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Decision 03-05-037 May 8, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for Authority to Establish Its Authorized rates of return on Common Equity for Electric Utility Operations and Gas Distribution for Test Year 2003. (U 39 M)	Application 02-05-022 (Filed May 8, 2002)
And Related Matters.	Application 02-05-025 (Filed May 8, 2002) Application 02-05-026 (Filed May 8, 2002) Application 02-05-031 (Filed May 8, 2002)

ORDER DENYING REHEARING OF DECISION NO. 02-11-027

Pacific Gas & Electric Co. (PG&E) and San Diego Gas and Electric Co. (SDG&E) have each filed an application for rehearing of D.02-11-027 (Decision), which determined the 2003 test year rate of return and return on equity (ROE) for each utility. These two utilities' applications were consolidated with the applications of Southern California Edison Co. (SCE) and Sierra Pacific Power Co. (Sierra). Public hearings were held from August 12-16, 2002. After briefs were filed submission of the proceeding was set aside to receive additional information regarding the Commission's reorganization plan for PG&E in the latter's ongoing bankruptcy court proceeding. The Decision was issued on November 7, 2002.

In their separate applications, PG&E requested an ROE of 12.50 percent on its electric operations and 12.25 percent for its natural gas service. SDG&E requested a 12.50 percent ROE on both its electric and gas operations. SCE sought an ROE of 13 percent on its electric service, and Sierra requested an ROE of 12.50 percent. The utilities contended that the requested ROE's were reasonable because they faced increased risks, such as "the financing of large under-collections, municipalization, Performance-Based Ratemaking mechanisms, cogeneration, direct access, distributed generation, substations, photovoltaic systems, diesel fuel, propane, power procurement, and pending legislation regarding generation, procurement, and purchase of high cost renewable energy."

Although the four individual applications were consolidated to conserve staff, company, and hearing time, the individual company ROEs and returns on rate base were based on the evidence of the individual utility's and interested parties' showing for that utility. After establishing reasonable capital structures for each utility, reasonable long-term debt and preferred stock costs, and considering the business and regulatory risks facing the utilities in light of the legal standard for setting a utility's just and reasonable rate of return established by the U.S. Supreme Court in the Bluefield and Hope cases,[1] we exercised our informed judgment and set the utilities' ROE and return on rate base as follows:

Utility		Common Equity	Return on Rate Base
PG&E	- Electric	11.22%	9.24%
	- Gas	11.22%	9.24%
SCE		11.60%	9.75%
Sierra		10.90%	9.04%
SDG&E	- Electric	10.90%	8.77%
	- Gas	10.90%	8.77%

With respect to PG&E, the proceeding was kept open in order to true up its test year ROE upon implementation of a financial plan approved in its bankruptcy

[1] The Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia, 262 U.S. 679 (1923).

proceeding. Subsequently, PG&E and SDG&E each filed for rehearing. No responses were filed.

<u>PG&E's Application</u>

PG&E objects to the Decision's adoption of a lower ROE (11.22 percent) as compared to SCE's (11.60 percent). In general, it claims that the Decision is not supported by the evidence, and that as a result it fails to comply with the legal standards set down in the <u>Bluefield</u> and <u>Hope</u> decisions. According to PG&E, under these standards its return should be equal to returns available on alternative investments of comparable risk made at the same time and in the same geographical area. Therefore, PG&E asserts that since its and SCE's circumstances are the same, PG&E's ROE should be the same as SCE's.

Specifically, it argues that the Decision fails to identify any differences between PG&E and SCE. It emphasizes that the relevant factors, such as equity ratio, business and regulatory risks, and the ROE range (10.80 to 11.80) are the same. It dismisses the difference in the embedded cost of debt (SCE's 8.19 percent compared to PG&E's 7.57 percent) by contending that both are in the same position because both companies' debt cost figure is higher than the September 2002 AA utility bond interest rate forecast of 7.16 percent for the test year. It also asserts that the 11.22 ROE fails to satisfy our conclusion that the risks facing the utilities justify a ROE in the mid to upward end of the adopted 10.8 to 11.8 ROE range. It concludes that, although SCE's adopted ROE of 11.60 percent is within the upper half of this range, the adopted ROE of 11.22 percent for PG&E is contradictory and inconsistent with the adopted range. After setting out the similarities between it and SCE, PG&E concludes that the 11.22 ROE is contrary to the evidence and the legal requirements of the <u>Bluefield</u> and <u>Hope</u> decisions.

<u>SDG&E's Application</u>

In its application SDG&E likewise contends that the adopted 10.9 percent ROE is not supported by the evidence; and that the limited discussion and sparse findings relating to it violates the requirement of Public Utilities Code (P. U. Code) Section 1705 that there be separately stated findings on all material issues. Therefore, according to

SDG&E the Decision is arbitrary, and also fails to follow the standards established in the Bluefield and Hope decisions.

Instead of containing findings on the basic facts upon which the ultimate finding is based, SDG&E claims that there are only two findings that "give any indication of how the Commission applied the evidence to render its decision" (SDG&E Application, p. 6). It claims that these two findings do not resolve every issue necessary to determine the ultimate finding, such as findings on market conditions, trends, or the financial models presented by the parties. In particular, SDG&E complains that failure of the Decision to consider its corrections to errors in the input assumptions used by the Office of Ratepayer Advocates (ORA) in its financial model constitutes a failure to make required findings on a material issues.

SDG&E attacks the Decision's reliance on the facts that its higher credit rating and its lower embedded cost of debt support a lower ROE than that determined for PG&E and SCE. SDG&E asserts there is no evidence supporting a lower ROE because it has secured a higher credit rating and lowered its interest costs. By so doing, a lower ROE based on these two facts simply penalizes a utility that reduces its cost of debt and raises its credit rating.

In addition, SDG&E contends that the Decision's conclusion that the ROE should be in the mid to upward end of the adopted ROE range is negated by setting SDG&E's ROE at only 10.9 percent which is in the lower end of the range. SDG&E states that under this conclusion, the ROE should be adjusted to at least the mid point of the adopted range, or 11.0 percent.

Finally, SDG&E maintains that the adopted ROE range for it of 10.5-11.5 percent is arbitrary when compared to the range adopted for PG&E and SCE. It complains that the Decision fails to identify any flaw in SDG&E's analysis supporting a range ending at 11.5 percent; and argues that the range for it should at least be the same as that for PG&E and SCE. The result according to the utility, is that there is no way to determine how we selected the 10.5-11.5 range for it.

We have reviewed the contentions by both utilities. As explained below, we conclude that they are without merit.

A. PG&E's Contentions

PG&E's primary contention is that by not setting its ROE equal to SCE's, the Decision fails to comply with the legal requirements for rate making as prescribed in the Bluefield and Hope cases. It points to several similar "financial difficulties" related to the two utilities, such as capital structure, similar risks faced in California, inability to pay dividends, etc. It then concludes that there are no differences between them and that the Hope case decision requires the same return for companies operating in the same general geographical and economic environment. Therefore, the Decision is arbitrary and capricious unless PG&E's return is revised to equal SCE's.

This argument misreads the legal standards established in Bluefield and Hope for reviewing whether a regulatory agency's ROE determination is lawful and sustainable upon judicial review. The Hope case was a gas pipeline rate case under the Natural Gas Act. The statutory standard for review of the rate decision is reasonableness. In Hope, the U. S. Supreme Court stated that under the just and reasonable standard "it is the result reached not the method employed which is controlling . . .'' (320 U.S. 602) Furthermore, the Court announced that review of a rate order requires scrutiny of the impact or the end result of that order:

> "It is not theory but the "impact" of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable judicial inquiry under the Act is at an end. *The fact that the method employed to reach that result may contain infirmities is not then important.* . . ." (320 U.S. 602; emphasis added.)

Next, in discussing the regulatory standard of balancing investor and consumer interests, the Court observed:

> "The fixing of prices, like other applications of the police-power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid. Bloch v. Hirsh, 256 U.S.

> 135, 155-7, . . . Nebbia v. New York, 291 U.S. 502, 523-539. . . .” (320 U.S. 601)
>
> “Thus we stated in the Natural Gas Pipeline Co. case that *‘regulation does not insure that the business shall produce net revenues’* [citation] . . . The conditions under which more or less [return] might be allowed are not important here.” (320 U.S. 603; emphasis added.)

Finally, the Court also stated the rule regarding scope of judicial review:

> “Moreover, the Commission’s order does not become suspect by reason of the fact that it is challenged. *It is the product of expert judgment which carries a presumption of validity*. And *he who would upset the rate order under the Act carries the heavy burden* of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences . . . “ (320 U.S. 602; emphasis added.)

Therefore, the Hope case means that (1) the Commission can use various formulae or methods in fulfilling its regulatory function under the Public Utilities Code; (2) if, when viewed in its entirety, the total effect of the rate order is fair (i.e., just and reasonable) to consumers and the company’s investors, the rate order must stand; (3) in balancing the consumer and investor interests regulation is not required to insure net profits; (4) the Commission’s order is the product of expert judgment which carries a presumption of validity; and (5) the burden of overturning the Commission’s decision is a heavy one and it must include a convincing showing of unreasonableness.

Similarly, the California Supreme Court has analyzed review of a Commission rate order as follows:

> The fixing of rates is a legislative act. American Toll Bridge Co. v. Railroad Com., supra, 12 Cal.2d 184, 191; see also People v. Western Airlines, Inc. (1954) 42 Cal.2d 621,630.) The standard is that of reasonableness. One challenging a rate-fixing order on constitutional grounds of confiscation is charged with the burden of showing that the evidence does not support the commission’s findings and that the rate as finally fixed is unreasonable and will result in confiscation. *Such burden is coupled with a strong presumption of the correctness of the findings and conclusions of the*

> *commission, which may choose its own criteria or method of arriving at is decision, even if irregular, provided unreasonableness is not "clearly" established. Thus responsibility for rate fixing, insofar as the law permits and requires, is placed with the commission, and unless its action is clearly shown to be confiscatory the courts will not interfere.*" Market St. Ry. Co. v. Railroad Com. (1944) 24 Cal.2d 378, 397-399, affd. 324 U.S. 548 [65 S.Ct. 770, 89 L.Ed. 1171], rehg. den. 324 U.S. 890 [65 S.Ct. 1020, 89 L.Ed. 1438]; see also Pac Tel. & Tel. Co. v. Public Utilities Com. (1950) 34 Cal.2d 822, 825 fn., 826, 832; Dyke Water Co. v. Public Utilities Com. (1961) 56 Cal.2d 105, 129.)
>
> (Pacific Tel. & Tel. Co. v. Public Utilities Comm., (1965) 62 Cal.2d 634, at 647; emphasis added.)

These court decisions clearly provide that the Commission's ROE determination carries a "strong presumption of correctness" and that PG&E must "clearly establish" its unreasonableness with the result that confiscation occurs. Although PG&E points to various similarities in the financial circumstances and difficulties applicable to it and SCE, it overlooks the fact that computing rate of return is a complex process involving a great many variables. This calculation is particularly within the expertise and judgment of the Commission. (See e.g. Southern Calif. Gas Co. v. Public Utilities Comm. (1979) 23 Cal.3d 470) These principles are fully set out in the Decision. (see pp. 16-17)

PG&E does not present any argument that the Decision's end result is confiscation. It just disagrees with the Commission's evaluation of the evidence and its ROE conclusion. For instance, PG&E downplays one significant difference between it and SCE; namely, that SCE's 8.19 percent embedded cost of debt is substantially higher than PG&E's 7.57 percent. SCE's debt cost is also substantially higher than the April 2002 forecasted 7.62 percent while PG&E's is lower. The September 2002 interest rate update forecasted a 7.16 percent interest rate for the test year. Although this indicated a downward trend for the ROE determination, it did not change the differential between PG&E's and SCE's debt cost.

In addition, there are other relevant factors that we believe justify our ROE determination:

1. PG&E requested a 12.50 percent ROE while SCE requested a 13.00 percent return. This suggests that PG&E itself recognized that its financial situation justified a somewhat lower return than SCE's.

2. PG&E's last authorized ROE (11.2 percent) was set by a June 2000 decision while SCE's last ROE (11.6 percent) was last determined earlier, in November, 1996.

3. The proceeding remains open for PG&E so that we can reassess PG&E's overall risk upon its implementation of a reorganization plan in its bankruptcy proceeding. On the other hand, the proceeding is closed for SCE. Furthermore, PG&E is currently operating under the protection of the bankruptcy laws, which acts somewhat to reduce its overall financial risk.

In summary, after considering the similarities and the differences between the two companies, and the specific factors relating to PG&E, as well as the environment of declining interest rates, the Decision's ROE determination for PG&E falls within the zone of reasonableness. There is no reduction in the ROE last set for PG&E in 2000 even though interest rates have declined and PG&E's corporate and financial structure are temporarily on hold pending conclusion of its bankruptcy proceeding. We believe that PGE's claims of legal error are therefore without merit.

B. SDG&E's Contentions

SDG&E also alleges that the Decision is arbitrary and capricious. It asserts that it fails to contain adequate findings and conclusions as required by P.U. Code Section 1705, as well as that it fails to satisfy Bluefield and Hope standards.

Section 1705 provides that Commission decisions contain findings of fact and conclusions of law on all issues material to the order or decision. Findings and conclusions are meant to assist the parties in preparing for rehearing or court review. This requirement, in turn, assists a reviewing court in determining whether the Commission acted arbitrarily or capriciously in making its decision. (See, e.g., Greyhound Lines, Inc. v. Public Utilities Comm., (1967) 65 Cal.2d 811, 813; Calif. Motor Transport Co. v. Public Utilities Comm., (1963) 59 Cal.2d 270, 274-275.) Findings and conclusions are adequate if they dispose of all issues necessary and relevant to our decision. (Goldin v. Public Utilities Comm., (1979) 23 Cal.3d 638, 670.)

We believe that the Decision contains sufficient findings of fact and conclusions of law. There are findings of fact on capital structure, long term debt and preferred stock costs, and on ROE, all of which are material issues in this case. For instance, Finding of Fact (FF) No. 2, which is applicable to all four applicants, including SDG&E, states that no party disagreed with any of the utilities' proposed capital structures. Thus, SDG&E's proposed structure was adopted and this finding applies to it. FF No. 11 adopts the long term debt and preferred stock costs proposed by the utilities. Again, this finding applies to SDG&E. The Decision also states that no party disputes these costs and that they are consistent with the September 2002 interest forecast of DRI. (Decision, mimeo, p. 15) Likewise, there are findings of fact related to financial models (See, e.g., FF Nos. 14-18). FF No. 18 sets out the ROE range based on these models for SDG&E as 8.97 percent to 14.85 percent. Finally, FF No. 25 expressly recognizes SDG&E's investment grade Single-A credit rating.

Next, the Decision sets forth conclusions of law (COL) adopting a test year ROE range of 10.5-11.5 for SDG&E and the ROE of 10.9 percent (COL Nos. 11 and 15). COL No. 11 expressly refers to financial model results, increased business and regulatory risks, no change in SDG&E's capital structure, the downward trend in interest rates, the fact that SDG&E's embedded debt cost is lower than the most recent forecast of the AA utility bond interest rate, and SDG&E's investment grade credit rating as set out in FF No. 25. Both the adopted ROE range of 10.5-11.5 percent and the ROE of 10.9 percent fall within the range derived from the parties' models as stated in FF No. 18. Significantly, SDG&E's analysis on rehearing fails to recognize that its ROE of 10.9 percent constitutes an increase from the 10.6 percent ROE approved in its prior ROE application, despite the downward trend in interest rates. In our opinion, these findings and conclusions adequately cover the material issues.

SDG&E also asserts that the Decision contains legal error because the 10.9 ROE falls within the lower end of the adopted range of 10.5-11.5, whereas we concluded that the ROE should be in the mid to upper sector of this range. This assertion is only correct on a strict mathematical basis in that 10.9 falls one tenth below the midpoint of 11.0. Moreover, SDG&E overlooks the fact that COL No. 5 states that the ROEs should be "at approximately the mid to upward end" of the adopted ROE range. If this small shortfall from the midpoint of the range constitutes error, in our opinion it is at the most an allowable infirmity in the ROE determination process.

SDG&E complains it is penalized with a lower ROE than SCE and PG&E because it has achieved a higher credit rating by lowering its interest costs. This contention also lacks merit. It ignores the increase in its ROE from 10.6 to 10.9 noted above. The Decision explains that each utility's ROE is based on the evidence relating to that particular company. The facts and circumstances relating to SCE and PG&E are not determinative of the reasonable ROE for SDG&E.

Finally, SDG&E contends there is legal error because we failed to identify the flaws in its proposed ROE range of 11.40-14.85 percent. This contention lacks merit. The Decision explains that the financial models are used only to create a range to which the parties applied their individual judgment to arrive at a proposed fair ROE. (Decision mimeo, p. 18) SDG&E does not cite any legal authority that requires the flaws in each party's financial models be included in the findings and conclusions. Under the Bluefield and Hope cases, the Commission only needs to consider the facts and circumstances surrounding each utility and then exercise its informed judgment to establish a fair ROE. We did this. The quantitative financial models were considered in determining the reasonable ROE range. (Decision, mimeo, p. 26) That is sufficient to comply with Bluefield and Hope.

In conclusion, we have reviewed the allegations in PG&E's and SDG&E's applications for rehearing, and do not find any legal error. Accordingly, we deny rehearing.

Therefore, **IT IS ORDERED** that:

1. Rehearing of Decision No. D.02-11-027 is denied.

2. This proceeding shall remain open as provided for in the Decision.

This order is effective today.

Dated May 8, 2003 at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners