STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION

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Ratesetting

TO PARTIES OF RECORD IN APPLICATION 09-08-019

Enclosed are the proposed decision of Administrative Law Judge (ALJ) Maribeth A. Bushey previously designated as the presiding officer in this proceeding and the alternate proposed decision of Commissioner Timothy Alan Simon. The proposed decision and the alternate proposed decision will not appear on the Commission's agenda sooner than 30 days from the date they are mailed.

Pub. Util. Code § 311(e) requires that the alternate item be accompanied by a digest that clearly explains the substantive revisions to the proposed decision. The digest of the alternate proposed decision is attached.

This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Upon the request of any Commissioner, a Ratesetting Deliberative Meeting (RDM) may be held. If that occurs, the Commission will prepare and publish an agenda for the RDM 10 days beforehand. When an RDM is held, there is a related ex parte communications prohibition period. (See Rule 8.2(c)(4).)

When the Commission acts on these agenda items, it may adopt all or part of the decision as written, amend or modify them, or set them aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision and alternate proposed decision as provided in Pub. Util. Code §§ 311(d) and 311(e) and in Article 14 of the Commission's Rules of Practice and Procedure (Rules), accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3, opening comments shall not exceed 15 pages.

Comments must be filed pursuant to Rule 1.13 either electronically or in hard copy. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic and hard copies of comments should be sent to ALJ Bushey at mab@cpuc.ca.gov and Commissioner Simon's advisor Shivani Ballesteros at sb3@cpuc.ca.gov. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

/s/ MICHELLE COOKE for
Karen V. Clopton, Chief
Administrative Law Judge

KVC:gd2

Attachment

ATTACHMENT

Digest of Differences
Between ALJ Maribeth A. Bushey's Proposed Decision and
Commissioner Timothy Alan Simon's Alternate Proposed Decision

Administrative Law Judge Bushey's Proposed Decision denies Z-factor treatment but authorizes a limited memorandum account for increased liability insurance premiums. Commissioner Simon's Alternate Proposed Decision grants the application, with exceptions, by allowing Z-factor treatment of San Diego Gas & Electric Company's insurance premiums for 2009-2010, and may increase its revenue requirement by $28,884,000.

(END OF ATTACHMENT)

Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER SIMON (Mailed 11/16/2010)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of San Diego Gas & Electric Company (U902E) for Authorization to Recover Unforeseen Liability Insurance Premium and Deductible Expense Increases as a Z-Factor Event.	Application 09-08-019 (Filed August 31, 2009)

(See Appendix A for List of Appearances.)

DECISION GRANTING REQUEST FOR "Z-FACTOR" TREATMENT FOR LIABILITY INSURANCE PREMIUM AND DEDUCTIBLE INCREASES

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DECISION GRANTING REQUEST FOR "Z-FACTOR" TREATMENT FOR LIABILITY INSURANCE PREMIUM AND DEDUCTIBLE INCREASES

1. Summary

San Diego Gas & Electric Company (SDG&E) applied for Z-factor treatment for 2009-2010, to recover cost of increased insurance premiums amounting to $28,884,000. SDG&E also requested Z-factor advice letters for years 2010-2012, until its next General Rate Case (GRC) rates became effective.

This decision grants SDG&E's request for Z-factor treatment for the first year 2009-2010, and allows SDG&E to increase its revenue requirement for that year by $28,884,000. SDG&E's request for Z-factor advice letters is denied for years 2010-2012. However, SDG&E instead may file Tier-3 advice letters for these years.

2. Description of the Application

On August 31, 2009, San Diego Gas & Electric Company (SDG&E) filed Application (A.) 09-08-019 seeking Commission authorization to increase its electric and natural gas revenue requirement by $28,884,000 to reflect unforeseen liability insurance premium and deductible expense, and to create a new advice letter and amortization process for future expenses until its next general rate case (GRC) decision. As justification for this proposed post-test year ratemaking adjustment, SDG&E contends that the unforeseen liability insurance premium and deductible expense meets the Commission's standard for treatment as unexpected and uncontrollable events which occurred after test year ratemaking has been completed. Known colloquially as a "Z-factor" adjustment, SDG&E states that the Commission has authorized such a mechanism for SDG&E most recently in Decision (D.) 08-07-046[1], and SDG&E contends that the unforeseen liability insurance premium and deductible expense meet all applicable standards for adjusting revenue requirement pursuant to this mechanism.

3. Background

The subject case revolves around the unforeseen increase in liability insurance expense SDG&E incurred in 2009-2010. This increase, accompanied by a significant reduction in the amount of liability insurance coverage available to SDG&E, is consequences of the dramatic insurance market changes. The severe contraction in the insurance market was driven in large part by injection of over a billion dollars of claims into the market after the 2007 wildfires and insurers' concerns over the increasing use of "inverse condemnation" for California utilities, particularly given their assessment of future risk of fires in SDG&E's service territory. As explained later, SDG&E's premiums increased from $4.5 million authorized in its 2008 GRC to $47 million in 2009, an approximate 1,000% increase. Additionally, SDG&E's deductible increased from $1 million to $5 million during the same time.

Sempra Energy (Sempra) is the parent entity of subsidiaries SDG&E and Southern California Gas Company (SoCalGas). SDG&E's liability insurance coverage is procured on SDG&E's behalf by Sempra Energy Risk Management (SE Risk Management). SE Risk Management is a shared service at the Sempra parent company level; it procures insurance coverage on an aggregate basis for

[1] D.08-07-046, 2008 Cal. PUC LEXIS 281 (represents SDG&E's most recent general rate case (GRC)).

all Sempra subsidiaries (regulated and unregulated) and allocates a share of premium expenses to each affiliate.

The genesis of the Z-factor criteria is best understood in historical context. The Z-factor mechanism was developed as an element of incentive-based ratemaking.[2] For the first time, however, the Commission here is considering the application of Z-factor criteria in the context of SDG&E's cost-of-service ratemaking. Under cost-of-service ratemaking the Commission has stated it has a "regulatory policy of allowing [cost-of-service regulated] utilities to recover reasonable costs incurred in the performance of utility service," and ensure an opportunity to earn a fair return. [3]

The Commission initiated the use of a "Z-factor" when moving large telecommunications carriers from cost-of-service rate regulation to incentive or price-cap regulation in the late 1980's and early 1990's. The Commission adopted a new regulatory framework in 1989 that replaced general rate cases with a price-cap index formula for the large local exchange carriers, then known as Pacific Bell and GTE California Incorporated.[4] This framework, rather than scrutinizing the actual costs incurred by the large carriers in providing telecommunications service to the public, focused on creating powerful financial incentives for the utilities to manage their operations in the most efficient manner

[2] *See* D.89-10-031, 1989 Cal. PUC LEXIS 576; D.94-06-011, 1994 Cal. PUC LEXIS 456.

[3] D.92-12-015, 1992 Cal. PUC LEXIS 864, at *31 - 32 (citing *Fesler v. Pacific Tel. and Tel. Co.*, 4 Cal R.R.C. 711 (1914) and *F.C.P. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)).

[4] D.89-10-031, *supra* note 2, at *384-385.

possible, with cost savings shared between ratepayers and shareholders.[5] To accomplish this, the Commission adopted the following price-cap index formula:

> $Rate_2 = Rate_1 \times (1 + I - X \pm Z/R)$
>
> Where the Rate for time period 2 is equal to the Rate for time period 1 multiplied by the sum of one plus Inflation,[6] less a productivity factor initially set at 4.5%, the "X-factor," and then plus or minus the annualized dollar effect of authorized exogenous cost changes, the "Z-factor."[7]

The large local exchange carriers were relieved of the obligation to file general rate cases in exchange for a rate formula that allowed annual rate increases for inflation and cost increases "clearly beyond the utility's control" <u>less</u> an assumed annual productivity improvement rate of 4.5%, which was subsequently increased to 5.0%. The carriers were presumed to improve their efficiencies by the productivity or "X-factor," set at up to 5% a year, but allowed a companion Z-factor for events out of their control. These dual factors, X and Z, were created in light of the Commission's desire to create incentives for cost reduction, but provide utilities protection from unforeseen and exogenous events.

When adopting price incentive regulation for SDG&E, the Commission continued this pattern of adjusting rates for inflation, less productivity improvement, and calculating a plus or minus factor for approved exogenous

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5 *Id*. at *7-8.

6 Inflation was defined as Gross National Product Price Index. *Id* at *4.

7 *Id*. at *384.

events.[8] Subsequently, SDG&E returned to cost-of-service regulation and retained the Z-factor (but not the X-factor) as part of a settlement agreement.[9] Unlike the subject case, in incentive regulation the application of Z-factor did *not* require the Commission to take into account its overarching obligation to ensure the opportunity of cost-of-service regulated utilities to earn a reasonable rate of return. The Commission has acknowledged that under cost-of-service regulation, "the real controlling element in fixing rates is what it costs the utility to perform the service."[10] Therefore, under incentive-based regulation the central question revolves around the *degree* of utility control and whether permitting recovery of the cost increase would undermine the incentives built into the program (*i.e.*, "if the Z-factor were allowed to apply to changes in costs due to factors within management control, there would no longer be an incentive for operation efficiency in the framework").[11] On the other hand, under cost-of-service regulation the key question in Z-factor analysis is whether the costs are *reasonable* and whether recovery should be permitted in order to allow the utility to earn a reasonable return.[12]

The Post-Test Year Ratemaking (PTYR) Settlement Agreement approved by the Commission in D.08-07-046 provides "that attrition year revenue requirement changes will be fixed dollar amounts, to avoid disputes about

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[8] D.99-05-030, 1999 Cal. PUC LEXIS 263, at *113-114.

[9] D.08-07-046, *supra* note 1, Appendix 4.

[10] D.92-12-015, *supra* note 3, at *31.

[11] D.94-06-011, *supra* note 2, at *86-87.

[12] D.92-12-015, *supra* note 3, at *31-32.

escalation factors, productivity factors or customer growth rates." That decision adopted a Z-factor mechanism as part of a settlement in a cost-of-service general rate case and was part of a combination of post-test year ratemaking. The settlement provided for fixed increases to SDG&E's revenue requirement of $41 million for 2009, $44 million for 2010, and $44 million in 2011.[13] The settlement further specified that the "current Z-factor mechanisms shall continue through 2011" and that the "issue of customer growth is moot as no forecast of customer growth is required."[14] In agreeing to the settlement, the parties specifically stated that they:

> Based their respective post test year proposals using differing factors for cost escalation, productivity and customer growth and with different mechanisms for earnings sharing and other elements of PTYR. In many instances the differences in the resulting post-test year outcomes result from employing different escalation indices or from using different assumptions regarding productivity or customer growth. The Joint Parties agree that determination of post-test year revenue requirements requires the use of judgment and that, as in any forecasting exercise, there is a range of reasonable outcomes. The Joint Parties also agree that different methods can produce results within this range and that no single method will produce the sole reasonable result in every instance.[15]

The parties to the settlement went on to conclude that having considered the "totality of all parties' positions and risks," their ultimate consent to the

[13] D.08-07-046, *supra* note 1, Appendix 4.

[14] *Id*. at *254.

[15] *Id*. at *218-219.

Post-Test Year Ratemaking Settlement Agreement was explicitly premised on "the bottom line result achieved."[16]

In the settlement agreement, the parties compromised their positions and agreed upon a set amount by which SDG&E's revenue requirement would increase each year before its next general rate case. The parties' stated objective was to avoid litigating the appropriate escalation index or productivity and customer growth assumptions. The parties further specified that the existing Z-factor mechanism would remain unchanged as part of the post-test year ratemaking.

4. Procedural Matters

On September 25, 2009, the Utility Consumers' Action Network (UCAN)[17] protested the application as raising complex and difficult factual and legal issues, including: (1) whether the increased insurance premium is reasonable and prudent, (2) whether the increased premium and deductible expense meet the standards for Z-factor treatment, and (3) whether an advice letter process should be adopted for such future costs. UCAN recommended evidentiary hearings, with discovery and expert testimony, and offered to present an alternative procedural schedule at the prehearing conference.

On September 18, 2009, Ruth Henricks, an individual, also filed a protest to the application challenging SDG&E's assertions that the increased premium and deductible are exogenous or external to SDG&E. Henricks stated that the

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[16] *Id*. at *156.

[17] UCAN filed its Notice of Intent to Claim Intervenor Compensation on December 31, 2009.

precipitating events for the wildfire insurance premium increases were that certain wildfires that occurred in 2007 were caused by SDG&E. Henricks concluded that SDG&E has not reasonably incurred these premium increases and its request for Z-factor relief should be denied.

The Commission's Division of Ratepayer Advocates (DRA) protested the application on October 5, 2009, and raised issues with each of the Z-factor criteria. DRA stated that SDG&E bears the burden of proof on each criterion. DRA specifically questioned whether SDG&E could meet its burden of proving that the increase in insurance cost was clearly beyond management control and that management actions could not have prevented or mitigated the insurance rate increase.

SDG&E replied that UCAN's and Henricks' protests raised issues beyond the proper scope of this proceeding.

The assigned Commissioner and Administrative Law Judge (ALJ) convened a prehearing conference on December 14, 2009, where a procedural schedule was adopted and the parties agreed to an initial plan for discovery.

On January 29, 2010, the assigned Commissioner issued a Scoping Memo and Ruling (Scoping Memo) for this proceeding which declared that SDG&E must prove by a preponderance of the evidence that the increased liability insurance premium and deductible expense are:

1. Caused by an event exogenous to SDG&E;
2. Caused by an event that occurred after the implementation of rates;
3. Costs that SDG&E cannot control;
4. Costs that are not a normal cost of doing business;
5. Caused by an event that affects SDG&E disproportionately;

6. Costs that have a major impact on SDG&E;
7. Costs that have a measureable impact on SDG&E; and
8. Costs that SDG&E has reasonably incurred.

The scoping memo also adopted a procedural schedule that included evidentiary hearings and designated the assigned ALJ as the presiding officer.

Evidentiary hearings were held on April 5, 6, and 7, 2010, in San Francisco. The parties filed opening briefs on May 10, 2010, and reply briefs on May 28, 2010. The Commission held Final Oral Argument on August 11, 2010.

5. Evidence and Argument Presented

5.1. SDG&E

SDG&E seeks Commission authorization to increase its electric and natural gas revenue requirement by $28,884,00 to reflect unforeseen liability insurance expense for the 2009-2010 renewal period, and to create a new advice letter and amortization process for recovery of future liability insurance expenses until its next GRC decision.

SDG&E's opening brief highlights the fact that this case is the Commission's first opportunity to consider application of the Z-factor criteria in the context of traditional cost-of-service ratemaking as opposed to a "new regulatory framework" (NRF) incentive-based scheme.[18] Under NRF, analysis revolves around the degree of utility control and whether permitting recovery of the cost increase would undermine the incentives built into the program. The central question under cost-of-service Z-factor analysis, according to SDG&E, is

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[18] SDG&E Opening Brief at 10.

whether the costs are reasonable and whether recovery should be permitted in order to allow the utility to earn a reasonable return.[19]

SDG&E presented three witnesses to offer testimony in support of its application. The first, SDG&E and SoCalGas Senior Vice President of Regulatory, Finance and Legislative Affairs, Lee Schavrien described the history and function of the Z-factor mechanism and explained why the liability insurance premium and deductible expense increases qualified for recovery under the mechanism. Schavrien testified that SDG&E fully performed the procedural requirements for Z-factor recovery by notifying the Commission of its intent to designate unforeseen liability insurance premium expense increases as a Z-factor event. According to Schavrien, SDG&E established a subaccount of the Z-factor Memorandum Account to track annual liability insurance expense above the level authorized in D.08-07-046 and began recording the increase in liability insurance expense in the accounts in July 2009.

Turning to the substantive requirements for Z-factor recovery, the witness contended that increased liability insurance premium and deductible expense met the first of the eight standards for Z-factor recovery, exogenous to the utility, because the financial market meltdown and recent California wildfires injected over a billion dollars of claims into the market, resulting in drastically increased liability insurance premiums and reduced insurance availability. Schavrien also pointed to insurance market conditions as demonstrating that the costs were beyond SDG&E management's control, which is the third standard for Z-factor recovery.

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[19] *Id.*

Schavrien next explained that the increase in liability insurance costs became apparent in early 2009, well after the conclusion of SDG&E's most recent general rate case in July 2008. The 2008 liability insurance prices had been "reasonable" and coverage levels consistent with previous years. Schavrien concluded that the timing met the second Z-factor standard because the cost increases occurred after the end of the last rate case.

To demonstrate that increased insurance liability and deductible costs are not a normal cost of doing business, the witness stated that SDG&E is "somewhat unique" in the eyes of insurance carriers such that these carriers assign "disproportionate risk premiums" to SDG&E. Schavrien attributed this disproportion to the fact that SDG&E is an electric utility with thousands of miles of distribution and transmission lines, a history of catastrophic wildfires in its service territory, and that it is subject to the legal doctrine of inverse condemnation under which liability is imposed without regard to fault.

To show that the insurance cost increases have a disproportionate impact on the utility, the witness included a report from the San Diego County Grand Jury which found that San Diego County suffers from a lack of fire preparedness and firefighting resources. As a result, SDG&E has experienced disproportionate fire-related claims such that insurers perceive greater future wildfire risks and assess higher premiums.

Schavrien stated that increases in insurance liability costs have a major impact on SDG&E's overall costs because SDG&E's adopted revenue requirement includes only $4.5 million for liability insurance, though its actual costs were $47 million for 2009, a 10-fold increase. The unanticipated cost increase represents about eight percent of SDG&E's net 2008 operating income and over 10 percent of the total administrative and general expenses reported in 2008.

To meet the seventh criterion, SDG&E must show that the cost impact is measurable. Schavrien stated that the 2009 total liability insurance premium was $47 million, based on testimony of SDG&E's witness, Risk Manager, Maury De Bont.

SDG&E's final factual demonstration for Z-factor treatment is a showing that the cost was reasonably incurred. Here, Schavrien relied on De Bont's testimony to show that the insurance procurement process was reasonable. Schavrien also offered a summary of SDG&E's Community Fire Safety Program which includes:

1. physical improvements to SDG&E's overhead electric transmission and distribution system in areas that are prone to wildfires,
2. modification of the operation of reclosers for overhead power lines in areas of high fire risk,
3. expanded inspections of overhead power lines and associated facilities in areas of high fire risk, and
4. increased vegetation management for approximately 72,000 trees located near overhead power lines in areas of high fire risk.

SDG&E next presented De Bont to describe the authorized 2008 liability insurance expense and the dramatic increase in the 2009 insurance renewal process. De Bont explained that for 2008, SDG&E and SoCalGas had purchased $1.17 billion of liability insurance, with a $1 million deductible, for $13.6 million. This liability insurance included liability caused by wildfires.

In contrast, for 2009, De Bont stated that insurers separated out the potential wildfire liability from general liability insurance. For $800 million of general liability insurance, with a $5 million deductible, SDG&E and SoCalGas paid $15.2 million. For $399 million of wildfire liability, SDG&E agreed to pay the first $5 million in claims and 50% of the next $60 million, for a premium of $40 million.

De Bont attributed these cost increases to five factors:

1. insurers' perception that the inverse condemnation doctrine imposed strict liability on utilities for wildfire damages,
2. "payback" for claims arising out of the 2007 fires,
3. assessment of greater wildfire risk due to climate change,
4. increase in reinsurance prices for wildfire liability and decrease in the number of firms offering to sell it, and
5. global catastrophic losses and financial market conditions.

In light of these factors, De Bont explained that SDG&E also negotiated with off-shore insurance companies in London, Europe, and Bermuda to create competition among potential providers and to select layers of insurance overage based on terms, conditions, and premiums. Ultimately, SDG&E obtained seven layers of wildfire insurance and eight layers of general liability insurance, and went from 18 individual insurers in the 2008 program to 28 individual insurers for general liability, and 27 for wildfires, in 2009. De Bont also explained that SDG&E keenly negotiated deductible amounts by obtaining quotes from each prospective insurance provider with various deductible levels and using historical losses to tabulate the lowest expected overall cost, premium plus deductible.

De Bont also testified that Sempra, the corporate parent of SDG&E, purchases liability insurance for the entire corporate family, the costs of which must then be allocated among the corporations, including SDG&E and SoCalGas. The general liability insurance premium of $15.2 million will be divided between

SDG&E and SoCalGas based on the methodology used in the last general rate case which is based on a multi-factor analysis.

SDG&E proposed allocating the total wildfire premium based on number of electric circuit miles, which results in 99.48% being allocated to SDG&E, 0.35% to SoCalGas, and 0.17% to Sempra Energy. Sempra uses a multi-factor allocation formula as authorized in SDG&E's last general rate case to allocate general liability insurance. Using this formula, SDG&E was allocated $7.1 million of the $15.2 million in 2009 general liability costs. While wildfire liability premium was allocated based on electric circuit miles, with SDG&E being responsible for $39.9 million of the total $40.1 million.[20]

In rebuttal, De Bont stated that SDG&E worked closely with its highly experienced insurance broker to carry out the negotiation process which includes "constant dialogue" between SDG&E and the broker. SDG&E's representative met directly with its primary insurer to make an informational presentation on SDG&E's activities and operations, including the 2007 fires. Witness De Bont summarized the process and result:

> Despite its comparatively disadvantageous negotiation position in the 2009-2010 renewal, SDG&E did not merely accede to "unreasonable" terms with [its primary insurer]. Rather, in consultation with and at the direction of SDG&E, [the broker] negotiated coverage terms and conditions and pricing over many months with the [insurance company] underwriter, going back and forth to achieve final terms. Ultimately, SDG&E made it known to [the insurance company] that there may come a point in time where [the insurance company] would price coverage to a level where it would be deemed too expensive and

[20] See Hearing Exh. 3 at 10.

> would no longer represent an acceptable risk transfer. We informed [the insurance company] through [the broker] that we would self insure the $35 million layer should it increase the premium above what was already being offered.[21]

De Bont also rebutted UCAN's allegations that SDG&E did not sufficiently consider alternatives to traditional insurance by explaining that the timing and costs associated made the alternatives infeasible and not cost competitive when compared to commercial insurance. De Bont refuted UCAN's witness's analysis of the insurance coverage for the premium cost and showed that in exchange for SDG&E's premium of $4.4 million, SDG&E secured $17 million of insurance protection for the first $40 million of wildfire losses.[22] De Bont also noted that SDG&E's wildfire insurance expense is expected to decline over time dependant on sustaining no further wildfire losses.

In briefs, SDG&E explained that the Z-factor event over which it had no control, i.e., exogenous to the utility, was the insurance market changes resulting in a dramatic increase in SDG&E's liability insurance costs beginning in the 2009-2010 renewal period.[23] SDG&E stated that the record shows that it "undertook aggressive efforts to develop the most comprehensive and cost-effective package possible under the circumstances;" and that, this high degree of effort to minimize the cost of procuring sufficient liability insurance

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[21] Hearing Exh. 4 at MD-6.

[22] *Id*. at MD-11.

[23] SDG&E Opening Brief at 11.

does not equate to exercising a high degree of control over the ultimate cost or availability of liability insurance.[24]

SDG&E next addressed the requirement that the cost for which it seeks Z-factor treatment occurred after the implementation of its current rates. SDG&E's last GRC was D.08-07-046, with rates effective January 1, 2008. The information on the price of liability insurance, in contrast, was not known until early 2009, about a year after the effective date of the GRC decision.

SDG&E emphasized that the third criterion "costs that SDG&E cannot control" is more accurately stated by its tariff language implementing the Z-factor mechanism which requires only that the event be "*largely* uncontrollable by management."[25] SDG&E analyzed Commission decisions and argued that although a utility may be exercising some degree of control in purchase selections or negotiating cost, such efforts to respond to limit the financial impact would not preclude a finding that the event was not controllable.[26]

SDG&E next argued that the 1,000% increase in the cost of liability insurance premium it experienced was not a normal cost of doing business. Noting that this criterion is closely related to the "disproportionate impact" criterion, SDG&E pointed out that the Commission's goal with both criteria was to ensure that utilities did not double-recover for costs through the inflation increase and as a separate Z-factor event. SDG&E contrasted "economy-wide"

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[24] SDG&E Reply Brief at 19.

[25] SDG&E Opening Brief at 24, *citing* SDG&E Preliminary Statement, Section IV. (Emphasis as shown in brief.)

[26] *Id*. at 25.

costs which are a normal cost of doing business, with the liability insurance premium increases which were primarily the result of unique factors that impacted California electric utilities in general, and SDG&E in particular.[27] SDG&E concluded that its unique "risk profile" resulted in liability insurance premium cost increases that far exceeded the normal cost of doing business.

SDG&E argued that the liability insurance premium cost increases will have a major impact on SDG&E because these cost increases will negate about eight percent of its 2008 net operating income, and is over 10 percent of its total administrative and general expenses reported in 2008.[28]

SDG&E presented documented evidence of its exact 2009-2010 liability insurance expense to show that the cost increase is measurable. As for future liability insurance premium costs, for which it is seeking to establish an advice letter process, SDG&E contends that the Commission has indicated a willingness to allow Z-factor recovery for future cost changes that are known with a high degree of certainty.[29]

Finally, SDG&E argued that it incurred the increased liability insurance premium costs reasonably and offered a detailed explanation of the insurance procurement process undertaken by SE Risk Management on behalf of SDG&E and SoCalGas. First, SE Risk Management canvassed worldwide insurance markets for qualified insurers including utility industry mutual providers, United States domestic markets, Lloyds of London and other European

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[27] *Id*. at 35.

[28] *Id*. at 37.

[29] *Id*. at 38.

companies, and the Bermuda insurance markets. Based on the offerings obtained from these markets, SE Risk Management was able to build up separate towers (sequential layers) of coverage for general third-party liability risks and, separately, for third-party wildfire liability.[30] Ultimately, through negotiation on a layer-by-layer basis, SE Risk Management was able to obtain $399 million of wildfire liability insurance in seven layers, and $800 million in general liability in eight layers. This "layering" resulted in Sempra having 27 different insurers for wildfire liability, and 28 for general liability (an increase of 10 from the previous year). SDG&E also considered and rejected several Alternative Risk Transfer options as being too expensive and time-consuming to create. SDG&E concluded that its lengthy and detailed process resulted in reasonable liability insurance premium costs.[31]

Based on its analysis, SDG&E stated that it had met its burden of demonstrating by a preponderance of the evidence that the increased liability insurance premium cost met the Commission's standard for Z-factor recovery, and that the Commission should authorize SDG&E to recover the 2009 costs as well as future costs through its proposed advice letter mechanism.

5.2. DRA

DRA recommends that the Commission deny the subject application. DRA concludes that SDG&E's request does not meet the Commission's standards for Z-factor recovery as the costs were neither exogenous to SDG&E, nor outside the control of the utility, and that future costs are not measureable.

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[30] *Id*. at 44.

[31] *Id*. at 49.

DRA analyzed SDG&E's presentation and found that SDG&E attributed the insurance premium increases to five factors that increased prices and availability of liability insurance. DRA first focused on SDG&E's description of its insurance renewal process that included negotiations with several potential providers, market intelligence and data gathering, and use of independent insurance brokers; all showing that SDG&E was actively making judgments and, thus, had a degree of control over its final insurance purchase decisions in 2009.

Next, DRA noted that SDG&E attributed part of the liability insurance premium increase to "loss coverage" from the 2007 fires that resulted in damage claims against SDG&E far in excess of its $1.1 billion liability insurance coverage. DRA contends that the loss coverage was not exogenous to the utility due to SDG&E's partial "responsibility regarding the fires."

DRA concluded that the liability insurance procurement process was not exogenous to SDG&E, and, based on the same factual analysis, was not beyond SDG&E's control, two requirements for Z-factor treatment.

DRA then turned its attention to SDG&E's request for "additional, future liability insurance premium and deductible expense incurred by SDG&E prior to a decision in its next rate case." DRA posits this request failed to meet the Z-factor requirement that all costs be measurable, because the future costs were unknown.

In briefs, DRA argues that SDG&E failed to meet its burden of demonstrating that the costs requested in the application should be recoverable from ratepayers through the Z-factor mechanism. DRA contends that SDG&E's 2009 insurance expenses were not costs "that are completely external to the utility" because SDG&E actively participated in the procurement process and made decisions about how much and what type of insurance to purchase. DRA also argued that the loss coverage to which SDG&E attributed some of the increase in its insurance premium along with the increased perception of risk by the insurance providers was based primarily on the concern that SDG&E was at fault for various major wildfires in San Diego County in October 2007. Because SDG&E failed to demonstrate that it did not cause the 2007 fires, DRA concludes that SDG&E has not demonstrated that the loss coverage activity and the perception of risk were entirely external to SDG&E. Similarly, DRA contends that since SDG&E planned and implemented its insurance procurement process, and ultimately agreed to the terms and conditions of over 50 insurance policies, SDG&E exercised control over the insurance procurement process, which negates the criterion for Z-factor recovery that the cost be beyond the control of management.

DRA devoted much of its brief to contesting SDG&E's request for future insurance premium and deductible costs. DRA contends that these costs are unknown and thus do not have a "measurable impact" on SDG&E's operations, a requirement of Z-factor criteria. DRA challenged SDG&E's proposed advice letter process for recovering the future costs as prejudging whether any future insurance expenses qualify under the Z-factor criteria, and bypassing any meaningful scrutiny of the costs by DRA or the Commission. DRA concludes that SDG&E's request for unbounded amounts for future liability insurance premiums and deductible expenses amounted to a "blank check" and that the Commission should deny the request.

5.3. UCAN

UCAN presented the testimony of Robert Sulpizio, an insurance expert with 48 years of experience in the insurance industry. The testimony contends that SDG&E could control the insurance premium costs, asserted that such costs are a normal cost of doing business that did not disproportionately affect SDG&E, and that the costs are not reasonably incurred.

UCAN's witness Sulpizio stated that SDG&E should have been involved more actively in the insurance renegotiation process, including meeting directly with insurance underwriters.[32] Sulpizio stated that the client is best able to educate insurers about the potential risks and risk offsets. He particularly focused on the legal doctrine of inverse condemnation as a topic that SDG&E pointed to as causing the rates to increase, and that SDG&E's own legal experts should have explained this directly to underwriters.

The testimony provided a detailed analysis of the options to traditional liability insurance that SDG&E could have considered but did not. Sulpizio explained that a fundamental principle of insurance is to diversify risk, and that SDG&E violated this principle by relying to an "extraordinarily high" degree on the London reinsurance market. This reliance made SDG&E susceptible to the cyclical nature of the liability insurance market where suppliers are plentiful and prices low when losses are few, but catastrophic losses drive competitors out and prices higher. Sulpizio stated that after the 2007 fires, SDG&E should have anticipated higher liability insurance premiums and taken steps to diversify its insurance risk.

Sulpizio criticized Commission ratemaking policies for encouraging over-dependence by public utilities on traditional insurance by treating such costs as "pass through" costs to ratepayers. These policies, according to Sulpizio, subject alternative risk financing techniques, which may be equally or more

[32] Sulpizio's testimony is Hearing Exh. 10.

prudent, to greater scrutiny. This, in turn, discourages public utilities from taking a long-term view of risk financing requirements and making efforts to stabilize the cost of risk. Sulpizio recommended that public utilities use the same practices used by other commercial customers to hedge risk cost-effectively. Among the Alternative Risk Transfer options suggested for consideration were: captive insurance, risk retention groups, and capital market solutions such as catastrophe bonds. Sulpizio concluded that the "magnitude of the problems facing SDG&E in securing insurance capacity for its wildfire risk, both now and in the future, dictate that every possible alternative be given more thorough consideration and analysis than one or more telephone conversations."

UCAN argued in its briefs that SDG&E's presentation on its evaluation of alternatives was "highly compromised" by offering only a junior manager to submit largely hearsay testimony on insurance acquisition efforts and evaluations of alternatives. UCAN concluded that the Z-factor mechanism creates a "perverse incentive" for utilities to adopt short-term strategies to address risk, rather than take aggressive actions to mitigate costs.

In its overall analysis of the Z-factor standards, UCAN argued that insurance costs are not beyond SDG&E's control, are a normal cost of doing business, and did not have a major impact on SDG&E's overall costs. Consequently, UCAN concluded that SDG&E had failed to demonstrate that the increased 2009 liability insurance premium was eligible for Z-factor treatment.

UCAN pointed to the Commission's 2000 decision[33] denying Z-factor treatment for a property tax refund to the telephone companies now known as AT&T California and Verizon California Inc. By denying Z-factor treatment, these companies retained the tax refunds and customers received no benefit. In the decision, the Commission found that management influenced the tax refund by voluntarily participating in settlement agreements, such that the refund was not "beyond management control," and thus not within the terms of the Z-factor mechanism. UCAN argued that like the settlement agreement in the 2000 decision, SDG&E management here could exercise its discretion in choosing from among various viable options to obtain the best deal on liability insurance, and thus the premium paid was not beyond management control.

UCAN next turned to a later 2000 decision[34], where the Commission denied now-AT&T's request for Z-factor treatment for a public education program necessary to implement an area code overlay in seven area codes throughout California. There, as in the earlier 2000 decision, the Commission found that where utility management has the discretion to "comparison shop and negotiate terms," management retains sufficient control of the expenditure to negate Z-factor treatment. UCAN concluded that, as the Commission found with public education program expenses, allowing SDG&E to recover increased insurance costs would remove its incentive to negotiate and obtain the best price for insurance.

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33 D.00-01-021, 2000 Cal. PUC Lexis 7.

34 D.00-12-32, 2000 Cal. PUC LEXIS 966.

UCAN next argued that risk management is a normal cost of doing business, and that an increase in such a cost should not be eligible for Z-factor recovery.[35] UCAN explained that SDG&E conceded that obtaining liability insurance is a normal cost of doing business, and that should this cost increase it does not become a "non-normal" cost of doing business.

UCAN next argued that SDG&E failed to mitigate the insurance premium increases by participating in the negotiation process and directly relating its story in a persuasive fashion, thoroughly evaluating alternatives to traditional insurance, and diversifying its risks.

UCAN contends that SDG&E management had control over the liability insurance procurement process and that it should have exercised better judgment in its actions. UCAN concluded that if the Commission authorizes SDG&E to recover these costs from ratepayers, then SDG&E will always capitulate to the prices stated by traditional insurance underwriters because it will not have any incentive to aggressively negotiate or consider alternatives.

5.4. Henricks

Henricks presented the testimony of an investigator, Kevin Christensen, alleging that SDG&E failed to offer for the record sufficient evidence for wildfire specific insurance. The testimony explained that SDG&E did not include invoices from insurance brokers or underwriters specifically for wildfire insurance and did not offer a witness to testify about this particular type of insurance product. Christensen states in written testimony that the SDG&E

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[35] D.94-06-011, *supra* note 2, at *98.

witnesses lacked personal knowledge of the insurance procurement process or the creation of a separate wildfire insurance classification.

In briefs, Henricks argues that SDG&E's application should be denied, and the issues of increased liability insurance premiums and wildfire costs addressed, in SDG&E's 2012 general rate case. Henricks explained that the facts shown by SDG&E failed to meet the Commission's standards for Z-factor rate recovery.

Henricks contends that SDG&E was well aware of the liability insurance claims arising from the 2007 wildfires and "conspicuously chose not to raise the issue of increased fire insurance premiums" in the then-pending 2008 GRC, showing that the purported Z-factor event did not occur after the last GRC. Henricks also argued that SDG&E's equipment was cited as a cause of two of the fires, so that the increased insurance premium was not exogenous or external to SDG&E.

Henricks argued that increased fire insurance premiums are a normal cost of SDG&E doing business and that these particular cost increases did not have a major impact on SDG&E's overall costs because from 2001 to 2009, SDG&E's operating expenses increased an average of $59 million a year, considerably less than the claimed $28 million increase here. Henricks also noted that the other large electric utilities in California were experiencing similar increases in insurance costs and reductions in availability, and that SDG&E was not "disproportionately impacted" by the increases.

Henricks challenged SDG&E's showing on the reasonableness of insurance procurement efforts and argued that SDG&E failed to make a proper showing because it did not produce its insurance brokers for discovery.

6. Discussion

SDG&E must prove by a preponderance of the evidence that the increased liability insurance premium and deductible expense are:

1. Caused by an event exogenous to SDG&E;
2. Caused by an event that occurred after the implementation of rates;
3. Costs that SDG&E cannot control;
4. Costs that are not a normal cost of doing business;
5. Caused by an event that affects SDG&E disproportionately;
6. Costs that have a major impact on SDG&E;
7. Costs that have a measureable impact on SDG&E; and
8. Costs that SDG&E has reasonably incurred.

As analyzed below, we find that SDG&E has met this burden, including a demonstration that the increased insurance costs are exogenous and beyond the control of management. We, therefore, grant single-year, one-time Z-factor treatment for 2009- 2010 incurred costs in the amount of $28,884,000. We, however, deny SDG&E's advice letter proposal for multi-year recovery of future unforeseen liability insurance premium and deductible expenses through a Z-factor mechanism subject to a one-time $5 million deductible. Instead, SDG&E may file a Tier-3 advice letter for recovery in years 2010-2012.

6.1. Application of the Z-factor Criteria

6.1.1. Was SDG&E's Increase in Insurance Liability Costs Caused by an Exogenous Event and Out of Their Control?

We will combine our analysis of the first and third criteria of the eight Z-factor mechanism because common facts are implicated in each criterion. Whether the increase in liability insurance cost is the result of an exogenous event is closely related to whether management controlled the event. The

Commission has not set forth a definite standard for determining when an event is exogenous or out of a utilities' control. Thus, these standards are to be analyzed in the framework of what examples the Commission has provided in piecemeal fashion.

First, we look at the exogenous factor and how it overlaps with the control criteria. In a line of cases, the Commission considered whether certain property tax savings realized by incentive-based regulated utilities, Pacific Bell (PacBell) and GTEC California, Inc. (GTEC), should be afforded Z-factor treatment.[36] Among other issues, the Commission considered whether the voluntary participation by PacBell and GTEC in the settlement agreements was an exogenous event. Although it concluded that the decision to voluntarily participate in settlement agreements was within the control of PacBell/GTEC and therefore was not exogenous, it went on to observe that the exercise of some degree of management control does not automatically make an event internal and preclude Z-factor treatment:

> [W]e do not believe that the simple action of participating in a settlement transfers the control of a specific cost onto the utilities' management. We can foresee a situation in which [PacBell/GTEC] and the Commission staff could negotiate the impact of a future mandated change in accounting rules, while still including as part of the settlement a Z-factor adjustment. *We would not reject the Z-factor adjustment outright based solely on the fact that [PacBell/GTEC] showed their degree of management control by participating in the settlement.*[37]

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[36] *See* D.95-06-053, 1995 Cal. PUC LEXIS 474; D.98-06-084, 1998 Cal. PUC LEXIS 493; D.00-01-021, *supra* note 33.

[37] D.95-06-053, *supra* note 36, at *23 (emphasis added).

According to this decision, simply because a utility may exercise *some* degree of control over an event, does not dictate a finding that the event was internal or endogenous. Although the Commission concluded that PacBell/GTEC has exercised management control regarding the property settlement refund and thus failed that part of the Z-factor analysis, that determination did not alter the Commissions finding that the event was exogenous. Thus, a finding of some degree of control does not preclude a finding of exogeneity.

The exogenous event in the subject case is the insurance market changes, which resulted in an increase in SDG&E's liability insurance costs. Clearly, the global insurance market place is affected by factors outside of SDG&E's control, including supply, demand, competition, economic conditions, and perception of an entities exposure to risk. The large injection of claims into the market after the 2007 wildfires, insurer's concerns over the increasing use of "inverse condemnation," and the financial market meltdown all contributed to the reduction in the amount of insurance offered to SDG&E. Consequently, in an effort to obtain as much liability insurance as prudently possible, SDG&E as "price taker", had to accept the imposed changes in costs and availability of insurance caused by the above external factors.

DRA challenges the conclusion that the reduction in availability of liability insurance and the corresponding dramatic increase in cost was an exogenous event. DRA argued that "[n]othing in SDG&E's description of its 2009 renewal process describes a buyer at the mercy of an unresponsive market," and further that SDG&E "was active, was making judgments, and had a certain degree of control over its final insurance purchase decisions in 2009."[38] As mentioned above, however, the existence of some degree of control does not make an event endogenous. Based on Commission precedent, a Z-factor "event" is not merely a utility transaction; it is an event that affects utility operations and causes unexpected costs.[39] The issue here does not focus on individual insurance transactions, rather on the monumental change in insurance *markets.* The Commission agrees with SDG&E's claim that although it participated in the negotiation and acquisition of liability insurance, a cost increase of 1000 percent cannot be viewed as a creation of SDG&E; it is plainly exogenous, and we find accordingly.

6.1.1.1. The Control Criterion

The Commission holds that while SDG&E did exert a degree of control through actively seeking to procure the largest amount of insurance at the most reasonable cost, it ultimately did not control the pricing imposed by insurers or the terms of coverage offered. We agree with SDG&E's assertion that under its Commission-approved tariff, a Z-factor event is one which is *largely* uncontrollable by management.[40] According to Commission precedent, the question is not whether a utility has some degree of control over an event, but

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[38] DRA/Logan, Exh. 17, at 3-4.

[39] *See, e.g.,* D.97-04-043, 1997 Cal. PUC LEXIS 355.

[40] SDG&E Preliminary Statement, Section IV.

rather whether the level of control is "substantial" or "significant" enough that the utility can largely control the outcome.[41]

SDG&E stated that it had no control over the changes in the liability insurance market that caused the premium to increase.[42] SDG&E attributed these changes to the five factors listed above to the dramatic increase in SDG&E's 2009 premium.[43] SDG&E presented detailed evidence on how it "canvassed the world's insurance market" for insurance offerings and "a balance was struck between good coverage and premiums," with "appropriate deductibles" also negotiated with underwriters, ultimately achieving a two-tower, seven- and eight-layer, liability and wildfire insurance program provided by 27 and 28 providers.[44] SDG&E stated that it "accepted terms that were economically reasonable for risk transfer"[45] and "declined to purchase coverage from insurers whose rates would have negatively impacted premium costs."[46]

We agree with SDG&E that a high degree of effort taken to develop the most reasonable and cost-effective liability insurance package does not equate to a high degree of control. The Commission concludes that while SDG&E actively did seek to procure the largest amount of insurance at the most reasonable cost,

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41 D.94-06-011, *supra* note 2, at *95-96; D.00-12-032, *supra* note 34.

42 Hearing Exh. 1 at 6–7, 9–10.

43 Hearing Exh. 3, at 3–5.

44 *Id*. at 6–7.

45 Hearing Exh. 4 at MD–5.

46 Hearing Exh. 3 at 7.

it ultimately did not control the pricing imposed by insurers or the terms of coverage offered.

In an effort to establish sound public policy, we agree that SDG&E's decision to obtain all the liability insurance that was reasonably available in the world insurance market was a prudent risk mitigation strategy. DRA's argument that the cost of SDG&E's insurance coverage was tied to their decision to obtain the same level of coverage as the previous year is misplaced. In fact, SDG&E did not procure the same level of insurance for the 2009-2010 period as it had in the prior policy period. Instead, realizing its exposure to wildfire liability and understanding that this exposure could exceed the insurance market's ability to provide protection, SDG&E attempted to buy all the liability insurance reasonably available in the existing market.

Ultimately, SDG&E received less liability insurance coverage than during the prior policy period, at a dramatically higher price. SDG&E was not able to prevent the dramatic cost increases imposed in the 2009-2010 renewal, effectively controlling neither the availability nor cost. Accordingly, we find the first and third criteria of the Z-factor mechanism has been met.

6.1.2. Was SDG&E's Increase in Insurance Liability Costs Caused by an Event That Occurred After the Implementation of Rates?

In D.08-07-046 we authorized SDG&E's Test Year 2008 revenue requirement (including both liability insurance and deductible expense), with an effective date retroactive to January 1, 2008. Specific information regarding the unexpected changes in liability insurance was unknown to SDG&E until early 2009 when the effort to procure insurance for the next 12-month period began. The exact liability insurance premium expense increase was not known until the renewal date of June 26, 2009.[47] Thus, we conclude that the incurred costs caused by increases in insurance occurred in 2009, after the implementation of rates in 2008, thus satisfying the second Z-factor criterion.

6.1.3. Was SDG&E's Increase in Insurance Liability Costs Not a Normal Cost of Doing Business and Affect SDG&E Disproportionately?

The analysis applied for both of these criteria involves similar arguments, thus will be discussed together. We have ruled before that "[e]ssentially, the disproportionate impact test is simply a restatement of the requirement that the cost at issue be something other than a normal cost of doing business."[48] The Commission finds that a cost caused by an event that affects SDG&E disproportionately is also a cost that is not normal to the process of doing business.

SDG&E is correct in stating that a 1,000 percent increase in liability insurance cost over the amount forecasted in their 2008 GRC is *not* a normal cost of doing business. The dramatic increase in liability insurance cost was the result of several unique factors, causing California electric utilities and SDG&E in particular, to be impacted exceptionally hard. Precedent states that to qualify as abnormal, costs imposed by an event must not be the result of general economic conditions, but must result from factors which specifically impact the utilities.[49]

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[47] SDG&E Opening Brief, at 24.

[48] D.94-06-011, *supra* note 2, at *100; D.00-01-021 *supra* note 33, at *19.

[49] D.94-06-011, *supra* note 2, at *98-99.

We agree that SDG&E has a heightened risk profile due to its excessive wildfire risk exposure, its legal liability under inverse condemnation, and the imposition on California investor-owned utilities of strict liability for wildfires, thus, exposing it to insurance liability costs far exceeding the normal cost of doing business. No other investor-owned-utility experienced such an increase in liability insurance costs, nor did this change affect all business on an economy-wide basis. Thus, SDG&E incurred abnormal costs disproportionate to the costs paid by all other investor-owned utilities. Accordingly, we find SDG&E satisfied Z-factor criteria four and five.

6.1.4. Did SDG&E's Increase in Insurance Liability Costs Have a Major Impact?

Pursuant to Commission precedent, Z-factor adjustments only should be granted if the alleged Z-factor event has a major impact on a utility's overall costs.[50] The cost of liability insurance allocated to SDG&E increased from an authorized level of $4.5 million in 2008 to an actual level of $47 million in 2009.[51] Evidence establishes that this 1,000 percent increase will consume almost the <u>entire</u> attrition increase SDG&E received for normal inflation and operations in the 2008 GRC. This increase represents approximately 8 percent of SDG&E's 2008 net operating income and over 10 percent of the total administrative and general expenses reported in 2008. We find this clearly is a major impact on SDG&E's overall costs; especially when considering that the impacts of these specific costs will be cumulative with the costs expected to be incurred in the

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[50] D.94-06-011, *supra* note 2, at *104-105; D. 00-01-021, *supra* note 33, at *21.

[51] SDG&E/De Bont, Exh. 3, at 11.

2010-2011 and 2011-2012 renewals. Accordingly, we find the sixth Z-factor criterion has been met.

6.1.5. Did SDG&E's Increase in Insurance Liability Costs Have a Measurable Impact?

In D.00-01-021 we stated that if actual costs can be used to measure financial impacts or, with reasonable certainty and minimal controversy the financial impacts can be determined, the cost may be eligible for Z-factor treatment.[52] We agree that the documented evidence of the exact amounts of 2009-2010 liability insurance costs were clearly measureable and sufficient to meet this criterion.

However, we agree with DRA in that SDG&E cannot presently recover costs for the 2010-2011 and 2011-2012 policy periods since the total amount of liability insurance expenses in subsequent years currently is unknown and, therefore, impossible to measure the impact. The Commission acknowledges the chance that the effects of this single-year Z-factor event may not be felt in future years, thus, we decline to apply Z-factor treatment now on a forward-looking basis. Consequently, however, we do grant SDG&E the ability to seek recovery via a Tier 3 Advice Letter for unforeseen costs incurred during the policy renewal periods prior to its next GRC. Accordingly, we find the seventh Z-factor criteria is satisfied, and narrowly applied to the current 2009-2010 renewal period in question.

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[52] D.00-01-021, *supra* note 33, at *24-25.

6.1.6. Was SDG&E's Increase in Insurance Liability Costs Reasonably Incurred?

The Commission has stated a policy of "allowing [cost-of-service] utilities to recover reasonable costs incurred in the performance of utility service."[53] Commission precedent reflects the notion that any major exogenous event beyond the utility's control for which costs are found to be reasonable, and which are not fully reflected in the economy-wide inflation factor, are recoverable through Z-factor adjustment.[54] We agree that SDG&E incurred the costs reasonably for the following reasons.

First, SDG&E took aggressive steps to procure liability insurance in a prudent and reasonable manner. SDG&E's insurance coverage is procured on its behalf by SE Risk Management. Through the use of a seasoned brokerage firm Marsh USA, Inc., and client executive Joseph Phillips, SE Risk Management was able to canvass the global insurance market to reach qualified insurers, including utility industry mutual companies. Given SDG&E's exposure to wildfire liability and the potential for this exposure to exceed the insurance market's ability to provide protection, the Commission finds this to be a reasonable procurement strategy. We agree that SDG&E implemented a comprehensive and cost-effective insurance package as was available under the circumstances.

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[53] D.92-12-015, *supra* note 3, at *32.

[54] D.94-06-011, *supra* note 2, at *107; D. 00-01-021, *supra* note 33, at *29.

Second, SDG&E has reasonably explored Alternate Risk Transfer mechanisms and reasonably determined their mechanisms to be infeasible and not cost competitive with the commercial insurance market. Third, SDG&E has taken and continues to take proactive steps to improve its risk profile, including the implementation of a multi-pronged "Community Fire Safety Program" (elaborated earlier in "Evidence and Argument Presented"). Applying the evidence to the unique facts of this case leads the Commission to conclude that SDG&E did incur the reported costs reasonably, and we therefore find the eighth and final criterion of the Z-factor test has been met.

6.2. Treatment of Future Unforeseen Liability Insurance Premium and Deductible Expenses

We are granting recovery for a Z-factor event that is isolated to the insurance policy renewal period of 2009-2010. Under the traditional Z-factor mechanism, once the Commission approves Z-factor treatment of a cost, the utility makes the approved revenue requirement change and that revenue requirement remains in place for each subsequent year of the Z-factor event, and no further advice letter or application filling seeking approval is required. Although SDG&E proposed to implement an additional advice letter process for recovery of liability insurance expenses as Z-factor costs in subsequent years, we deny that proposal because it would presume that we hold the Z-factor event to be "multi-year" in nature and subject to only a single $5 million deductible.

We reject SDG&E's claim that this is a multi-year Z-factor event subject to a single $5 million deductible applicable *only* to this year's unforeseen liability premium expenses. By rejecting that finding, we deny SDG&E's advice letter proposal based on the multi-year Z-factor event notion. On the other hand, we also decline to require, as DRA suggests that SDG&E file new applications for

Z-factor treatment and recovery in subsequent years, and offer an alternative solution. If the Z-factor event recognized in this decision occurs in a subsequent year, prior to its next GRC, SDG&E may file a Tier 3 Advice Letter and upon approval establish a memorandum account to record applicable costs; however, and recovery would be subject to a Z-factor deductible.

6.3. Conclusion

SDG&E has met its burden of proving by a preponderance of the evidence that the cost increase in liability insurance for 2009 meets all eight applicable Z-factor criteria. Accordingly, we grant Z-factor recovery for 2009 liability insurance cost increases less the applicable one-time $5 million deductible. We deny the proposed treatment of future liability insurance cost increases at this time and instead direct SDG&E to file a Tier 3 Advice Letter for approval of subsequent Z-factor treatment and recovery, subject to a deductible.

7. SDG&E's Transmission/Distribution Allocation Proposal

We decline to reach a decision regarding SDG&E's request to add any liability insurance premium or deductible expenses disallowed by Federal Energy Regulatory Commission (FERC) to the Z-factor Memorandum Account (ZFMA), for recovery of future liability insurance premium or deductible expenses that remain CPUC-jurisdiction in the event FERC does not approve SDG&E's separately-file request for a change in the FERC methodology used to allocate wildfire liability insurance costs.

8. Henricks' Disqualification Motion

On September 20, 2010, Protestor Henricks moved to disqualify Commissioner Simon from further participation in this proceeding. Henricks contends that two *ex parte* meetings, subsequent to the oral argument held in this preceding, violated Rule 13.13 of the Commission's Rules of Practice and

Procedure (Rules), which requires that the oral argument be "final" as well as constitutional due process obligations.

In opposition, SDG&E explained that *ex parte* meetings are not part of the record and thus the Commission may not base its decision on the content of any such meeting as provided in Rule 8.2(k). Such meetings also are governed by Rule 8, with which the parties meeting with the Commissioner complied. SDG&E noted that the Commission adopted what is now Rule 8 in 1991 and at that time the Commission carefully discussed the balance it was striking between allowing Commissioners to have full access to relevant information and ensuring that no party has "unfair access to decision makers." SDG&E concluded that the motion was "entirely without merit" and followed Henricks' pattern in this proceeding of being "at best, careless and, at worst, willfully ignorant of the Commission Rules and precedent."

DRA also opposed the motion and stated that Henricks had misinterpreted Rule 8, particularly Rule 8.2(c)(1), which authorizes ex parte communications "at any time with a Commissioner," subject to certain requirements. DRA also showed that Henricks had misinterpreted the term "final" in Rule 13.13 as prohibiting the parties from subsequent attempts to influence the Commission because the Commission's Rules allow for additional filings, such as comments on proposed decisions. DRA concluded that it had complied with Rule 8's notice and filing requirements which revealed the substantive contents of its meeting with Commissioner Simon, as required by the Rule 8 to protect the due process interests of other parties.

Henricks' motion is denied. Rule 13.13 does not prohibit ex parte meetings, as set forth in Rule 8, after oral argument. Moreover, Henricks has made no attempt to meet the substantive standards and evidentiary requirements to disqualify a Commissioner, see D.06-12-042.

9. Comments on Proposed Decision

The alternate proposed decision of the Commissioner in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3. Comments were filed on ____________________, and reply comments were filed on ________________ by ____________________.

10. Assignment of Proceeding

Timothy Alan Simon is the assigned Commissioner and Maribeth A. Bushey is the assigned ALJ in this proceeding.

Findings of Fact

1. SDG&E's Z-factor mechanism was adopted by the Commission as part of a settlement agreement in SDG&E's last general rate case.

2. The Commission previously has adopted the following criteria for Z-factor recovery for SDG&E:

   a. Caused by an event exogenous to SDG&E;
   b. Caused by an event that occurred after the implementation of rates;
   c. Costs that SDG&E cannot control;
   d. Costs that are not a normal cost of doing business;
   e. Caused by an event that affects SDG&E disproportionately;
   f. Costs that have a major impact on SDG&E;
   g. Costs that have a measureable impact on SDG&E; and
   h. Costs that SDG&E has reasonably incurred.

3. SDG&E sought and obtained liability insurance offerings from domestic and international insurance markets, negotiated premiums and deductibles, and ultimately selected a two-tower liability insurance program comprised of seven layers of general liability insurance with 27 providers, and a separate wildfire tower with eight layers and 28 providers.

4. SDG&E is subject to general rate case regulation and the incentive structure of which Z-factor is a component does not apply to SDG&E's current rate regulation.

5. SDG&E could and did negotiate levels of liability insurance coverage and deductibles for its 2009 liability insurance premium.

6. A finding of some degree of control does not preclude a finding of exogeniety.

7. Specific information regarding the unexpected changes in liability insurance was unknown to SDG&E until early 2009 when the effort to procure insurance for the next 12-month period began.

8. SDG&E has a heightened risk profile due to its excessive wildfire risk exposure, its legal liability under inverse condemnation, and the imposition on California investor-owned utilities of strict liability for wild fires.

9. In 2009, SDG&E's annual premium for third-party liability insurance was $47 million and the revenue requirement adopted in its last general rate case included $4.5 million for third-party liability insurance.

10. The documented 1,000 percent increase in cost of insurance over the amount forecasted will consume close to the entire attrition increase SDG&E received for normal inflation and operations in the 2008 GRC.

11. SDG&E used brokerage firm Marsh USA, Inc., and agent Joseph Phillips, to canvass the global insurance market to reach qualified insurers, including

utility industry mutual companies in the United States, London, European, and Bermuda insurance markets.

12. The increase in 2009 liability insurance premium and deductible expense meets the Z-factor criteria for inclusion in regulated revenue requirement and recovery from ratepayers.

13. The present case involves a stand-alone event and does not qualify as a multi-year Z-factor mechanism with a single, one-time deductible.

14. No evidence was presented that SDG&E and DRA failed to comply with Rule 8 in their respective *ex parte* meetings with Commissioner Simon on August 23, 2010, and September 2, 2010, respectively.

Conclusions of Law

1. SDG&E bears the burden of proving by a preponderance of the evidence that its 2009 increase in liability insurance costs meets all eight of the Z-factor criteria.

2. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was caused by an event exogenous to SDG&E.

3. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was caused by an event beyond the control of SDG&E.

4. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was caused by an event that occurred after the implementation of rates.

5. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was not a normal cost of doing business.

6. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was caused by an event that affects SDG&E disproportionately.

7. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs had a major impact on SDG&E.

8. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs had a measurable impact on SDG&E.

9. SDG&E has met its burden of proving that the 2009 increase in liability insurance costs was reasonably incurred.

10. SDG&E's application for Z-factor recovery of 2009 increased liability insurance costs should be granted, and limited to recovery for just the policy period of 2009-2010.

11. SDG&E's Z-factor recovery of 2009-2010 is subject to a $5 million deductible.

12. SDG&E should be authorized to file a Tier 3 advice letter to create a memorandum account in which to record subsequent unforeseen increases in insurance liability premiums and deductibles for the years 2010-2011 and 2011-2012.

13. Rule 13.13 does not prohibit ex parte meetings otherwise in compliance with the Commission's Rules of Practice and Procedure after oral argument.

14. The Commission's ex parte rules are consistent with due process requirements.

15. Henricks' motion to disqualify Commissioner Simon should be denied.

16. This application should be closed.

O R D E R

IT IS ORDERED that:

1. San Diego Gas & Electric Company is authorized to recover unforeseen liability insurance premium expenses as a single-year, one-time Z-factor event for year 2009-2010 that is subject to one single $5 million Z-factor deductible.

2. The incremental revenue requirement of $28,884,000 associated with actual 2009 liability insurance premium expense increases is approved.

3. San Diego Gas & Electric Company is authorized to recover this incremental revenue requirement by transferring a total of $28,884,000 into San Diego Gas & Electric Company's Electric Distribution Fixed Cost Account (for electric) and San Diego Gas & Electric Company's Core and Noncore Fixed Cost accounts (for gas) and amortizing over a period of not less than 12 months beginning on June 1, 2010.

4. San Diego Gas & Electric Company's proposal to recover through the advice letter and amortization process any future unforeseen liability insurance premium and deductible expense increases until the next general rate case decision based on the notion that this is a multi-year Z-factor event subject to only one $5 million Z-factor deductible is denied.

5. San Diego Gas & Electric Company is authorized to file for Z-factor treatment and recovery of unforeseen liability insurance premiums and deductible expense increases in subsequent years prior to its next general rate case decision through a Tier 3 Advice Letter.

6. Protestant, Ruth Henricks' motion to disqualify Commissioner Simon is denied.

7. Application 09-08-019 is closed.

This order is effective today.

Dated ______________________________, at San Francisco, California.

APPENDIX A: LIST OF APPEARANCES

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(END OF APPENDIX A)

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated November 16, 2010, at San Francisco, California.

/s/ GLADYS M. DINGLASAN
Gladys Dinglasan

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to ensure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

* *

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