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Witnesses:	M. Rao

(U 933-E)

2025 General Rate Case

Before the California Public Utilities Commission

Chapter 10: Rate of Return

Tahoe Vista, California

September 20, 2024

Liberty-10: Rate of Return

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I. RATE OF RETURN

A. Introduction

The development of the Return on Rate base is typically done in three stages. First, a capital structure is established whereby the total capitalization of the company is divided into components (including long-term debt, preferred stock, and common equity), and each component is assigned its percentage value of the whole. Second, the effective cost of each component is determined. Third, a weighted cost is developed for each component by multiplying its cost by its percentage of the total capitalization. The Return on Rate base is then calculated as the sum of the weighted costs of the components of capitalization.

In addition, the weighted cost of long-term debt calculated in the third step is typically used to calculate the ratemaking interest deduction to taxable income (interest = weighted cost of debt times rate base). The components of capitalization, their costs and weighted costs, and the resulting Return on Rate base for the years 2025-2027 for Liberty Utilities (CalPeco Electric) LLC ("Liberty") is shown in Table I-1.

Table I-1
Cost of Capital Debt/Equity Percentages (2022-2024)

	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	47.50%	5.87%	2.79%
Common Equity	52.50%	11.00%	5.78%
Total	100.00%		8.57%

B. Capital Structure

The capital structure proposed is consistent with the current capital structure authorized by the Commission for Liberty.

As of December 31, 2023, Liberty's total equity is $367,609,000. Liberty does not have any preferred stock; the capital structure consists only of common equity and long-term debt. Liberty is in the process of preparing a new long-term debt application to recapitalize its capital structure with intercompany financing. Liberty anticipates that this application will be filed in the fourth quarter of 2024 and will reflect the cost of debt proposed in this application. With the assumption of a new intercompany debt issue in 2025 from Liberty Utilities Co. ("LUCo"), the common equity percentage average over 2025-2027 is estimated to be 52.50%, absent any adjustment. Liberty believes that the currently authorized 52.50% common equity and 47.50% debt to be an appropriate capital structure for a company of its size and conditions and does not propose any changes for 2025-2027.

C. Cost Of Debt

As stated above, in Q4 of 2024, Liberty will seek Commission authority to issue long-term debt through in the form of 10-year promissory notes from its parent company, LUCo, priced according to the 10-year United States Treasury rate effective at the time of note issuance. A credit spread will also be added, which will be equal to the like term credit spread last secured by LUCo for its private debt placements. Liberty estimates an effective rate of 5.87% based on prevailing 2024 10-year United States Treasury rates plus a credit spread.

The calculation is based upon Liberty's estimated costs for a projected long-term intercompany financing in 2025, which includes proposed rates, issuing costs, amount of issue and sinking fund payments for those debt issues.

The calculation of Liberty's estimates of the effective cost of long-term debt for 2025-2027 is shown in Table 10-1.

II. RETURN ON EQUITY

A. Introduction

To determine the return of equity, Liberty's outside consultant, Thomas J. Bourassa, conducted a quantitative analysis of market data of publicly-traded companies. As described in Chapter 7, the analysis resulted in a finding of the recommended range of ROE to be 9.80% to 11.30%, with a mid-point of 10.6%, for those publicly-traded companies. For Liberty, Mr. Bourassa's recommendation is that the ROE be on the higher side of the t range for publicly-traded companies by at least 40 basis points, resulting in a ROE for Liberty of 11.00%. The 11.00% ROE for Liberty is reasonable because as discussed throughout the GRC testimony, it reflects the risks faced by the Company's equity holders.

The Proxy Group of large publicly-traded electric companies is not comparable to Liberty in terms of risk. Hence, there is a continued necessity for a risk premium in the adopted ROE for Liberty above the ROE found reasonable for the Proxy Group. Liberty's equity has a higher risk compared to the Proxy Group, and a premium is required to reflect that differential in risk. The evidence, both in this testimony and in the testimony of Mr. Bourassa, supports a risk premium of no less than 40 basis points.

B. Regulatory Risk

When comparing regulatory risk of a company, like Liberty, to those of the Proxy Group, the overall risk of the entire panoply of different regulatory rules and mechanisms of that company in its regulatory jurisdiction must be specifically (and not generally) considered. For example, the regulatory risks that Liberty faces are unique to Liberty and rooted in the regulations in California. A company in the Proxy Group that may operate in California is not necessarily be subject to the same California regulations. The Proxy Group includes companies

that have some operations in California but primarily operate in other states and subject to the jurisdiction of other regulatory commissions. Yet, the Public Advocates Office ("Cal Advocates") typically points to regulatory mechanisms available in California to argue that California has a favorable regulatory climate and relatively low regulatory risk compared to the Proxy Group. However, as discussed in more detail below, the comparison of the regulatory risks of the Proxy Group does not accurately reflect the risks for a company like Liberty.

1. Disallowance or Uncertainty of Return on Investment

All regulated utilities have some degree of capital investment risk, *i.e.* the potential for delay and/or disallowance of the recovery and return on the company's investments in plant. In general, the greater the need for more capital, the greater the investment risk. Larger capital investment programs tend to face more regulatory resistance in GRCs, and there is greater likelihood of projects being disallowed and/or deferred to advice letters. Uncertainty of return on investment has also increased due to fluctuations in materials prices and continued increases in local government permitting fees which, in turn, increase the potential for actual cost of projects to exceed forecasts developed years earlier.

A future three-year rate case cycle works reasonably well when things are stable, and the utility can predict its expense and capital requirements out for three years with some degree of reliability (assuming capital requirements and expenses vary primarily with inflation and customer growth). When things are in a state of flux and can change rapidly in unpredictable ways, that same rate case cycle creates a substantial increase in regulatory risk.

The existence of mechanisms that allow for some recovery between GRCs does not eliminate regulatory risk. Whenever such a mechanism is utilized, it creates the potential for delay or loss of a portion of recovery. Even for expense increases and revenue loss that are

1 covered by interest-bearing balancing or memorandum accounts, the use of the 90-day
2 commercial paper rate to calculate interest in those accounts results in a negative arbitrage for
3 the Company. This effect is exacerbated by the fact that, due to the existence of the balancing
4 accounts for energy costs, no attempt is made in the GRC to forecast increases in those costs.
5 Increases in numbers of filings of various types create other problems that increase risk.
6 There continues to be increases in the filing of advice letters to implement sur-charge or sur-
7 credit to amortize the balance of balancing accounts and memorandum accounts. The increased
8 number of rate changes and the increased number of notices to customers results in increased
9 workload for Liberty both in the preparation of filings and in responding to customer reaction or
10 questions. All of this creates even greater potential for actual costs to exceed adopted levels. The
11 increased workload in preparing filings is exacerbated by the new rules and reporting
12 requirements associated with continued generic proceedings, all of which add workload to the
13 company's regulatory staff, both in the participation and dealing with the outcome. This
14 increased workload and revised procedures increases the potential for some inadvertent error or
15 oversight and therefore increases risk.
16 **2. Operational Risk**
17 Liberty continues to face unmitigated financial exposure to wildfires. This is exemplified
18 by several fires that have occurred in recent years in Liberty's service area. Climate change,
19 extreme heat, severe droughts, high winds, and the increasing wildland-urban interface have
20 contributed to the potential for catastrophic wildfire events. Despite the mitigation measures
21 undertaken by Liberty to limit the likelihood of and damage caused by wildfires, there remains
22 exposure to shareholders under the State's regulatory and legislative framework. Liberty and the
23 other California electric utilities are facing risks as the direct result of the devastating California

wildfires and the threat of imposition of the resulting liabilities on shareholders. The intensity of California wildfires has increased over time, with over 75% of the State's largest fires on record occurring in the past 20 years. This fact coupled with over 90% of the Liberty service area operating in high-fire risk area has caused the Company to develop measures to prevent and withstand the immense wildfire threat that exists in California. Liberty is therefore operating in a unique environment with respect to operating and financial risks.

Due to the recurrence of devastating wildfires and the risk associated with inverse condemnation, special consideration is warranted in the ratemaking process. California applies the doctrine of inverse condemnation to utilities, holding them strictly liable when their facilities are the cause of a wildfire. Liberty can be held liable and required to pay judgments for property damages and attorney's fees regardless of fault.

In July of 2019 California enacted Assembly Bill 1054 that established the "wildfire fund". While the wildfire fund provides certain benefits to the California's large, investor-owned electric utilities (Southern California Edison Company ("SCE"), San Diego Gas & Electric ("SDG&E"), and Pacific Gas & Electric ("PG&E"), it was economically unfeasible for small utilities like Liberty to participate in the fund. After buying into the fund, Liberty would need to have claims in excess of one billion dollars to access the fund. This provision of the legislation excluded Liberty from participating in the wildfire fund.

The wildfire legislation did not address California's application of the inverse condemnation doctrine. Wildfire legislation notwithstanding, Liberty and the other California utilities are still subject to an unfavorable application of inverse condemnation relative to other jurisdictions. Without any changes in how inverse condemnation applies to utility wildfire liabilities, Liberty faces substantial business and solvency risks in the future.

As previously stated, Liberty has taken steps to mitigate the risk associated with wildfires. Liberty established its Wildfire Mitigation Plan, a comprehensive portfolio of the Company's mitigation programs and strategies. The programs focus on system hardening, vegetation management, operational programs, and situational awareness. The purpose of the Wildfire Mitigation Plan is to mitigate potential ignitions and lessen the impacts should a fire occur. It does not, however, address the liabilities due to wildfire given the legal doctrine of inverse condemnation. California's inverse condemnation doctrine, which exposes all of the California utilities to liabilities from wildfires, regardless of whether they were negligent, is applicable as long as their equipment was involved in the incident.

As stated above, all California electric utilities including Liberty face similar risk with respect to catastrophic wildfires. The recurrence of catastrophic wildfires and the risks associated with inverse condemnation warrant special consideration for ratemaking purposes. The California utilities are distinguished from the average utility risk profile nationwide due to the potential that wildfire liabilities may be unrecoverable. The traditional approach to the cost of capital for utility ratemaking is inadequate for the current circumstances. A wildfire risk premium is appropriate for Liberty as a direct result of the devastating California wildfires and the potential imposition of the resulting liabilities on shareholders.

C. <u>Conclusion</u>

The assumption that Liberty's risk is no higher, or only marginally higher, than that of the Proxy Group not only ignores the Company's business risk but also ignores the benefit that customers get from the Company's maintenance of a reasonable and efficient capital structure and safe and reliable service.

The slight increase in cost is a legitimate cost of business for Liberty, a company of this size and circumstances and a cost that should be recoverable through rates. The Commission, in its electric rate design, concedes that there is a value to continuation of service; interruptible service may be obtained at a lower rate than can regular non-interruptible service. Despite this fact, quality of service and continuation of service are largely taken for granted and, as such, not appreciated until they are not present—then suddenly they become very highly valued. Liberty is proud that it receives a minimal number of complaints connected with reliability and quality of service and its customers place a high value on keeping it that way. By maintaining a slightly higher equity position, Liberty seeks to continue the present conditions. In order to support this equity position, Liberty requests that its customers, who are the ultimate beneficiaries of this higher equity position, pay a legitimate business cost and allow Liberty to provide a fair return for the risk faced by its investors.

Appendix A

Witness Qualifications

1 **LIBERTY UTILITIES (CALPECO ELECTRIC) LLC**

2 **QUALIFICATIONS AND PREPARED TESTIMONY**

3 **OF MANASA RAO**

4 **Q. Please state your name and business address for the record.**

5 A. My name is Manasa Rao, and my business address is 9750 Washburn Road, Downey,

6 California 90241.

7 **Q. Briefly describe your present responsibilities at Liberty Utilities (CalPeco Electric)**

8 **LLC.**

9 A. I am the Director of Financial Planning & Analysis, West Region.

10 **Q. Briefly describe your educational and professional background.**

11 A. I have been the Director of Financial Planning & Analysis, West region since 2019. Prior

12 to that, I was employed by Liberty Utilities (Canada) Corp for over seven years in various

13 Finance related positions, including Manager, External Reporting and Senior Manager,

14 Financial Planning & Analysis. I received my Bachelors in Business Administration from

15 Truman State University, MO in 2004 and also hold a Chartered Professional Accountant

16 (CPA, CMA) designation from Canada.

17 **Q. What is the purpose of your testimony in this proceeding?**

18 A. The purpose of my testimony in this proceeding is to sponsor Chapter 10: Rate of Return.

19 **Q. Was this material prepared by you or under your supervision?**

20 A. Yes, it was.

21 **Q. Insofar as this material is factual in nature, do you believe it to be correct?**

22 A. Yes, I do.

23 **Q. Insofar as this material is in the nature of opinion or judgement, does it represent**

1 **your best judgement?**

2 A. Yes, it does.

3 **Q. Does this conclude your qualifications and prepared testimony?**

4 A. Yes, it does.