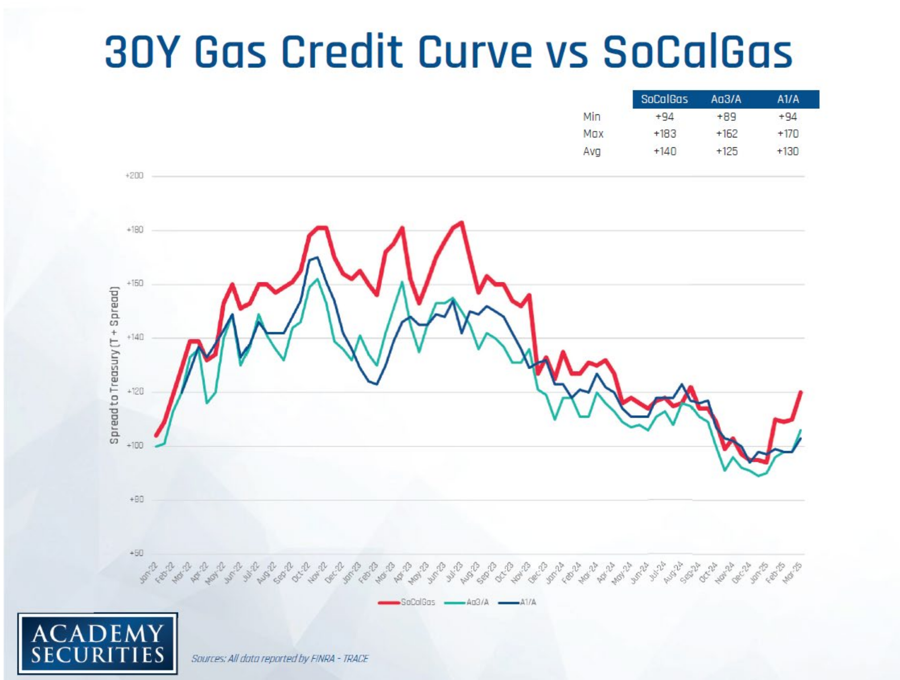
19 Exhibit (Ex.) SCG-03 (Nowak) at 10-11; *see* D.22-12-031 at 15 (the Commission "attempt[s] to set the [ROE] at a level of return commensurate with market returns on investments having corresponding risks and adequate to enable a utility to attract investors," ensuring a return that is "reasonably sufficient to ensure confidence in 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.").

20 *See* D.22-12-031 at 15 (finding that ROR must be set at a level to "maintain and support" a utility's credit rating).

21 D.12-12-034 at 7-8.

Stated another way, the riskier that SoCalGas is considered as an investment by credit rating agencies or investor analysts, the more expensive it is for the Company to raise capital—because it must compensate bond and shareholders for that increased risk—through higher interest rates, a higher return on equity or, most likely, both.[22] Customers ultimately bear these costs. For example, SoCalGas's 30-year first mortgage bonds have traded higher on a spread basis over the past three years compared to peers of the same rating and even one notch below,[23] which is evidence of the premium that SoCalGas must pay investors to attract capital.

FIGURE 1 – 30-YEAR GAS CREDIT CURVE



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[22] D.03-12-035 at 42 ("the cost of investment grade debt is considerably less […] the lower cost of a utility's debt translates into lower rates, all else being equal." (citation omitted)).

[23] Peers with credit rating(s) one notch lower than SoCalGas at Moody's.

SoCalGas's current senior secured credit rating is Aa3 for Moody's and A for S&P and, as shown in Figure 1 above, SoCalGas's 30-year spreads were an average of 140 basis points compared to 125 basis points for Aa3/A rated peers and 130 basis points for A1/A rated peers, a difference of 10-15 basis points.[24] For example, for the $3.4 billion issued over 2022-2024 period, an additional 15 basis points in interest rates results in $5.1 million of incremental annual borrowing costs. If SoCalGas's credit rating is downgraded further—in addition to the recent S&P January 2024 downgrade[25]—that could further increase interest costs to customers.

To determine a reasonable return on equity for SoCalGas, Mr. Nowak applied the results of three ROE-models (Discounted Cash Flow Model, Capital Asset Pricing Model, and the Bond Yield Plus Risk Premium Model) to a proxy group of seven investment-grade, dividend-paying natural gas utilities to establish a just and reasonable ROE range.[26] Mr. Nowak found a reasonable range for the proxy group to be 10.25-11.25 percent, before accounting for SoCalGas's specific risk profile. As Mr. Nowak noted, interest rates have dramatically increased and remained high over the past several years in response to the Federal Reserve's focus on record high inflation following the COVID-19 pandemic.

Mr. Nowak then considered SoCalGas's risk profile (as he noted in his testimony, and I address below) to develop an ROE recommendation within that range. Mr. Nowak concluded that SoCalGas's above-average risk compared to other regulated utilities in its proxy group supports an ROE in the top half of Mr. Nowak's range. Hence, Mr. Nowak recommends an ROE for SoCalGas of 11.00% at the midpoint of the upper half of the zone of reasonableness.

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[24] Source: Academy Securities (March 10, 2025).

[25] Source: S&P Global Ratings, *Research Update: Sempra Outlook Revised to Negative, Ratings Affirmed; Southern California Gas Downgraded, Outlook Stable.* (January 9, 2025).

[26] Ex. SCG-03 (Nowak) at 4, 46.

IV. SOCALGAS'S ABOVE AVERAGE RISKS COMPARED TO COMPARABLE UTILITIES SUPPORT ITS COST OF CAPITAL PROPOSAL

In this section, I detail SoCalGas's above-average risks, which, in connection with Mr. Nowak's testimony, support SoCalGas's proposal for an ROE of 11.00%. This portion of my testimony presents a qualitative assessment of financial, regulatory and business risks that the Company faces as a gas-only utility in California, focusing on risks identified by credit rating agencies and investors.

A. Credit Rating Agencies and Investors Have Recognized Additional Above-Average Risks for SoCalGas

Risks that impact SoCalGas's financial profile are closely reviewed and monitored by the investment community (*e.g.*, credit rating agencies and investors). Capital markets determine the cost of investor capital based on the amount of risk to potential investors in relation to other investment opportunities. Because investors have a significant array of options to choose from, SoCalGas must offer a rate of return and ROE that is commensurate with its risk to investors to attract the most cost-effective investor capital.

While California utilities face higher regulatory, financial and business risk in many areas compared to non-California utilities,[27] SoCalGas faces additional, unique risk as a gas-only utility in a state that is looking to rapidly decarbonize. Indeed, Moody's stated in a January 2024 SoCalGas credit opinion: "SoCalGas'[s] business risk profile is higher compared to most other peer LDCs in the US, tempering its credit quality. Public attention on the company and the demand on utilities to implement the state's decarbonization policy goals drives its higher

[27] Source: Moody's, *Credit Opinion: Southern California Gas Company* (January 4, 2022), (stating, "We view California as having higher political risk than most jurisdictions in the US. California's utilities tend to receive a higher level of scrutiny from both the media and public and issues can quickly become contentious and litigious. We observe a higher level of disallowances, impairments, fines and penalties compared to other jurisdictions in the US." It also listed, "Elevated legal and political risk amid high public scrutiny" as a credit challenge for SoCalGas.)

political risk exposure… SoCalGas'[s] stable outlook assumes that there will be a constructive outcome of the general rate case for the test year 2024 (2024 GRC), along with continued access to cost recovery mechanisms and favorable regulatory parameters, will underpin its ability to maintain some headroom in financial metrics."[28]

The investment community recognizes the impact of California's progressive energy policy on state utilities. As Moody's stated in a June 2020 SoCalGas credit opinion, "We think California uses its utilities to implement state policies more than other jurisdictions across the US."[29] S&P further noted in a January 2025 credit update, "[W]e expect subsidiary SoCalGas...to likely face gradual increase in business risk given California's ongoing energy transition away from natural gas-fueled technologies."[30]

In a credit opinion, Moody's clarifies that its rating outlook for SoCalGas is predicated on the state's (and Commission's) support of policies and actions that will not result in stranded costs: "A rating downgrade is likely if there is significant deterioration in the regulatory supportiveness in California, including...an adverse resolution of the pending gas system related regulatory proceedings that, for example, expose the utility to significant stranded cost. In addition, a downgrade is possible if there is an increase in long-term risks around natural gas policy in California."[31]

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[28] Source: Moody's, *Credit Opinion: Southern California Gas Company* (January 19, 2024). Moody's "A2" rating is equivalent to "A."

[29] Source: Moody's, *Credit Opinion*, *Southern California Gas Company* (June 2, 2020) at 1.

[30] Source: S&P Global Ratings, *Research Update: Sempra Outlook Revised to Negative, Ratings Affirmed; Southern California Gas Downgraded, Outlook Stable* (January 9, 2025) at 3.

[31] Source: Moody's, *Credit Opinion: Southern California Gas Company* (January 19, 2024). Moody's "A2" rating is equivalent to "A."

In addition, the Commission has recently stated the following in SoCalGas's most recent GRC Decision issued in December 2024: "We are currently facing a unique situation where we must balance affordability in rates, achieve our decarbonization goals, and test technological advancements for regulated monopolies."[32] Guggenheim noted in its 2025 Sector Outlook that "In 2024 we have seen the CA Governor issue an executive order on affordability, and while it did not specifically call out ongoing proceedings, there has been an increased amount of debate on affordability in multiple major proceedings…setting up the optic of goal seeking for bill inflation."[33] Given this tension with the different interests identified by the Commission, should affordability concerns continue to drive the Commission to decline to authorize sufficient revenue requirement for SoCalGas to continue to meet increasing regulatory requirements focused on the safety, reliability and resiliency of existing infrastructure while simultaneously making investments to support energy decarbonization, SoCalGas's risk increases, credit ratings suffer (i.e., recent S&P credit downgrade[34]) and costs to customers increase.

Furthermore, SoCalGas is experiencing protracted Commission proceedings for cost recovery for mandated safety work. Such costs are awaiting recovery in regulatory balancing and memorandum accounts while cost recovery requests are taking extended periods of time to be decided upon by the Commission. This requires SoCalGas to arrange incremental financing for longer periods (due to the extended regulatory lag), at higher rates (due to the premium that SoCalGas is having to pay on its debt from higher business risk as described earlier). SoCalGas's undercollected regulatory account balances were approximately $850 million at the

[32] D.24-12-074 at 406.

[33] Source: Guggenheim, *'25 Utilities Outlook* (January 23, 2025) at 55.

[34] Source: S&P Global Ratings, *Research Update: Sempra Outlook Revised to Negative, Ratings Affirmed; Southern California Gas Downgraded, Outlook Stable* (January 9, 2025).

end of 2024 compared to less than $120 million at the end of 2021 (see below). At the current pace of proceedings, the risk of carrying elevated regulatory account balances for long periods may lead to additional balance sheet and credit metric pressure, potentially resulting in additional credit downgrades, which increases costs to customers.

B. Increased Financial and Regulatory Risk at SoCalGas

Historically, SoCalGas used its capital structure to manage financial risk by utilizing increased levels of Common Equity relative to Long-Term Debt and Preferred Equity. As noted in the direct testimony of Ricardo Gonzalez (Chapter 2), SoCalGas has had to increase its debt funding in recent years, which has resulted in a deterioration in credit metrics and resulted in a recent downgrade by S&P.[35] SoCalGas's credit rating is one of the primary factors in determining the price of investor capital and is a signal to investors.

Specifically, rating agencies have taken notice of regulatory delays and its impacts on financial metrics, commenting "The ratings also capture the recent deterioration in the company's financial metrics largely due to some regulatory lag on the recovery of certain expenditures given the considerable delay in the utility's pending general rate case order for the test years 2024-2027."[36]

1. Increased Uncertainty in the California Regulatory Environment Due to Regulatory Lag and Significant Undercollected Balances

Regulatory delays and uncertainty also increase the utilities' investment risk and resulting financing costs and project viability. The delay in recovery of costs tracked in regulatory accounts increases the risk of SoCalGas's cash flows, credit metrics, and capital structure being

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35 Ex. SCG-02 (Gonzalez) at 4.

36 Source: Moody's Ratings, *Periodic Review: Southern California Gas Company and San Diego Gas & Electric Company* (November 28, 2024).

negatively impacted. More importantly, when timely decisions are not made on applications ranging from pilot projects to general rate cases, costs continue to accrue which are ultimately borne by customers. In the following sub-sections, I include examples to illustrate this point.

a) <u>Increased Regulatory Lag Across Most Proceedings and Advice Letters Increases SoCalGas's Financial Risks</u>

Regulatory accounts allow utilities to track costs and seek cost recovery at a later date, which is generally viewed positively as a risk mitigation tool by the investment community and rating agencies. Regulatory accounts can be helpful and afford the Company the opportunity to recover the outstanding balances in such accounts when reasonable and appropriate. Costs tracked in regulatory accounts without full and timely authorization of cost recovery increases the risk of SoCalGas's cash flows, capital structure, and credit metrics being negatively impacted and increases the costs to customers.

To this end, SoCalGas continues to experience an increase in the amount of time it takes for proceedings and advice letters to be resolved. For example, SoCalGas filed its Test Year 2024 General Rate Case (GRC) application, A.22-05-015, in May 2022. This was the first large utility GRC filed pursuant to the revised Rate Case Plan, whereby GRC applications are now filed earlier so that final decisions could be timely issued one year ahead of the test year.[37] However, this outcome did not materialize. SoCalGas received a final decision in December 2024, one year later than contemplated by the revised Rate Case Plan in D.20-01-002, and at the end of the 2024 test year. The delayed outcome in the 2024 GRC application resulted in additional uncertainty for customers, investors, and the utility alike. Further, almost $11 million

[37] D.20-01-002 at 76 (Finding of Fact (FOF) 7).

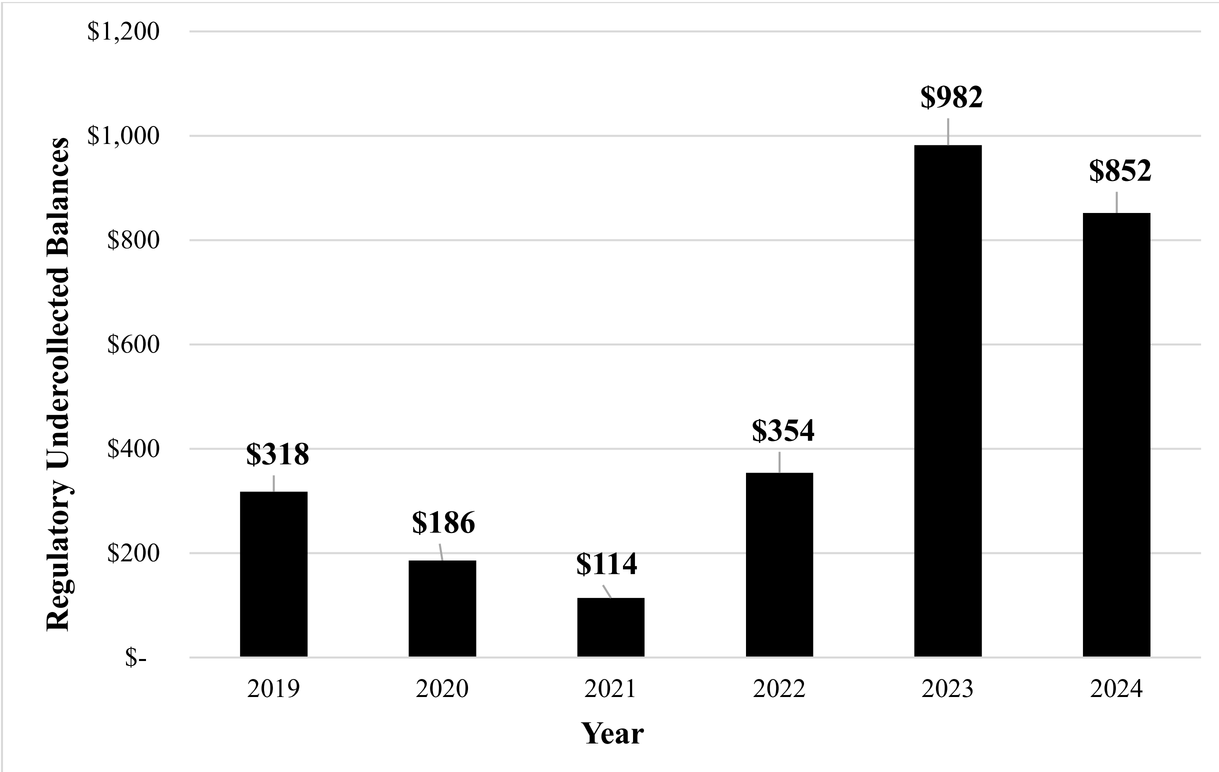
in interest accrued in the GRC memorandum account due to the delay, which increases costs to customers.

As another example of increase in regulatory lag, seeking recovery through advice letters has taken much longer in recent years. Through Advice Letter 5057G, SoCalGas sought recovery of undercollected funds in its Transmission Integrity Management Program Balancing Account (TIMPBA) in advice letter 5057G on November 4, 2016. This advice letter was approved by Resolution G-3528 on November 9, 2017. By contrast, SoCalGas submitted advice letter 6060-G on November 23, 2022 (supplemented on January 13, 2023), yet this advice letter was not approved until May 30, 2024 in Resolution G-3600 – a period of time 50% longer than when a similar advice letter was filed a few years before. Similarly, Advice Letter 6224-G was submitted on November 17, 2023, for recovery of undercollected funds in the Distribution Integrity Management Program Balancing Account (DIMPBA). However, as of the date this Cost of Capital application was filed, a draft resolution has yet to be issued despite over 16 months having passed from the Advice Letters submission. More timely reviews and approvals of proceedings may support reduced costs for customers not only through enhanced efficiency but also by reducing the cost (interest expense) of financing the underlying project costs that are ultimately borne by those customers; costs which can become significant during protracted proceedings.

b) <u>$852 Million in Undercollected Balances and the Elimination of Balancing Accounts Increases SoCalGas's Financial Risk</u>

SoCalGas financial risk increases when it invests in projects up front that may later be denied cost recovery. As illustrated in the figure below, the undercollected balances were approximately $318 million in 2019 and has grown to $852 million as of December 31, 2024:

FIGURE 2 – UNDERCOLLECTED BALANCES ($ in Millions)



If recent trends are any indication of future activity, a review of SoCalGas's total regulatory account balances that it has not put in rates are forecasted to grow significantly over the next several years and may take a considerable amount of time to recover in rates leading to increased financial risk. It also will lead to the need to attract additional capital as SoCalGas goes through the regulatory process of seeking and obtaining cost recovery approval, which is subject to what may be significant regulatory lag.

In addition, SoCalGas must comply with increasing requirements to enhance the safety and reliability of its energy system. Specifically, infrastructure investments and system upgrades are necessary for SoCalGas to continue to provide safe, reliable, and resilient service to its customers. Increasing requirements are often difficult to forecast and predict and, therefore, the CPUC has in the past provided regulatory mechanisms to address these situations. The CPUC's final decision in SoCalGas's 2024 General Rate Case substantially limited previously relied upon regulatory account mechanisms, such as balancing accounts,[38] which increases risk as the investment community views access to cost recovery mechanisms favorably. Specifically, for memorandum accounts, cost recovery is not guaranteed, resulting in additional financial risk that could negatively impact credit metrics and increase costs borne by customers.

C. Increased Business Risk at SoCalGas

Business risk pertains to the risks a Company is exposed to in its operations and external environment that have the potential to negatively impact its financial health. To compensate for higher levels of business risk, investors require the opportunity to earn a higher rate of return. As a gas-only distribution utility regulated in the State of California, SoCalGas has faced increasing business risk in recent years and expects to experience elevated business risk for the foreseeable future.[39] Investors and creditors identified risks relating to meeting California's ambitious climate goals; and operations, including severe weather events and natural disasters such as wildfires, mudslides and land movements.

1. California's Ambitious Climate Goals and the Energy Transition Creates a Perception of Risk to SoCalGas

California remains one of the most progressive states in the United States in terms of its energy policy and decarbonization goals, which will increase customer costs. This focus is evidenced by a growing body of legislation and policies aimed at achieving carbon neutrality. These policies include Senate Bill (SB) 100 which set the state's Renewable Portfolio Standard (RPS) requiring renewable energy and zero-carbon resources to supply all retail electricity sales

[38] D.24-12-074 at 908.

[39] D.12-12-034 at 30.

by 2045[40] and SB 32 which requires statewide GHG emissions to be 40% below 1990 levels by 2030.[41] Furthermore, California Executive Order B-55-18 dramatically expanded the state's GHG emission reduction goal by calling for carbon neutrality no later than 2045 and negative emissions thereafter.[42]

As used herein, "Transition Risk" refers to SoCalGas's risk associated with continuing to provide safe, reliable and affordable natural gas service to its customers while operating its business to continue to support the state's energy decarbonization goals. The magnitude of SoCalGas's transition risk is apparent in the California Air Resources Board's (CARB) 2022 Scoping Plan for Achieving Carbon Neutrality (Scoping Plan).[43] The Scoping Plan provides a sector-by-sector roadmap for California to achieve carbon neutrality by 2045 and makes clear the potentially extreme changes planned for California's natural gas system:

> The major element of this unprecedented transformation is the aggressive reduction of fossil fuels wherever they are currently used in California [...] phasing out the use fossil gas used for heating our homes and buildings […] continuing to build out […] resources that provide clean, renewable energy to displace fossil-fuel fired electrical generation […] Successfully achieving the outcomes called for in this Scoping Plan would reduce demand for […] fossil fuel by 86 percent in 2045 relative to 2022.[44]

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[40] SB 100 – California Renewables Portfolio Standard Program: emissions of greenhouse gases. (De León, 2018) *available at:* https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180SB100.

[41] SB 32 – California Global Warming Solutions Act. (Pavley, 2016) *available at: https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160SB32*

[42] State of California – Executive Department, *Executive Order B-55-18* (September 10, 2018), *available at:* https://www.ca.gov/archive/gov39/wp-content/uploads/2018/09/9.10.18-Executive-Order.pdf.

[43] CARB, *2022 Scoping Plan for Achieving Carbon Neutrality* (December 2022), *available at:* https://ww2.arb.ca.gov/sites/default/files/2023-04/2022-sp.pdf.

[44] Scoping Plan at 1-2.

Reducing emissions continues to be a major focus of certain local, state and federal agencies that have passed or proposed legislation, regulation, policies and ordinances to prohibit or restrict the use of natural gas in new buildings, appliances and other applications. These actions could have the effect of reducing natural gas use over time. Investors are warned of the potential risks within Sempra's Form 10-K filing with the U.S. Securities and Exchange Commission:

> A substantial reduction in or the elimination of natural gas use in California without adequate recovery of investments could result in impairment of some or all of SoCalGas'...natural gas infrastructure assets if they were not permitted to be repurposed for alternative fuels, were required to be depreciated on an accelerated basis or were to become stranded, which could have a material adverse effect on SoCalGas'[s] […] results of operations, financial conditions, cash flows and/or prospects.[45]

While the goal to achieve carbon neutrality is twenty years away, CARB's Scoping Plan urges, "there is no time to waste,"[46] California and the Commission are acting and considering policy determinations now that will impact SoCalGas's risk profile in this TY 2026 Cost of Capital cycle, which could create additional uncertainty amongst investors.

As evidenced by the above examples, SoCalGas continues to face an unprecedented and unique challenge as a gas-only utility operating in a state with some of the most progressive decarbonization goals and legislation in the country.

Accordingly, it will be critical for SoCalGas to maintain favorable credit ratings, a strong balance sheet, and investor confidence to have access to capital markets at a reasonable cost to remain affordable[47] while supporting the state's goals. SoCalGas requires a capital structure and

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[45] Sempra Energy 2024 Form 10-K (February 26, 2025) at 52.

[46] Scoping Plan at 11.

[47] As referenced above, natural gas supplies about 65% of household energy while only representing about 25% of household utility energy bills.

ROE that that will successfully attract low-cost capital and thus allow for the necessary investment in infrastructure to enable a safe, reliable, resilient, and affordable energy transition.

2. Affordability Concerns with Respect to Transition Risk

While SoCalGas's rates are affordable[48], increasing regulatory requirements and breadth of energy transition related projects necessitate growing investments in the safety and reliability of existing gas infrastructure, climate change drives the need for investments to maintain system resiliency, and the state's climate goals require additional investments to support the state's decarbonization goals. These required investments with considerable long-lead regulatory processes will continue to put upward pressure on SoCalGas's rates as decarbonization measures inherently increases customer costs.

3. SoCalGas Faces Unique Risks from Declared Disasters Impacting the SoCalGas Service Territory and Its Customers

SoCalGas's business and financial risks increased as a result of severe weather, natural disasters, including wildfires, equipment failures, third-party dig-ins, or other events that may disrupt operations, damage facilities, or subject the utility to liability. Specifically, SoCalGas experienced fifteen fire and winter storm events occurring between 2017 and 2019, which the Company included in a 2023 Catastrophic Event Memorandum Account (CEMA) Application filed in November 2023 seeking the approximate recovery of $53.915 million.[49] Briefing was

48 Calculated based on California Energy Commission (CEC) 2019 California Residential Appliance Saturation Study average household energy consumption at: https://www.energy.ca.gov/sites/default/files/2021-08/CEC-200-2021-005-ES.pdf ; statewide average residential electricity rates from the CEC Demand Forms at: https://efiling.energy.ca.gov/GetDocument.aspx?tn=253591&DocumentContentId=88826, and CEC provided spreadsheet on average residential natural gas rates. Also, SoCalGas is currently in the top quartile lowest average bill, 2020-2023 American Gas Association: Top 50 IOU's by Total Customers.

49 A.23-11-003, Application of SoCalGas for Authorization to Recover Costs Recorded in Its Catastrophic Event Memorandum Account and Its COVID-19 Pandemic Protections Memorandum Account (November 2, 2023).

completed in October 2024 and a proposed decision has not been issued as of this filing. The following table highlights officially declared disasters since 2023 which are not included in SoCalGas's CEMA Application identified above:

TABLE 4 – RECENT STORM AND WILDFIRE DISASTERS

Year	Events
2023	Winter storms, Tropical Storm Hilary
2024	February 2024 storm, Rancho Palos Verdes, Line Fire, Ridge Fire, Airport Fire
2025	Los Angeles Wildfires

The recent wildfires in Southern California underscore the increasing risk fires pose for utilities. While SoCalGas is not an electric utility, it is not free from wildfire risk as a Fitch report has previously observed that "SoCalGas is subject to contagion risk from its utility affiliate, San Diego Gas & Electric Company, which carries higher operating risks, as its service territory is prone to wildfires."[50]

Although certain costs resulting from responding to these events may be recovered through established regulatory mechanisms (e.g., CEMA), if recent history is indicative of future events, the total potential costs are likely to grow significantly over the next several years and may take a considerable amount of time to recover in rates leading to increased financial risk related to cash flow and balance sheet health.

[50] Source: *Fitch, Southern California Gas Company* (May 8, 2018); *see also*, Fitch, *Fitch Affirms Sempra, et al* (April 19, 2019) ("However, SoCalGas is not immune from contagion risks from SDG&E and Sempra. Failure in addressing SDG&E's wildfire recovery risks and negative rating actions on Sempra could pressure SoCalGas'[s] ratings.").

V. SOCALGAS RECOMMENDS MAINTAINING ITS CURRENT CAPITAL STRUCTURE

Mr. Gonzalez's direct testimony, supports SoCalGas's currently authorized capital structure of 52% common equity, 2.4% preferred equity, and 45.6% long term debt for Test Year 2026 to reflect its recent actual recorded capital structure.[51] Any regulatory action that would increase SoCalGas's leverage, such as higher debt in the authorized capital structure, may be perceived as an unsupportive regulatory environment and counted as credit negative to rating agencies.[52]

IV. CONCLUSION

SoCalGas's proposed capital structure, ROE, and overall ROR is consistent with financial modeling, relevant capital market data, and SoCalGas's increased and unique risks. As described above, credit rating agencies and analysts believe there is increased risk with being a gas-only utility in California, and the proposed capital structure and ROE are necessary to compensate investors for their increased risk. In turn, this will support the financial health of the utility, which can reduce the costs of financing, allowing the Company to manage operational costs, and invest in infrastructure to help keep utility services safe and reliable, which ultimately leads to lower costs for energy customers in the long run.

This concludes my prepared direct testimony.

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[51] Ex. SCG-02 (Gonzalez) at 2.

[52] *Id*. at 1-3.

V. WITNESS QUALIFICATIONS

My name is Sara P. Mijares. My business address is 555 W. 5th Street, Los Angeles, CA 90013. I am employed at SoCalGas as the Vice President, Chief Accounting Officer, Assistant Treasurer and Controller.

In this role, I am responsible for overseeing SoCalGas's accounting and financial reporting. I assumed my current position in August 2024. Prior to this, I have served in roles of increasing responsibility at SoCalGas since June 2020.

Prior to my time at SoCalGas, I worked for PricewaterhouseCoopers from 2003 to 2020 in the Audit group. I hold a Bachelor of Science Degree in Accounting from Loyola Marymount University. I am a Certified Public Accountant (CPA).

I have previously testified before the Commission.