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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE

STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company (U 902-M) for Authority, Among Other Things, to Increase Rates And Charges for Electric And Gas Service Effective on January 1, 2012.	)))))	Application 10-12-005 (Filed December 15, 2010)
Application of Southern California Gas Company (U 904 G) for authority to update its gas revenue requirement and base rates effective on January 1, 2012.	))))	Application 10-12-006 (Filed December 15, 2010)

<u>OPENING BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E)</u>

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OPENING BRIEF OF SOUTHERN CALIFORNIA EDISON (U 338-E)

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<u>OPENING BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E)</u>

Pursuant to Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission (Commission) and Administrative Law Judge John Wong's amended ruling of March 13, 2012, Southern California Edison Company (SCE) submits its opening brief in the 2012 General Rate Case (GRC) of San Diego Gas & Electric Company (SDG&E) and Southern California Gas Company (SCG).[1] This brief follows the common briefing outline circulated by the Sempra Utilities on January 31, 2012.

17.2 <u>The Commission Should Fully Fund Incentive Compensation as One Element of a Reasonable Compensation System</u>

The Commission has long recognized that "incentive compensation should be analyzed as 'part and parcel of the overall compensation scheme,' and that 'the allocation of total cash

[1] SDG&E and SCG are referred to collectively as the Sempra Utilities.

compensation between salaries and incentives should be left to each utility's discretion.'"[2] This conclusion followed a workshop report recommending that the Commission "not attempt to micromanage utility incentive compensation programs."[3] The Division of Ratepayer Advocates (DRA) actively participated in the workshop, and "consensus was reached swiftly by parties that rarely agreed."[4] Subsequent decisions have affirmed that "as long as [a utility's] total compensation levels are appropriate we will not dictate how [the utility] distributes compensation among various types of employment benefits."[5]

Several decisions have strayed from this approach and only partially funded incentive compensation programs. In each of those decisions, certain facts may have troubled the Commission and caused the discrepancy. Those facts included a failure to pay previously authorized incentives,[6] unreliable compensation study data,[7] a lack of specificity about an incentive program's design and compensation calculations,[8] and the historic economic collapse of late 2008.[9] In the last case, although the Commission denied full funding, it premised its cuts on the assumption that reductions would not impact the utility's ability to recruit and retain employees.[10]

In SCE's 2003 GRC, the Commission acknowledged the confusion regarding incentive compensation.[11] The Commission comprehensively reviewed its past decisions and concluded that properly-structured incentive compensation programs should be fully funded as long as total

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2 *Re Southern California Gas Co.*, Decision (D.) 93-12-043, 52 CPUC 2d 471, 496 (quoting *Re Pacific Gas & Electric Co.*, D.92-12-057, 47 CPUC 2d 143, 201).

3 *Re Pacific Gas & Electric Co.*, 47 CPUC 2d at 201.

4 *Id.*

5 *Re Time Schedules for the Rate Case Plan & Fuel Offset Proceedings*, D.97-07-054, 73 CPUC 2d 469, 518; *see also Re Southern California Edison Co.*, D.04-07-022, pp. 206-08.

6 *Re Pacific Gas & Electric Co.*, D.95-12-055, 63 CPUC 2d 570, 591-92; *Re Pacific Gas & Electric Co.*, D.00-02-046, 4 CPUC 3d 315, 436.

7 *Re Southern California Edison Co.*, D.96-01-011, 64 CPUC 2d 241, 363-65.

8 *Re Southern California Edison Co.*, D.06-05-016, p.143.

9 *Re Southern California Edison Co.*, D.09-03-025, p.135.

10 *Id.* at pp. 135-36.

11 *Re Southern California Edison Co.*, D.04-07-022, p.206.

compensation is at market levels.[12] If utilities provided all compensation in the form of cash, "there presumably would be no issue of ratepayer cost responsibility."[13] Market-level compensation is a legitimate cost of service.[14] The Commission considers compensation to be at market and reasonable if it is within five percent of the mean.[15] When total compensation is reasonable, utilities retain the discretion "to adjust the appropriate mix of base salary and incentives."[16]

The Commission's interest is in ensuring that ratepayers do not fund compensation that exceeds the market. The total compensation studies provide that assurance. Towers Watson found that SCG's overall compensation is within 3.2 percent of the market average;[17] SDG&E's is within 3.4 percent.[18] Because both are within five percent, the utilities' compensation is at market and should be found reasonable. The Commission should not micromanage the various components of a market-level compensation system. Provided overall compensation is at market, it would be no more appropriate for the Commission to disallow incentives than it would be to remove prescription drug coverage from employee benefits.

None of the facts from the decisions that have denied funding are present here. The incentive compensation programs at issue are properly structured to deliver benefits to ratepayers. The programs reward a variety of financial and operating goals, including safety and customer satisfaction.[19] Improved safety and customer satisfaction directly benefit ratepayers. Financial performance also benefits ratepayers, as financially strong companies can obtain more favorable financing terms and lower the cost of ratepayer-funded projects.[20] In addition, DRA

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[12] *Id.* at pp. 206-08.
[13] *Id.* at p.208.
[14] *Id.*; *see also* Ex. 589, pp. 2-4 (explaining that cost-of-service ratemaking requires ratepayers to cover all reasonable costs of providing service).
[15] *Re Pacific Gas & Electric Co.*, 63 CPUC 2d at 591.
[16] *Re Southern California Edison Co.*, D.04-07-022, p.208.
[17] Ex. 375, pp. 3-4.
[18] Ex. 372, pp. 3-4.
[19] Ex. 375, p.6; Ex. 372, p.6.
[20] Ex. 374, p.6; Ex. 377, pp. 6-7.

participated in the compensation study,[21] and there is no allegation that the underlying data was unreliable. The Sempra Utilities have not failed to pay previously authorized incentives.[22] Finally, ratepayers benefit from a stable workforce, and the incentive compensation programs are critical to attracting, motivating, and retaining employees.[23] Because the incentive compensation programs are properly structured and the Sempra Utilities' overall compensation is at market levels, the Commission should not micromanage the components of that compensation.

18.4 A Diminished Rate of Return on Legacy Electromechanical Meters Would Punish Innovation and Deter Equity Investment in Utilities

In a comprehensive rulemaking proceeding initiated in 2002, the Commission ordered the investor-owned electric utilities to propose Advanced Meter Infrastructure (AMI) plans.[24] SDG&E supported the effort, developed a plan, and successfully deployed AMI meters.[25] DRA and The Utility Reform Network (TURN) propose stripping SDG&E of any return on its legacy electromechanical meters.[26] DRA, perhaps recognizing that this argument is overzealous, offers an alternative of a return approximately equal to the cost of debt.[27]

The Commission recently ruled that utilities should receive a return on equity for legacy meters. In Pacific Gas & Electric's (PG&E's) 2011 GRC, DRA and TURN similarly argued that utilities should not earn any return on retired meters.[28] The Commission disagreed, declaring that "[w]e do not wish to discourage utilities from replacing their existing assets with new technologies under these circumstances, especially when we have found the replacement to be

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21 Ex. 372, app. 1, p.2; Ex. 375, app. 1, p.2.
22 *See* Ex. 372, app. 1., p.4 (showing actual total cash compensation exceeding target total cash compensation); Ex. 375, app. 1, p.4 (same).
23 Ex. 374, p.2; Ex. 377, p.2.
24 Ex. 346, pp. 7-8 & n.9.
25 Ex. 346, pp. 8-11.
26 Ex. 506, pp. 9-10; Ex. 554, p.4.
27 Ex. 506, p.13.
28 *Re Pacific Gas & Electric Co.*, D.11-05-018, pp. 35-36.

cost-effective for customers."[29] The Commission considered evidence that a "reduced return would send the wrong signal to investors who may wish to consider future technological replacements that could better serve customers."[30] Nonetheless, the Commission adopted a reduced rate of return in D.11-05-018.

The Commission should not repeat the flawed result it adopted in D.11-05-018. A reduced rate of return would send a clear signal to company management and investors that investing in technological change places the return on existing assets at risk, whereas investing in old, existing technology does not.[31] At a broader level, withholding a return would increase the overall risk of investing in a utility, thereby threatening the ability of investor-owned utilities to attract capital.[32] DRA and TURN's proposals would punish investors twice: first, they would confiscate the investors' return on their equity investments; second, investors would lose additional funds because SDG&E remains contractually obligated to pay bondholders and preferred equity holders.[33] Neither DRA nor TURN explain why SDG&E should be punished for pursuing the Commission's policy initiative. Principled ratemaking would fully inform companies about the terms of an initiative before directing companies to act. Reducing the return after-the-fact is not right.

DRA's alternative proposal of a rate of return roughly equal to the cost of debt suffers from the same infirmities. As with its primary plan, the alternative would reduce investors' return and leave them with diminished funds from which to pay bond and preferred equity holders.[34] The PG&E 2011 GRC decision establishes that investors should be rewarded for their risk and receive a return exceeding the rate of return for debt.[35] Only SDG&E's proposal would

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[29] *Id.* at p.62.
[30] *Id.*
[31] Ex. 589, pp. 25-26.
[32] *See id.* at p.25.
[33] *Id.* at pp. 25-26.
[34] *Id*. at p.26.
[35] *See* D.11-05-018, pp. 62-63.

grant investors a return beyond the cost of debt. The Commission should acknowledge that SDG&E invested in technological innovation in furtherance of Commission policy and grant it the full rate of return on its legacy meters.

19.1.1 <u>The Sempra Utilities Properly Account for Contributions in Aid of Construction</u>

Utilities collect payments from third parties in exchange for performing construction activities.[36] These construction activities occur in three separate contexts: (1) the construction and installation of a new asset; (2) the retirement of an existing asset; and (3) replacement, which includes both construction and installation of a new asset and retirement of an existing asset.[37]

Payments submitted by third parties for the construction and installation of new assets are referred to as Contributions in Aid of Construction (CIAC). The Federal Energy Regulatory Commission's (FERC's) Uniform System of Accounts (USOA) requires that "[c]ontributions in the form of money or its equivalent toward the construction of electric plant shall be credited to accounts charged with the cost of such construction."[38] The same rule applies to CIAC for gas plant.[39] In accordance with this requirement, SDG&E and SCG record CIAC in the accounts charged with the construction costs.[40] DRA's witness, Marek Kanter, confirmed that SDG&E and SCG properly account for CIAC received for new construction.[41]

The USOA treats asset retirement differently than asset construction. For retirement, the accumulated depreciation account "shall be charged with the book cost of the property retired and the cost of removal and shall be credited with the salvage value and any other amounts recovered, such as insurance."[42] SDG&E records salvage and other retirement-related credits in

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[36] Ex. 589, p.14.
[37] *Id.* at p.15.
[38] 18 C.F.R. § 101, Electric Plant Instructions 2(D).
[39] 18 C.F.R. § 201, Gas Plant Instructions 2(D).
[40] Ex. 361, pp. 2-3.
[41] Tr. 4278:14 – 4279:5; Tr. 4280:26 – 4282:6 (Kanter, DRA).
[42] 18 C.F.R. § 101, Balance Sheet Account 108, Rule B; 18 C.F.R. § 201, Balance Sheet Account 108, Rule B.

the depreciation account.[43] SCG's treatment is different from SDG&E's but still consistent with the USOA.[44]

Replacement activities do not constitute a unique category but rather combine aspects of construction, installation, and retirement. The USOA mandates "that all items relating to the retirements shall be kept separate from those relating to construction."[45] Accordingly, when SDG&E replaces assets, it properly records construction and installation reimbursements (such as CIAC) as offsets to plant-in-service, and it records retirement reimbursements (such as insurance proceeds) as offsets to accumulated depreciation.[46]

Contrary to the USOA requirements, DRA proposes to record all reimbursements as gross salvage.[47] This contradicts the testimony of DRA's own witness, who admitted that CIAC should be credited to the account charged with the cost of construction.[48] DRA's proposal fails to distinguish between CIAC, which applies to construction and installation activities, and insurance and salvage, which apply to retirement activities. Instead, DRA conflates these different payments into one category: third-party reimbursements (TPRs).[49] DRA's proposal fails to recognize that construction and retirement are separate activities with separate types of payment and separate treatment under the USOA.

DRA attempts to justify its position by mischaracterizing SCE's testimony from its 2012 GRC. DRA argues that SCE's testimony on depreciation "impl[ies] that TPRs less expenses should be treated as gross salvage."[50] As explained in this section, SCE does not agree that all TPRs should be treated as gross salvage. Like SDG&E, SCE follows an approach consistent

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43 Ex. 361, p.7.
44 *Id.*
45 18 C.F.R. § 101, Electric Plant Instructions 11(A); 18 C.F.R. § 201, Gas Plant Instructions 11(A).
46 Ex. 361 at pp. 6-7; *see also* Ex. 589, p.15.
47 Ex. 471, p.12.
48 *See* Tr. 4278:14 – 4279:5; Tr. 4280:26 – 4282:6 (Kanter, DRA).
49 *Id.*
50 *Id.* at p.17.

with the USOA and distinguishes between credits for retirement activities and credits for construction and installation activities.[51]

DRA has shifted its position in the mere months between SCE's GRC and the instant proceeding, thereby revealing its misunderstanding of TPR accounting. In SCE's GRC, DRA argued that the gross amount of TPRs should be applied to gross salvage.[52] Now, DRA proposes that TPRs should be applied to gross salvage only as they exceed expenses.[53] DRA's testimony fails to explain the inconsistent positions taken in these nearly simultaneous GRCs. The only consistent and proper approach is that followed by the utilities.

20.1 <u>Accumulated Deferred Income Tax Balances Should Not Be Reflected in Rate Base Until They Actually Reduce Tax Liability</u>

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allows taxpayers to claim bonus depreciation on certain assets.[54] Due to bonus depreciation, SDG&E will be in a tax net operating loss (NOL) position in 2011, and SCG will be in a tax NOL position in 2010, 2011, and 2012.[55] The Sempra Utilities propose carrying back the NOLs to the previous two years, then carrying forward the remaining NOLs.[56] DRA argues that the carry-forwards are unnecessary, are harmful to ratepayers, and conflict with Commission precedent.[57] As explained below, the Sempra Utilities' proposal reflects the required tax treatment pursuant to the Internal Revenue Code, which is also in accord with economic reality and Commission policy; DRA's protest is divorced from economic reality and is inconsistent with tax normalization rules.

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[51] Ex. 589, pp. 16-17.
[52] *Id.* at p.17.
[53] Ex. 471, p.12.
[54] *See* Ex. 590, pp. 7-8.
[55] Ex. 302, p.4.
[56] *Id.*
[57] Ex. 480, p.13.

Accelerated tax depreciation can be thought of as a loan from the federal government. (Bonus depreciation is a type of accelerated depreciation.) This occurs when the accelerated depreciation reduces a taxpayer's current tax liability and, in subsequent years, the asset upon which the depreciation was based produces revenue and increases the taxpayer's tax liability. The time between these two events is the effective period of the loan.[58] The amount of the loan (i.e., the tax benefit) is recorded as accumulated deferred federal income tax (ADFIT). The ADFIT balance generally reduces rate base because it represents zero-interest loans.[59]

When deductions exceed taxable income, the taxpayer is in an NOL situation. The NOL can be carried back to offset the prior two years' taxable income, then the remaining NOL can be carried forward up to 20 years.[60] The NOL carry-forward does not produce a cash tax benefit until it offsets taxable income or reduces tax liability in a future year.[61] Returning to the loan analogy, the loan from the carry-forward does not exist until the taxpayer reduces a tax liability. For example, if a taxpayer's current NOL is $200 and it has $50 of taxable income from the prior two years, it can carry back $50 to reduce past liability and carry forward $150 to future years. The $150 carry-forward has no present economic value because it has not reduced any tax liability. DRA's proposal to ignore carry-forwards, however, would presume that the taxpayer received a present benefit (or loan) from that $150. Delaying recognition of the tax benefit would not prejudice ratepayers because the utility has not yet recognized a tax benefit. However, DRA's proposal to immediately recognize the carry-forward amount would punish shareholders because they would be forced to cover the rate base deduction without receiving a concomitant tax benefit.

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58 Ex. 590, p.7.
59 *Id.* at p.8.
60 *Id.* at p.9.
61 *Id.* at p.10.

Various regulatory agencies recognize that NOL carry-forwards do not reduce rate base until the taxpayer obtains actual tax benefits.[62] In *Kern River Gas Transmission Company*, the utility used bonus depreciation that resulted in a net NOL position that could only be carried forward.[63] FERC determined that "the NOL is carried forward as a regulatory asset in future years and is reduced as the tax savings actually accrue to [the utility]."[64]

The economic reality of carry-forwards is reflected in the IRS's normalization rules. Normalization rules impose a delay between when a utility obtains accelerated depreciation and when the tax benefits are passed on to ratepayers; otherwise, if tax benefits flowed immediately to ratepayers, the utilities would not benefit from the "loan" (i.e., the favorable tax treatment).[65] More specifically, the amount of a utility's ADFIT reserve that can be applied to reduce rate base may not exceed the amount used to compute a utility's cost of service. The carry-forward amounts do not defer any tax and cannot be included in the cost-of-service calculation as a tax expense.[66] Thus, DRA's proposal to reduce rate base by the portion of ADFIT associated with the NOL for which the Sempra Utilities did not receive a concomitant tax benefit is inconsistent with the tax normalization requirements and could cause a normalization violation. The penalty for violating normalization rules is a prohibition on claiming accelerated depreciation. This penalty would harm both ratepayers and shareholders.[67]

The Sempra Utilities' proposal to exclude the tax NOL carry-forward from the calculation of cost-of-service income tax expense in future years is consistent with the Commission's past statements regarding NOL carry-forwards. In its 1984 tax decision referred

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62 *See Kern River Gas Transmission Co.*, 117 FERC ¶ 61,007, 2006 WL 3337394, at *61 (Oct. 19, 2006); *Re Yankee Gas Services Co.*, 2011 Conn. PUC LEXIS 189, at *4-8 (Sept. 28, 2011); *In Re Public Service Co. of New Mexico*, 2011 N.M. PUC LEXIS 35, at *250-59 (July 28, 2011). *But see In Re Las Quintas Serenas Water Co.*, 2011 Ariz. PUC LEXIS 225, at *12 (July 25, 2011) (note that utility failed to provide authority in support of argument).

63 *Kern River Gas Transmission Co.*, 2006 WL 3337394, at *61.

64 *Id.*

65 Ex. 590, p.15.

66 *Id.* at p.19.

67 *Id.* at p.21.

to as OII 24, the Commission discussed the effect of NOL carry-backs and carry-forwards on tax expense.[68] The Commission concluded that carry-backs and carry-forwards should be excluded from calculating the test-year income tax expense.[69] An NOL carry-forward has no effect on calculating the test-year income tax expense.[70] The Sempra Utilities correctly propose to have the tax NOL carry-forwards affect only the ADFIT reserve, which is a component of rate base; OII 24 only addresses income tax expense, which is the cost-of-service component of the revenue requirement.[71] Accordingly, the Sempra Utilities' treatment of NOL carry-forwards complies with OII 24.

24.1 Collective Bargaining Agreements Are More Accurate Sources of Future Labor Costs Than Estimated Escalation Factors

DRA has historically agreed that escalation rates for union labor should be based on collective bargaining agreements.[72] Spurning a long-established methodology, DRA now proposes using wage escalation forecasts from Global Insight Power Planner.[73]

The purpose of labor escalation is to most accurately estimate labor costs. When labor costs are known, whether in the past or in the future, they are the most accurate depiction of the company's labor costs. The Commission has found that "[i]t is hardly arguable that specific data based upon actual circumstances provide a basis for estimating future test years that is more accurate and therefore better than can be achieved from merely escalating [a prior year's] recorded payroll expense by a general labor escalation factor."[74] Recognizing the superiority of actual data, the Commission's Rate Case Plan requires utilities to submit "[k]nown changes in

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[68] *See Re Income Tax Expense for Ratemaking Purposes*, D.84-05-036, 15 CPUC 2d 42, 55-56.
[69] *Id.* at 56.
[70] Ex. 590, p.24.
[71] Ex. 302, p.11.
[72] Ex. 493, p.1.
[73] *Id.*
[74] *Re Park Water Co.*, D.91-05-024, 40 CPUC 2d 73, 93.

cost of labor based on contract negotiations" in their update exhibits.[75] This strongly suggests that bargained rates are the proper source for labor escalation and it is not necessary to hazard a guess.

The Sempra Utilities have current, valid, and enforceable collective bargaining agreements for union employees with wage increases of 3.5% for each of the years 2010 and 2011.[76] DRA argues that labor escalation should be based on Global Insight's index for utility service workers, which projects wage increases of 1.9% in 2010 and 1.8% in 2011.[77] DRA's argument appears to rest on the fact that the index's projections are lower than the actual increases,[78] not that they accurately estimate labor costs. If future collective bargaining agreements secure increases at a lower rate than predicted by Global Insight, DRA would be expected to change its methodology again.

It would be unreasonable to not use the actual labor cost data to derive authorized labor cost escalation. The existence of a collective bargaining agreement, which accurately represents the cost increases that the company actually incurred, renders the use of projections unnecessary. The Commission should affirm past practice and the Rate Case Plan and base labor escalation on the actual wage increases.

24.1.2 <u>The Consumer Price Index Is an Inappropriate Measure of Utility Cost Escalation</u>

DRA and the Federal Executive Agencies (FEA) contend that post-test-year escalation should be based on the Consumer Price Index (CPI).[79] The Commission has opposed using the CPI as an escalation factor.[80] In SCE's 2003 GRC, a consumer advocacy group argued in favor of using the CPI. Its argument was based on the fact that the CPI is simple to apply and would

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[75] *Re Time Schedules for the Rate Case Plan & Fuel Offset Proceedings*, D.89-01-040, 30 CPUC 2d 576, 609.
[76] Ex. 256, p.5.
[77] Ex. 493, p.7.
[78] *Id.* at pp. 1, 7-8.
[79] Ex. 529, p.6; Ex. 577, p.22. FEA, but not DRA, also proposes escalating 2009 costs to test-year levels based on the CPI. *See* Ex. 577, p.11. This section should be construed as applying equally to that argument.
[80] *Re Southern California Edison Co.*, D.04-07-022, p.278.

yield a lower revenue requirement than SCE's escalation methodology. The Commission rejected the argument, finding that "[t]he CPI may be a simple, accessible measure of general inflation faced by urban U.S. consumers, but that alone does not make it appropriate as a measure of price changes faced by an electric utility. It does not specifically cover the prices of the typical goods SCE purchases."[81]

DRA and FEA base their proposals on the already-rejected grounds of simplicity and lower rates. DRA notes that "[t]he CPI indexing method is simple in that it eliminates the use of multiple indices that the Utilities' proposal entails."[82] It also urges that the CPI would "give the Utilities' [sic] an incentive to effectively manage their labor costs."[83] These are the same arguments that the Commission found unpersuasive in SCE's 2003 GRC. In addition, they fail to address the purpose of escalation. Escalation is intended to cover cost changes that are beyond the utilities' control.[84] By describing CPI escalation as an incentive, DRA admits that it will fail to cover costs.

CPI — or more specifically, CPI-U — is designed to reflect the annual price increases that an urban household will incur. The major components of CPI-U include food, housing, apparel, education, and recreation costs. CPI-U may be appropriate to estimate a cost-of-living adjustment, but its components are not representative of the costs that a utility incurs. No party has suggested that a price index for gasoline, a price index for housing, or a price index for food would be an accurate index to predict utility cost escalation. It is difficult to understand why a combined price index for gasoline, housing, and food — as the CPI-U represents — would ever be considered as an appropriate inflation index for utility costs. The Commission has agreed,

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81 *Id.*
82 Ex. 529, pp. 6-7.
83 *Id.* at p.8.
84 Ex. 256, p.2.

characterizing the CPI as a tool addressing consumer goods and services.[85] The CPI is simple, but simplicity is no substitute for accuracy.

The goal in selecting a post-test-year ratemaking mechanism is to accurately predict the utility's future costs. All investor-owned utilities and the DRA use Global Insight's Power Planner for regulatory proceedings. This publication contains detailed utility cost indexes by utility function (e.g., transmission, distribution, nuclear generation, customer accounts, etc.) that are directly applicable to utility cost escalation. Copper wire, cable, transformers, poles, meters, concrete, office supplies, business software, and other utility-related costs are accurately represented by Global Insight Power Planner variables and are the types of commodities and services that a utility business will purchase. Unlike CPI-U, the Global Insight Power Planner indexes analyze the actual commodities and services purchased by utilities.

DRA and FEA fail to identify any authority to support their argument. Settlements adopted by the Commission are not precedential unless expressly provided otherwise.[86] Every decision referred to by DRA and FEA was a settlement expressly providing that it did not constitute binding precedent.[87] In addition, settlements are the product of complex negotiations over various provisions and do not reflect actual agreement over any particular topic.[88] The Commission should affirm its precedent and reject the CPI as a basis for utility cost escalation.

25.1 The Formula for Computing the Allowance for Funds Used During Construction Does Not Require Utilities to Finance Construction with Short-term Debt

FERC USOA regulations set two formulas regarding the Allowance for Funds Used During Construction (AFUDC): one formula defines the gross allowance for borrowed funds, and the second formula defines the allowance for non-borrowed funds.[89] The allowance for non-

[85] *See* D.04-07-022, p.278. *See also* Ex. 589, p.19; Ex. 256, p.3.
[86] Commission Rule of Practice and Procedure 12.5.
[87] Ex. 589, pp. 22-23.
[88] *Id.* at pp. 23-24; Ex. 402, pp. 6-7.
[89] 18 C.F.R. § 101, Electric Plant Instructions 3(A)(17)(a); 18 C.F.R. § 201, Gas Plant Instructions 3(A)(17)(a).

borrowed funds decreases as the amount of short-term debt increases.[90] In practical terms, these formulas make actual short-term debt the primary factor in calculating AFUDC. DRA argues that because short-term debt controls the AFUDC calculation, utilities should exhaust their short-term debt authorization before using other funds for construction work in progress (CWIP).[91] The regulations, however, do not require utilities to use short-term debt to finance CWIP. The FERC orders that established the AFUDC formulas and the USOA regulations explain that the purpose of the formulas is to allow recovery of short-term debt, not to mandate the incursion or use of short-term debt.

In the rulemaking that resulted in the AFUDC formulas, various utilities "argued that short-term debt is not necessarily the first source of construction funds, as would be indicated by" the formulas.[92] The Federal Power Commission (FPC, the FERC's predecessor) agreed that "[i]t is generally impossible to specifically trace the source of funds used for various corporate purposes and it was not the purpose of our proposed rule to do so."[93] Rather, the FPC found that short-term debt was not ordinarily included in rate proceedings, yet it was a reasonable cost of service that should be recovered.[94] The FPC used the AFUDC formula to permit the recovery of the cost of short-term debt through rates.[95] There was no intention to mandate the use of short-term debt for construction purposes.[96] DRA witness Grant Novack admitted that the formula does not mandate the use of short-term debt, stating that utilities are "not required to finance CWIP. [The formula] doesn't require that you actually finance CWIP with short-term debt or long-term debt or common stock or preferred stock."[97]

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[90] *Id.*

[91] Ex. 489, pp. 16-17.

[92] Order No. 561, 57 F.P.C. 608, 608 (1977), *aff'd in relevant part by* Order No. 561-A, 59 F.P.C. 1340 (1977).

[93] Order No. 561, 57 F.P.C. at 608-09.

[94] *Id.* at 609.

[95] *Id.*

[96] *See id.* at 608-09.

[97] Tr. 4387:4-19 (Novack, DRA). *See also* Tr. 4389:21-26 (affirming that AFUDC formula does not require financing CWIP with short-term debt); Tr. 4390:25 – 4391:1 (same); Tr. 4393:15-23 (same).

The AFUDC formulas contain two components relevant to short-term debt: average short-term debt and short-term debt interest rate.[98] These refer to actual debt and the actual interest rate; neither of them measure potential or authorized debt. The USOA regulations emphasize that these components are to be based on actual data.[99] To the extent estimates are used, utilities must recalculate their AFUDC as actual data becomes available.[100] The AFUDC formulas do not require any amount of indebtedness.[101] If a utility decides to incur short-term debt, the AFUDC calculation will reflect that decision. However, as affirmed by Mr. Novack, utilities retain the discretion to decide whether and how to use short-term debt.[102] The AFUDC formulas are silent on this aspect of financial management.

Prudent financial management funds long-lived assets with long-lived securities.[103] DRA argues that the Sempra Utilities should finance all of their CWIP with short-term debt.[104] This mismatches assets and liabilities because the Sempra Utilities would be forced to finance long-lived assets with short-lived liabilities.[105] Under this risky approach, the Sempra Utilities would have to continually renegotiate or refinance their debt.[106] The Sempra Utilities would be in a weak bargaining position because they would have an immediate need for cash.[107] Lenders may impose conditions that would misalign financing and cash flow needs, such as requiring all short-term debt to be retired once per year.[108] They may also deny financing or require prohibitive interest rates because the supported asset (CWIP) would not produce cash from

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98 18 C.F.R. § 101, Electric Plant Instructions 3(A)(17)(a); 18 C.F.R. § 201, Gas Plant Instructions 3(A)(17)(a).
99 *See* 18 C.F.R. § 101, Electric Plant Instructions 3(A)(17)(a); 18 C.F.R. § 201, Gas Plant Instructions 3(A)(17)(a).
100 18 C.F.R. § 101, Electric Plant Instructions 3(A)(17)(a); 18 C.F.R. § 201, Gas Plant Instructions 3(A)(17)(a).
101 *See* Tr. 4387:4-19 (Novack, DRA).
102 *See id.*
103 Ex. 350, p.8; Ex. 589, p.26.
104 Ex. 489, pp. 16-17
105 Ex. 350, p.8.
106 *Id.*
107 *See id.*
108 *Id.*

which to repay the loan.[109] The Sempra Utilities' inability to obtain reasonable interest rates or access to short-term debt could lead to illiquidity and bankruptcy.[110] The Commission should protect the Sempra Utilities' viability and managerial discretion and reject DRA's proposed imposition of short-term debt.

30 Conclusion

For the factual, legal, and policy reasons discussed herein, SCE respectfully requests that the Commission issue an order:

1. Finding reasonable the Sempra Utilities' compensation systems, including their incentive compensation programs;
2. Approving the full rate of return for SDG&E's legacy electromechanical meters;
3. Approving the Sempra Utilities' accounting for Contributions in Aid of Construction (CIAC);
4. Approving the Sempra Utilities' proposal to carry back net operating loss (NOL) for tax purposes to the prior two years, then carry forward the remaining NOL for up to 20 years;
5. Continuing to base labor escalation for union employees on the actual wage increases memorialized in collective bargaining agreements;
6. Approving the Sempra Utilities' formula for utility cost escalation; and
7. Rejecting any requirement that the Sempra Utilities finance construction work in progress (CWIP) with short-term debt.

[109] *Id.* at p.11.
[110] *Id.* at pp. 8-9; Ex. 589, pp. 26-27.

Respectfully submitted,

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