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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION **RESOLUTION E-4450**
December 15, 2011

R E S O L U T I O N

Resolution E-4450. San Diego Gas & Electric Company (SDG&E) requests to recover unanticipated increases in liability insurance costs over the amounts authorized in SDG&E's 2008 general rate case decision (D. 08-07-046), for the 2009-2010 and 2010-2011 policy periods pursuant to the Z-factor provisions of the decision.

PROPOSED OUTCOME: Approves SDG&E's request to recover an increase of $63.3 million above the revenue requirements authorized in SDG&E's 2008 General Rate Case.

ESTIMATED COST: An increase of approximately $63.3 million above the revenue requirements authorized in SDG&E's 2008 General Rate Case.

By Advice Letter 2251-E filed on April 29, 2011.

SUMMARY

SDG&E is authorized to recover $63.3 million in increased insurance costs above the levels authorized in SDG&E's 2008 General Rate Case (GRC) as requested in this advice letter. This includes $61.0 million for the cost of the traditional general liability and traditional wildfire liability insurance, and the cost of a reinsurance product procured by SDG&E for 2010-2011 as requested. It also includes updated insurance costs in the amount of $ 2.3 million for 2009-2010 as requested.

SDG&E's Advice Letter (AL) 2251-E is approved. SDG&E is authorized to increase electric revenue requirements by $63.3 million over the amount approved in its 2008 GRC to recover general liability and wildfire insurance costs, including the cost of a reinsurance product, for the 2010-2011 policy year, and to recover updated insurance costs for the 2009-2010 policy year.

BACKGROUND

SDG&E filed A.09-08-019 (Z-factor application) to request recovery of unforeseen increases in liability insurance premiums and deductible expenses as a Z-factor event.

In August 2009, SDG&E filed Application (A.)09-08-019 to request recovery of unforeseen increases in liability insurance premiums and deductible expenses as a Z-factor event.[1] Z-factor events are exogenous events that are unforeseen at the time the general rate case (GRC) revenue requirement is established and authorized by the Commission, largely uncontrollable by management, and have a material and disproportionate impact on SDG&E.[2] In SDG&E's 2008 General Rate Case (GRC) decision, D.08-07-046, the Commission authorized SDG&E to continue its previously approved Z-factor mechanism through 2011.

In the Z-factor application SDG&E requested to increase its electric and natural gas revenue requirement by $28.9 million to recover unexpected insurance premium increases for the 2009-2010 policy period as a Z-factor event.[3] SDG&E claimed that the high insurance premiums are Z-factor events that were exogenous and unforeseen at the time of the 2008 GRC. SDG&E experienced difficulty in procuring insurance for the 2009-2010 policy year at historic rates because of the contraction in the insurance market driven in large part by the injection of over a billion dollars of claims into the insurance market after wildfires blazed in SDG&E's service territory in 2007, and insurers were increasingly concerned over "inverse condemnation" for California utilities. In the 2008 GRC, SDG&E was authorized to recover $4.5 million for its 2008 annual liability insurance premium. In 2009, the liability insurance premium increased

[1] The term "Z-factor application" is used interchangeably with "A.09-08-019" in this resolution.

[2] SDG&E Tariffs, Preliminary Statement, IV Electric Distribution and Gas PBR Mechanism, Sheet 1.

[3] Sempra Energy's liability insurance program renews annually on June 26. Sempra's Insurance and Risk Advisory department procures liability insurance on behalf of itself and its affiliates, including SDG&E (see AL 2251-E, p. 3).

to $47 million, an approximate 1000% increase. Deductible expense also increased from $1 million in 2008 to $5 million in 2009.[4]

In order to recover costs under the Z-factor mechanism, SDG&E must prove that the unforeseen insurance cost increase satisfies eight criteria. The eight criteria are part of a framework established over several Commission decisions that determine whether an event qualifies for Z-factor treatment. Z-factor rate-making mechanism was first established in D.89-10-031 to allow rate adjustments for exogenous factors outside of inflationary changes.[5] The eight criteria are:

1. The event must be exogenous to the utility;
2. The event must occur after implementation of rates;
3. The costs are beyond the control of the utility management;
4. The costs are not a normal part of doing business;
5. The costs must have a disproportionate impact on the utility;
6. The costs must have a major impact on overall costs;
7. The cost impact must be measurable; and
8. The utility must incur the cost reasonably.

D.10-12-053 in A.09-08-019 granted SDG&E's request for Z-factor treatment for 2009-2010 liability insurance premium and deductible expense increases.

D.10-12-053 found that the unforeseen insurance premium increases satisfy the eight criteria. The decision authorized SDG&E to recover unforeseen liability insurance premium expenses as a one-time Z-factor for year 2009-2010. Subject to a single $5 million Z-factor deductible, D.10-12-053 allowed SDG&E to

[4] See D.10-12-053, mimeo, pp. 3, 12. "Inverse condemnation" is a legal doctrine under which liability is imposed without regard to fault.

[5] In D.99-05-030, the Commission established a Z-factor mechanism for SDG&E based on the nine criteria first identified in D.94-06-011. In D.05-03-023 the Commission continued the Z-factor mechanism established by D.99-05-030 but eliminated one of the original nine criteria.

increase its electric and natural gas revenue requirement by $28.9 million, amortizing it over a period of not less than 12 months beginning January 1, 2011.[6]

D.10-12-053 authorized SDG&E to file insurance cost increases in subsequent years prior to its next GRC for Z-factor treatment through a Tier 3 advice letter. SDG&E states that it has filed Advice Letter 2251-E pursuant to D. 10-12-053 to request recovery of increased liability insurance costs for 2010-11 and to recover updated 2009-10 insurance costs.

D.10-12-053 requires that SDG&E must demonstrate in the Tier 3 advice letters how the eight Z-factor criteria are met, and provide details of the insurance costs and efforts by SDG&E to seek competitive rates.

On April 29, 2011, SDG&E filed AL 2251-E to request an increase of $63.290 million in its electric revenue requirement, above the amount authorized in its 2008 GRC, to recover increased liability insurance amounts for the 2009-2010 and 2010-2011 policy periods under the Z-factor provisions. The $63.290 million revenue requirement increase consists of two parts: $61.038 million of the request would recover liability insurance expenses incurred for the policy year 2010-2011 that exceeds the $4.5 million authorized in SDG&E's 2008 GRC. The remaining $2.252 million of SDG&E's request would recover modifications to the amounts authorized in D.10-12-053 for liability insurance expenses SDG&E incurred during the 2009-2010 policy year.

As with the 2009-2010 liability insurance addressed by D. 10-12-053, SDG&E procured a two tower insurance product for 2010-2011: a tower for general liability and a tower for wildfire liability. For the general liability insurance tower, SDG&E was able to obtain essentially the same coverage at a slightly higher premium than the previous year (the 2009-2010 policy year). The general liability coverage, which applies to both SDG&E and Southern California Gas Company (SoCalGas), for the 2010-2011 policy year is the same as that for the 2009-2010 policy year, $800 million, but at a slightly higher premium of $15.4

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[6] Insurance premium costs are allocated mostly to SDG&E's electric department. Because the portion of the $5 million Z-factor deductible amount allocated to the gas department is greater than the gas portion of insurance costs authorized in the GRC, the $28.9 million increase authorized by D.10-12-053 is collected entirely in electric rates.

million ($7.6 million allocated to SDG&E, and $7.8 million allocated to SoCalGas), compared to $15.2 million for 2009-2010 ($7.1 million allocated to SDG&E, and $8.1 million allocated to SoCalGas). The deductible, however, decreased to $4 million, from $5 million per occurrence for 2009-2010.

The coverage obtained for SDG&E and SoCalGas for traditional wildfire insurance in 2010-2011, $400 million, is similar to the amount obtained in previous policy year, $399 million. Premiums are slightly higher for 2010-2011, $40.4 million ($40.2 million allocated to SDG&E, and $0.2 million allocated to SoCalGas), compared to $40.0 million for the previous year ($39.9 million allocated to SDG&E, and $0.1 million allocated to SoCalGas). SDG&E also procured a reinsurance product for the 2010-2011 policy year, in addition the traditional wildfire insurance it procured for the 2009-2010 policy year.

In addition to procuring the traditional wildfire insurance product that SDG&E had procured for 2009-10, SDG&E has also procured an additional reinsurance product. SDG&E seeks in AL 2251-E to recover costs for this reinsurance product.

The reinsurance product SDG&E has procured is a new product. This product is an alternative risk transfer (ART) mechanism that SDG&E obtained to supplement its traditional wildfire insurance.

Prior to the 2009-2010 policy year, before claims related to the 2007 wildfires were processed, SDG&E had liability insurance of $1.17 billion which included liability caused by wildfires. The traditional insurance market now only provides $400 million of wildfire coverage to SDG&E. SDG&E states that it has procured the reinsurance to obtain an additional $600 million of wildfire coverage through the reinsurance market to fill in the gap and attain wildfire liability coverage of $1 billion, similar to the amount of wildfire liability coverage SDG&E had prior to the 2009-2010 policy year.

In its Z-factor application, SDG&E described that it explored ART mechanisms for its 2009-2010 renewal process, given the reduction in the availability of traditional liability insurance, but decided against these options as too expensive and time-consuming to create.[7] In its advice letter, SDG&E explains that the ART options in the 2009-2010 renewal process could not provide desirable levels of coverage.

The reinsurance product that SDG&E procured is a new ART product that became available in 2010. SDG&E maintains that the reinsurance product is a viable, cost-effective option for extending liability coverage. The reinsurance product would provide $600 million in wildfire property damage reinsurance coverage. Coverage is more limited than the traditional wildfire insurance. The reinsurance will cover damage, destruction, or loss of use of property caused by wildfires. It does not provide coverage for claims that the traditional wildfire insurance provides, such as government fire suppression reimbursement claims, personal liability (bodily injury), medical payments, or business interruption. SDG&E believes that the reinsurance is a viable option because property damage claims make up the bulk of the claims from wildfires. The premium for the wildfire reinsurance is $32.2 million and is allocated entirely to SDG&E. According to SDG&E, the increase in SDG&E's annual revenue requirement that would result from reflecting recovery of the reinsurance premium in rates is approximately $28 million.

SDG&E also requests in AL 2251-E, recovery of costs for the 2009-2010 policy period that the Federal Energy Regulatory Commission did not allow to be allocated to the electric transmission department.

In addition to requesting a revenue requirement increase to recover insurance costs for 2010-2011 policy year, SDG&E also requests in AL 2251-E, to increase revenue requirement by $2.252 million to recover additional updated costs for the 2009-2010 policy year. These updated costs include a $2.852 million increase in wildfire liability insurance costs that SDG&E originally proposed to be allocated for recovery in electric transmission rates regulated by the FERC. In addition SDG&E has updated 2009-2010 costs to include a $0.502 million reduction in O&M and capital costs, a $0.008 million increase in interest on the Z-factor memorandum account, a $0.332 million reduction in the Gas Department deductible that is transferred to the Electric Department revenue, a $0.126 million

[7] See D.10-12-053, mimeo, p. 19.

increase for capital-related costs, and a $0.100 million increase for franchise fees and uncollectible expenses.

SDG&E's request to allocate the $2.852 million to electric transmission rates was denied by FERC after the record in A.09-08-019 was closed. Thus the $28.884 million increase that D.10-12-053 approved for SDG&E's 2009-2010 insurance costs was based on an assumption that FERC would grant SDG&E's allocation request. Since FERC rejected the proposed allocation, SDG&E seeks in AL 2251-E to recover the $2.852 million through electric distribution rates.

NOTICE

Notice of AL 2251-E was made by publication in the Commission's Daily Calendar. SDG&E states that a copy of AL 2251-E was served in accordance with Section 7.2 of General Order 96-B, and on the service list in A.09-08-019.

PROTESTS

On May 31, 2011, the Division of Ratepayer Advocates (DRA), and counsel for Protestor Ruth Henricks (Henricks), an individual ratepayer, timely filed protests on AL 2251-E. SDG&E replied to the protests on June 10, 2011.[8]

DRA contests recovery of the reinsurance product through AL 2251-E, and recommends that the Commission deny recovery of the $2.852 million that FERC did not allow to be allocated to transmission rates.

In its protest, DRA requests that SDG&E file an application and submit testimony which should be subject to hearings and depositions to address the facts and circumstances of SDG&E's procurement of the reinsurance product. DRA requests that the amount be removed from the revenue requirement requested in this advice letter. DRA believes that the reinsurance product with a $32 million premium is significantly and materially different from items

[8] By letter dated May 18, 2011, the Commission's Executive Director granted DRA's May 17, 2011 request for an extension of time to file protests until May 31, 2011. In the same letter the Executive Director also granted an extension until June 10, 2011 for SDG&E's replies to protests.

discussed in the Z-factor application and D.10-12-053. Because of these material differences, DRA asserts that the Energy Division or the Commission cannot rely on D.10-12-053 to assess the reasonableness of SDG&E's request in AL 2251-E. In particular, DRA questions whether SG&E procured the reinsurance product reasonably, which is necessary to satisfy the eighth criterion for the reinsurance product to qualify as a Z-factor.

DRA cites information attached to AL 2251-E showing that the $600 million reinsurance product offered by an affiliate of the company of Joseph Phillips, SDG&E's lead insurance broker, appears to have been discussed as early as December 2009. The same reinsurance product was procured by SDG&E eight months later. DRA states that no evidence is provided in the AL that other reinsurance products were in competition with that suggested by Mr. Phillips' affiliate. DRA believes more information is needed to assess the reasonableness of SDG&E's procurement of the reinsurance product, and that based on the information provided in AL 2251-E the reinsurance package has the appearance of self-dealing between affiliated insurance brokers.

DRA also recommends that the Commission deny the $2.852 million that FERC did not allow to be allocated to transmission rates. DRA argues that the Commission does not have the obligation to approve the costs, even though the costs were denied by FERC, and questions the validity of the costs given FERC's denial.

Henricks recommends that AL 2251-E be denied since SDG&E has not satisfied procedural and substantive requirements for Z-factor treatment for its increased liability insurance costs.

Henricks protested AL 2251-E, for the following reasons: 1) The record in A.09-08-019 has not demonstrated by a preponderance of evidence that SDG&E experienced a multi-year Z-factor event; 2) SDG&E has not met its burden in proving that all eight Z-factor criteria have been met, 3) the new insurance vehicles that SDG&E has proposed (i.e., the reinsurance product) should be reviewed for their effectiveness for ratepayers before being approved by the Commission, and 4) requests for rehearing of D.10-12-053 are pending before the Commission, rendering that decision not yet final. Henricks requests that Commission action on AL 2251-E be stayed until the pending procedural steps in A.09-08-019 are finalized, and that the issues raised by this advice letter be addressed in a formal proceeding before the Commission.

SDG&E recommends that the protests of DRA and Henricks be rejected.

In reply to DRA's protest, SDG&E maintains that the reinsurance product should be approved without the need for hearings. SDG&E asserts that DRA's request for testimony, depositions and hearings should be rejected as a collateral attack on D.10-12-053. SDG&E notes that D.10-12-053 declined to require SDG&E to file applications for Z-factor recovery in insurance policy years after 2009-2010 as suggested by DRA. SDG&E cites discussion in that decision which states we instead "direct SDG&E to file a Tier 3 Advice Letter for approval of subsequent Z-factor treatment and recovery"[9].

Furthermore, SDG&E disputes DRA's claim that the reinsurance product is materially different from the insurance products discussed in SDG&E's Z-factor application, noting that the reinsurance product is an ART product. ART products were introduced in the proceeding. SDG&E notes that the Commission expressly endorsed the consideration of ART products as a reasonable component of its insurance procurement strategy in D.10-12-053. SDG&E states that reinsurance is an ART product closest in type to traditional insurance, and procurement of the product allowed it to obtain adequate wildfire coverage. SDG&E maintains that the procurement of the reinsurance product was reasonable and consistent with the strategy approved by D.10-12-053, and thus satisfies the eighth Z-factor criterion.

SDG&E asserts that DRA's suggestion of an inconsistency in the timeline of procuring the reinsurance product is not relevant. SDG&E notes that while the concept of the reinsurance product was discussed in December 2009, it did not actually become available until 2010 after an extensive global marketing effort. SDG&E contends that there is no rational basis for the notion of self-dealing between Marsh (Phillips' company), and Guy Carpenter and Company (GCC, Marsh's affiliate). SDG&E states that there was no direct benefit to Marsh conferred by GCC's acting as the broker for the reinsurance product; that Phillips did not handle the reinsurance placement because he is not licensed as a reinsurance broker; and that GCC, a prominent and well-respected licensed broker, was a prudent choice to handle the reinsurance product.

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[9] D.10-12-053, mimeo, p. 38.

In addition, SDG&E counters DRA's recommendation to deny the $2.852 million that FERC did not allow to be allocated to transmission rates. SDG&E explains that FERC rejected the $2.852 million because it rejected SDG&E's proposed accounting treatment of wildfire insurance costs but not the reasonableness of the wildfire insurance costs. Because FERC denied the proposed accounting treatment of the wildfire costs, the $2.852 million that was to be recovered through FERC-jurisdictional transmission rates if the new methodology was approved should now be recovered through CPUC-jurisdictional distribution rates. SDG&E notes that DRA fails to establish that the $2.852 million is not CPUC-jurisdictional or that it is not a valid 2009-2010 liability insurance Z-factor expense.

In its reply to Henrick's protest, SDG&E states that Henrick's claim that AL 2251-E must be deferred pending resolution of the applications for rehearing (AFR) is incorrect, according to Rule 16.1 of the Commission's Rules of Practice and Procedure. SDG&E notes that an application for rehearing (AFR) does not operate to stay a Commission decision, except under very narrow circumstances that do not apply here. Also, SDG&E states that Henrick's arguments regarding each of the eight Z-factor criteria were thoroughly addressed and rebutted by SDG&E in A.09-08-019. The Commission rejected these arguments in D.10-12-053.

DISCUSSION

SDG&E's entire package of general liability and wildfire insurance costs, including the cost of the reinsurance product, for policy year 2010-2011 are approved for Z-factor ratemaking treatment.

As described above, costs for general liability and traditional wildfire insurance coverage incurred by SDG&E for the 2010-2011 policy year are very much the same as those procured for the previous year.[10] D.10-12-053 determined that these insurance costs for policy year 2009-2010 met the eight Z-factor criteria and qualified for Z-factor ratemaking treatment. The costs of SDG&E's entire

[10] The term "traditional wildfire insurance" as used in this resolution refers to the $400 million in wildfire coverage that SDG&E procured for the 2010-2011 policy year and excludes the additional insurance covered by the reinsurance product.

package of general liability and wildfire insurance, including the costs for the reinsurance product for policy year 2010-2011 also meet the Z-factor criteria as discussed below.

1. SDG&E's general liability and wildfire insurance costs for policy year 2010-2011 are exogenous to SDG&E.

D.10-12-053 states that the significant increase in insurance premium costs in 2009 compared to historic rates approved in the 2008 GRC proceeding are exogenous to SG&E. It states, "The Commission agrees with SDG&E's claim that although it participated in the negotiation and acquisition of liability insurance, a cost increase of 1000 percent cannot be viewed as a creation of SDG&E; it is plainly exogenous, and we find accordingly." The decision explains that the increased insurance premiums are results of insurance market changes. These market changes are exogenous to SDG&E because they are caused by external factors that are outside of SDG&E's control, such as claims resulting from the 2007 wildfires, insurer's concerns over "inverse condemnation," and the financial market meltdown. SDG&E is a price taker that had to accept the increased costs and lower availability of insurance caused by these external factors. [11]

In its advice letter, SDG&E explains that the factors affecting the 2009-2010 renewal period continue to affect the insurance market during the 2010-2011 insurance market. The external factors affecting the 2009-2010 insurance market that caused the decrease in availability and increase in insurance costs continue to affect the 2010-2011 market. SDG&E, in its 2010-2011 renewal period, continues to experience higher insurance costs with less coverage because they face the same insurance market conditions which D.10-12-053 deemed are caused by factors external to SDG&E and outside of SDG&E's control. Since D.10-12-053 determined that the increase in insurance costs for policy year 2009-2010 are exogenous because the increases in costs are due to market changes caused by factors outside of SDG&E's control, similarly, the increase in SDG&E's general liability and wildfire insurance costs for policy year 2010-2011 are exogenous to SDG&E.

[11] D.10-12-053, mimeo, pp. 29-30.

2. The cost increases for SDG&E's 2010-2011 general liability and wildfire insurance occurred after implementation of rates (adoption of SDG&E's 2008 GRC revenue requirement).

The last GRC decision (D.08-07-046) which authorized SDG&E's Test Year 2008 GRC revenue requirement, authorized SDG&E $4.5 million for insurance expenses, which was based on average historic levels. The significantly higher insurance costs, compared to the amount SDG&E was authorized in 2008 GRC, was quoted to SDG&E during its annual renewal of the traditional liability insurance in June 2010. Hence, the increase in insurance costs occurred after the implementation in rates.

3. SDG&E's general liability and wildfire insurance costs for policy year 2010-2011 were beyond the control of the utility management.

As discussed in D.10-12-053 an event satisfies the beyond control criterion if the utility cannot significantly control the outcome. D.10-12-053 states that SDG&E did not have control over the pricing imposed by insurers or the terms of coverage offered even though it actively sought to procure as much insurance as is reasonably available . The decision determined that the increase in costs and decrease in coverage for policy year 2009-2010 were the result of insurance market changes caused by factors outside of SDG&E's control. Hence, D.10-12-053 found that the control criterion was met for the 2009-2010 liability insurance cost increase.[12]

In its advice letter, SDG&E states that the insurance market conditions in the 2010-2011 renewal period were essentially unchanged from when it was procuring insurance for the 2009-2010 policy period. SDG&E again actively sought to procure reasonable levels of insurance at reasonable prices. SDG&E did not have control over the level of insurance coverage and the insurance premiums offered. The decrease in coverage and increase in prices of insurance in the 2010-2011 policy period were caused by the same external market factors that affected SDG&E in the 2009-2010 policy period and were determined by D.10-12-053 to be out of SDG&E's control. Thus, the increase in general liability

[12] *Id.*, pp. 30-32.

and wildfire insurance costs for the 2010-2011 policy period were beyond SDG&E's control.

4. The costs SDG&E incurred for general liability and wildfire insurance for the 2010-2011 policy year are not a normal part of doing business.

D.10-12-053 referred to D.94-06-011, which determined that an event qualifies as abnormal if the costs are caused by factors that specifically impact the utility but not because of general economic conditions. D.10-12-053 determined that the increase in liability insurance costs during the 2009-2010 policy year is not a normal part of doing business for SDG&E because it is a 1000% increase over the forecasted amount from its 2008 GRC. Furthermore, the decision also indicated that the increase in liability insurance costs was not a result of general economic conditions but was for reasons that impacted SDG&E particularly. Specifically, D.10-12-053 pointed out that SDG&E has a heightened risk profile because of its excessive wildfire risk exposure, San Diego County's inadequate firefighting resources, and its legal liability under inverse condemnation. D.10-12-053 further noted that no other investor-owned-utility experienced such a dramatic increase in liability insurance costs. Thus, D.10-12-053 determined that the increased insurance costs for the 2009-2010 policy year are not a normal part of doing business. [13]

In its advice letter, SDG&E stated that it is facing the same insurance climate for its 2010-2011 renewal which it faced for its 2009-2010 renewal. SDG&E stated the high cost of insurance premiums for its 2010-2011 renewal results from the same factors that affected the 2009-2010 renewal period. We agree.

SDG&E's general liability and wildfire insurance premiums for 2010-2011 increased by almost 1670% above the amount forecasted in its 2008 GRC.[14] In addition, SDG&E faced the same insurance climate for its 2010-2011 renewal as it did during its 2009-2010 renewal. SDG&E continued to have a heightened risk

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[13] *Id.*, pp. 33-34.

[14] Table I at p. 23 of SDG&E's AL 2251-E shows that SDG&E's total liability costs for the 2010-2011 policy year were approximately $80 million, nearly 1670% above the $4.5 million authorized in the GRC.

profile because the same factors contributing to its high risk profile in 2009-2010 still existed in the 2010-2011 policy year. SDG&E continued to face high wildfire risk exposure, San Diego County's inadequate firefighting resources, and its legal liability under inverse condemnation. Hence, as in 2009-2010, SDG&E's insurance premium cost increase was not a result of general economic conditions but a result of factors that impact SDG&E specifically. SDG&E's insurance costs in 2010-2011 were not a normal part of doing business.

5. The costs SDG&E incurred for general liability and wildfire insurance for the 2010-2011 policy year had a disproportionate impact on SDG&E.

D.10-12-053 cites D.94-06-011 and D.00-01-021 which ruled that the disproportionate impact test is simply a restatement of the requirement that the cost at issue be something other than a normal cost of doing business.[15] The Commission determined that if the cost is not a normal cost of doing business, then the costs also have a disproportionate impact on the utility. Since D.10-12-053 determined that the insurance cost increase in 2009-2010 was not a normal part of doing business for SDG&E, it also has a disproportional impact on SDG&E. Similarly, since the insurance cost increase for general liability and traditional wildfire insurance costs for the 2010-2011 renewal year was not a normal part of doing business for SDG&E, it also has a disproportional impact on SDG&E.

6. SDG&E's costs for general liability and wildfire insurance costs for the 2010-2011 policy period had a major impact on overall costs.

D.10-12-053 found that the insurance cost increase in 2009-2010 had a major impact on SDG&E's overall cost because the 1000% increase in SDG&E's premium would consume almost the entire attrition increase SDG&E received for normal inflation and operations in its 2008 GRC. SDG&E was authorized $4.5 million in its 2008 GRC for its 2009-2010 insurance renewal. In contrast, the cost of insurance for the 2009-2010 renewal was $47 million. The increase was approximately 8 percent of SDG&E's 2008 net operating income and over 10 percent of its 2008 total administrative and general expenses.[16]

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[15] *Id.*, p. 33.

[16] *Id.*, p. 34.

The cost for SDG&E's 2010-2011 general liability and wildfire insurance was $80.0 million.[17] The cost of this insurance is much higher than the cost for the 2009-2010 renewal period, and is nearly 1670% above the amount authorized in SDG&E's 2008 GRC. Hence, the 2010-2011 general liability and wildfire insurance costs had a major impact on SDG&E's overall cost.

7. The cost impact of SDG&E's 2010-2011 general liability and wildfire insurance is measureable.

As noted above the cost of SDG&E's 2010-2011 general liability and wildfire insurance was $80.0 million. Thus the cost impact of this insurance is measurable.

8. SDG&E's 2010-2011 general liability and traditional wildfire insurance costs are reasonable in light of the determination made by the Commission in D.10-12-053 for SDG&E's 2009-2010 costs.

D.10-12-053 determined that SDG&E incurred the costs of the 2009-2010 insurance increase reasonably because of the reasons set forth below.

First, D.10-12-053 determined that SDG&E took aggressive steps to procure liability insurance in a prudent and reasonable manner, canvassing the global insurance market for insurers. The decision also determined that SDG&E, given limited insurance availability due to its high wildfire risk, had a comprehensive and cost-effective insurance package. Second, the decision also acknowledged that SDG&E has reasonably explored other alternatives, such as ART mechanisms which were determined to infeasible at the time by SDG&E because they were not cost effective, in building its insurance package. Third, the decision also noted SDG&E's proactive efforts in improving its risk profile, including implementing a multi-pronged "Community Fire Safety Program".[18]

In AL 2251-E SDG&E states that its insurance procurement strategy in the 2010-2011 renewal was identical to the 2009-2010 renewal. SDG&E claimed that it

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17 See SDG&E AL 2251-E, Table II, p. 25.

18 D.10-12-053, mimeo, pp. 36-37.

sought to procure as much insurance as is reasonably available aiming to maximize coverage and reduce premiums. SDG&E hired the same insurance broker it hired during the 2009-2010 renewal, who, as he did for the 2009-2010 renewal, canvassed the global insurance market on behalf of SDG&E to put together a comprehensive and cost-effective insurance package. SDG&E also explored ART mechanisms, as it did in the 2009-2010 renewal. SDG&E notes that it continues to proactively improve its risk profile by continually building upon its "Community Fire Safety Program" through expanding its original initiatives to include more fire prevention measures.

We find that SDG&E followed the same strategy in procuring general liability and traditional wildfire insurance for the 2010-2011 policy year as it employed during the prior year. For 2009-2010, it explored the ART mechanisms, but determined them to be infeasible at the time because they were not cost effective in building its insurance package. SDG&E described its efforts to procure the reinsurance product in A. 09-08-019 and Commission decision D. 10-12-053 acknowledged that SDG&E had reasonably explored other alternatives, such as ART. Accordingly, we find that SDG&E's increases in general liability and traditional wildfire insurance costs for 2010-2011 were reasonably incurred.

SDG&E's request to recover $2.852 million for 2009-2010 general liability and wildfire insurance costs it had initially allocated to FERC jurisdictional transmission rates is approved.

The updated insurance costs for the 2009-2010 policy period that SDG&E seeks to recover largely stem from a $2.852 million cost that SDG&E originally proposed to allocate for recovery in FERC jurisdictional transmission rates. FERC denied allocating that amount to transmission rates after the record in A.09-08-019 was closed, and D.10-12-053 did not reflect the FERC Order that denied SDG&E's proposed allocation.

SDG&E proposes to reduce the $2.852 million amount for the FERC allocation by $600,000 for other adjustments. These adjustments, noted above in the Background section, were made to conform estimated costs that SDG&E included in its Z-factor application, to actual costs recorded in its ZFMA. We have reviewed the uncontested $600,000 reduction for these adjustments and determine that it is a reasonable.
As described above, DRA objects to the recovery of this amount. In its reply to DRA's protest, SDG&E contends that FERC did not reject any specific insurance

expense based on the reasonableness of the 2009-2010 wildfire insurance costs. According to SDG&E, FERC instead rejected the proposed accounting treatment of wildfire insurance costs.[19] We agree.

In its October 8, 2010 Order in Docket ER10-2235-000 on SDG&E's Transmission Owner formula rate mechanism, FERC addressed SDG&E's proposal to apply its circuit-mile mechanism to its wildfire liability insurance premium costs (in order to determine what portion of those costs should be allocated to transmission customers) and directly assign those costs to Account 566. FERC rejected SDG&E's proposal because the approach is inconsistent with: appropriate accounting under the Uniform System of Accounts (USOA); the formula rate approved by FERC; the settlement under which FERC approved the formula rate; and the filed rate. According to the FERC Order, SDG&E improperly used a transmission circuit-mile allocator to allocate costs to transmission, even though such an allocator is not found in the formula rate contained in the settlement approved by FERC.

The October 8, 2010 FERC Order determined that recording general liability insurance premiums in Account 925 and allocating these to electric distribution and transmission functions using the Transmission Wages and Salaries Allocation Factor (i.e., FERC's standard labor ratio method) is appropriate. FERC additionally determined that booking wildfire insurance premiums to Account 925, rather than to Account 566 as proposed by SDG&E, is consistent with the USOA, and that wildfire insurance premiums are more akin to an administrative and general expense of SDG&E's utility business rather than costs associated with operating its transmission system.

The October 8, 2010 FERC Order addressed an accounting issue, and determined how general liability and wildfire insurance costs should be allocated to transmission customers. The FERC Order did not address the reasonableness of SDG&E's insurance costs.

In D.10-12-053 we determined that SDG&E implemented a cost-effective insurance package for the 2009-2010 policy year.[20] The costs that FERC declined

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[19] SDG&E's June 10, 2011 reply to protests on AL 2251-E, p. 8.

[20] D.10-12-053, mimeo, p. 36.

to allocate to transmission customers were incurred to procure that package. SDG&E's proposed $2.852 million update to these costs based on the October 2010 FERC Order addressing accounting and allocation is reasonable, and these costs should be allocated to distribution customers. As such, the total update to 2009-2010 insurance costs that SDG&E proposes in AL 2251-E, $2.852 million related to the October 2010 FERC Order, less $600,000 for other adjustments, or $2.252 million, is approved as requested by SDG&E.

SDG&E's proposal to recover reinsurance costs for the 2010-2011 policy period is reasonable.

SDG&E notes that it procured the reinsurance product, an ART mechanism that was not available prior to the 2010-2011 policy period, as a cost-effective option for extending liability coverage. According to SDG&E, this reinsurance product has enabled SDG&E to cost effectively procure liability coverage, including wildfire liability at a level equivalent to what SDG&E had prior to the 2009-2010 policy year even, as a cost-effective option for extending liability coverage, though the additional coverage from reinsurance is limited to property damage, destruction, and loss. Prior to 2009-2010, SDG&E had liability coverage of $1.17 billion (including general and wildfire liability). In the aftermath of the 2007 wildfires, SDG&E's traditional wildfire liability insurance coverage was limited to $400 million. The reinsurance product provides SDG&E an additional $600 million in coverage for property damage, destruction and loss bringing SDG&E's liability coverage limits up to $1 billion which is comparable to levels of coverage SDG&E procured prior to the 2009-2010 policy year. SDG&E points out that the $600 million in coverage that it obtained through the reinsurance product has an average rate of $0.05 per dollar of coverage, while the traditional wildfire insurance, with a total coverage of $400 million, has an average rate of $0.08 per dollar of coverage in the final layer of the program (i.e., coverage from $300 million to $400 million). Additionally, SDG&E notes that property damage makes up the bulk of claims emanating from a typical wildfire.[21]
The costs that SDG&E incurred for the reinsurance product for the 2010-2011 policy year are reasonable. D.10-12-053 determined that SDG&E reasonably explored ART mechanisms when procuring insurance for the 2009-2010 policy year, and the reinsurance product is a cost-effective ART mechanism that

[21] See SDG&E's June 10, 2011 reply to protests on AL 2251-E, p. 4, and AL 2251-E, p.11.

SDG&E procured. SDG&E notes the lower average rate per dollar of coverage for reinsurance as compared to that of traditional wildfire insurance. This demonstrates that the reinsurance product is cost-effective.

DRA states in its protest that the reinsurance product is materially different from the items discussed in SDG&E's Z-factor application and D.10-12-053. Although the reinsurance product was not addressed in D.10-12-053, the decision determined that SDG&E reasonably explored ART mechanisms, and this ART product cost-effectively increased SDG&E's wildfire liability coverage by $600 million to bring its coverage more in line with that obtained prior to 2009. Based on experience in the aftermath of the 2007 wildfires, this additional coverage is justified.

The suggestion that there may have been self dealing between affiliated insurance brokers, Marsh and GCC, in procuring the reinsurance product has no basis. As noted in SDG&E's reply to protests, there was no direct benefit to Marsh as a result of its affiliate, GCC, acting as the broker for the reinsurance product. GCC was a prudent choice to handle the procurement of the reinsurance for SDG&E.

Procurement of the reinsurance product is an issue in SDG&E's 2012 GRC, A.10-12-005.

In phase 1 of its 2012 GRC, A.10-12-005, SDG&E states that it anticipates a continuing need for the reinsurance product, and its forecast for test year 2012 includes $35.8 million for wildfire property damage reinsurance.[22] SDG&E's forecasted expense for this reinsurance product is contested in the GRC.[23] This resolution does not prejudge the Commission's decision in A.10-12-005 on the reasonableness of including any expenses for reinsurance in test year 2012 and the attrition years addressed in the GRC.

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[22] See Exhibit SDG&E-24, pp. MBD-1 – MBD-9, in A.10-12-005, December 2010.

[23] See the Prepared Testimony of Robert Sulpizio on behalf of Utility Consumers Action Network in A.10-12-005, September 22, 2011.

The protests of DRA and Henricks are denied.

The protests of DRA and Henricks are denied, including Henrick's request that AL 2251-E be rejected pending Commission resolution of AFRs filed on D.10-12-053. Rule 16.1 of the Commission's Rules of Practice and Procedure sets forth that filing of an application for rehearing of a Commission order or decision shall not excuse compliance with an order or decision.[24] Furthermore, D.11-12-023 issued on December 2, 2011 denied the applications for rehearing on D.10-12-053.

COMMENTS

Per statutory requirement, a draft resolution was mailed to parties for comment.

Public Utilities Code section 311(g)(1) generally requires resolutions to be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Accordingly the draft resolution was issued for public review and comment no later than 30 days prior to a vote of the Commission.

On December 5, 2011, SDG&E, DRA, and Henricks submitted comments on the draft resolution. SDG&E supports the draft resolution. DRA and Henricks oppose the draft resolution.

DRA recommends that the draft resolution be rejected.

DRA recommends that the draft resolution be rejected, and that the Commission instead approve a separate version of the draft resolution that denies without prejudice SDG&E's recovery of costs for the reinsurance product.
DRA states that the reinsurance product was not authorized in D.10-12-053 because there was no record in A.09-08-019 regarding the reasonableness of that category of costs. DRA asserts that there is no basis to find that the reinsurance product is cost-effective because D.10-12-053 and A.09-08-019 have no record of

[24] Rule 16.1 sets forth that an AFR filed ten or more days before the effective date of an order suspends the order until the application is granted or denied. This does not apply here since the effective date of D.10-12-053 was December 16, 2010 and the AFRs were filed on January 21, 2011.

the cost or coverage levels of reinsurance, thus there is no record to evaluate the potential costs and benefits.

DRA also states that reinsurance and traditional insurance are different products that provide different coverage, costs, and benefits, and that D.10-12-053 does not indicate that SDG&E was directed to increase its total coverage to $1 billion or close to the coverage levels prior to 2009. DRA notes that the Commission determined in D.10-12-053 that a $47 million insurance premium for $400 million in total liability coverage was reasonable and that nothing in that decision can be interpreted to increase coverage at a particular cost. DRA asserts that a new application is required to allow the Commission to evaluate the reinsurance product within the context of the Z-factor criteria and to do otherwise would improperly approve a $28 million increase in revenue requirement.

DRA's concludes that Public Utilities Code section 454(a) prohibits a rate increase without a showing before the Commission and a finding by the Commission that a new rate is justified. DRA asserts that without a showing of reasonableness or applicable findings in D.10-12-053, the draft resolution exceeds the Commission's authority under the Public Utilities Code.[25]

DRA's comments demonstrate no errors in the draft resolution.

No revisions have been made to the draft resolution based on DRA's comments. SDG&E provided a basis for the cost-effectiveness of the reinsurance product in AL 2251-E. The showing by SDG&E in its advice letter and our finding in this resolution regarding the reasonableness of the reinsurance product justifies allowing the cost of the product to be recovered in rates.

Henricks requests that the draft resolution be set aside and that all relief requested in AL 2251-E be denied.

In comments Henricks asserts that SDG&E's practices caused fires in San Diego and that the impact on future insurance rates was fully anticipated in 2008, and the 2008 GRC could have been used as a vehicle for presenting the insurance issue. Hendrick states that SDG&E admitted it was on notice of facts in 2008

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[25] DRA cites *California Manufacturers Association v. Public Utilities Commission*, 1979 Cal. LEXIS 256, *259-260.

while the 2008 GRC was open, from which a reasonable person would conclude that SDG&E would face increased rates due to increased claims resulting from fires that occurred in 2007. Henricks cites a portion of Sempra's 2008 10-K report filed with the Securities and Exchange Commission (SEC) which describes the October 2007 wildfires in Southern California, Cal Fire's press release stating that power lines caused three fires in San Diego County, and lawsuits against SDG&E related to the fires. The portion of the report cited by Henricks also noted that the company had in excess of $1 billion in liability insurance. Henricks concludes that SDG&E was on notice in February 2008 of substantial claims.

Henricks also cites a portion of SDG&E's 2009 10-K report to the SEC that describes 2007 wildfire litigation, claims related to the fires and amounts paid by insurers. The portions of the report cited by Henricks also state that SDG&E would request authorization from FERC and the CPUC to recover amounts in utility rates which exceed its $1.1 billion liability insurance, and that the degree of success SDG&E may have in pursuing such requests or the timing of recovery was unpredictable. Henricks states that fire insurance allows SDG&E to manage risk of future fires, and that it can mitigate that risk by adopting more stringent modes of operations. Henricks asserts that insurance costs are higher because of SDG&E's record of unsafe practices resulting in the 2007 fires and the resulting claims, and SDG&E's unwillingness to use less risky means for producing and transporting power. Henricks requests that the Commission take judicial notice of the portions of the 2008 and 2009 10-K reports to the SEC that it cites in its comments.

Henricks requests that any decision on AL 2251-E be stayed pending final resolution of pending procedural steps in A.09-08-019, and that this issue be opened as a formal proceeding before the Commission.

Henricks' comments demonstrate no errors in the draft resolution.

No revisions to the draft resolution were made based on Henrick's comments. The draft resolution follows from guidance provided by D.10-12-053. The applications for rehearing on that decision were denied by D.11-12-023 and there is no need to stay resolution of the issues raised by AL 2251-E.
Henricks' comments relate to the cause of the 2007 fires, what SDG&E should have known about the run up in insurance premiums after the fires, and how SDG&E can mitigate the risk of future fires. D.10-12-053 determined that the 2009 increase in liability insurance costs was caused by an event exogenous to,

and beyond the control of SDG&E. This resolution similarly finds that the increases in costs for the 2010-2011 policy period were exogenous to and beyond the control of SDG&E. It is not necessary to take notice of the portions of Sempra's 2008 and 2009 reports to the SEC, as Henricks requests, to address the issues resolved by this resolution.

FINDINGS AND CONCLUSIONS

1. D.08-07-046 in SDG&E's 2008 general rate case approved SDG&E's current Z-factor mechanism which allows SDG&E to seek recovery of costs associated with exogenous events that are unforeseen at the time of ratemaking, largely uncontrollable by management, and have a material and disproportionate impact on SDG&E.
2. The Commission has adopted the following criteria for Z-factor recovery for SDG&E:
    a. The event must be exogenous to SDG&E;
    b. The event must occur after implementation of rates;
    c. The costs are beyond control of SDG&E management;
    d. The costs are not a normal part of doing business;
    e. The costs must have a disproportionate impact on SDG&E;
    f. The costs must have a major impact on overall costs;
    g. The cost impact must be measurable; and,
    h. SDG&E must incur the costs reasonably.

3. SDG&E filed A.09-08-019 to request recovery of unforeseen liability insurance premium and deductible expense increases as a Z-factor event in 2009.
4. D.10-12-053 approved SDG&E's request in A.09-08-019 to increase revenue requirements by $28.9 million over the amount authorized in the 2008 GRC to recover increased general liability and wildfire insurance costs for the 2009-2010 policy period.
5. D.10-12-053 authorized SDG&E to file a Tier 3 advice letter to request Z-factor treatment and recovery of unforeseen liability insurance premiums and deductible expense increases in subsequent years prior to its next GRC.
6. SDG&E filed AL 2251-E on April 29, 2011 to request recovery of increased liability costs for the 2010-2011 policy year as a Z-factor event, and to request recovery for updates to costs approved for recovery in D.10-12-053 for the 2009-2010 policy period including $2.852 million that FERC declined to allocate to transmission customers.

7. SDG&E seeks in AL 2251-E an electric revenue requirement increase that amounts to $63.3 million above revenues authorized by D.08-07-046 in its 2008 GRC.
8. For the 2010-2011 policy year, SDG&E procured a reinsurance product, an Alternative Risk Transfer mechanism that was not available for the 2009-2010 policy year, to supplement its $400 million of traditional wildfire liability insurance coverage.
9. The reinsurance product provides an additional $600 million in coverage for loss, damage, and destruction of property, has a premium of approximately $32 million, and a revenue requirement impact of approximately $28 million.
10. According to the schedule set forth in the Commission's Executive Director's May 18, 2011 letter, the Commission's Division of Ratepayer Advocates and counsel for Ruth Henricks, an SDG&E ratepayer, protested AL 2251-E on May 31, 2011, and SDG&E replied to the protests on June 10, 2011.
11. The general liability and traditional wildfire insurance costs, and reinsurance costs, incurred by SDG&E for the 2010-2011 policy year meet all eight criteria identified in Finding and Conclusion 2 for Z-factor recovery.
12. In its October 8, 2010 Order in Docket ER10-2235-000, FERC rejected SDG&E's proposed accounting treatment associated with wildfire insurance costs for the 2009-2010 policy year, and thus rejected SDG&E's proposal to allocate the costs to FERC jurisdictional transmission customers.
13. FERC did not determine any wildfire insurance costs incurred by SDG&E for the 2009-2010 policy year to be unreasonable.
14. SDG&E's 2009-2010 wildfire insurance costs that FERC declined to allocate to transmission customers in its October 8, 2010 Order were incurred to procure an insurance package for the 2009-2010 policy year that the Commission determined in D.10-12-053 was cost-effective, and thus should be allocated to distribution customers.
15. SDG&E should be allowed to recover $2.252 million in updates to insurance costs for the 2009-2010 policy year, comprised of $2.852 million that FERC declined to allocate to transmission customers, less $600,000 for other adjustments to conform estimated to recorded amounts.
16. D.10-12-053 determined that SDG&E reasonably explored ART mechanisms in procuring insurance for the 2009-2010 policy period.
17. The reinsurance product that SDG&E procured for the 2010-2011 policy period is cost-effective.
18. There is no basis for the suggestion that any self-dealing occurred between affiliated insurance brokers in the procurement of the reinsurance product.

19. SDG&E's request to recover costs for reinsurance is an issue in its 2012 GRC A.10-12-005.
20. This resolution does not prejudge the Commission's decision in A.10-12-005 on recovery of reinsurance costs.
21. The protests of DRA and Henricks are denied.

THEREFORE IT IS ORDERED THAT:

1. SDG&E's Advice Letter 2251-E is approved.
2. SDG&E is authorized to recover effective January 1, 2012 increased costs requested in Advice Letter 2251-E for the 2010-2011 insurance policy period associated with general liability and traditional liability wildfire insurance, and the wildfire reinsurance product.
3. SDG&E is authorized to recover effective January 1, 2012 updated insurance costs totaling $2.252 million incurred during the 2009-2010 policy period as requested in AL 2251-E.
4. SDG&E is authorized to consolidate the revenue requirements increases approved by this resolution in its annual consolidated electric rate change advice letter for rates effective on January 1, 2012.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on December 15, 2011; the following Commissioners voting favorably thereon:

/s/Paul Clanon
Paul Clanon
Executive Director

MICHAEL R. PEEVEY
PRESIDENT
TIMOTHY ALAN SIMON
MICHEL PETER FLORIO
CATHERINE J. K. SANDOVAL
Commissioners

I dissent.

/s/ MARK J. FERRON
Commissioner