

Company: Southern California Gas Company (U 904 G)
Proceeding: Test Year 2026 Cost of Capital
Application: A.25-03-XXX
Exhibit: SCG-02

CHAPTER 2

PREPARED DIRECT TESTIMONY OF

RICARDO GONZALEZ

ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

(CAPITAL STRUCTURE & COST OF CAPITAL FUNCTIONALITY)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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1 **PREPARED DIRECT TESTIMONY OF RICARDO GONZALEZ**
2 **ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY**

3 **I. INTRODUCTION**

4 My testimony presents Southern California Gas Company’s (“SoCalGas” or “Company”)
5 proposals regarding test year (TY) 2026 authorized capital structure, as well as the embedded
6 costs of long-term debt¹ and preferred equity. The authorized capital structure refers to the
7 capital ratios of three components: long-term debt, preferred equity and common equity. The
8 authorized capital ratios, in conjunction with the forecasted authorized costs, will determine the
9 TY 2026 ratemaking weighted-average cost of capital (COC) and authorized rate of return
10 (ROR). Authorizing SoCalGas’s proposed ROR is necessary to attract the capital necessary to
11 fund our capital investment plan and continue to provide safe, reliable and affordable energy to
12 its 21 million customers.

13 The Company’s authorized ROR is determined by applying the Company’s return on
14 equity (ROE) and embedded costs of debt and preferred to its authorized capital structure. An
15 optimal capital structure is necessary for SoCalGas to maintain its credit investment grade
16 profile, which lowers borrowing costs for both the Company and customers. All things being
17 equal, SoCalGas would have proposed an increase in its common equity ratio to improve its
18 credit metrics. However, due to carrying the costs of the significant customer arrearages and
19 undercollected regulatory balances in recent years, SoCalGas has had to increase its debt levels
20 resulting in deteriorating credit metrics and was subsequently downgraded by Standard & Poor’s

¹ The terms “debt” and “long-term debt” are used interchangeably, unless specifically noted otherwise. Long-term debt is defined as debt that is due more than one year in the future. This includes the current portion of long-term debt and excludes short-term debt (due within one year).

1 (“S&P”).² At this time, SoCalGas proposes to maintain its current capital structure until
2 regulatory undercollections and customer arrearages have been addressed.

3 **TABLE 1 – CURRENT AND PROPOSED AUTHORIZED CAPITAL STRUCTURE**

Component	Current Authorized ³	Proposed 2026
Long-Term Debt	45.60%	45.60%
Preferred Equity	2.40%	2.40%
Common Equity	52.00%	52.00%
Total	100.00%	100.00%

4 SoCalGas proposes to update its authorized embedded cost of long-term debt and
5 maintain its authorized cost of preferred equity, as shown in Table 2. SoCalGas’s proposal
6 regarding the authorized cost of common equity is presented in the Direct Testimony of Joshua
7 C. Nowak (Exhibit (Ex.) SCG-03).

8 **TABLE 2 – CURRENT AND PROPOSED AUTHORIZED EMBEDDED COSTS**

Component	Current Authorized ⁴	Proposed 2026
Long-Term Debt	4.63%	5.02%
Preferred Equity	6.00%	6.00%

9 **II. CAPITAL STRUCTURE**

10 Capital structure is the ratio of long-term debt, preferred equity and common equity that
11 comprise long-term financing. As stated by the California Public Utilities Commission
12 (Commission), “Because the level of financial risk that the utilities face is determined in part by
13 the proportion of their debt to permanent capital, or leverage, we must ensure that the utilities’

² S&P Global, *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>.

³ Decision (D.)22-12-031 at 1.

⁴ SoCalGas Advice Letter (AL) 6404-G, pursuant to D.24-10-008, available at: <https://tariffsprd.socalgas.com/view/filing/?utilId=SCG&bookId=GAS&flngKey=4871&flngId=6404-G&flngStatusCd=Approved>.

1 adopted equity ratios are sufficient to maintain reasonable credit ratings and attract capital while
2 also ensuring there are adequate ratepayer protections regarding the costs of the components of
3 capitalization.”⁵

4 Long-term debt is a measurement of a company’s financial leverage. Debt is generally
5 less expensive than equity, due to its tax advantages. The long-term debt ratio of a utility’s
6 authorized ratemaking capital structure represents a measurement of a company’s financial
7 leverage, indicative of the amount of capital funded by debt. A high long-term debt ratio
8 increases the financial risk around debt repayment to lenders, potentially resulting in reduced
9 credit ratings and higher costs of capital over the long-term. Conversely, a long-term debt ratio
10 that is too low is also not ideal as it does not represent sufficient use of a tax-deductible source of
11 financing that is priced lower than the cost of equity.

12 Preferred equity is a source of capital that is issued in shares and pays dividends, like
13 common equity, but preferred equity dividends are paid at an agreed upon amount at regular
14 intervals. Preferred equity generally has a lower cost than common equity, but a higher cost than
15 long-term debt.⁶ Preferred equity holders have a higher claim on assets and earnings than
16 common equity holders but are subordinate to debt holders in the event of liquidation. Thus,
17 credit rating agencies, like S&P, generally treat preferred stock as a hybrid of debt and equity,
18 assigning a percentage of equity content in accordance with the security’s features.

19 Common equity represents the amount of capital provided by stockholders. The common
20 equity ratio reflects how a company is financing its capital needs and reflects the percentage of

⁵ D.22-12-031 at 4.

⁶ Credit rating agencies generally treat preferred equity as a hybrid of debt and equity, assigning a percentage of equity content in accordance with the security’s features.

1 assets on which the stockholders have a claim. A high common equity ratio lowers financial risk
2 by reducing the reliance on long-term debt.

3 SoCalGas proposes to maintain its authorized capital structure of 45.60% long-term debt,
4 2.40% preferred equity and 52.00% common equity. This will allow SoCalGas to manage the
5 higher debt levels in recent years, fund capital investments authorized in the recent 2024 General
6 Rate Case Decision,⁷ and maintain credit metrics in line with investment grade rating
7 benchmarks.

8 **A. Historical Capital Structure**

9 Historically, SoCalGas has consistently maintained an actual capital structure that
10 supported strong credit investment grade credit ratings, resulting in lower borrowing costs for
11 ratepayers. This was primarily accomplished by maintaining a long-term debt ratio that
12 supported strong investment grade credit metrics. However, due to the moratorium on
13 collections practices due to COVID-19 and increased regulatory lag for undercollected balances,
14 SoCalGas has had to increase its debt funding in recent years, which has resulted in a
15 deterioration in credit metrics and resulted in a recent downgrade by S&P. As a result of this
16 latest rating action, SoCalGas anticipates an increase in borrowing costs in the near term for
17 future issuances, resulting in higher costs for customers and the utility.

⁷ D. 24-12-074.

TABLE 3 – HISTORICAL CAPITAL STRUCTURE⁸

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Long-Term Debt	44.31%	46.11%	43.47%	44.80%	44.50%	48.05%	46.65%	47.50%	47.71%	47.42%
Preferred Equity	0.39%	0.33%	0.31%	0.28%	0.25%	0.22%	0.21%	0.17%	0.15%	0.14%
Common Equity	55.30%	53.56%	56.22%	54.92%	55.25%	51.73%	53.14%	52.33%	52.14%	52.44%

1. Higher Customer Arrearages Due to COVID-19

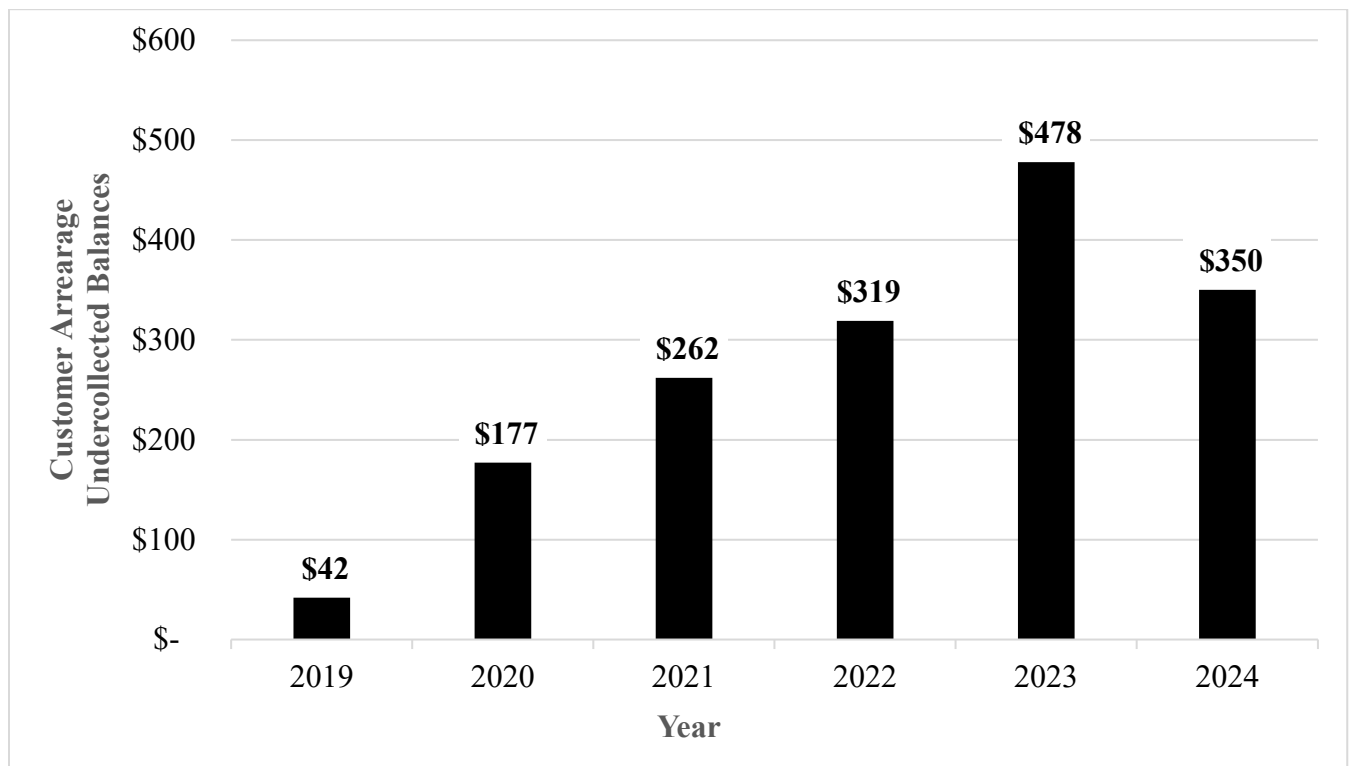
Timely customer collections are important for maintaining stable cash flows and supporting investment grade credit metrics, both of which have been negatively impacted by various events in recent years. As shown in the table below, elevated customer arrearages due to the COVID-19 pandemic continue to put significant pressure on SoCalGas's credit metrics. Customer arrearages, representing residential and commercial accounts receivable over 30 days past due, including Arrearage Management Payment Plan (AMP)⁹ program and credit balances, totaled around \$42 million prior to the pandemic at year-end 2019. Customer arrearages peaked at \$544 million ending Q2-2023 when the moratorium was finally lifted and is currently at \$350 million at year-end 2024.

⁸ Represents capital structures recorded at year-end. These percentages are rounded to the hundredth decimal point. In the event they do not add up to 100.00%, it is due to rounding.

⁹ Enrollments to AMP began in February 2021.

FIGURE 1 – CUSTOMER ARREARAGES UNDERCOLLECTED BALANCES

(\$ IN MILLIONS)

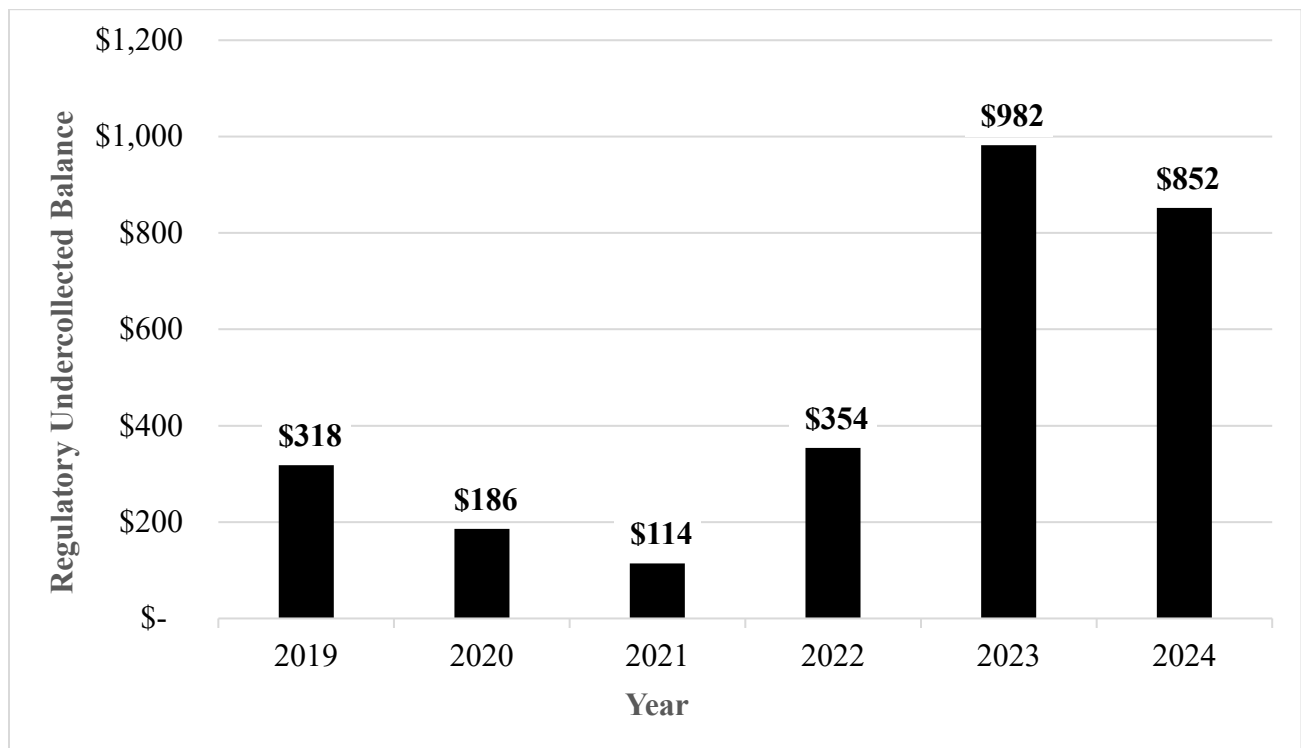


2. Growing Regulatory Undercollections

Growing regulatory undercollections have increased SoCalGas's regulatory and financial risk, which are key aspects of rating agencies' determination of credit rating. As of year-end 2024, SoCalGas's regulatory undercollected balances were \$852 million, compared to historical balances of \$114 million in 2021 and \$186 million in 2020. Over the past five years, these balances have grown significantly, increasing the company's financial risk and pressure on the Company's credit metrics.

FIGURE 2 – REGULATORY UNDERCOLLECTED BALANCES¹⁰

(\$ IN MILLIONS)



Long periods of regulatory undercollected balances necessitate supplemental levels of both long-term and short-term financing, which ultimately tie up capital that could otherwise be used for operational or investment purposes. As the delay in recovering these balances grows over time, the prolonged financing period increases the company's exposure to interest rate fluctuations.

Rating agencies have taken notice of these regulatory delays, commenting "the recent deterioration in the company's financial metrics largely due to some regulatory lag on the

¹⁰ Balances includes \$281 million and -\$49 million in 2023 and 2024, respectively, of Residential Uncollectible Costs – Reserve, recorded to Residential Uncollectible Balancing Account (RUBA).

1 recovery of certain expenditures given the considerable delay in the utility's pending general rate
2 case order for the test years 2024-2027.”¹¹

3 **B. Capital Expenditures**

4 SoCalGas’s capital investment plan of approximately \$9.7 billion over 2025-2029
5 reflects crucial infrastructure investments to support safety and reliability, such as compressor
6 station modernization projects, integrity management programs, and other pipeline safety work.
7 As part of SoCalGas’ 2024 GRC, the Commission approved certain of SoCalGas’s capital
8 investments proposals to support SoCalGas’s operations to safely, reliably and affordably serve
9 its customers. An optimal capital structure is critical to maintaining strong investment grade
10 credit ratings for SoCalGas to attract the necessary capital to fund these authorized investments.

11 S&P has commented that “While the industry’s robust capital spending is necessary for
12 prudent investments in safety, reliability, and energy transition, it is directly leading to high cash
13 flow deficits. If these deficits are not funded with debt and equity in a balanced manner, credit
14 quality will likely weaken.”¹² Additionally, Moody’s explains that “Financial strength is
15 necessary for a regulated electric and gas utility to attract capital at a reasonable cost in order to
16 invest in its...assets, so the utility can fulfill its service obligations at a reasonable cost to rate-
17 payers and service debt. The financial strength of utilities, which are characterized by large
18 investments in long-lived property, plant and equipment, includes the ability to service debt and
19 provide a return to shareholders.”¹³

¹¹ Source: Moody’s Ratings, *Periodic Review: Southern California Gas Company and San Diego Gas & Electric Company* (November 28, 2024).

¹² Source: © 2025 S&P Global Market Intelligence.

¹³ Source: Moody’s Ratings, *Rating Methodology, Regulated Electric and Gas Utilities* (August 6, 2024).

C. Authorized Capital Structure Should Be Credit Supportive

An optimal capital structure supports a strong investment credit rating, resulting in lower borrowing costs for customers and the utility. This optimal capital structure involves a blend of long-term debt and common equity financing. SoCalGas manages its actual capitalization in a manner that supports and maintains its investment grade credit ratings. In an environment of significant business and regulatory risks, as described earlier and further detailed in Ex. SCG-01 (Mijares), it is crucial to manage financial risk. Financial risk can be effectively mitigated by managing debt levels, such that debt relative to total capitalization does not exceed thresholds prescribed by the credit rating agencies.

The major credit rating agencies commonly employ a few key credit metrics as a means to quantify financial strength such as (1) funds from operations (“FFO”) as a percent of total debt and (2) debt as a percentage of total capital. FFO represents cash generated from a company’s operations, excluding non-cash items like depreciation and amortization. Together with their assessment of business and regulatory risk, the major credit rating agencies utilize these credit metrics to inform and substantiate their assigned credit ratings.

1. FFO-to-Total Debt

FFO-to-Total Debt is a financial metric used to assess a company’s ability to manage its debt using its operating income. A higher ratio indicates a stronger ability to cover debt obligations with operating income, suggesting a lower financial risk. Conversely, a lower ratio suggests higher leverage and potentially greater financial risk which indicates a company may struggle to covers its debt with its operating income alone. In January 2025, S&P downgraded SoCalGas from “A” to “A-”, stating that “The downgrade of SoCalGas reflects our expectation that the company’s financial measures will remain consistently below our downgrade threshold

1 of FFO to debt of 20%.¹⁴ S&P expects SoCalGas's FFO to debt to be 17%-19% through 2027
2 and explains that SoCalGas could be further downgraded if FFO-to-Total Debt falls below
3 16%.¹⁵

4 Moody's evaluates financial strength based off a calculation of Cash Flow from
5 Operations Pre-Working Capital ("CFO Pre-WC"), which, unlike FFO, captures the changes in
6 long-term regulatory assets and liabilities¹⁶. Moody's recently affirmed SoCalGas's ratings
7 (before issuance of the final GRC decision), including its A2 senior unsecured rating, with a
8 stable outlook and specified an expectation that SoCalGas generate a ratio of CFO pre-WC to
9 debt in the range of 22-23% on a sustained basis¹⁷.

10 These stated credit metric targets represent a lower bound in order to sustain an A rating
11 over time. SoCalGas prudently manages debt levels so that its credit metrics remain reasonably
12 above the lower bounds presented in these analyses, in order to accommodate short-term
13 fluctuations and disruptions to credit markets and the business environment to ultimately
14 maintain its A rating for senior unsecured debt.

15 **2. Debt Ratio**

16 In addition to FFO-to-Total Debt, credit rating agencies also factor debt ratio into
17 assessing financial risk. This ratio helps rating agencies to understand how much of a company's

¹⁴ S&P Global, *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>.

¹⁵ *Id.*

¹⁶ Source: Moody's Ratings, *Rating Methodology, Regulated Electric and Gas Utilities* (August 6, 2024).

¹⁷ Source: Moody's Ratings, *Periodic Review: Southern California Gas Company and San Diego Gas & Electric Company* (November 28, 2024).

assets are financed by debt. Moody's provides a rating grid which can be used as a reference tool to approximate credit profiles within the regulated electric and gas sector.

TABLE 4 – MOODY'S DEBT / BOOK CAPITALIZATION BENCHMARKS¹⁸

Rating	Debt/Capital % ¹⁹
Aaa	<25%
Aa	25% - 35%
A	35% - 45%
Baa	45% - 55%
Ba	55% - 65%
B	65% - 75%
Caa	≥75%

Together with other indicators, Moody's uses the table above as a guideline for assigning a utility's credit rating. The table suggests that for SoCalGas to sustain its strong single A bond rating, it should maintain a debt ratio in the range of 35% – 45%. SoCalGas's proposed Long-Term Debt ratio of 45.60% is 60 basis points²⁰ above Moody's stated range.

Credit metric guidance provided by the credit rating agencies is a valuable guide to determine the appropriate use of debt. Debt utilization beyond the levels indicated by the target credit metrics defined above would put downward pressure on SoCalGas's A credit ratings.

¹⁸ Source: Moody's Ratings, *Rating Methodology, Regulated Electric and Gas Utilities* (August 6, 2024).

¹⁹ Ratios shown are for companies that Moody's has identified to have a standard risk profile.

²⁰ A one, ten, or 100 basis point change equals a 0.01%, 0.1% or 1.0% change, respectively.

D. Authorized Equity Ratios of Comparable Natural Gas Utilities

As a benchmark, SoCalGas evaluates its authorized capital structure relative to the authorized capital structure of other natural gas utilities. U.S. natural gas utilities, the vast majority of which do not share the same business and financial risks as SoCalGas, received an average authorized common equity ratio of 51.99% over the past three years.²¹

TABLE 5 – NATIONAL AVERAGE AUTHORIZED COMMON EQUITY RATIO

Year	Average Authorized Common Equity Ratio	Number of Rate Cases
2022	51.52%	32
2023	52.06%	34
2024	52.30%	40
Average	51.99%	106

The testimony of Mr. Nowak walks through a detailed discussion of a proxy group selection that reflect comparable companies to SoCalGas in terms of business and financial risks. The proxy group’s operating utilities’ average actual common equity ratio is 53.72%²², which is higher than SoCalGas’s currently authorized common equity ratio of 52.00%.

These averages are a valuable benchmark for evaluating the appropriate authorized common equity ratio for SoCalGas.

²¹ Source: © 2025 S&P Global Market Intelligence.

²² See Ex. SCG-03 (Novak) at 48 and accompanying Ex. JCN-10.

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

A. Embedded Cost of Long-Term Debt

The embedded cost of debt represents all the costs associated with the issuance and servicing of debt, expressed as a percentage of the net proceeds received from debt issuances. SoCalGas proposes a test year embedded cost of long-term debt of 5.02%.

TABLE 6 – EMBEDDED COST OF LONG-TERM DEBT

Component	Current Authorized ²³	Proposed 2026
Long-Term Debt	4.63%	5.02%

Consistent with previous cost of capital decisions, SoCalGas recommends setting the authorized cost of debt equal to the forecasted test year embedded cost of debt. A detailed derivation of the proposed embedded cost of debt can be found in Appendix A. SoCalGas’s calculation utilizes recorded embedded cost of debt as of the end of December 2024 and incorporates SoCalGas’s current projection of long-term debt issuances. SoCalGas plans to raise approximately \$2.0 billion in 2025-2026 of new long-term debt to support its capital expenditure plan.²⁴ Costs for each issuance are based on the February 2025 S&P Global Market Intelligence forecast of the 30-year Treasury bond yield, plus an estimation of a SoCalGas-specific credit spread and expected issuance expenses.

The Commission has stated that, “[t]he latest available interest rate forecast should be used to determine embedded long-term debt and preferred equity costs in ROE proceedings.”²⁵

²³ SoCalGas AL 6404-G.

²⁴ The timing and amounts of the forecast provided herein are subject to change based on market conditions and management’s discretion.

²⁵ D.22-12-031 at 12.

1 In accordance with this guidance and prior Cost of Capital proceedings, SoCalGas plans to
2 submit an embedded cost update during this proceeding that reflects the latest forecast as well as
3 any changes to SoCalGas's Long-Term Debt forecast that may take place between the
4 preparation of this testimony and the submittal of the update.

5 **B. Embedded Cost of Preferred Equity**

6 The embedded cost of preferred equity represents all costs (including historical)
7 associated with the issuance and servicing of preferred equity, expressed as a percentage of the
8 net proceeds received from preferred equity issuances. SoCalGas proposes to maintain the
9 authorized cost of preferred equity of 6.00%. Appendix B shows the derivation of this figure.

10 **TABLE 7 – EMBEDDED COST OF PREFERRED EQUITY**

Component	Current Authorized	Proposed 2026
Preferred Equity	6.00%	6.00%

11 SoCalGas does not anticipate the need to issue any new preferred equity in 2025 or 2026.
12 However, if market conditions become more favorable, SoCalGas may consider preferred equity
13 as an advantageous financing option. Furthermore, none of SoCalGas's perpetual preferred
14 equity is expected to be called. In the absence of any projected issuances or retirements, the
15 forecasted embedded cost of preferred equity is equal to the current actual embedded cost of
16 preferred equity.

17 As discussed with respect to the embedded cost of Long-Term Debt, SoCalGas will
18 submit an update during the course of this proceeding, that will reflect any changes to
19 SoCalGas's preferred equity forecast that may take place between the preparation of this
20 testimony and the submittal of the update.

1 **IV. CONCLUSION**

2 SoCalGas seeks no changes to its currently authorized capital structure (52% equity,
3 45.6% long-term debt, and 2.4% preferred stock) for Test Year 2026 to reflect its recent actual
4 recorded capital structure.

5 SoCalGas also seeks a Test Year 2026 embedded cost of debt and preferred stock of
6 5.02% and 6.00%, respectively. These reflect forecasted embedded costs for the Test Year 2026.
7 SoCalGas respectfully requests the Commission adopts these proposals for 2026.

8 This concludes my prepared direct testimony.
9

1 **V. WITNESS QUALIFICATIONS**

2 My name is Ricardo Gonzalez. I am employed by SoCalGas as the Director of Financial
3 & Business Planning. My business address is 555 W. 5th Street, Los Angeles, CA 90013.

4 I received a Bachelor of Science degree in Business Administration with an emphasis in
5 Finance from California State University, Northridge in 2002. I also received a Master of
6 Business Administration degree with an emphasis in Global Business from the Graziadio School
7 of Business Management at Pepperdine University in 2010. I am a Certified Public Accountant
8 in the state of California and a Certified Management Accountant. I have been employed by
9 SoCalGas since 2003. In addition to my current position, I have held various Accounting and
10 Finance positions within the organization, including Director of Utility Accounting, Utility
11 Accounting Manager, and Financial Planning Manager.

12 In my current role, I am responsible for the development of SoCalGas's financial plan
13 and numerous treasury related functions.

14 I have previously testified before this Commission