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Exhibit No.: Liberty-10
Witnesses: Edward N. Jackson

(U 933-E)

2022 General Rate Case

Before the California Public Utilities Commission

Chapter 10: Rate of Return

PUBLIC VERSION

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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 each of the years 2022-2024 for Liberty Utilities (CalPeco Electric) LLC (“Liberty”) is shown in Table 10-1.

Table 10-1
Cost of Capital Debt/Equity Percentages (2022-2024)

	Capital Ratio	Cost Factor	Weighted Cost
2022			
Long-term Debt	46.00%	3.81%	1.75%
Common Equity	54.00%	10.50%	5.67%
Total	100.00%		7.42%
2023			
Long-term Debt	46.00%	3.81%	1.75%
Common Equity	54.00%	10.50%	5.67%
Total	100.00%		7.42%
2024			
Long-term Debt	46.00%	3.81%	1.75%
Common Equity	54.00%	10.50%	5.67%
Total	100.00%		7.42%

1 **B. <u>Capital Structure</u>**

2 The capital structure is based on the current capital structure authorized by the
3 Commission for Liberty Utilities (CalPeco Electric) ("Liberty") with an adjustment for new debt
4 as discussed below.

5 As of December 31, 2020, Liberty's total equity is $263,774,000. Liberty does not have
6 any preferred stock; the capital structure consisted only of common equity and long-term debt.
7 Liberty is in the process of preparing a new long-term debt application to recapitalize its capital
8 structure with intercompany financing. Liberty anticipates that this application will be filed in the
9 third quarter of 2021 and will reflect the cost of debt proposed in this application. With the
10 assumption of a new intercompany debt issue in 2022 from Liberty Utilities Co. ("LUCo"), the
11 common equity percentage average over 2022-2024 is estimated to be 54%, absent any
12 adjustment. For purposes of this proceeding, Liberty has calculated the average equity ratio over
13 the 2022-2024 period, including the Common Equity Adjustment (discussed below), and has
14 used that adjusted average capital structure, 54% common equity and 46% debt, to calculate the
15 cost of capital. Liberty believes this to be an appropriate capital structure for a company of its
16 size and conditions.

17 **C. <u>Cost Of Debt</u>**

18 As stated above, in Q3 of 2021, Liberty will seek Commission authority to issue evidence
19 of long-term debt through the issuance of 10-year promissory notes from its parent company,
20 LUCo, priced according to the 10-year United States Treasury rate effective at the time of Note
21 issuance. A credit spread will also be added, which will be equal to the like term credit spread
22 last secured by LUCo for its private debt placements. Liberty estimates an effective rate of
23 3.81%.

1 The effective cost of long-term debt for 2019-2021 is calculated based upon the assumed
2 debt issued by LUCo to Liberty.
3 The calculation is based upon Liberty's estimated costs for a projected long-term
4 intercompany financing in 2022 including the proposed rates, issuing costs, amount of issue and
5 sinking fund payments for those debt issues.
6 Finally, LUCo paid total debt issuance costs equal to ████ of the debt issuance amount
7 for its $600 million debt placement on September 23, 2020 and it has charged this same rate for
8 all of the newly provided subsidiary debt since that time. This fee will also be incurred for the
9 10-year promissory notes for Liberty. The fee level could also change in the future based on
10 actual charges incurred for future debt placements (namely, the prevailing market rate).
11 The calculation of Liberty's estimates of the effective cost of long-term debt for 2022-
12 204 is shown in Table 10-1. Because the Commission has historically adopted one ROE and one
13 average capital structure for all three years of the proceeding Liberty proposes that the average
14 effective cost of long-term debt over the period 2022-2024 be used for each year as well. Using
15 an average cost of long-term debt is consistent with the approach for the capital structure and
16 ROE and will avoid the necessity of dealing with small annual changes in ROR that would
17 otherwise result.

1 **II. RETURN ON EQUITY**

2 **A. Introduction**

3 The quantitative analysis of market data of publicly-traded companies performed by
4 Liberty's outside consultant, Thomas J. Bourassa, as described in Chapter 9, results in a
5 recommended range of ROE of 8.80% to 9.90%, with a mid-point of 9.3%, for those companies.
6 Mr. Bourassa recommends that the ROE for Liberty should be higher than that for those
7 companies by at least 120 basis points, resulting in a recommended range for Liberty of 10.00%
8 to 11.10%, with a mid-point of 10.5%. Mr. Bourassa's recommendation for the reasonable ROE
9 for Liberty is 10.50%. Mr. Bourassa's recommendation, 10.50%, is a reasonable return on equity
10 for Liberty that reflects the risks faced by the Company's equity holders.

11 The Proxy Group of large publicly-traded water companies is not comparable to Liberty
12 in terms of risk. There is a continued necessity for a risk premium in the adopted ROE for
13 Liberty above the ROE found reasonable for the Proxy Group. The evidence, both in this
14 testimony and in the testimony of Mr. Bourassa, supports a risk premium of no less than 120
15 basis points. Liberty's equity has a higher risk compared to the Proxy Group, and at least a 120
16 basis point premium is required to reflect that differential in risk.

17 **B. Regulatory Risk**

18 When comparing regulatory risk of Liberty, or any other company, to the proxy group,
19 one must compare the overall risk of the entire panoply of different regulatory rules and
20 mechanisms that Liberty faces as compared to those in the regulatory jurisdictions in which the
21 Proxy Group companies operate. Such a comparison on a rule-by-rule and mechanism-by-
22 mechanism basis would be difficult at best and impossible without detailed knowledge of the
23 rules and mechanisms in the other jurisdictions.

The Proxy Group contains some companies that operate primarily in California and others that have few, if any, operations in California, operating primarily in other states under the jurisdiction of other regulatory commissions. The Public Advocates Office 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. These regulatory mechanisms have been in place for some time now.

1. Disallowance or Uncertainty of Return on Investment

For all regulated utilities, there is some degree of capital investment risk, 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 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

covered by interest-bearing balancing or memorandum accounts, the use of the 90-day commercial paper rate to calculate interest in those accounts results in a negative arbitrage for the Company. This effect is exacerbated by the fact that, due to the existence of the balancing accounts for energy costs, no attempt is made in the GRC to forecast increases in those costs. Increases in numbers of filings of various types create other problems that increase risk. There continues to be increases in the filing of advice letters to implement sur-charge or sur-credit to amortize the balance of balancing accounts and memorandum accounts. The increased number of rate changes and the increased number of notices to customers results in increased workload for Liberty both in the preparation of filings and in responding to customer reaction or questions. All of this creates even greater potential for actual costs to exceed adopted levels. The increased workload in preparing filings is exacerbated by the new rules and reporting requirements associated with continued generic proceedings, all of which add workload to the company's regulatory staff, both in the participation and dealing with the outcome. This increased workload and revised procedures increases the potential for some inadvertent error or oversight and therefore increases risk.

2. Operational Risk

Liberty continues to face unmitigated financial exposure to wildfires. This is exemplified by the Mountain View fire that took place in Mono County on November 17, 2020. This wildfire impacted the communities of Walker and Coleville in Liberty's service area. Climate change, extreme heat, severe droughts, high winds, and the increasing wildland-urban interface have contributed to the potential for catastrophic wildfire events. Despite the mitigation measures undertaken by Liberty to limit the likelihood of and damage caused by wildfires, there remains exposure to shareholders under the State's regulatory and legislative framework. Liberty and the

1 other California electric utilities are facing risks as the direct result of the devastating California
2 wildfires and the threat of imposition of the resulting liabilities on shareholders. The intensity of
3 California wildfires has increased over time, with over 75% of the State's largest fires on record
4 occurring in the past 20 years. This fact coupled with over 90% of the Liberty service area
5 operating in high-fire risk area has caused the Company to develop measures to prevent and
6 withstand the immense wildfire threat that exists in California. Liberty is therefore operating in a
7 unique environment with respect to operating and financial risks. Due to the recurrence of
8 devastating wildfires and the risk associated with inverse condemnation, special consideration is
9 warranted in the ratemaking process. California applies the doctrine of inverse condemnation to
10 utilities, holding them strictly liable when their facilities are the cause of a wildfire. Liberty can
11 be held liable and required to pay judgments for property damages and attorney's fees regardless
12 of fault.
13 In July of 2019 California enacted Assembly Bill 1054 that established the "wildfire
14 fund". While the wildfire fund provides certain benefits to the large California electric utilities
15 (Southern California Edison Company ("SCE"), San Diego Gas & Electric ("SDG&E"), and
16 Pacific Gas & Electric ("PG&E")), it was economically unfeasible for small utilities like Liberty
17 to participate in the fund. After buying into the fund, to access the fund for payments, Liberty
18 would need to have claims in excess of one billion dollars. This provision of the legislation
19 excluded Liberty from participating in the wildfire fund.
20 The wildfire legislation did not address California's application of the inverse
21 condemnation doctrine. Wildfire legislation notwithstanding, Liberty and the other California
22 utilities are still subject to an unfavorable application of inverse condemnation relative to other

1 jurisdictions. Without any changes in how inverse condemnation applies to utility wildfire
2 liabilities, Liberty faces substantial business and solvency risks in the future.
3 As previously stated, Liberty has taken steps to mitigate the risk associated with
4 wildfires. Liberty established a Wildfire Mitigation Plan, a comprehensive portfolio of the
5 Company's mitigation programs and strategies. The programs focus on system hardening,
6 vegetation management, operational programs, and situational awareness. The purpose of the
7 Wildfire Mitigation Plan is to mitigate potential ignitions and lessen the impacts should a fire
8 occur. It does not, however, address the liabilities due to wildfire given the legal doctrine of
9 inverse condemnation. California's inverse condemnation doctrine, which exposes all of the
10 California utilities to liabilities from wildfires, regardless of whether they were negligent, is applicable
11 as long as their equipment was involved in the incident.
12 As stated above, all California electric utilities including Liberty face similar risk with
13 respect to catastrophic wildfires. The recurrence of catastrophic wildfires and the risks associated
14 with inverse condemnation warrant special consideration for ratemaking purposes. The
15 California utilities are distinguished from the average utility risk profile nationwide due to the
16 potential that wildfire liabilities may be unrecoverable. The traditional approach to the cost of
17 capital for utility ratemaking is inadequate for the current circumstances. A wildfire risk
18 premium is appropriate for Liberty as a direct result of the devastating California wildfires and
19 the potential imposition of the resulting liabilities on shareholders.
20 **C. <u>Conclusion</u>**
21 The assumption that Liberty's risk is no higher, or only marginally higher, than that of
22 the Proxy Group not only ignores the company's business risk but also ignores the benefit that

1 customers get from the company's maintenance of a reasonable and efficient capital structure
2 and safe and reliable service.
3 Liberty considers this slight increase in cost a legitimate cost of business for a company
4 of this size and circumstances and a cost that should be recoverable through rates. The
5 Commission, in its electric rate design, concedes that there is a value to continuation of service;
6 interruptible service may be obtained at a lower rate than can regular non-interruptible service.
7 Despite this fact, quality of service and continuation of service are largely taken for granted and,
8 as such, not appreciated until they are not present—then suddenly they become very highly
9 valued. Liberty is proud that it receives a minimal number of complaints connected with
10 reliability and quality of service and firmly believe that their customers place a value on keeping
11 it that way. By maintaining a slightly higher equity position, Liberty seeks to continue the
12 present conditions. In order to support this equity position, Liberty requests that its customers,
13 who are the ultimate beneficiaries of this higher equity position, pay a legitimate business cost
14 and allow Liberty to provide a fair return for the risk faced by their investors.

Appendix A

Witness Qualifications

LIBERTY UTILITIES (CALPECO ELECTRIC) LLC

QUALIFICATIONS AND PREPARED TESTIMONY

OF EDWARD N. JACKSON

1 Q. Please state your name and business address.

2 A. My name is Edward N. Jackson, and my business address is 9750 Washburn Road,
3 Downey, California 90241-7002.

4 Q. What is your present employment?

5 A. I am employed by Liberty Utilities (Park Water) Corp. ("Liberty Park Water") as
6 Director, Rates and Regulatory Affairs (West Region).

7 Q. Please describe your education and professional experience.

8 A. I have a B.S. in Electrical Engineering from California State University, Los Angeles. I
9 am certified as a Grade 2 Water Distribution Operator in the State of California. I have
10 attended the NARUC Utility Rate Seminar co-sponsored by the University of Utah. I
11 have also attended the Asilomar Economic Regulation Seminar sponsored by the
12 California Public Utilities Commission ("Commission"). From 1990 to 1992, I was
13 employed by the Commission as a Utilities Engineer, during which time my
14 responsibilities included preparing exhibits, investigating the adequacy of water supplies,
15 testifying before the Commission, analyzing operations, and making recommendations in
16 rate cases for large and small utilities. I currently serve as Vice President of the California
17 Water Association. I began working for Liberty Park Water (then known as Park Water
18 Company ("Park Co.")) in January 1993. As Director, Rates and Regulatory Affairs, I am
19 responsible for the overall coordination of Liberty Utilities regulatory filings with the
20 Commission including filings for Liberty Park Water, Liberty Utilities (Apple Valley

1 Ranchos Water) Corp. ("Liberty Apple Valley"), and Liberty Utilities (CalPeco Electric)
2 LLC ("Liberty CalPeco").
3 Q. What is the purpose of your testimony?
4 A. The purpose of my testimony is to develop an appropriate Return on Rate Base for use in
5 the determination of the revenue requirements for Liberty CalPeco for the years 2022,
6 2023, and 2024.
7 Q. What testimony do you offer in this proceeding?
8 A. My testimony will cover Liberty CalPeco's requested capital structure, cost of debt, and
9 return on equity.
10 Q. Was this material prepared by you or under your supervision?
11 A. Yes, it was.
12 Q. Insofar as this material is factual in nature, do you believe it to be correct?
13 A. Yes, I do.
14 Q. Insofar as this material is in the nature of opinion or judgement, does it represent your
15 best judgement?
16 A. Yes, it does.
17 Q. Does this conclude your qualifications and prepared testimony?
18 A. Yes, it does.