

## **Exhibit G**



### **Cost of Capital**

**Direct Testimony of Thomas F. Smegal  
Vice President and Chief Financial Officer**

**California Water Service Company**

**May 2021**

## Table of Contents

I.	INTRODUCTION.....	1
II.	QUALIFICATIONS.....	1
III.	CAPITAL STRUCTURE.....	4
IV.	CREDIT DOWNGRADE RISK.....	11
VI.	CAPITAL INVESTMENT PROGRAM.....	12
VII.	WATER COST OF CAPITAL MECHANISM.....	14

1 **I. INTRODUCTION**

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

3 A. I am testifying in support of California Water Service Company's ("Cal Water")  
4 requested capital structure and projected average cost of debt, integral parts of the  
5 overall cost of capital. I am also testifying about certain factors that I believe the  
6 Commission should consider as additional risks in determining the cost of equity  
7 applicable to Cal Water in this proceeding. I am not seeking additional return  
8 adjustments for these additional risks at this time, but point them out to fully inform  
9 the Commission of the operating, financial, and regulatory risks facing Cal Water.

10

11 **II. QUALIFICATIONS**

12 **Q. What are your qualifications for this testimony?**

13 A. I am Vice President and Chief Financial Officer of Cal Water. In that role, I have  
14 responsibility for debt and equity financing, maintaining and monitoring operating  
15 budgets, Securities and Exchange Commission financial reporting, and investor  
16 relations. I was appointed to the position in October 2012. Since my appointment, it  
17 has been my responsibility to monitor and manage the company's capital structure. In  
18 2013, as part of these responsibilities, I led a secondary stock offering for the California  
19 Water Service Group ("CWSG"). Starting in 2019, I have led an "at the market" ("ATM")  
20 stock sale program for CWSG. In 2015, 2019, and 2021 I led private placement debt  
21 offerings for California Water Service Company ("Cal Water"). I lead CWSG's cash

1 management and financing strategies and am therefore the most appropriate person at  
2 the company to testify on these subjects.

3

4 **Q. What is your educational background?**

5 A. I received a Bachelor of Science degree in Civil Engineering and a Bachelor of  
6 Arts Degree in History from Stanford University in 1990. I completed two years of  
7 graduate study focusing on water resources management at the University of California  
8 at Berkeley's Energy and Resources Group.

9

10 **Q. Do you hold any professional certifications?**

11 A. I am a licensed Civil Engineer in the State of California.

12

13 **Q. Please summarize your business experience.**

14 A. After graduating from Stanford University in 1990, I worked for the California  
15 Public Utilities Commission ("Commission") until 1997. During that time I worked for  
16 the Water Division and the Commission Advisory and Compliance Division, mainly  
17 processing rate case requests for small Class B, C, and D water utilities. Since joining  
18 Cal Water's Rates Department in May 1997 as a regulatory analyst, I was promoted to  
19 Manager of Rates in 2001, was later promoted to Vice President of Regulatory Matters  
20 in 2008, and was promoted to Chief Financial Officer in 2013. I have testified on  
21 numerous occasions before the Commission.

22

1 **Q. Can you summarize Cal Water’s request in this proceeding?**

2 A. Cal Water is seeking a return on common equity of 10.35%, with a cost of debt  
3 of 4.23%, a 53.4% equity capital structure, and an overall weighted return of 7.50%. As  
4 described by Akarsh Sheilendranath, Cal Water’s financial modeling witness, the  
5 recommended return on equity is necessary to maintain adequate access to capital.  
6 Mr. Sheilendranath’s Return on Equity calculations are based in part on Cal Water’s  
7 proposed capital structure. I describe below the need to maintain a capital structure  
8 similar to that last adopted by the Commission. I also describe Cal Water’s proposed  
9 regulatory treatment of the Water Cost of Capital Adjustment Mechanism (“WCCM”).  
10 The treatment of any revenue requirement increase which might be incurred as a result  
11 of Cal Water’s request is described in the Application. According to Cal Water’s  
12 calculations, the requested rate of return on capital necessary to ensure continued  
13 availability of capital would increase revenue requirements in Cal Water’s Class A  
14 ratemaking districts by between 0.3% and 0.9%.<sup>1</sup>

15  
16 **Q. Are you sponsoring any informational exhibits in this testimony?**

17 A. Yes, I am responsible for Cal Water’s financial statements and other data which  
18 are included as a separate Exhibit A, and Exhibit J in compliance with either the

---

<sup>1</sup> Cal Water also has a Class D ratemaking district, Grand Oaks (near Cal Water’s Antelope Valley systems). Cal Water does not propose to modify rates for Grand Oaks customers in this proceeding.

1 Commission’s rules of practice and procedure or the minimum data requirements  
2 established in Decision (“D.”) 07-05-062.

3

4 **III. CAPITAL STRUCTURE**

5 **Q. What capital structure is Cal Water requesting?**

6 A. Cal Water is requesting an authorized return on Common Equity of 10.35% for  
7 the period from January 1, 2022 through December 31, 2024 covered in these  
8 proceedings. Cal Water is providing workpapers and testimony to support this request.  
9 Cal Water projects on average maintaining its capital structure of 53.4% equity and  
10 46.6% debt, which is the previously Commission-approved capital structure for  
11 ratemaking purposes.<sup>2</sup>

12

13 **Q. Please explain why Cal Water is proposing to adopt this capital structure.**

14 A. An authorized capital structure of 53.4% equity and 46.6% debt has allowed the  
15 Company to maintain an A+ (stable) corporate rating from Standard & Poor’s (“S&P”).  
16 Achieving and maintaining this rating from S&P allows the Company access to lower  
17 cost debt, with the benefits of this lower cost of debt flowing to customers. If the  
18 Commission were to require Cal Water to increase the proportion of its’ future  
19 financing maintained as debt, this may therefore have the unintended consequence of  
20 increasing the cost of that debt. A company’s leverage is a key criterion within the

---

<sup>2</sup> D.18-03-035 at 2.

1 credit rating process of S&P, and as such, higher percentages of debt financing (*i.e.*  
2 greater leverage) would be expected to negatively impact a firm's rating.

3

4 **Q. Given that your workpapers and exhibits show variations from time to time in**  
5 **the company's capital structure, why would the market and S&P react to changes**  
6 **adopted by the Commission?**

7 A. What matters is the stated policy of the Commission and the Company. Cal  
8 Water is clear in its disclosures and investor presentations that its long-term goal is to  
9 target the capital structure set by the Commission. Investors and S&P analysts  
10 understand that financing with debt and equity cannot be proportional to the capital  
11 structure at every point in time.

12

13 **Q. What is the company's forecasted capital structure for the effective period of**  
14 **this cost of capital review?**

15 A. Cal Water is forecasting the average capital structure for each year and for the  
16 3-year period in Table 1 below:

17

**Table 1**

	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>Average</u>
Common Equity	49.9%	53.9%	56.2%	53.4%
Long-Term Debt	50.1%	46.1%	43.8%	46.6%

18

19

20

1 **Q. What assumptions underlie those projections?**

2 A. To make these projections, I made several key assumptions. First, Cal Water  
3 plans to finance its outside capital needs in 2022-2024 through a continuation and  
4 renewal of CWSG's ATM equity program. This program has been effective to infuse  
5 equity capital over time at relatively low transaction costs. Embedded within this  
6 assumption is that 100% of the new equity issued under this program will be assigned  
7 to Cal Water. As noted further below in my testimony, Cal Water anticipates funding of  
8 its \$280 million long-term debt private placement on May 11, 2021. I do not anticipate  
9 additional long-term debt issuances until after 2024.

10 The second major assumption is on capital investment for the period. Here, I  
11 have assumed \$300 million per year for annual capital investment, consistent with past  
12 rate case authorizations. Cal Water will be filing its 2021 General Rate Case ("GRC") in  
13 July and will request capital improvements of a different amount for the period. Should  
14 the Commission adopt a higher amount, we would need additional outside financing  
15 which is likely to be balanced to the adopted capital structure. If the Commission  
16 adopts lower annual capital in Cal Water's 2021 GRC, Cal Water would likely restrict its  
17 ATM program to balance, resulting in slightly lower equity percentages.

18 The final assumption is that Cal Water's parent will continue its current dividend  
19 policies, requiring dividends from Cal Water on a quarterly basis. All other retained  
20 earnings and depreciation expense would flow back to the capital program.

21



1 **Q. How would changing the capital structure to a higher debt ratio impact the**  
2 **Company?**

3 A. As a greater percentage of a company's capital structure is comprised of debt,  
4 the firm's equity investors, as residual claimants, are burdened with greater financial  
5 risk. As stated by Akarsh Sheilendranath, "The cost of equity and the capital structure  
6 are entwined in that the use of debt increases the financial risk of the company and  
7 therefore increases the cost of equity. The more debt, the higher is the cost of equity  
8 for a given level of business risk."<sup>3</sup>

9 Stockholders, or equity investors, face a risk in their investment, from a firm's  
10 operations. This business risk comes from uncertainty in projections of future  
11 operating income. Financial risk comes from using debt to fund operations. The use of  
12 debt for financial leverage adds a financial risk layer to the business risk that equity  
13 investors already face. The business risk inherent in projections of future income is not  
14 reduced by leveraging more financial risk. Rather, the business risk is increased for the  
15 equity investor through the amplification effects of leverage. Using more debt  
16 increases a firm's financial risk and magnifies the inherent business risks to the equity  
17 holder. The compounded effect of a higher debt ratio results in an even higher level of  
18 risk for equity investors. The higher compounded business and financial risk requires  
19 higher return on equity that is commensurate to the risk in order to attract investors.  
20

---

<sup>3</sup> Exhibit F, Direct Testimony of Akarsh Sheilendranath, page 10, lines 11-13.

1 **Q. What have been the recorded capital ratios during the last three years and**  
2 **what has been the effect in terms of Cal Water’s ability to finance debt?**

3 A. From 2018 through 2020, the Company had a capital structure as follows:

4 **Table 2**

	<u>2018</u>	<u>2019</u>	<u>2020</u>
Secured Long-Term Debt*	54.5%	52.8%	48.1%
Other Long-Term Debt	0.8%	0.7%	0.6%
Total Long-Term Debt	55.3%	53.5%	48.7%
Common Equity	44.7%	46.5%	51.3%

\* Calculated as First Mortgage Bonds less Unamortized Debt Premium  
and Expense

5 While the company has tried to maintain its capital structure at the  
6 Commission-adopted ratios, there are unavoidable variances resulting from the timing  
7 and size of financing activities and the amount of retained earnings on an annual basis.  
8 Larger offerings of debt or equity allow the company to reduce costs for customers  
9 through the realization of economies of scale in transactional costs (fees paid to  
10 investment banking firms and outside counsel). Cal Water’s most recent debt offerings  
11 have been \$280 million in 2021, \$400 million in 2019, and \$150 million in 2015. All  
12 three transactions utilized the lower-fee private placement process. The company has  
13 further reduced transaction costs by employing an ATM stock sale program, which is  
14 generally less expensive than a bullet offering. Thus Cal Water (for debt) and CWSG  
15 (for equity) continue to use lines of credit and other cash management to allow for  
16 greater competition among investors. As long as they are considered by the  
17 investment community as transitory events with the expectation that Cal Water is

1 targeting the approved capital structure, these fluctuations within the capital structure  
2 do not create negative ramifications for the company’s credit rating or its cost of  
3 capital.

4

5 **Q. How did you forecast the cost of debt for the period 2022-2024?**

6 A. Forecast debt levels are a weighted average of principal balances as of April 30,  
7 2021 for all existing debt, plus the \$280 million of First Mortgage Bonds Cal Water  
8 intends to issue on May 11, 2021 pursuant to a private placement announced in  
9 February. Cal Water does not anticipate issuing any additional long-term debt until  
10 after 2024. Essentially all of Cal Water’s existing long term debt is in the form of first  
11 mortgage bonds which have “make whole” provisions, meaning if they are redeemed  
12 prior to the due date, Cal Water would have to pay future interest to the due date.  
13 Therefore, I have not contemplated early refinancing of any existing Cal Water debt.  
14 The rates consist of the bonds’ coupon rate, plus any unamortized issuance costs. For  
15 the 2021 bond issuances, the coupons are 2.87% for 30-year debt and 3.02% for 4-year  
16 debt.

17 For Cal Water, the resulting weighted average cost of debt forecast as of year-  
18 end 2022 and over the three-year period covered by this application is 4.23%.

19

20 **Q. What guidance has the Commission offered on debt/equity structures for**  
21 **water utilities, and what structures have most recently been adopted for them?**

22 A. In December 2018, D.18-12-002, adopted the following capital structures.

1

**Table 3**

	Debt	Preferred Stock	Equity
Park/Apple Valley/Ranchos Water Companies	43.0%		57.0%
San Gabriel Water Company	35.54%		64.46%
Suburban Water Systems	37.74%	2.26%	60.0%
Great Oaks Water Company	30.0%		70.0%

2

3 The Commission has in the past recognized that equity investors bear significant  
4 risk:

5 Generally, long-term debt is the least expensive form of capital but the  
6 utility must ensure that it timely meets every interest payment and  
7 maintains any required terms or conditions of the loan agreements or  
8 mortgage indentures, and that it can refinance or refund the debt when  
9 it matures. Preferred stock is generally more expensive than debt and  
10 may or may not have a maturity or refund provision. Interest may  
11 usually be deferred but it then accumulates and takes preference over  
12 payment of dividends to common equity owners. Thus, equity owners  
13 assume more risk than either debt holders or preferred stock owners,  
14 including the risk of losing their entire investment, and therefore equity  
15 investors require the highest return over the long run.<sup>4</sup>

16

17 The Commission has also acknowledged that the financial risk that utilities face  
18 is determined in part by the debt and equity ratio. Because of the significant risk borne  
19 to equity investors, adopting a sufficient and fair equity ratio is critical “to maintain  
20 reasonable credit ratings and to attract capital without incurring unnecessary costs for  
21 an excessive amount of expensive equity.”<sup>5</sup>

22

---

<sup>4</sup> D.10-10-035 at 19.

<sup>5</sup> *Id.*

1 **Q. Would customers benefit from a deviation in the proposed capital structure?**

2 A. Not necessarily. While a short-term calculation would lead to a conclusion that  
3 revenue requirement is reduced through a lower equity ratio, in the long-term  
4 customers may not be better off. As the percentage of debt used within the capital  
5 structure is increased in an attempt to take advantage of lower-cost financing, it is  
6 counterbalanced by increases within the required return on equity and the cost of debt  
7 for incremental debt offerings in the future. It may be counterproductive to modify the  
8 existing capital structure in favor of more debt. Such efforts potentially make it more  
9 difficult for Cal Water to raise future financing, thereby placing Cal Water's capital  
10 investment program in jeopardy and raising the cost to customers.

11

12 **IV. CREDIT DOWNGRADE RISK**

13 **Q. Does Cal Water face a risk of a credit downgrade From Standard and Poors**  
14 **("S&P")?**

15 A. Yes, Cal Water faces a real and quantifiable risk of a credit downgrade from  
16 S&P. In the summary of S&P's latest credit grading of Cal Water, S&P made the  
17 following statement:

18 We could lower the rating on Cal Water over the next 12-24 months if  
19 the consolidated group's financial measures weaken reflecting FFO to  
20 debt consistently below 15%. This could occur if Cal Water experiences  
21 adverse regulatory outcomes that strain its credit measures or  
22 negatively affect its ability to earn close to its authorized returns. This  
23 could also occur if the company engages in material potential future

1 debt-financed acquisitions or if its financial policy deviates materially  
2 from our base-case scenario.<sup>6</sup>

3

4 Furthermore, S&P calculated Cal Water's Funds from Operations ("FFO")/debt  
5 for 2019 at 13.2% in the report and estimated FFO/debt of 15-18 times for 2020 and  
6 2021. This FFO/debt ratio can be affected by cash flow issues, such as delayed recovery  
7 of rate case increases, increasing amounts expected for future recovery in balancing  
8 accounts, lower authorized tax rates and depreciation rates, and lower effective  
9 returns on equity.

10

11 **Q. Please explain the FFO to debt ratio that S&P references.**

12 A. FFO are a financial metric used by investors to understand a company's cash  
13 flow. FFO is typically calculated by taking a company's annual earnings, then adding  
14 annual amortization and depreciation. There are also other adjustments in this  
15 calculation, including working cash, deferred taxes, and non-cash components. In order  
16 to calculate the FFO to debt ratio the company's FFO is divided by its long-term debt.  
17 S&P publishes this ratio quarterly.

18

## 19 **VI. CAPITAL INVESTMENT PROGRAM**

20 **Q. Are you responsible for financing Cal Water's capital investment program?**

21 A. Yes.

22

---

<sup>6</sup> April 17, 2020, S&P's credit research summary of Cal Water.

1 **Q. Does Cal Water have significant infrastructure needs in the covered period**  
2 **2022-2024?**

3 A. Yes, Cal Water is operating with a Commission-approved capital program of  
4 \$828 million of plant in service additions from 2019 through 2021, including advice  
5 letters. This compares to \$659 million authorized in rate base for the 2016-2018  
6 period.

7 While no general rate case covers the capital investments proposed beyond  
8 2021, Cal Water has good reason to expect continuing capital expenditures in that  
9 range in future rate cases including the rate case set to be filed in July 2021.

10 The bulk of Cal Water's approved budget are critical replacement-cycle  
11 investments in mains, services, motors, control equipment, and other water  
12 distribution facilities. Cal Water expects to make similar requests for replacement cycle  
13 items in its 2021 general rate case and must also begin, at some point, to address the  
14 replacement of groundwater wells in California. As described in Mr. Robert Kuta's  
15 testimony, wells lose capacity over time and must be rehabilitated (or replaced). The  
16 average age of Cal Water's wells is now over forty years.

17

18 **Q. What are the major capital needs identified in Cal Water's Water Supply &**  
19 **Facility Master Plans for the next 20-25 years?**

20 A. Most of the infrastructure in Cal Water's systems was constructed in the post-  
21 World War Two period, meaning that much of the infrastructure is now 50-60 years  
22 old. Our primary concern for infrastructure of this age is the condition of wells, supply

1 facilities, and pipelines. There is also a continuing need to invest in water treatment  
2 facilities in order to continue to meet current and future drinking water quality  
3 standards.

4

5 **Q. Does the amount of needed capital contribute to the need for a competitive**  
6 **rate of return?**

7 A. Yes, Cal Water’s increased Commission-approved capital budgets mean that the  
8 company will need large amounts of additional financing in the next few years. It is  
9 important that the Commission allow a reasonable return that will allow Cal Water to  
10 compete in the marketplace for debt and equity investors.

11

12 **VII. WATER COST OF CAPITAL MECHANISM (“WCCM”)**

13 **Q. What is Cal Water proposing for the WCCM?**

14 A. The Rate Case Plan directed companies to include in their 2008 cost of capital  
15 applications a proposal for adjusting the authorized cost of capital between cost of  
16 capital applications.<sup>7</sup> In D.09-07-051, the Commission approved a settlement  
17 agreement among the parties in Application 08-05-002 (including Cal Water and the  
18 Division of Ratepayer Advocates) that proposed a WCCM to adjust the base year 2009  
19 return on common equity to reflect any significant changes in interest rates that may  
20 occur in 2010 and 2011.<sup>8</sup> The settlement stated:

---

<sup>7</sup> D.07-05-062 at 15.

<sup>8</sup> D.09-07-051 at Ordering Paragraph 1.



1 While this settlement does not bind the Commission in  
2 future proceedings, the Parties agree that a similar  
3 adjustment to the cost of capital should be made  
4 following the adoption of a base year cost of capital in  
5 subsequent cost of capital proceedings for CWS, California  
6 American, and Golden State. In those future cases, the  
7 Parties envision the Commission setting a base year cost  
8 of capital and adopting a similar adjustment mechanism  
9 that would be recalibrated to reflect the new cost of  
10 capital.<sup>9</sup>

11

12 In D.12-07-009, the Commission adopted a settlement continuing the WCCM.  
13 The adopted base year return on equity for 2012 (9.99%) was therefore subject to  
14 possible adjustment in 2013 and 2014 using the new benchmark period of October 1,  
15 2010 through September 30, 2011.<sup>10</sup> The WCCM was triggered in 2012, lowering Cal  
16 Water's rate of return from 8.24% to 7.94% due to a 56 basis point decrease in the  
17 return on equity to 9.43%.<sup>11</sup>

18 In D.18-03-035, the Commission granted the continuance of the WCCM for the  
19 years 2019 and 2020, using the base year 2018.<sup>12</sup> The WCCM has not been triggered  
20 since the cost of capital established in D.18-03-035 and Cal Water's rate of return  
21 remains at 7.48%.

22

23 Q. **What is your request with regard to the WCCM?**

24 A. Cal Water proposes to retain the WCCM for years 2023 and 2024, using the

---

<sup>9</sup> D.09-07-051, Attachment A (Settlement Agreement) at 3-4 (emphasis added).

<sup>10</sup> D.12-07-009 at 13.

<sup>11</sup> Cal Water Advice Letter 2088 (filed October 15, 2012).

<sup>12</sup> D.18-03-035 at Order Paragraph 5.

1 base year 2022 that will be adopted in this proceeding, with a new benchmark period  
2 of October 1, 2020 through September 30, 2021.

3

4 **Q. Does this conclude your direct prepared testimony?**

5 A. Yes, it does.