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:hkr

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 **PROPOSED DECISION OF ALJ BUSHEY (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 DENYING REQUEST FOR "Z-FACTOR" TREATMENT FOR LIABILITY INSURANCE PREMIUM AND DEDUCTIBLE INCREASES

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

1. Summary

This decision finds that the increase in 2009 liability insurance premium and deductible expense does not meet the Z-factor criteria for inclusion in regulated revenue requirement and recovery from ratepayers. A memorandum account is authorized subject to limitations set forth below.

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 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 decision. As justification for this proposed post-test year ratemaking adjustment, SDG&E contends that the unforeseen liability insurance premium and deductible expense meet the Commission's standard for treatment as unexpected and uncontrollable events which occur 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 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. Procedural Background

On September 25, 2009, the Utility Consumers' Action Network (UCAN)[1] 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 future such costs. UCAN recommended evidentiary hearings, with discovery and expert testimony, and promised to present an alternative procedural schedule at the prehearing conference.

On September 18, 2009, Ruth Henricks filed a protest to the application which challenged SDG&E's assertions that the increased premium and deductible are exogenous or external to SDG&E. Henricks stated that the precipitating events for the wildfire insurance premium increases were certain 2007 wildfires that 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 Division of Ratepayer Advocates (DRA) protested the application on October 5, 2009, and raised issues with each of the Z-factor criteria. DRA observed 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.

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

SDG&E replied that the 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 the 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 the procedural schedule which included evidentiary hearings and designated the assigned ALJ as the presiding officer.

Evidentiary hearings were held on April 5, 6, and 7, 2010, in the Commission hearing rooms in San Francisco, California. 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.

4. Evidence and Argument Presented

SDG&E

SDG&E presented three witnesses to offer testimony in support of its application. SDG&E and Southern California Gas Company's (SoCalGas) Senior Vice President Regulatory and Finance, 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. He stated that the Commission adopted the Z-factor mechanism for SDG&E and SoCalGas in the late 1990's but neither utility has ever incurred a cost that met the standards to justify recovery of the cost from ratepayers.

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.

Schavrien next explained that the increase in liability insurance increases 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, 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 increase in insurance liability costs has a major impact on SDG&E's overall costs because SDG&E's adopted revenue requirement includes only $4.5 million for liability insurance but its actual costs were $47 million for 2009, a 1,000% increase. The unanticipated cost increase represents about 8 percent of SDG&E's net 2008 operating income.

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 SDG&E's witness Risk Manager, Maury De Bont's testimony.

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 negotiated with insurance companies based 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 both SDG&E and SoCalGas, 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 split 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. Wildlife liability premium was allocated based on electric circuit miles, with SDG&E receiving $39.9 million of the total $40.1 million.[2]

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, reports, and instructions from SDG&E. SDG&E's representative met directly with SDG&E's 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 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.[3]

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[2] See Hearing Exh. 3 at 10.

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

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 with these alternatives made them infeasible and not cost competitive when compared to commercial insurance. De Bont corrected 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.[4] De Bont also noted that SDG&E's wildfire insurance expense is expected to decline over time so long as no further wildfire losses are sustained.

SDG&E's final witness was SoCalGas' General Rate Case Analysis Manager, who provided the calculations for allocating the increased liability insurance premiums to both utilities and to distribute a portion of the costs to rates subject to the jurisdiction of the Federal Energy Regulatory Commission.

In briefs, SDG&E explained that the Z-factor event over which it had no control, i.e., exogenous to the utility, was dramatic changes in the price and availability of liability insurance. 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," but that this high degree of effort to minimize the cost of procuring sufficient liability insurance does not show that it exercised control over the ultimate cost of the liability insurance.[5]

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

[5] SDG&E Reply Brief at 19.

SDG&E next addressed the requirement that the cost for which it seeks Z-factor treatment have occurred after the implementation of its current rates. SDG&E showed that the most recent general rate case decision, D.08-07-046, approved 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.

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."[6] 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.[7]

SDG&E next argued that the 1,000% increase in price of liability insurance 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" 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

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

[7] *Id*. at 25.

general, and SDG&E in particular.[8] SDG&E concluded that its particular "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 cancel out about 8 percent of its 2008 net operating income, and is over 10 percent of its total administrative and general expenses reported in 2008.[9]

SDG&E presented documented evidence of its exact 2009-2010 liability insurance expense to show that the cost increase is measurable. As for the future liability insurance premium costs for which SDG&E is seeking to establish an advice letter process, SDG&E contended 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.[10]

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 Sempra Energy Risk Management on behalf of SDG&E and SoCalGas. First, Sempra canvassed worldwide insurance markets for qualified insurers including utility industry mutual providers, United States domestic markets, Lloyds of London, other European companies, and the Bermuda insurance markets. Based on the offerings obtained from these markets, Sempra was able to build up sequential layers of coverage in separate

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[8] *Id.* at 35.

[9] *Id*. at 37.

[10] *Id*. at 38.

towers for general third-party liability risks and, separately, for third-party wildfire liability.[11] Ultimately, through negotiation on a layer-by-layer basis, Sempra was able to obtain $399 million of wildfire liability insurance in seven layers and $800 million in general liability in eight layers. Sempra ended up with 27 different insurers for wildfire liability and 28 for general liability, up from 18 the previous year. SDG&E also considered and rejected several Alternative Risk Transfer options as too expensive and time-consuming to create. SDG&E concluded that its lengthy and detailed process resulted in reasonable liability insurance premium cost.[12]

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.

DRA

DRA submitted its report and recommended that the Commission deny the application. DRA found that the request does not meet the Commission's standards for Z-factor recovery because the costs were neither exogenous to SDG&E nor outside the control of the utility, and, as to future costs, not measureable.

DRA analyzed SDG&E's presentation and found that SDG&E attributed the insurance premium increases to five factors that increased prices and

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[11] *Id*. at 44.

[12] *Id*. at 49.

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, use of independent insurance brokers; all of which showed that the company 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 price 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 contended that 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 essential 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 found that this request "on its face" failed to meet the Z-factor requirement that all costs be measurable because the future costs were unknown.

In briefs, DRA argued that SDG&E had 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 contended 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 the SDG&E caused major wildfires in San Diego County in October 2007. DRA quoted from the hearing transcript and contended that SDG&E admitted that insurers raise premiums when an insured causes a fire. Because SDG&E failed to demonstrate that it did not cause the 2007 fires, DRA concluded that SDG&E has not demonstrated that the loss coverage activity and the perception of riskiness were entirely external to SDG&E. Similarly, DRA contended that where 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 also argued in its brief that general economic conditions do not quality for Z-factor treatment.

DRA devoted much of its brief to contesting SDG&E's request for future insurance premium and deductible costs. DRA contended that these costs are unknown and thus do not have a "measurable impact" on SDG&E's operations as is required by the 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 concluded 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.

UCAN

UCAN presented the testimony of Robert Sulpizio, an insurance expert with 48 years of experience in the insurance industry, including 45 years as an insurance broker with corporate clients in the public utility, financial services, construction, and other business sectors.

The testimony contended 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 more actively involved in the insurance renegotiation process, including meeting directly with insurance underwriters.[13] Based on decades of experience in the business, 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 go up that SDG&E should have had its own legal experts explain directly to underwriters. Sulpizio also noted that the potential for indemnification from a fiber optic cable owner that had a role in one of the 2007 fires was not explained to the underwriters.

Witness Sulpizio also challenged SDG&E's acquiescence to the role of "payback" for past liability claims in setting future insurance premiums. He stated that: "it is not apparent to me or any reasonable broker that an insured would consider it appropriate to 'pay back' their insurer for losses that the insurer had previously sustained."

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

The testimony provided its most 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 up. Sulpizio stated that after the 2007 fires, SDG&E should have anticipated higher liability insurance premiums and taken steps to diversify its insurance risk. The witness also noted that SDG&E's primary insurance carrier is about one fifth the size in terms of assets as compared to SDG&E.

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. The policies subject alternative risk financing techniques, which may be equally or more prudent, to greater scrutiny, which 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 thorough consideration by SDG&E were: (1) captive insurance, (2) risk retention groups, and (3) 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[14] 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, the companies retained the tax refunds and customers received nothing. In that decision, the Commission found that management influenced the tax refund by negotiating and settling litigation, 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 could exercise its discretion to comparison shop for the best deal on liability insurance and thus the premium paid was not beyond management control.

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[14] Pacific Bell and GTE California Incorporated, 4 CPUC3d 32, 36-37 (D.00-01-021).

UCAN next turned to a decision from later in 2000, where the Commission denied now-AT&T's request for Z-factor treatment for the public education program necessary to implement an area code overlay in seven area codes throughout California.[15] 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.

UCAN next argued that risk management is a normal cost of doing business and that the mere fact that a normal cost of business is increasing does not make such increased costs eligible for Z-factor recovery.[16] UCAN explained

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15 Order Instituting Rulemaking/Investigation on the Commission's Own Motion Into Local Exchange Service, R.95-04-043, I.95-04-044:

> It remained within the management discretion of the utility to implement each program measure in the most efficient and cost-effective manner. For example, if money was budgeted for advertising or public service announcements about the overlay, it was within management discretion to do comparison shopping and to negotiate the most favorable terms with media sources consistent with maintaining quality control over the results. Guaranteeing LE-factor recovery of PEP expenditures would defeat the purpose of NRF which was to preserve the utility's incentive to manage costs by holding the utility financially responsible for the outcome of its management actions.

D.00-12-032 at 11.

16 Re GTE California Incorporated, 55 CPUC2d 1, 38 (D.94-06-011):

Footnote continued on next page

that SDG&E conceded that obtaining liability insurance is a normal cost of doing business. The mere fact that this cost is increasing does not turn these costs into "non-normal" costs of doing business.

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

UCAN contended 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

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> As stated above, the normal cost of doing business is specifically excluded as a Z factor cost. One of the key benefits of the NRF to ratepayers is the fact that they are no longer responsible for making NRF utilities whole for each cost increase which exceeds the GDPPI inflation index figure used in the annual price cap filings. Consequently, to the extent that costs at issue are simply normal business costs, the mere fact that they are increasing does not make them eligible for Z factor treatment. . . .
>
> Moreover, as indicated earlier, Commission decisions which simply extend a utility practice or regulatory requirement which was in effect at the time of the startup revenue requirement decision do not create new costs which may be considered for Z factor treatment. D.93-01-050, *supra*, at 5; see also, D.89-10-031, *supra*, 33 CPUC2d at 138. Extensions of existing costs are, in essence, normal costs of doing business and thus ineligible for Z factor treatment. In light of the NRF policy of providing incentives for profit maximization through efficient utility management of operating costs, the granting of Z factor treatment for increases in the normal costs of doing business would be counterproductive.

capitulate to the prices stated by traditional insurance underwriters because it will not have any incentive to aggressively negotiate or consider alternatives.

Henricks

Henricks presented the testimony of its investigator which showed that SDG&E had failed to offer for the record sufficient evidence for wildfire specific insurance. The testimony explained that SDG&E had not included invoices from insurance brokers or underwriters specifically for wildfire insurance and had not offered a witness to testify about this particular type of insurance product. Henricks' investigator stated in written testimony that the SDG&E witnesses lacked personal knowledge of the insurance procurement process or the creation of a separate wildfire insurance classification.

In briefs, Henricks argued that SDG&E's application should be denied and the issues of increased liability insurance premiums and wildfire costs be 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 contended 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 general rate case, showing that the purported Z-factor event did not occur after the last general rate case. 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, which is 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 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.

5. 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 failed to meet its burden of demonstrating that the increased insurance costs are exogenous and beyond the control of management. We, therefore, deny Z-factor treatment for these costs.

5.1. Z-factor History

The genesis of the Z-factor criteria is best understood in the historical context in which the Commission created them. We are also mindful of the general rate case settlement agreement which carried forward this historical artifact of incentive regulation to SDG&E's current cost-of-service regulation.

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.[17] 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 possible, with cost savings shared between ratepayers and shareholders.[18] 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,[19] 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."[20]

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17 Re Alternative Regulatory Frameworks for Local Exchange Carriers, 33 CPUC2d 43, 162 (D.89-10-031).

18 *Id*. at 60.

19 Inflation was defined as Gross National Product Price Index. *Id*.

20 *Id*. at 160.

In other words, the large local exchange carriers were relieved of the obligation to file general rate cases in exchange for a rate formula that allowed them annual rate increases for inflation and cost increases "clearly beyond the utility's control" less 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, made sense in light of the Commission's desire to create incentives for cost reduction, but provide utilities protection from cost changes beyond their control.

When adopting price incentive regulation for SDG&E, the Commission continued this pattern of adjusting rates for inflation, less productivity improvement, and plus or minus approved exogenous events.[21] 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.[22] SDG&E describes its Z-factor as "a relic of its experiment with incentive based ratemaking" and contends that its request to increase its rates to recover increased liability insurance costs should be considered in the context of the currently-applicable cost-of-service ratemaking.[23]

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[21] Re San Diego Gas & Electric Company, 86 CPUC2d 327, 366 (D.99-05-030).

[22] San Diego Gas & Electric Company and Southern California Gas Company, D.08-07-046 at Appendix 4.

[23] SDG&E Opening Brief at 4.

This incentive regulation "relic" was adopted as part of a settlement in a cost-of-service general rate case and was part of an unusual patchwork combination of post-test year ratemaking. 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 escalation factors, productivity factors or customer growth rates." The agreement provides for fixed increases to SDG&E's revenue requirement of $41 million for 2009, $44 million for 2010, and $44 million in 2011.[24] The settlement agreement further specifies 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."[25] 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.[26]

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[24] D.08-07-046, Appendix 4 at 5.

[25] *Id*. at 6.

[26] *Id*. at 4.

The parties to the settlement went on to conclude that having considered the "totality of all parties' positions and risks," their ultimate agreement to the Post-Test Year Ratemaking Settlement Agreement was explicitly premised on "the bottom line result achieved."[27]

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. Due to its role as a component of a settlement agreement, we will closely follow Commission precedent in applying the Z-factor criteria to ensure that we are effectuating the parties' intent as reflected in their settlement agreement. The Commission's earlier interpretations of the Z-factor criteria would have formed the parties' common understanding of this provision of the settlement agreement. Consequently, these earlier Commission decisions will strongly inform our evaluation of the evidence and argument presented in this proceeding.

5.2. Commission Precedents Applying the Z-factor Standards

The Commission has granted Z-factor recovery once, for a Commission-mandated accounting change that greatly increased the current cost to utilities for their employees' post-retirement benefits other than pensions. In

[27] *Id*. at 3.

D.92-12-015, the Commission noted that the Financial Accounting Standards Board had adopted Statement of Financial Accounting 106 which required employers to recognize the future costs of providing post-retirement benefits other than pensions to their employees by recording these costs as they are earned, rather than on a pay-as-you-go basis.[28] This accounting change resulted in material increases in utilities' cost. GTE California Incorporated (GTE California) and Pacific Bell, operating under the incentive ratemaking mechanisms described above, sought Commission authorization to treat two types of increased costs as Z-factor events, prefunded benefit costs and ongoing costs.

The Commission denied Z-factor recovery for the prefunded costs, finding that "no utility was required to make pre-funded contributions" although such contributions were made "in order to mitigate the impact" on ratepayers of the then-anticipated accounting rule change.[29] The Commission found that the decision to prefund or not was "well within the utilities control" and thus did not meet the Z-factor requirement that the prefunded contributions were "beyond their control."[30]

In contrast, the Commission authorized the recovery of ongoing benefit costs increases due to the accounting change because once adopted by the Commission, the utilities will "have no choice but to implement" the change.[31]

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[28] Re Post-retirement Benefits Other than Pensions, 46 CPUC2d 499 (1992).

[29] *Id*. at 526.

[30] *Id*. at 526–527.

[31] *Id*. at 527.

DRA agreed that the change itself met the exogenous requirement, but DRA argued that management could control the ultimate costs incurred by, for example, determining the number of employees and benefit packages offered. The Commission rejected DRA's position finding that day-to-day control over the actual payment level is not sufficient to show control over the obligation.[32] On rehearing the Commission elaborated on this point: "while we agree that the [utilities] exercise control over the day-to-day changes in the [benefit] costs, such day-to-day changes are driven by operational factors separate and distinct from the accounting measurement change resulting from the adoption of SFAS 106 over which the [utilities] had no control."[33] The Commission went on to require that the changes in those controllable factors be "excluded from the Z-factor."[34]

In 2000, the Commission determined that a negotiated property tax refund received by GTE California and Pacific Bell did not meet several of the criteria for Z-factor recovery, including beyond management control, because the utilities "exercised management control to mitigate the financial impact of this event through the settlement process."[35] As a result, shareholders retained the full property tax refund. The Commission went on to describe an external event that would meet the Z-factor requirement of being beyond management control:

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32 *Id*.

33 Re Post-retirement Benefits Other than Pensions, 71 CPUC2d 653, 663 (D.97-04-043) (1997).

34 *Id*.

35 Re Pacific Bell and GTE California Incorporated, 4 CPUC3d 32 (D.00-01-021).

> [T]here may be circumstances in which an outside entity initiates an event which imposes upon a NRF utility specific costs which can be objectively determined and which cannot be significantly affected by any action of utility management. On the other hand, there will be circumstances in which an outside event requires the utility to take some action, but does not impose specific objectively determinable costs or wholly limit the utility's response to the event. In the latter circumstances, the utility may have the ability to respond to the event in a manner that limits the financial impact of the event. In sum, the utility may be able to control, and thus lessen, the adverse impact.[36]

Later in 2000, the Commission denied Z-factor recovery of Commission-mandated public education program costs for overlay area codes in various areas of California.[37] The Commission was not persuaded that the public education program costs met the applicable Z-factor criteria.[38] In considering whether the costs are the result of an exogenous event, the Commission held that while it was true that the Commission mandated the public education program as a condition of the area code overlay and approved the budget, the utility had a "significant degree of control" over the actually incurred costs:

> The Commission-approved [public education program] budget included a number of program elements that were intended to inform and educate the public about the overlay. It remained within the management discretion of the utility to implement each program measure in the most efficient and cost-effective manner. For

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[36] *Id*. at 36.

[37] Order Instituting Rulemaking/Investigation on the Commission's Own Motion into Competition for Local Exchange Service, R.95-04-043/I.95-04-044. (D.00-12-032.)

[38] The applicable Z-factor mechanism was termed "Limited Exogenous" or "LE" but was substantially similar to SDG&E's Z-factor standards. *Id*. at 11 *citing* to D.94-06-011.

> example, if money was budgeted for advertising or public service announcements about the overlay, it was within management discretion to do comparison shopping and to negotiate the most favorable terms with media sources consistent with maintaining quality control over the results. Guaranteeing LE-factor recovery of [public education program] expenditures would defeat the purpose of NRF which was to preserve the utility's incentive to manage costs by holding the utility financially responsible for the outcome of its management actions.[39]

In summary, during the over 20 years of various utilities operating under Z-factor mechanisms, the Commission has only once authorized recovery of the requested costs. The Commission authorized only the costs flowing directly from the mandated external event; the Commission rejected recovery for anticipatory actions by the utility and ancillary cost increases. The Commission stated that only objectively determinable costs which utility management cannot affect meet the requirements for Z-factor recovery. Where utility management can comparison shop and negotiate the most favorable terms to comply with a Commission-mandated program, the costs will not be recovered through the Z-factor mechanism.

We now apply this precedent to SDG&E's request to recover increased liability insurance premium and deductible expense from its customers through the Z-factor mechanism.

5.3. SDG&E's Role in Acquiring Liability Insurance—The Exogenous, Control, and Reasonableness Criteria

We will combine our analysis of three of the eight Z-factor criteria because common facts are implicated in each criterion. Whether the increase in liability

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[39] *Id*. at 11.

insurance cost is the result of an exogenous event is closely related to whether management controlled the event, which in turn is closely related to the facts that show whether management incurred the costs reasonably.

SDG&E stated that changes in the liability insurance market were the event that caused the liability insurance premium to increase, and that it had no control over these changes.[40] SDG&E attributed these changes to the five factors listed above that occurred in or affected the liability industry and which resulted in the dramatic increase in SDG&E's 2009 premium.[41] 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.[42] SDG&E stated that it "accepted terms that were economically reasonable for risk transfer"[43] and "declined to purchase coverage from insurers whose rates would have negatively impacted premium costs."[44]

SDG&E's testimony fails to meet the Commission's criteria that the alleged Z-factor event was exogenous to SDG&E and beyond management's control. First, the domestic mutual and international liability insurance markets, as

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[40] Hearing Exh. 1 at 6–7, 9–10.

[41] Hearing Exh. 3, at 3–5.

[42] *Id*. at 6–7.

[43] Hearing Exh. 4 at MD–5.

[44] Hearing Exh. 3 at 7.

described in SDG&E's testimony, are not "an entity" but rather numerous independent businesses offering insurance services on a variety of terms and conditions. While these businesses may all participate in the liability insurance market, that market is not a monolithic "entity" that could impose and enforce specific, uniform limitations on insurance products to be offered to SDG&E. The domestic mutual and international liability insurance markets do not have authority similar to a regulatory agency or board to impose fixed obligations on SDG&E.

Second, SDG&E has not shown that it incurred objectively identifiable insurance costs that cannot be significantly affected by any action of management.[45] As quoted above, SDG&E negotiated with prospective providers, accepted some offers and rejected others, and "produced the maximum limits of liability insurance available at a reasonable price."[46] With its negotiations and product selections, SDG&E determined the ultimate cost for the liability insurance package it assembled.[47] No outside entity imposed specific objectively identifiable and uncontrollable costs on SDG&E.

In terms of Commission precedent, SDG&E has not shown that the changes in the liability insurance market are substantially similar to the

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45 As described above, UCAN's witness presented a credible challenge to sufficiency of SDG&E's negotiation efforts, and offered examples of alternatives to the traditional liability insurance market that SDG&E should have more thoroughly evaluated.

46 Hearing Exh. 3 at 8.

47 SDG&E even threatened to "self insure," i.e., retain the risk and not purchase the first level of liability insurance, if the provider were to "increase the premium above what was already being offered." Hearing Exh. 4 at MD-6.

accounting rule adopted by the Financial Accounting Standards Board and this Commission because SDG&E, unlike the utilities with the accounting rule, had options from which it could select. The instant facts appear most analogous to the area code overlay public education program. While prudent levels of liability insurance are required by the Commission, much like the public education plan, "it remained within the management discretion of the utility to implement each program measure in the most efficient and cost-effective manner." As with SDG&E's insurance procurement process described above, the telephone companies were free to comparison shop and negotiate the most favorable terms with media sources consistent with quality control. Even though the Commission imposed an overall objective, management retained autonomy to determine the implementation actions.

In sum, SDG&E's testimony fails to demonstrate by a preponderance of the evidence that the increase in liability insurance premium costs was exogenous to SDG&E and that SDG&E could not control these costs. SDG&E's evidentiary presentation to demonstrate that the costs were reasonably incurred also reveals that SDG&E actively negotiated the terms, including price and deductible, of the liability insurance SDG&E purchased. We find, therefore, SDG&E has not met the exogenous and beyond management control criteria for Z-factor recovery.

5.4. Remaining Z-factor Criteria

Having found that SDG&E failed to show that liability insurance premium costs meet two of the required criteria for Z-factor recovery, we need not fully analyze the remaining five factors. We note, however, the doubtful outcome on SDG&E's proposed advice letter process for future costs in light of DRA's challenge on whether these future, unknown costs could meet the criterion of having a measurable impact on SDG&E.

5.5. Conclusion

SDG&E has not 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 deny Z-factor recovery for 2009 liability insurance cost increases and the proposed Z-factor treatment of future such costs.

5.6. Has SDG&E Otherwise Justified Extraordinary Relief?

As set forth above, the Commission has historically included a Z-factor as a component of a ratemaking plan premised on maintaining proper cost control incentives for management as a substitute for cost of service regulation in a general rate case which would include a test year forecast and a mechanism or adjustment to offset operating and financial attrition between rate cases. SDG&E for example did not have general rate cases for some years but instead had a more flexible performance-based or incentive regime which included a "Z-Factor" escape mechanism for truly extraordinary and unique events. Consequently, the precedents upon which we base our Z-factor analysis are also drawn from a ratemaking context that reflects a premise of incentive, rather than cost-of-service ratemaking. Here, however, SDG&E is subject to general rate case regulation and the incentive structure of which Z-factor is a component does not apply.

SDG&E argues that this difference in ratemaking methodology imposes an additional ratemaking inquiry on our review of its application to recover increased liability insurance premium costs. The applicable ratemaking standard, as described by SDG&E, is the Commission's "overarching obligation to ensure the opportunity of cost-of-service regulated utilities to earn a reasonable rate of return."[48] We also note that our other "overarching" obligation is to ensure that ratepayers receive safe and reliable service at the lowest reasonable cost. Neither obligation is superior to the other.

We agree that in the cost-of-service regulatory realm, our analysis of post-test year ratemaking requests does not end with the Z-factor criteria but must include consideration of our broader and inescapable ratemaking standards, including evaluation of the increased cost against the standard of allowing a utility an opportunity to earn a reasonable rate of return. We emphasize that this standard only extends to SDG&E, or any utility operating under this regulatory structure, an opportunity, not a guarantee, to earn a reasonable return.

Traditionally, a public utility subject to cost-of-service ratemaking could only obtain post-test year ratemaking adjustments via a two-step process. First, to avoid illegal retroactive ratemaking, the utility must obtain Commission authorization to record the amount in a memorandum account. Second, the utility must seek Commission permission to recover any reasonable and prudent amount or some fraction therefore from ratepayers, typically in a general rate case or program-specific application.[49] We will use this traditional structure, limited as set out below, to fashion a means to ensure the SDG&E has an opportunity to earn its authorized rate of return while still providing ratepayers safe and reliable service at the lowest reasonable cost.

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[48] SDG&E Opening Brief at 10.

[49] See, e.g., Order Instituting Rulemaking into the operation of interruptible load programs offered by Pacific Gas and Electric Company, SDG&E, and Southern California Edison Company and the effect of these programs on energy prices, other demand responsiveness programs, and the reliability of the electric system, D.02-04-060.

SDG&E argues that it has a right to earn its authorized return—but equally it has no right to earn in excess of its authorized return. Any mechanism that allows the recovery of changes in costs between rate cases quite simply reduces the risk borne by shareholders and transfers that operating risk to ratepayers. Therefore, we must temper our consideration of any recovery of the significant increase in liability insurance costs and ensure that SDG&E does not, as a result, earn in excess of its authorized return. Therefore, the mechanism we adopt in today's decision is limited so that any recovery will occur only when SDG&E's earnings, computed on a jurisdictional basis, would otherwise fall below the authorized return on equity on regulated operations.

In balancing the competing objectives and especially in light of the unique importance to the public of third-party liability insurance, we will use the traditional memorandum account ratemaking mechanism to ensure that SDG&E has an opportunity to earn its authorized return on equity in light of the extreme increase in liability insurance costs. We authorize SDG&E to file an advice letter to create a memorandum account in which to record one-half the actual annual calendar year costs of liability insurance in excess of the amount adopted in the most recent general rate case. We limit the amount to one-half to provide SDG&E shareholders incentive to aggressively and innovatively manage the costs of third-party liability insurance.

We also require that the annual amount recorded in the memorandum account be further limited to the amount necessary for SDG&E to obtain its authorized return on equity for the calendar year in question. To implement this limitation, SDG&E shall tabulate its recorded return on equity for a particular calendar year, removing extraordinary revenue and expenses. The insurance liability costs recorded in the memorandum account for that year shall be limited to the amount by which the recorded return is below SDG&E's last authorized return on equity. Any insurance liability costs recorded in the memorandum account which, if added to SDG&E's revenue requirement, would result in a return on equity in excess of the last authorized shall be removed from the memorandum account and not recovered from ratepayers. If the recorded return on equity for any calendar year is greater than last authorized, SDG&E shall remove from the memorandum account all liability insurance costs recorded for that calendar year. SDG&E may transfer such amounts that meet these requirements from its existing Z-factor memorandum account to the newly created memorandum account. SDG&E may seek permission to amortize reasonable amounts properly recorded, subject to the return on equity limitation, in the memorandum account in its next general rate case.

The Director of the Energy Division is authorized to determine the most efficient procedural means for SDG&E to make the required memorandum account filings.

6. Henricks' Disqualification Motion

On September 20, 2010, Protestor Henricks moved to disqualify Commissioner Simon from further participation in this proceeding. Henricks contended that two ex parte meetings subsequent to oral argument on August 11, 2010, 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 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. As explained by the opposing parties, 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.

7. Comments on Proposed Decision

The proposed decision of the ALJ 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 ______________.

8. 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 has previously 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. The domestic and international liability insurance markets are comprised of independent businesses and not a single unit subject to any one person's or entity's control.

5. No external entity determined the level of liability insurance coverage, deductibles, or premium paid by SDG&E in 2009.

6. SDG&E could and did comparison shop among prospective liability insurance providers.

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

8. 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.

9. Traditional cost-of-service ratemaking provides for post-test year ratemaking adjustments via a memorandum account and subsequent Commission authorization for ratemaking recovery, often in a general rate case or program-specific application.

10. 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.

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

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 not 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 not 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's application for Z-factor recovery of 2009 increased liability insurance costs should be denied.

5. SDG&E has no right to earn in excess of its authorized return on equity.

6. SDG&E should be authorized to file an advice letter to create a memorandum account in which to record for later ratemaking consideration third-party liability insurance premium amounts subject to the following limitations:

a. No more than one-half of amount by which the premium for a calendar year exceeds the amount adopted in SDG&E's most recent general rate case, and

b. The liability insurance premiums recorded in the memorandum account for each calendar year shall be limited to the amount necessary for SDG&E to achieve its authorized return on equity. Any insurance liability costs recorded in the memorandum account which, if added to SDG&E's revenue requirement, would result in a return on equity in excess of the last authorized shall be removed from the memorandum account and not recovered from ratepayers. If the recorded return on equity for any calendar year is greater than last authorized, SDG&E shall remove from the memorandum account all liability insurance costs recorded for that calendar year.

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

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

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

10. This application should be closed.

O R D E R

IT IS ORDERED that:

1. San Diego Gas & Electric Company is authorized to file an advice letter to create a memorandum account in which to record for later ratemaking consideration third-party liability insurance premium amounts subject to the following:

   a. No more than one-half of the amount by which the premium for a calendar year exceeds the amount adopted in San Diego Gas & Electric Company's most recent general rate case may be recorded in the memorandum account;

   b. The liability insurance premiums recorded in the memorandum account for each calendar year shall not exceed the amount necessary for San Diego Gas & Electric Company to achieve its authorized return on equity for that year. Any insurance liability costs recorded in the memorandum account which, if added to San Diego Gas & Electric Company's revenue requirement, would result in a return on equity in excess of the last authorized shall be removed from the memorandum account and not recovered from ratepayers. If the recorded return on equity for any calendar year is greater than last authorized, San Diego Gas & Electric Company shall remove from the memorandum account all liability insurance costs recorded for that calendar year;

   c. Such amounts that meet the above requirements may be transferred from the existing Z-factor memorandum account to the newly created memorandum account;

   d. San Diego Gas & Electric Company may seek permission to amortize reasonable amounts properly recorded, subject to the return on equity limitation, in the memorandum account in its next general rate case; and

e. The Director of the Energy Division is authorized to determine the most efficient procedural means for San Diego Gas & Electric Company to make the required memorandum account filings.

2. San Diego Gas & Electric Company shall close the subaccount of its Z-factor Memorandum Account that tracks annual liability insurance expense above the level authorized in Decision 08-07-046, and shall not recover in rates the balance recorded in that subaccount except as provided in Ordering Paragraph 1.

3. Henricks' motion to disqualify Commissioner Simon is denied.

4. Other than as set forth above, Application (A.) 09-08-019 is denied, and A.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/ KE HUANG
Ke Huang

N O T I C E

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* *

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