BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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Application of Southern California Edison Company (U338E) for Authority to Establish Its Authorized Cost of Capital for Utility Operations for 2020 and to Partially Reset the Annual Cost of Capital Adjustment Mechanism.	Application 19-04-014 (Filed April 22, 2019)
And Related Matters.	Application 19-04-015 Application 19-04-017 Application 19-04-018

OPENING BRIEF OF THE UTILITY REFORM NETWORK CONCERNING THE 2020 COST OF CAPITAL APPLICATIONS OF THE FOUR LARGE CALIFORNIA INVESTOR OWNED UTILITIES

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SUMMARY OF RECOMMENDATIONS

- In order to set appropriate and reasonable Return on Equity (ROE) rates and capital structures for the four investor-owned utilities, the Commission should use its informed judgment and should consider current market conditions, reflecting especially the passage of AB 1054 and expectations of a low interest rate environment, as well as the recent results from other jurisdictions which have addressed similar issues in setting equity returns for other energy utilities.
- The Commission should find that AB 1054 has reduced utility shareholder risk from wildfire liabilities sufficiently that risk premiums at the levels calculated by the utilities are unreasonable, as they are based on erroneous factual assumptions and a method that is unreasonable for calculating any equity premiums.
- The Commission should find that the "implementation risks" of AB 1054 as described by utility witnesses are based on a misrepresentation of the relevant FERC and CPUC cases addressing SDG&E's operations related to the 2007 wildfires.
- The Commission should find that if any risk premium is warranted due to continued market uncertainty regarding the impacts of AB 1054 and inverse condemnation, such a premium should be no higher than 0.65%, based on Mr. Gorman's analysis of historical bond yield spreads.
- The Commissions should authorize for PG&E a return on equity of 9.50% and an equity capital ratio of 52%.
- The Commissions should authorize for SCE a return on equity of 9.65% and an equity capital ratio of 50%.
- The Commissions should authorize for SDG&E a return on equity of 9.40% and an equity capital ratio of 52%.
- The Commissions should authorize for SCG a return on equity of 9.20% and an equity capital ratio of 52%.
- The Commission should order PG&E to file a new application within three months of existing bankruptcy in order to update its forecast cost of debt.

- The Commission should continue the same ratemaking treatment for customer deposits as adopted in D.14-08-032 by reducing PG&E's long-term cost of debt based on the level of customer deposits.

OPENING BRIEF OF THE UTILITY REFORM NETWORK CONCERNING THE 2020 COST OF CAPITAL APPLICATIONS OF THE FOUR LARGE CALIFORNIA INVESTOR OWNED UTILITIES

1 INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

History repeats itself, but always with changes that confound simple analogies. The utilities today request large increases in returns on equity (ROEs),[1] akin to their requests after the debacle of energy deregulation almost twenty years ago. But there are at least three major differences between 2000 and 2020 that impact any assessment of risk and return. First, two of the three electric utilities still have investment grade ratings, and PG&E is below investment grade because it voluntarily sought bankruptcy protection. Second, while the energy deregulation law froze rates and shifted the risk of high wholesale electricity prices onto utility shareholders, the law of inverse condemnation shifts the risk of third-party claims onto utility ratepayers, except when the utility if found to have acted imprudently and unreasonably. Third, recent changes adopted by AB 1054 and SB 901 reduce and cap any utility shareholder risk due to inverse condemnation and any finding of utility imprudence in causing wildfires.

There are numerous arguments in this case about risk-free rates, proper choice of proxy groups, growth rates, and what investors really think about California utilities; but when one strips away the rhetoric and the financial jargon, many of the issues boil down to the following key questions:

[1] ROEs may also colloquially be called equity returns or profits.

- Should California utilities be rewarded with equity returns significantly above the national averages due to inverse condemnation and wildfire risk, even after the passage of Assembly Bill (AB) 1054?
- Should utility investors be validated *and even rewarded* for allegedly being nervous that this Commission cannot evaluate prudent management behavior similarly to the way other states and the Federal Energy Regulatory Commission (FERC) conduct such reasonableness reviews, even after changes to the prudence and burden of proof standards adopted by AB 1054?
- Should the Commission accept various adjustments and adders used by utility modeling witnesses to create equity returns that are significantly higher than those calculated by non-utility witnesses or adopted by other state commissions during the past five years?

In the following brief TURN reviews the available record evidence and suggests that the answer to all of these questions is a simple "No." The Commission should rely on credible market evidence and undisputed analyses to conclude that inverse condemnation places all the risks on ratepayers, except when a utility acts imprudently. Recently adopted AB 1054 then caps any utility liability for imprudence, and requires this Commission to use more relaxed standards to evaluate management reasonableness.[2] Utility arguments that there is some residual risk because investors are concerned that this Commission will not apply the prudence standard appropriately

[2] TURN uses the terms "reasonableness review" and "prudence review" interchangeably, as we believe they refer to the same regulatory paradigm.

are rooted in a fundamental misrepresentation of this Commission's prior decision regarding the "SDG&E WEMA" case.[3] The Commission should consider all available market data and evidence, placing emphasis on national data on average equity returns in other states and recent forecasts of declining interest rates, in order to determine the proper level of equity returns for the four investor-owned utilities.

TURN, in collaboration with the Energy Producers and Users Coalition (EPUC) and the Indicated Shippers (IS),[4] together sponsored the testimony of Mr. Michael Gorman.[5] Mr. Gorman is a former Director of the Financial Analysis Department of the Illinois Commerce Commission, and has been conducting sophisticated financial analyses in cost of capital cases, mergers and reorganizations as a consultant since 1990.[6] In this case, Mr. Gorman used accepted modeling methods to calculate a reasonable range of equity returns from 8.5% to 9.0% for all of the utilities.[7] Mr. Gorman also calculated a maximum potential premium of 65 basis points to account for investor unease about inverse condemnation and the scale of wildfire liabilities,

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[3] WEMA is the term for the Wildfire Event Memorandum Account, and refers to the account where SDG&E recorded costs related to claims resulting from three fires in 2007. The SDG&E WEMA application was resolved in D.17-11-033.

[4] TURN represents the interests of the residential and small commercial customers of all four utilities; EPUC represents the interest of some of the large industrial customers of PG&E and SCE; and IS represents the interests of large non-core gas customers of PG&E and SCG.

[5] Identified as Exhibit EPUC/IS/TURN-01 in the record. In this brief, TURN often refers to "TURN witness Gorman" as a shorthand, with the understanding that Mr. Gorman sponsored testimony concerning PG&E, SCE and SCG jointly on behalf of EPUC, IS and TURN, and sponsored testimony concerning SDG&E solely on behalf of TURN.

[6] For a more complete curriculum vitae, see Exh. EPUC/IS/TURN-01, p. I-1 to I-3.

[7] Exh. EPUC/IS/TURN-01, pp. VI-35, VII-40, VIII-38, and IX-38.

though Mr. Gorman did not recommend that the Commission add this premium to any authorized ROEs for the electric utilities.[8]

The modeling results in this case consistently show that utility ROEs should be significantly reduced from their currently authorized levels. Indeed, the modeling results of all intervenors in this case suggest that present market conditions warrant setting equity returns even lower than the "national averages" of utility cases decided in other jurisdictions in 2018 and 2019, most likely reflecting current data as compared to data from 2017 and 2018 used in those cases.[9]

TURN opposes a wildfire risk premium that would reward utility imprudence. Nevertheless, TURN agrees that there is market "uncertainty" due to the significant regulatory changes adopted by AB 1054, and market concern regarding the scale of potential liabilities for wildfire claims under inverse condemnation. The choice of equity returns in this cost of capital case sends a signal to market participants. Keeping this in mind, considering the modeling conducted both by Mr. Gorman as well as other experts in this case, and considering the other market evidence, TURN recommends that the Commission adopt equity returns above the modeling range found by Mr. Gorman, as shown in the table below:

[8] Exh. EPUC/IS/TURN-01, p. II-6:3-13.

[9] Keeping in mind that those cases were litigated using market data likely six to twelve months old at the time of the decision. As we saw in this case, significant changes in key factors such as interest rates have occurred in just the past six months.

Table 1: TURN's Recommended ROEs and Capital Structures for the Four Utilities

	PG&E	SCE	SDG&E	SCG
Return on Equity	9.50%	9.65%	9.40%	9.20%
Common Equity Ratio	52%	50%	52%	52%

Aside from the level of authorized ROEs for 2020, the other key issues litigated in this case concern the authorized capital structure for the utilities and the continuation or modification of the capital adjustment mechanism (CAM). TURN provides limited briefing on those two issues, and TURN's recommended common equity ratios are presented in Table 1 above.

Lastly, the issue of the ratemaking treatment for customer deposits was litigated for PG&E. While TURN originally agreed with PG&E that the ratemaking adopted in D.14-08-032 should be suspended while PG&E is in bankruptcy, because PG&E changed its positions in rebuttal testimony, and because it will likely exit Bankruptcy Court within six months of any new rates authorized in this proceeding, TURN now recommends that the Commission not alter the ratemaking treatment of customer deposits and continue to treat them as an offset to long-term debt. The Commission should decide whether to reconsider this issue for all utilities in the next cost of capital proceeding, or to continue to address it separately for each utility in its general rate case.

2 LEGAL STANDARDS AND POLICY CONSIDERATIONS

2.1 The Standard for Authorizing a Reasonable ROE is Well Accepted

Multiple witnesses in this case document the seminal Supreme Court language from *Hope* and *Bluefield* describing the legal standards for setting a reasonable return on equity (ROE). The Commission has repeatedly discussed these cases, and summarized the applicable standard as follows:

> Such return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties.
>
> …
>
> We attempt to set the ROE at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility service obligation.[10]

2.2 Authorized ROEs Should Not Compensate Shareholders for Management Imprudence

There is, however, one critical caveat to the applicable legal standard that, regrettably, is of paramount importance in this case. The phrase "under efficient management," derived from the *Bluefield* decision,[11] is not empty verbiage. Rather, it signifies the fact that shareholders cannot

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[10] D.12-12-045, *mimeo.* at 18.

[11] See, *Bluefield*, 262 U.S. 679 (1923) ("The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and

be protected from management inefficiency or imprudence. The Commission recognized this notion explicitly in its last cost of capital decision, when it noted:

> The Hope decision reinforces the Bluefield decision and emphasizes that such returns should be sufficient to cover operating expenses and capital costs of the business. The capital cost of business includes debt service and stock dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, **we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.**[12]

This "duty to ratepayers" is entirely consistent with accepted jurisprudence, which holds that utility shareholders should not be shielded from management imprudence. If a utility's investments are imprudent or not used-and-useful, regulators have no obligation to guarantee that utility's financial success or even its viability.[13] Authorized equity returns should not compensate for disallowances resulting from management imprudence.

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economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties.")

[12] D.12-12-045, *mimeo.* at 18 (emphasis added).

[13] See, for example, *Covington & Lexington Tpk. Rd. Co. v. Sandford*, 164 U.S. 578, 596–597 (1896) ("If a corporation cannot maintain such a highway and earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens on the public."); *Consumers Power Co.*, Case No. U-7830 Step 3B, 1991 Mich. PSC LEXIS 119, at *133-36 (Mich. Pub. Serv. Comm'n May 7, 1991) ("The [federal and state] constitutions do not guarantee that Consumers [Power] will earn, or have the opportunity to earn, its authorized rate of return if it engages in unreasonable or imprudent activities."). See also, *20th Century Ins. Co. v. Garimendi*, 8 Cal. 4th 216, 297-298 (regulated firm does not have right to demand a profit at level that an investor could reasonably expect to earn in other businesses, to the exclusion of other regulatory considerations.)

All of the expert witnesses representing the utilities in this case fully, if not enthusiastically, endorsed this principle that equity returns should not be authorized so as to compensate shareholders for losses due to disallowances caused by management imprudence, as illustrated by the following sample of responses:

> **PG&E Witness Bijur**:
>
> Q If as a result of, let's use a hypothetical of PG&E's negligence, PG&E bears risks. Should PG&E receive a higher return on equity as a result of the risks of that negligence?
>
> A PG&E should not receive a higher ROE if we are negligent.[14]
>
> **SDG&E Witness Folkmann**:
>
> Q Is it SDG&E's position that it should be allowed to recover from ratepayers the cost that the Commission has disallowed in a cash strapped wildfire proceeding?
>
> A No.[15]
>
> **SCE Witness Stern**:
>
> In return for a duty to serve all customers, regardless of risk, IOUs are entitled to recover their cost of service in rates, where those costs are determined to be just and reasonable. This is the regulatory contract in its most fundamental form.[16]
>
> A So it certainly is true that negligence or mismanagement by the utility is not something that should be compensated for through the ROE.[17]
>
> A …. Clearly, demonstrably, mismanaged, imprudent actions by a utility should not be rewarded with an ROE. The question is, well, what if there's a

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[14] 1 RT 38:16-22, Bijur, PG&E.

[15] 5 RT 795:23-27, Folkmann, SDG&E.

[16] Exh. SCE-01, p. 44:14-16.

[17] 2 RT 179:7-10, Stern, SCE.

> judgment associated with what that standard of prudence is that is fundamentally different in different parts of the country?[18]

This regulatory principle is supported by common sense. Obviously, disallowance of costs that were found to be imprudent is intended to protect ratepayers against paying for costs that are not just and reasonable, and thus consistent with §451. Authorizing recovery of those very costs through the back door of increasing the rate of return portion of revenue requirements would obviate this bedrock regulatory principle.

Furthermore, this regulatory principle is supported by finance theory, since an inordinate risk of disallowances due to utility management imprudence represents a diversifiable risk which should not be incorporated in calculating reasonable equity returns,[19] as explained by TURN witness Gorman:

> To the extent that a specific utility has a record of imprudent operations, (and as such experiences a higher likelihood of wildfire -related losses than another utility), that is a risk investor may avoid by simply investing in a different utility company or by removing management that fails to conduct itself in a prudent manner. Thus, as a rule the capital markets compensate investors via risk premium for assuming risks that may be avoided or eliminated by replacing ineffective management or by a management simply conducting itself prudently. Ratepayers should not be asked to fund a premium to offset the consequences of imprudent operations, because these risks can be avoided. Beyond the normal risk associated with the prudent manager standard as applied across the entire utility industry which is already reflected in the fair Base ROE, market efficiency

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[18] 2 RT 181:8-15, Stern, SCE. Mr. Stern expounded at length about the risks due to the "prudence standard being applied differently in California. This issue is addressed in Section 3.4.5.1 below.

[19] See, for example, D.94-11-076, *mimeo.* at 45 ("we should give little to no weight to risks that are diversifiable.")

prevents the inclusion of a risk premium for investors caused by poor management that results in cost disallowances which reduce earnings.[20]

3 RETURN ON EQUITY

3.1 Introduction and Summary of Recommendations

In the past few cost of capital proceedings, the Commission has considered all the evidence and exercised informed judgment to select a specific return on equity for each utility. While the evidence always includes the results of financial modeling, the Commission has closely considered ROEs recently adopted in other jurisdiction,[21] and other market evidence of utility risks. National ROE data and market evidence are unbiased and observable indicators of the capital market conditions facing California IOUs and provide a valuable reality check on consistent utility arguments that increased risks in California warrant authorizing ROEs at the top of the modeling range results.[22] The national data indicate that in other states Commissions have, on average, authorized equity returns around 9.6% during the past two years, which is lower than the modeling results of utility experts, but higher than Mr. Gorman's modeling results.

This case is unique for at least two reasons. The first is the obvious fallout of two years of extreme and deadly wildfires sparked by utility equipment, and the financial repercussions of the application of inverse condemnation in California. As a result, in their original April testimonies

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[20] Exh. EPUC/IS/TURN-01, p. V-4:6-17.

[21] For example, D.12-12-045, *mimeo.* pp. 39, 40, 42, 44.

[22] See, for example, D.12-12-045, p. 28-29, 38, 40, 43 (for example, "PG&E selected the upper end of its ROE range to compensate it for increased financial, business and regulatory risks.").

the electric utilities requested large "wildfire risk adders" of 3.4% (SDG&E), 5.0% (PG&E) and 6.0% (SCE). Based on directions in the Assigned Commissioner's Scoping Memo, and due to the passage of AB 1054, the utilities revised their presentations and proposed smaller wildfire risk premiums in supplemental testimonies submitted on August 1, 2019. The revised wildfire risk adders range from 0.85% (SCE) to 1.48% (SDG&E), as shown in Table 2 below. Oddly enough, the utility – SCE - that originally requested the highest adder, now requests the lowest adder, and the utility – SDG&E – that originally requested the lowest adder, now requests the highest. Apparently the utilities have different perceptions of wildfire risks both before and after the passage of AB 1054.

Table 2: Utility Base ROE Requests and Wildfire Risk Premiums Requested After the Passage of AB 1054

IOU	Current ROE	Base ROE Requested April 22, 2019	Base ROE Requested August 1, 2019	Wildfire Risk Adder in Supplemental Testimonies (%)
SCE	10.30	10.60	11.45	0.85
PG&E	10.25	11.00	12.00	1.00
SDG&E	10.20	10.90	12.38	1.48
SoCalGas	10.05	10.70	10.70	0.00

As TURN explains in detail in Section 3.4 below, the Commission should firmly reject the requested wildfire risk premiums calculated by the utilities. First, the "risk" to shareholders due to inverse condemnation is solely the risk of utility imprudence, since ratepayers would pay any third party wildfire claims absent management imprudence, and compensating such risk is contrary to the regulatory compact, as discussed in Section 2.2. Second, the utilities allege that

the risks that investors perceive as remaining after AB 1054 is the risk that this Commission cannot properly implement the prudence standards adopted in the legislation. This risk is based on continued misrepresentations of the relevant CPUC and FERC decisions concerning SDG&E's liabilities from the 2007 fires, and the Commission should not aid the utilities' in perpetuating a fiction that this Commission is a deviant in reasonableness reviews.

TURN appreciates that the potential scale of any liabilities due to wildfire disallowances may be larger than typical disallowance risks, and investors (or at least the bond ratings analysts, as no one has ever presented evidence of actual difficulties in issuing new stock) may genuinely be uncertain about the exact impacts of AB 1054, which represents a complex change in the regulatory paradigm concerning potential wildfire-related mitigation work and third-party claims. Mr. Gorman calculated a maximum risk "premium" of 65 basis points using relevant historical bond yield spreads. Mr. Gorman explained in his testimony that his base ROE recommendation for all four IOUs was 9.0%, but that if the Commission chooses to adopt a premium for wildfire risk, it could adopt an ROE as high as 9.65%.[23] This recommendation is in line with average national ROEs adopted in 2018-2019. TURN cautions, however, that should the Commission adopt such a premium, it should be a temporary measure owing to unusual market conditions and current market jitters regarding perceived California regulatory risks; it should in no event become a permanent feature of California cost of capital proceedings.

Based on a consideration of the modeling results and other available evidence, TURN recommends that the Commission adopt the ROEs for the four utilities shown in

[23] Exh. EPUC/IS/TURN-01, pp. II-5 to II-6.

Table 1, as reproduced below:

Table 3: TURN's Recommended ROEs for All Four IOUs

	PG&E	SCE	SDG&E	SCG
TURN's Recommended Return on Equity	9.50%	9.65%	9.40%	9.00%

3.2 Modeling Results Support Equity Returns Below 10% for All Utilities

3.2.1 Intervenor Experts All Recommend Equity Returns Below 10%, While Utility Experts All Recommend ROEs Above 10%

The utilities hired three outside consultants to model equity returns. At least five intervenors similarly hired experts to model equity returns, though some intervenors addressed only a single utility. All experts agree that their recommended equity returns comply with the accepted legal standard that such returns provide sufficient profit levels to attract capital and are similar to returns for companies with similar risks. The resulting "duel of the experts" produced the point recommendations summarized in Table 4:

Table 4: Base ROE Recommendations from Modeling Results by the Various Expert Witnesses in This Case

Third Party	Witness	PG&E	SCE	SDG&E	SCG
TURN/EPUC/IS	Gorman	9.00%	9.00%	9.00%	9.00%
Cal Advocates	Rothschild	8.49%	8.65%	8.49%	8.49%
FEA	O'Donnell	9.75%	9.75%	9.50%	n/a
UCAN/POC	Griffing	n/a	n/a	9.15%	n/a
DelMonte	Knecht	7.11%	n/a	n/a	n/a

Utility	Witness	PG&E	SCE	SDG&E	SCG
PG&E	Vilbert	11.00%	n/a	n/a	n/a
SCE	Villadsen	n/a	10.60%	n/a	n/a
SDG&E	Morin	n/a	n/a	10.90%	n/a
SCG	Morin	n/a	n/a	n/a	10.70%

Table 4 illustrates that all utility witnesses recommended equity returns above 10.5%, while all intervenor witnesses recommended equity returns below 10%, generally in the range of 8.5% to 9.5%. How is the Commission to choose from these competing numbers?

TURN does not contend that there is a "true" answer among these competing numbers. All of the witnesses here are financial experts who routinely testify concerning cost of capital for utilities in various jurisdictions. They each use the various models, including the Capital Asset Pricing Model (CAPM), the Discounted Cash Flow model (DCF), or the Risk Premium Model (RPM); but each expert may differ in their selection of proxy groups, or other inputs such as betas, risk-free rates, dividend growth rates, etc. etc. Many of these model inputs can be "justified" by expert opinion. The question boils down to a subjective evaluation of the validity and accuracy of these expert choices weighted in the context of broader market information.

3.2.2 To Select Among the Competing Modeling Results, the Commission Need Only Follow Its Precedent and Consider National Data Based on Decisions from Other Jurisdictions

Fortunately, the Commission has repeatedly made clear that it need not resolve the multitude of disputes among modeling experts,[24] as the Commission has explained that it will use the modeling results merely "as a starting point" to provide a "rough gauge" of reasonableness:

> In the final analysis, it is the application of informed judgment, not the precision of financial models, which is the key to selecting a specific ROE estimate. We affirmed this view in D.89-10-031, noting that it is apparent that all these models have flaws and, as we have routinely stated in past decisions, the models should not be used rigidly or as definitive proxies for the determination of the investor-required ROE. Consistent with that skepticism, we found no reason to adopt the financial modeling of any one party. The models are only helpful as rough gauges of the realm of reasonableness.[25]

TURN does not attempt to evaluate each of the numerous disputed factual elements of the equity modeling in this brief; and we expect that other parties, including EPUC/IS, the FEA, and the Cal PA, will provide a more thorough discussion of the modeling controversies. But there will likely remain some areas of dispute that are not easily settled "by the evidence," as these experts just differ in their professional opinions. TURN thus recommends that that in evaluating how much weight to give to each expert's opinion, the Commission should be guided by its own precedents, by consideration of key market factors such as interest rate forecasts and analyst evaluations of the impacts of AB 1054, and lastly by consideration of the outcomes reached by

[24] For example, D.94-11-076, *mimeo.* at 19 ("We cannot and will not resolve technical arguments about modeling details.")
[25] D.12-12-045, pp. 28. Similar language can be found in other cost of capital decisions.

other commissions in setting equity returns and evaluating the of some of the very same witnesses as in this case.

3.2.2.1 Several of the Utilities Modeling Inputs and Adjustments Run Counter to Evidence and Precedent

A few of the modeling disputes can be resolved by the application of precedent and by resorting to undisputed evidence.

For example, the experts differ in their selection of the "risk-free" rate to use in the CAPM. Mr. Gorman (TURN) used 2.80% based on *Blue Chip Financial Forecasts'* projection of 30-year Treasury bond yields;[26] Mr. Rothschild (Cal PA) used 2.12% based on the 3-month Treasury bond yield as of June 30, 2019; and Mr. Knecht (DelMonte) used 2.34% based on the 20-year Treasury bond yield as of July 1, 2019. On the other hand, Mr. Vilbert (PG&E) and Ms. Villadsen (SCE) used 3.90% and 4.10% based on the *Blue Chip Economic Indicators* forecasted yield of the 10-year Treasury bond in 2020, adjusted upwards based on the premium of the 20-year over the 10-year Treasury bond.[27]

A key issue in the dispute regarding "risk-free rates" described above is the question of what interest rates will do over the next three years. Mr. Vilbert and Ms. Villadsen calculated a high risk-free rate based on the assumption that "interest rates are expected to increase."[28] This

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[26] See, for example, Exh. PG&E-03, p. 1-14 to 1-15.

[27] Exh. PG&E-01, p. 2-57:13 to 2-58:4. Exh. SCE-02, p. 40:18-26.

[28] Exh. PG&E-01, p. 2-57:15.

assumption, based on rate increases from 2008 to 2018, is no longer defensible.[29] Mr. Gorman explained that even the short term federal fund rates increases since 2008 have not increased long-term interest rates, and current projections are for long-term interest rates to remain near 3.0%.[30] Furthermore, the Federal Reserve cut the funds rate on July 31, 2019 by a quarter point.[31] The Commission can take official notice of the fact that, since the filing of testimonies, the Federal Reserve has cut the federal funds rate by another quarter point on September 18, 2019, and analysts now expect low interest rates for the near future.[32]

At least two other issues should be easily disposed of based on precedent. First, Dr. Morin adds about 20 basis points to his DCF results to account for "flotation costs,"[33] the fee that stock underwriters charge when a utility issues new stock. Mr. Gorman explained that adding a generic adder for flotation costs, when there are not actual known of forecast fees due to stock issuances, is inappropriate, especially since the vast majority of SDG&E's equity capital comes from retained earnings, which incur no flotation expenses.[34] Moreover, the Commission has rejected

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[29] See, for example, 2 RT 322-323, Villadsen, SCE; 3 RT 542, Vilbert, PG&E.

[30] Exh. EPUC/IS/TURN-01, III-9:18-23.

[31] Exh. EPUC/IS/TURN-01, p. III-11 to III-12.

[32] For example, Exh. EPUC/IS-03-C, July 22, 2019, p. 2 (RRA explains that while "additional increases were initially anticipated in 2019," analysts now expect reductions in the federal funds rates.). In quoting from proprietary analyst reports that are marked as confidential, TURN complies with the directions provided by the ALJs that it is permissible to quote "passages of a reasonable length" from the copyrighted documents, which are not *per se* confidential. See, 6 RT 1068-1069.

[33] See, Exh. EPUC/TURN/IS-01, p. X-2-, lines 10-15.

[34] *Id.*, p. X-20 to X-21.

this approach since at least 1992, and made repeatedly clear that a utility would have to demonstrate compliance with three specific factors in order to justify flotation costs.[35] Dr. Morin did not even attempt to comply with these factors,[36] and the flotation adjustment must be denied.

Second, the Commission has consistently provided guidance that proxy groups should use Value Line electric industry utilities that meet three exclusions screens.[37] PG&E witness Vilbert used several different proxy groups, including a "non-regulated" industry group and a regulated utility group that included utilities which violate the merger screen, as explained by TURN witness Gorman.[38] The Commission should place very little weight on Mr. Vilbert's results based on use of these non-standard proxy groups, particularly when clear guidance as to the appropriate construction of a proxy group was readily available.

In general, the Commission should discount those utility witness results which rely on inputs and assumptions that run counter to established Commission policies.

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[35] For example, D.12-12-045, p. 24 (The utility must demonstrate 1) actual flotation costs; 2) new stock issuances in test year; and 3) that stocks are trading below book value.)

[36] See, Exh. SDG&E-04, p. 48-53.

[37] See, D.12-12-045, *mimeo.* at 19. The three screens are: (1) exclude companies that do not have investment grade credit ratings; (2) exclude companies that do not have a history of paying dividends; and, (3) exclude companies undergoing a restructure or merger.

[38] Exh. EPUC/IS/TURN-01, p. VI-38:13 to VI-40:15.

3.2.2.2 National Data and Decisions by Other Regulatory Commissions Indicate that the Utilities' Methodologies Are Flawed and Their ROE Requests Are Too High

The Commission has historically placed considerable weight on data concerning national authorized ROEs, and the Commission should closely consider such evidence in this case. Other commissions have apparently rejected the methodologies and inputs promoted by these same utility witnesses, and have instead authorized lower equity returns.

Perhaps the clearest example of how other jurisdictions view certain of the technical machinations is demonstrated by responses to Mr. Vilbert's so-called "ATWACC adjustment," which increases equity returns by at least 0.60%.[39] Mr. Vilbert argues the adjustment is necessary to account for different financial risks and thus creates an "apples to apples" comparison.[40] Mr. Gorman countered that the ATWACC is flawed because a company has only one level of financial risk, and it should not depend on whether one is evaluating based on market or book capital structure.[41]

Mr. Vilbert has made the same argument in other jurisdictions, and other utility commissions have always rejected his position.[42] Indeed, while in his rebuttal testimony Mr. Vilbert concedes

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[39] Exh. EPUC/IS/TURN-01, p. VI-43:28-30.

[40] See, for example, Exh. PG&E-01, chapter 2, *passim* (for example, 2-4, 2-11, 2-27).

[41] Exh. EPUC/TURN/IS-01, pp. VI-44 to VI-46.

[42] See, Exh. EPUC/IS/TURN-02, VI-46:36 – VI-47:4. (Michigan PUC rejects ATWACC.) See, also, Oklahoma Corporation Commission, Order 672864, December 11, 2017, p. 21, Parag. 69, 71.

only that the ATWACC "is not widely used by regulatory commissions in the U.S,"[43] in reality it has *never* been adopted for any energy utility in the United States.[44] In other words, no other commission has accepted Mr. Vilbert's adjustment.

Removing simply the ATWACC adder from Mr. Vilbert's calculations reduces his ROE results by between 0.5% and 1.5%.[45] Without the ATWACC adder, Mr. Vilbert's modeling results are in the range of 8.5% to 9.8%, and are thus not dissimilar from the modeling results of non-utility experts.[46]

There is no need, however, to review individual decisions from different jurisdictions. The fact that most Commissions have eschewed the high ROEs recommended by these utility consultants is most clearly evidenced in the national data compiled by the Regulatory Research Association, an arm of S&P. The RRA documents the following national average ROEs for utilities since 2013, the year that this Commission last adopted litigated ROEs for the California utilities:

[43] Exh. PG&E-03, p. 1-62, lines 3-5.

[44] 3 RT 540:27 – 541:2, Vilbert, PG&E.

[45] Exh. EPUC/IS/TURN-02, Table 17, p. VI-36.

[46] *Id.*, p. VI-37:18-21.

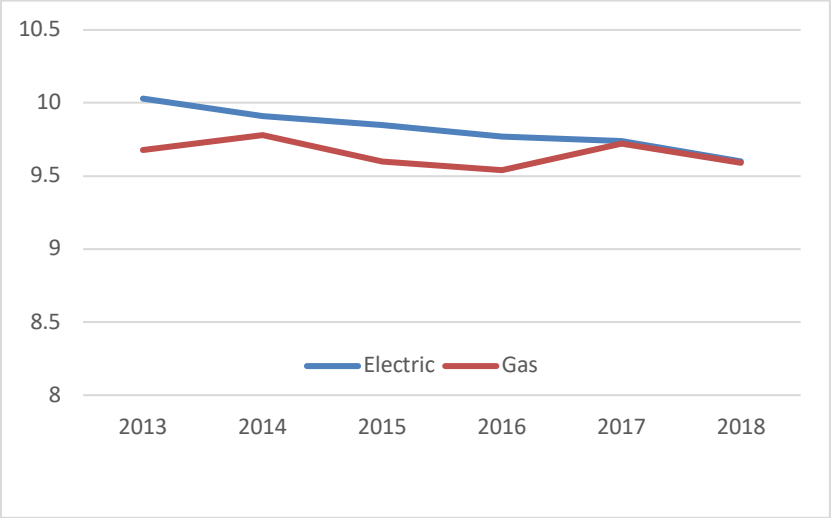
Table 5: Average National Utility ROEs 2013-2019[47]

Year	Electric Average ROE (%)	Gas Average ROE (%)
2013	10.03	9.68
2014	9.91	9.78
2015	9.85	9.6
2016	9.77	9.54
2017	9.74	9.72
2018	9.6	9.59
First Half 2019	9.66	9.63

These data demonstrate that for electric utilities average ROEs have steadily declined over the past five years, while gas ROEs have stayed relatively steady, as illustrated more vividly in Figure 1.

[47] Source: S&P Global Market Intelligence, July 22, 2019, Table 1. Exh. EPUC/IS-3-C. TURN reproduces only a small portion of the data in the tables of the report.

Figure 1: National Average ROEs for Electric Utilities Have Consistently Declined From 2013 to 2019[48]



The S&P report further explains that ROEs for those electric utilities that are no longer in the generation business, which includes the California utilities,[49] typically have ROEs 30 to 65 basis points lower than vertically integrated utilities,[50] thus suggesting that California ROEs should be toward the lower end of the national range.

3.2.2.3 A Short Digression About Modeling Results and Controversies

Back in the late 1980's and early 1990's, when cost of capital proceedings were conducted more frequently, the Commission directed parties to use the "'bare-bones' forms of three models," and

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[48] TURN acknowledges that the y-axis origin of the graph has been shifted to 8.0 in order to highlight the declining trend.

[49] While California electric utilities own hydroelectric generation and a few specific power plants, they are no longer in the business of building new generation.

[50] Exh. EPUC/IS-3-C, p. 3.

instructed parties to standardize model structures and assumptions.[51] The Commission admonished parties that the proceeding should not be "a battle of economic theorists," and cautioned that the Commission "will not resolve technical arguments about modeling details." In the 2000's, the Commission evaluated modeling results but emphasized that its ROE choices reflect consideration of all evidence and the use of "informed judgment."

In this proceeding, the multiple modeling experts submitted hundreds (if not thousands) of pages discussing the intricate details and permutations of the various models. PG&E witness Vilbert, for example, lists eighteen different results from using permutations of the CAPM model and five results from the DCF model.[52]

TURN appreciates that using multiple inputs and sensitivities can at times provide useful information; however, we believe that the amount of testimony and technical controversy in this case exceeds the relative importance of the various modeling results. TURN thus recommends that, at a minimum, the Commission order a workshop and provide some additional guidance to standardize presentations and reduce technical disputes before the next cost of capital proceeding.

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[51] See, D.94-11-076, *mimeo.* at 18-20, 37-39.

[52] Exh. PG&E-01, Tables 2-15 and 2-17.

3.3 There Are No Unique Business or Regulatory Risks in California That Warrant Increased ROEs, Although TURN's Witness Gorman Already Recommended an ROE at the Top of His Modeling Results

TURN will address the issue of wildfire risk in Section 3.4; however, at least three of the utilities – SCE, SDG&E and SCG – allege that various other "risks" are unique to California, and not sufficiently captured in proxy group results, and warrant selecting an ROE at the top of the modeling range. Though some of the alleged risks are rather flimsy, TURN provides a brief response to the main arguments. TURN first explains that equity investors are worried primarily about cost recovery risk that could impact earnings and market returns; TURN then discusses why it is not valid to adjust modeling results for allegedly unique risks; TURN identifies various regulatory policies in California that greatly reduce the risks of cost recovery; and lastly, TURN rebuts some of the utility arguments, showing that most of the alleged risks do not represent risks to shareholders, but rather represent cost risks for utility customers. Indeed, many of the so-called "risks" are really opportunities for increased capital expenditures, as the utilities make clear in their investor presentations. The overall lack of cost recovery risk is reflected in the fact that three of the four utilities have consistently over-earned their authorized ROEs since the last litigated cost of capital decision in 2012.

3.3.1 The Experts Agree that California Risks Are Embedded in the Modeling Results

The modeling results based on utility proxy groups capture all non-diversifiable market risks that are also present in the proxy group companies. It is undoubtedly true that different utilities face different risks; however, a fundamental assumption of the financial modeling is that use of a large group of regulated private utilities fully captures the range of non-diversifiable market

risks. To the extent a utility has truly unique risks, investors can reduce such risks by diversifying their portfolio, and the authorized equity returns are not intended to reward investors for diversifiable risk.[53]

It is also true that California has often led the nation in energy policy innovations, including policies to spur demand-side management, the unbundling and deregulation of the generation function, the promotion of rooftop solar, and the establishment of renewable procurement mandates. Other states have often followed suit. Sometimes, as with the energy crisis due to a flawed deregulation design, those policies have had negative consequences. But more often these policies have helped ratepayers save money and have reduced harmful emissions due to power generation.

The utilities have historically pointed to California risks as warranting higher equity returns than national averages, and warranting adopting ROEs at the high end of the modeling results. In D.12-12-034 the Commission concluded that "the ROE ranges being adopted in this proceeding from the various financial models adequately compensate the utilities for these [the financial, business and regulatory] risks" in California.[54]

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[53] See, for example, D.94-11-076, *mimeo.* at 45 (57 CPUC2d 533, 550). ("In determination of risks that deserve compensation from ratepayers, we should give little or no weight to risks that are diversifiable.")

[54] D.12-12-034, *mimeo* at 37.

In this case, it appears that the utilities agree that the modeling results do incorporate all risk factors,[55] and they (especially SCE and SDG&E) discuss the various "California risks" in order to justify selecting the maximum end of the modeling range for their ROE requests.[56]

3.3.2 California Regulatory Policies Provide Significant Cost Recovery Protections and Reduce Business and Operational Risks, and the Results are Evidenced in High Utility Earned ROEs

In its last cost of capital decision, the Commission explained that cost recovery risk was one of the three categories of regulatory risk.[57] The Commission concluded that the effects of all categories were already "reflected in the financial modeling results."[58] Utility witnesses in this case agreed that when push comes to shove, the primary risks that matter to investors are those that would reduce actual earned ROEs by increasing the potential of unrecovered costs.

California has implemented numerous regulatory mechanisms which eliminate or mitigate this cost recovery risk. The result is that, aside from the impacts of the accounting of wildfire claims on utility books, the utilities have consistently over-earned their authorized ROEs since the last litigated cost of capital proceeding.

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[55] See Section 3.3.1. Whether wildfire risks are also included in the modeling results appears to be a disputed issue, and utility testimonies on this are conflicting.

[56] For example, SCE witness Wood claimed that SCE's ROE expert, Dr. Villadsen, determined an ROE range and placed "SCE at the high end of that range based on unique risks that SCE and other California IOUs face." Exh. SCE-01, p. 6:20-23. See, also, 1 RT 126-127, Stern, SCE.

[57] D.12-12-034, *mimeo*. at 31.

[58] D.12-12-034, *mimeo.* at 32, 35, and 36.

3.3.2.1 The Fundamental Question for Equity Investors Is Whether There Is a Significant Risk of Utility Underearning Its Authorized Equity Returns Due to Higher Costs or Lower Revenues

Some of the utilities sponsor extensive testimony alleging that the "complexity" of clean energy policies, including renewable procurement, distributed energy resources, grid hardening, transportation electrification, and the growth of community choice aggregation, all impose risks on utilities in California that exceed the risks faced by other utilities.[59]

In evaluating the validity of these allegations, the Commission should focus on what is the risk that investors, especially shareholders for purposes of analyzing the return on equity, must consider in deciding whether to invest their money (i.e., purchase stock) in those utilities. As clarified during the cross examination of PG&E company Treasurer Bijur, the most relevant risk is the risk of "under-earning," which could then result in lower dividends or reduced market value (aka stock price).[60] Mr. Bijur further clarified that the utility's risk of under-earning really arises from three potential factors: disallowances, ineffective management (meaning actual costs exceeding authorized forecasts), or fines and penalties.[61]

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[59] See, for example, Exh. SCE-01, pp. 9-30, 92-93.

[60] 1 RT 43, Bijur, PG&E.

[61] 1 RT 45:1-23, Bijur, PG&E.

TURN witness Gorman explained similarly that the primary operational risk, which includes both business and regulatory risks,[62] is the risk of not recovering its cost of service, which can occur due to three potential factors:

> First, utilities' actual costs may exceed the forecast costs included in rates (Rate Recovery Risks). Second, actual revenues collected may be less than the forecasted revenues approved for recovery due to sales variations (Sales Risks). And third, the Commission could affirmatively deny recovery of costs due to imprudence or unreasonableness (Costs Disallowance).[63]

As discussed in the following subsections, California laws and regulatory policies eliminate sales risks and reduce cost recovery risk for much of the revenue requirement.[64]

3.3.2.2 California Regulatory Policies Insulate the Utilities from Cost Recovery Risk

California has adopted several regulatory mechanisms that ameliorate or eliminate these risk factors. First, California reduces rate recovery risk by using forecast test years and a significant number of balancing or memorandum accounts. Analysts view a fully forecast test period as the "most constructive" of different rate case methods, and only about 23% of state commissions have adopted fully forecast test years.[65] Roughly half of utility revenue requirements are

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[62] See, D.12-12-034, *mimeo.* p. 30-31, for a concise explanation of business and regulatory risks. Aside from capital structure, all of the risks identified by the utilities fall into these two categories.

[63] Exh. EPUC/IS/TURN-01, p. IV-2:5-9.

[64] The "rate recovery risk" is equivalent to the risk of "ineffective management," meaning actual costs end up exceeding authorized forecasts.

[65] Exh. SDG&E-19-C, RRA, May 9, 2019, p. 11.

recovered in balancing and memorandum accounts, including all procurement costs.[66] California utilities face almost zero risk of recovering of procurement costs (fuel and purchased power), due to the paradigm adopted by AB 57 after the deregulation crisis.

Second, California has fully decoupled electric revenues from sales, and mostly decoupled gas revenues, meaning that utility revenues will not fluctuate due to sales fluctuations.[67] This eliminates all sales risk, which is perhaps why Mr. Bijur did not even mention sales risk as an element of cost recovery risk. It likewise shifts the risk of reduced sales due to self-generation (i.e. rooftop solar photovoltaic systems) to other utility customers.

The risk of disallowances is a different risk, since, and as discussed in Section 2.2, utility equity returns are not supposed to protect shareholders against utility imprudence. If shareholders believe that a particular utility has a higher risk of disallowances compared to the average utility, they should diversify their investments in other utilities or seek other means of affecting management. Mr. Gorman explains that disallowances for imprudence must be addressed by management or shareholders:

> Again with respect to the risks of specific utility companies, the evidence and results of regulators applying the prudent management standard in the form of regulatory decisions which disallow imprudently incurred costs is also public information. To the extent that a specific utility has a record of imprudent operations, (and as such experiences a higher likelihood of wildfire -related losses than another utility), that is a risk investor may avoid by simply investing in a different utility company or by removing management that fails to conduct itself in a prudent manner. Thus, as a rule the capital markets compensate investors via

[66] Exh. EPUC/IS/TURN-01, p. IV-4 to IV-5.

[67] Exh. EPUC/IS/TURN-01, p. IV-6.

> risk premium for assuming risks that may be avoided or eliminated by replacing ineffective management or by a management simply conducting itself prudently. Ratepayers should not be asked to fund a premium to offset the consequences of imprudent operations, because these risks can be avoided. Beyond the normal risk associated with the prudent manager standard as applied across the entire utility industry which is already reflected in the fair Base ROE, market efficiency prevents the inclusion of a risk premium for investors caused by poor management that results in cost disallowances which reduce earnings.[68]

California utilities have a significantly lower risk of disallowances than some other utilities. California utilities are no longer in the business of building power plants. Large generation projects had significantly higher risks of material cost disallowances.[69] Moody's explained that utilities that invest only in transmission and distribution have "a lower business risk profile than their vertically integrated peers,"[70] and RRA explained that "ROEs in vertically integrated cases [over the past 12 years] are about 30 to 65 basis points higher than in delivery-only cases, arguably reflecting the increased risk associated with ownership and operation of generation assets."[71]

Overall, S&P has rated the California regulatory environment as highly credit supportive, though this assessment was revised one notch down in June 2018 due to issues concerning inverse condemnation and wildfires.[72] Similarly, RRA reduced its California regulatory ranking by one notch in August 2019, placing it in the Average 2 category, which places the state exactly in the

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[68] Exh. EPUC/IS/TURN-01, p. V-4, lines 4-17.

[69] Exh. EPUC/IS/TURN-01, p. IV-8.

[70] Exh. EPUC/IS/TURN-01, p. IV-7 (quoting Moody's, June 23, 2017).

[71] Exh. EPUC/IS-03-C, p. 3 (RRA, July 22, 2019).

[72] Exh. EPUC/IS/TURN-01, pp. IV-9:8 to IV-10:22.

middle of RRA's regulatory rankings distribution.[73] RRA had previously ranked California as Average 1, above the middle, but reduced the rankings due to PG&E's bankruptcy and ongoing concerns about inverse condemnation:

> The team is lowering the ranking of California regulation to Average /2 from Average/1 in light of ongoing uncertainty for investors with respect to the PG&E Corp. bankruptcy and the ongoing risk for PG&E Corp. subsidiary Pacific Gas & electric Co. and other investor-owned utilities in the state resulting from the reliance on interpretation of "inverse condemnation," under which a utility may be held liable for damage associated with force majeure events even if it has adhered to prevailing safety guidelines. While recently enacted legislation mitigates some of the utilities' exposure, it is unclear whether the funding mechanisms outlined in the law will avert similar situations in the future. The frequency at which severe weather-related events are occurring argues for a more comprehensive approach in RRA's view. These factors are more or less offset by the more constructive aspects of the California regulatory framework, which accounts for California's placement within a balanced category.[74]

TURN understands that there is continuing "uncertainty" regarding inverse condemnation, given the potentially large damages associated with wildfires, and it is for this reason that we recommend ROEs for the electric utilities that are above Mr. Gorman's modeling range results.

3.3.2.3 Procurement, Grid Modernization and Clean Energy Policies Do Not Represent Real Risks to Investors

SCE and SDG&E claim that a variety of risks related to California renewable procurement and clean energy policy create some kind of "complex, systemic risk."[75] For the most part, the utility

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[73] See, Exh. SDG&E-20-C, RRA, August 15, 2019, p. 1-2. See, also, Exh. EPUC/IS/TURN-01, pp. IV-10:23 to IV-11:22.

[74] Exh. SDG&E-20-C, pp. 2-3.

[75] Exh. SDG&E-03, p. 20:1-3.

claims are so vague and ill-formed that it is difficult to even discern what the claimed risk might be.[76] Nevertheless, TURN briefly addresses some of these claims.

First, any claim that conventional or renewable procurement creates risks due to stranded costs is pretty much bunk. Mr. Gorman explained that "Relying on power purchase agreements rather than building new generation also reduces the risk of the Commission disallowing major utility capital costs and puts the risk of poor performance on the third-party generator."[77] The regulatory system put in place by AB 57 insulates utilities from any reasonableness reviews of procurement costs once a procurement plan is approved, and guarantees timely recovery of any large balancing account under-collections.[78]

The only possible procurement risks identified by the utilities is the potential for stranded costs due to "departing load," caused by customers switching their generation procurement service to a community choice aggregator (CCA).[79] But as explained in the next subsection, the risk falls entirely on bundled customers, and has largely been eliminated by the exit fees required by statute and adopted by the Commission.

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[76] See, for example, Exh. EPUC/IS/TURN-01, p. IV-24 to IV-25.

[77] Exh. EPUC/IS/TURN-01, p. IV-23 to IV-24.

[78] See, P.U. Code § 454.5(d)(2) and (3).

[79] For example, witness Stern discusses this issue extensively in response to questions by ALJ Stevens. 2 RT 170-174, Stern, SCE.

Second, while SCE and SDG&E wave their arms about grid modernization, distributed energy resources, and the "complex, systemic risk" due to clean energy policies,[80] they can point to no specific risks to shareholders, and the reality is that the increased bulk and retail renewables and other distributed resources have provided the utilities an opportunity to grow rate base by investing in batteries, grid (both T&D) modernization technologies, and electric vehicle charging stations. While the utilities proclaims certain programs present "risks" in testimonies in this proceeding, the utilities applaud these same programs as an avenue for rate base growth in their presentations to investors. Edison International touts that the "Electric-led Clean Energy Future" of SCE will be the key driver of "sustained earnings and dividend growth."[81]

The utilities' complaints generally boil down to the fact that rooftop solar has reduced sales and increased cost pressures on non-NEM customers.[82] TURN does not at all disagree that the tremendous growth in rooftop solar "shifts costs from those customers eligible for NEM tariffs to all other customers," but the key fact for this proceeding is that "there is no revenue recovery risk for the utility."[83] The fact that many utility residential customers are already hurting due to intra-class cost shifting caused by NEM should not be used as justification to make those cost pressures even worse by needlessly increasing utility profits!

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[80] For example, Exh. SDG&E-03, p. 20:1-8.

[81] Exh. EPUC/IS/TURN-01, ch. IV, Exhibit MPG-2, p. 2. See, also, Exh. TURN-05, p. 108 (showing that SDG&E's proposed investments in electric vehicle charging and batteries represent the "major capital projects" that will influence future financial performance).

[82] For example, Exh. SDG&E-03, p. 20:11 – 21:9.

[83] Exh. EPUC/IS/TURN-01, p. IV-22:9-15.

3.3.2.4 CCAs and Retail Choice

TURN fully agrees that the rapid growth of CCAs over the past couple of years poses challenges for the energy sector. However, the challenge is to this Commission and to the Legislature – to determine how to meet clean energy and reliability goals when there are numerous procurement entities that are more lightly regulated. It is certainly not a challenge for utility cost recovery, since the Commission has adopted an "exit fee," the so-called Power Charge Indifference Adjustment (PCIA), to cover above-market costs of any power procured for departing load,[84] and the only risk is the potential of cost shifts to bundled utility customers.

Procurement costs are a pass-through for the electric utilities, and they earn no returns on procurement spending.[85] Thus, absent any potential risk of "stranded costs" due to load shifting, in and of itself there is no risk to the utility when a customer takes service from a CCA or a direct access provider and pays that provider for the generation component of the bill. That is why the RRA "generally does not view a state's decision to implement retail competition for generation as either positive or negative from an investor viewpoint."[86]

When push comes to shove, even the utilities acknowledge that the Commission's decision on the PCIA has pretty much rectified any cost recovery concerns.[87] Indeed, any risk due to departing load is really a risk that falls on bundled customers, since the utilities will recover all

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[84] Exh. EPUC/IS/TURN-01, p. IV-21:1-10.

[85] For example, 5 RT 827:13-21, Folkmann, SDG&E.

[86] Exh. SDG&E-20-C, p. 18 (RRA Report, August 15, 2019).

[87] See, Exh. SCE-01, pp. 23:8 – 24:9; see, also, 2 RT 174, Stern, SCE.

procurement costs either from bundled customers or through the PCIA. As a last resort, SCE engages in some hand waving to allege that there is continuing "uncertainty" regarding PCIA details remaining after the Decision reforming the PCIA methodology,[88] but as Mr. Gorman explained these uncertainties pose no material risk to utility shareholders:

> SCE attempts to continue to carry this argument on grounds that "uncertainty remains around how accurate the true-up process will be, what impact the cap will have, and what potential portfolio optimization measures the Commission will require SCE to implement," and then claims that these uncertainties continue to impose risks on SCE. Again, these risks fall on ratepayers due to the California cost recovery mechanisms. Moreover, based on the progress to date of two of the three PCIA working groups, there is no indication of any new risk to ratepayers from the outcome of these proceedings to fine tune the PCIA structure in 2018.
>
> Both SCE and SDG&E claim that their role as the provider of last resort creates risks due to returning load. SCE warns that its role of provider of last resort could lead to the utility absorbing an influx of unexpected load on relatively short notice should a CCA fail or improperly plan for its needs. The Commission is cognizant of the potential for the IOUs to provide backstop energy and in its decision on LSE procurement plans states that "the procurement track, in the near term, should focus on backstop procurement needed." In fact the procurement track of the ongoing IRP will "consider a development of a type of trigger mechanism for procurement activities" as well as a central procurement entity. The Commission is clearly aware of potential procurement concerns related to departing load, and, in the meantime, it is highly unlikely that the Commission would decline to provide cost recovery for power procured in this scenario.[89]

TURN does not deny that the growth of CCA may pose challenges to meeting clean energy and reliability goals, as there are concerns about meeting in long-term renewables or resource

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[88] Exh. SCE-01, p. 24.

[89] Exh. EPUC/IS/TURN-01, p. IV-21:11 – 22:7 (citations omitted).

adequacy contracting requirements. However, those challenges have nothing to do with risks to the investor-owned utilities and do not affect the appropriate level of equity returns in this case.

3.3.2.5 SCE, SDG&E and SCG Have Consistently Over-Earned Their Authorized ROEs Since the Last Cost of Capital Decision

Of course, what ultimately matters most to investors are actual utility profits. The impact of California policies is reflected at least in part in the consistent profits (actual equity returns) earned by the California utilities. The following table illustrates that since the last cost of capital decision, three of the four California utilities have consistently over-earned their authorized ROEs in 2013-2018. SCE's average annual overearnings were 0.88%, while SDG&E and SCG both over-earned by a whopping 2.72% (272 basis points) per year.

Table 6: Utility Actual ROEs Exceeded Authorized in 2013-2018[90]

YEAR	SCE Authorized	SCE Earned	SDG&E Authorized	SDG&E Earned	SoCal Gas Authorized	SoCal Gas Earned
2013	10.45%	11.85%	10.30%	11.56%	10.10%	14.39%
2014	10.45%	12.91%	10.30%	12.57%	10.10%	12.71%
2015	10.45%	11.59%	10.30%	23.17%	10.10%	14.87%
2016	10.45%	11.09%	10.30%	11.27%	10.10%	12.77%
2017	10.45%	10.97%	10.30%	7.85%	10.10%	11.60%
2018	10.30%	9.43%	10.20%	11.58%	10.05%	10.53%
Avg annual (earned-authorized)		0.88%		2.72%		2.72%

[90] Sources: Exhibits TURN-06 and TURN-07.

TURN did not reach agreement on a final exhibit with PG&E. PG&E's authorized and earned ROEs through 2016 are posted on the Commission's website.[91] Unlike the other three utilities, PG&E has not consistently over-earned its authorized ROE since 2011 due to some large penalties and fines related to a variety of company regulatory violations, as well as due to additional spending required to rectify deficiencies in the gas pipeline system and vegetation management practices.

3.4 There is No Justification for an Increased ROE Due to "Wildfire Risk," Since AB 1054 Has Insulated Shareholders Except When There is Management Imprudence, and the Residual Risks Identified by the Utilities Should Not be Compensated by Higher Equity Returns

Utility investors, participants in California's regulatory policy, as well as all Californians were understandably concerned in early 2019 by the scale of catastrophic wildfires ignited by utility equipment in 2017 and 2018, and resulting damage claims pursuant to inverse condemnation or just plain negligence. Even though inverse condemnation imposes shareholder risk only in the face of imprudence, that disallowance risk is unusually large.[92] The Commission's decision concerning the SDG&E's application for recovery of costs in the Wildfire Emergency Memorandum Account[93] contributed to investor unease, even though there is theoretical agreement that disallowances for imprudence represent a diversifiable risk that should not be rewarded with higher ROEs under the utility regulatory paradigm.

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[91] See, https://www.cpuc.ca.gov/General.aspx?id=12094

[92] See, for example, Exh. PG&E-01, p. 3-Atch1-13 to 3-Atch1-14.

[93] The "SDG&E WEMA" decision, or D.17-11-033.

The utility witnesses focus on this situation, which was admittedly the case when they filed their applications and testimonies in April 2019, to argue for ROEs above the currently authorized returns. They note that credit ratings for all of the electric utilities were downgraded in 2018, and that it is obvious that the market perceives the utilities as "riskier" today than they were in 2018, when the current ROEs were authorized, or even in 2013, when the last litigated ROEs were adopted. [94] Thus, they conclude that the ROEs authorized in this case should be higher than the currently authorized ROEs, which range from 10.2% to 10.3% for the electric utilities.

While this argument is superficially appealing, it ignores the fundamental impact of AB 1054 in ameliorating the actual risk faced by utility investors, and it ignores the positive market response to AB 1054. Rating agencies warned at the outset of 2019 that California utilities might be downgraded below investment grade, but reversed this outlook after the passage of AB 1054.

It is true that ratings agencies discuss the risk of "implementation" of AB 1054 and the risk of fund exhaustion, as two potential long-term risks. There is undoubtedly some market "uncertainty" regarding how the new regulatory system under AB 1054 will function. However, the "implementation risk" as discussed by utility witnesses in this case is overblown, as the utilities continue to misrepresent the differences between this Commission's evaluation of SDG&E's prudence concerning the 2007 wildfires and the FERC analysis of related claims, and

[94] The current ROEs, which went into effect in 2018, were authorized by D.17-07-005 based on a settlement, and reduced the previously litigated ROEs by 5 to 15 basis points. See, Exh. EPUC/TURN/IS-01, p. II-2, Table 2.

the utilities ignore the mitigations and future potential state action to mitigate any risk that AB 1054 will not sufficiently protect the electric industry from future wildfire risks.

3.4.1 AB 1054 Fundamentally Reduces and Caps Investor Risks Due to Inverse Condemnation and Utility Imprudence

Recognizing the gravity of the issues and the necessity of creating a sustainable financial foundation, the California Legislature and the Offices of Governor Brown, and later Governor Newsom, took several key steps. The Legislature passed SB 901 in August 2018, which addressed potential liabilities due to the 2017 wildfires and enacted a process to ensure better wildfire mitigation through the annual filing and approval of wildfire mitigation plans.[95] After his inauguration, Governor Newsom appointed a Strike Force and a Wildfire Commission, and later released a wildfire fund proposal that was rapidly adopted by the Legislature as AB 1054.[96] Numerous witnesses in this case expound on the various risk-mitigating elements of AB 1054, as do the various rating agency reports included in the record of this case. TURN believes there is significant consensus on the technical aspects of the statute, so rather than providing any lengthy legal analysis, TURN briefly summarizes the key elements of AB 1054 that reduce or cap shareholder risk:

> 1) The statute institutes a new Wildfire Fund, jointly capitalized by shareholders and ratepayers, so as to provide immediate liquidity and ensure the financial ability to pay large wildfire claims.

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[95] See, Exh. FEA-02, p. 6, Exh. EPUC/IS/TURN-01, pp. V-1 to V-3, V-9.

[96] For example, Exh. FEA-02, p. 9; Exh. EPUC/IS/TURN-01, p. V-2.

2) Section 451.1(b) amends the standard for reasonableness reviews of wildfire claims cost recovery to specify that "reasonable conduct … encompasses a spectrum of possible practices, methods or acts consistent with utility system needs," and that the determination of cost recovery may take into account factors beyond the utility's control, "including humidity, temperature and winds."

3) Section 451.1(c) requires the utility's conduct to be deemed reasonable if the utility has a valid safety certification, unless a party to the cost recovery proceeding creates a serious doubt as to the reasonableness of the electrical corporation's conduct.

4) Section 3292(h)2(C) adopts a cap on any potential shareholder liability to repay the fund due to disallowances for imprudence.

Given the fact that shareholder liability under inverse condemnation arises only from management imprudence, it is not surprising that one of the key provisions for investors is the cap on disallowances for imprudence:

> The "liability cap on cost disallowances is the most credit supportive feature of the [wildfire] fund because it allows us to quantify and limit a utility's maximum exposure to a catastrophic wildfire event if the utility is not found to be prudent according to the new prudency standard.[97]

While TURN believes that analyst fears about the SDG&E WEMA decision are borne of a misunderstanding, or even a misrepresentation, of the differences between the CPUC and the FERC reviews of SDG&E's WEMA claims, as explained in Section 3.4.5.1.3, it is not surprising that analysts emphasize the change in the required burden of proof standard:

[97] Exh. SDG&E-01-S, Appendix E, p. 1 (Moody's, July 12, 2019 Report).

> As long as SDG&E maintains a valid safety certification, the new CPUC standard would presume that it acted reasonably during a wildfire-linked event …. It also requires the CPUC to consider factors that were beyond the utility's control (e.g. humidity, temperature and winds) when deciding the total or partial allocation of costs. The most important change is that the burden of proof has shifted from the utility to the intervenors, who are required to raise serious doubt as to the reasonableness of the utility's conduct. We understand that this revised prudency standard is in line with the recovery standards applied by FERC. This is an important change because, in the case of SDG&E's 2007 wildfires, while the CPUC denied recovery, the FERC rules that SDG&E acted prudently and allowed the recovery of the wildfire costs.[98]

Mr. Gorman concluded that the policy framework adopted by AB 1054 "is designed to support the financial integrity of IOUs" and "is skewed toward protecting shareholders."[99] This is further buttressed by the response of rating agencies and the wider investment community, as detailed in the following section.

3.4.2 Market Reaction to AB 1054 Indicates that Investors Perceive that AB 1054 Has Stabilized the Utilities and Warrants Continued Investment Grade Credit Ratings for SCE and SDG&E

The market reaction to AB 1054 was positive. Even utility witnesses agree that after SCE and SDG&E chose the "wildfire insurance fund" as their preferred option towards the end of July, rating agencies reacted favorably:

> As discussed in Mr. Folkmann's testimony, credit rating agencies Moody's, Standard & Poor's ("S&P") and Fitch Ratings ("Fitch") similarly view SDG&E's participation in the wildfire fund as credit supportive, at least in the medium term. As reflected in those agencies' post AB-1054 reports, the wildfire fund potentially moderates some of the most dire risks facing SDG&E from California's

[98] Exh. SDG&E-23-C, p. 5 (Moody's Aug. 2, 2019 Report).

[99] Exh. EPUC/TURN/IS-01, p. V-8:12-20.

> catastrophic wildfire liability regime of inverse condemnation strict liability and the Commission's separate prudence review, principally through:
>
> > The availability of immediate liquidity to pay wildfire claims;
> > The cap on utility liability;
> > The alterations to the prudency standard; and
> > The incentive to settle subrogation claims.[100]

Mr. Widjaja goes on in that supplemental testimony to quote analyst reports that explain that positive impact of AB 1054 on SDG&E's credit quality.

The utilities emphasize that the rating agencies did not actually upgrade their credit ratings after passage of AB 1054. However, it is important to remember that, except for the obvious example of PG&E, the other two electric utilities continue to have investment grade ratings.[101] Moreover, Moody's, S&P and Fitch changed their "credit rating outlook" for SCE and SDG&E from negative to stable, and explained that selecting the wildfire insurance fund was a "major credit positive" event.[102] As summarized by S&P:

> The stable outlook reflects our view that the credit-supportive elements within California's new law, designed to minimize the impact of a catastrophic wildfire and to reduce the associated financial impact to an investor-owned electric utility, supports the regulatory construct and reduces business risk for SDG&E over the medium term.[103]

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[100] Exh. SDG&E-03-S, p. 1:17 – 2:7.

[101] PG&E's credit ratings are low due to its selection of bankruptcy protection. Its credit ratings will likely change after it exits bankruptcy court.

[102] Exh. SDG&E-01-S, Appendix C (Fitch Ratings, July 29, 2019) and Appendix E (Moody's July 29, 2019); Exh. SDG&E-22-C (S&P, July 30, 2019). See, also, Exh. EPUC/IS/TURN-01, p. IV-14 to IV-15.

[103] Exh. SDG&E-22-C, p. 1 (S&P, *San Deigo Gas & Electric Co. Ratings Affirmed, Outlook Revised to Stable from Negative*, July 30, 2019).

Prior to these improved credit rating outlooks, the rating agencies had lowered SDG&E's and SCE's credit rating outlooks to "negative." More importantly, as SDG&E witness Widjaja explained at length in his original direct testimony submitted in April 2019, at the outset of 2019 the rating agencies were very clear that California utility ratings would likely be downgraded *below* investment grade absent significant action by the State:[104]

> **Could a second California electric utility potentially file for voluntary bankruptcy in 2019?**
> We think it is possible. Without any regulatory reform, we view it as entirely possible that another electric utility could face a devastating wildfire during the 2019 wildfire season and, depending on the magnitude and severity, its board of directors could similarly determine that the best course of action would be to file for a voluntary bankruptcy before year-end 2019. In our view, the rapid decline in creditworthiness--PG&E filed for Chapter 11 only two months after the Camp Fire--shows how quickly things can change in California, given the current regulatory construct.
>
> **Does S&P Global Ratings believe that there is still time for California to take constructive steps that support credit quality?**
> |Yes. As we see it, there is a window of opportunity to bring clarity to the regulatory construct. However, that opening will start to close at the beginning of the 2019 wildfire season. From a ratings perspective, we would need to see clear evidence that concrete steps are being taken during this relatively short period to strengthen California's regulatory construct for electric utilities. *Absent clear evidence of leadership to identify concrete and realistic steps to reduce wildfire liability risks, S&P Global Ratings would lower the ratings on Edison, SCE, and SDG&E by one or more notches.*[105]

But State action did in fact occur. The Governor and Legislature acted rapidly to pass AB 1054, and the rating agencies did not further downgrade utility ratings. The outlook of the financial

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[104] See, Exh. SDG&E-03, p. 14:10 – 17:13.

[105] S&P Global Ratings, *Will California Still Have an Investment-Grade Investor-Owned Electric Utility?*, February 19, 2019 (emphasis added). Cited by Mr. Widjaja in Exh. SDG&E-03, in footnotes 29-32 and 38.

markets adjusted to the current level of risk, and the rating agencies acknowledged that AB 1054

1054 largely mitigated the wildfire risks face by California utilities.

> The stable outlook reflects our view that the credit-supportive elements within California's new law, designed to minimize the impact of a catastrophic wildfire and to reduce the associated financial impact to an investor-owned utility, supports the regulatory construct and reduces business risk for SDG&E over the medium term.[106]
>
> The stable outlook on Edison and SCE reflects SCE's decision to choose the insurance fund under AB 1054 and its receipt of a valid safety certification from the CPUC. We expect that Edison and SCE will benefit from the credit-supportive measures within AB 1054, which offset the risks of its increased susceptibility to catastrophic wildfires due to climate change and California's courts interpretation of inverse condemnation.[107]
>
> It is notoriously difficult to model wildfire risk because it is hard to quantify the effects of weather, climate change and the utilities' risk mitigation measures. Nonetheless, we believe the insurance fund will be large enough to cover all but the most extreme downside scenarios over the next decade.[108]

As a result SCE and SDG&E still have investment grade credit ratings, a sign that Wall Street

retains confidence in the financial stability of the utilities. Their stocks have continued to

appreciate.[109]

The fact that rating agencies have not increased utility ratings reflects some uncertainty about the long-term impacts of AB 1054, given that market participants are understandably unsure about the full scale of the impacts of a complex new legislation. The continued investment grade credit ratings and the change to stable rating outlooks is strong evidence that California utilities are not more risky than their peers across the country. This conclusion warrants reducing the utility ROEs to levels that more closely correspond to the ROEs that have been authorized across the country, which have averaged below 10% consistently since 2014, as shown in

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[106] Exh. SDG&E-22-C (S&P July 30, 2019), p. 1.

[107] See, Exh. EPUC/IS/TURN-01, p. VII-4. Similar comments were made by S&P, Moody's and Fitch. See, *Id.*, pp. VII-3 to VII-6 and VIII-2 to VIII-5.

[108] Exh. SDG&E-01-S, Appendix E (Moody's July 29, 2019).

[109] See, Exh. FEA-02, pp. 20-23, 29.

Table 5.

3.4.3 Nevertheless, Utilities Continue to Request a Wildfire Risk Premium

The Scoping Memo in this case indicated that the Commission will not consider a separate wildfire adder.[110] In their supplemental testimonies submitted after the passage of AB 1054, the utilities changed their terminology, but still maintain that wildfire risk warrants adopting ROEs higher than the number determined from modeling results, in other words it warrants a wildfire risk premium. The utilities calculate the premium using the same general methodologies as in their original testimonies, but now assuming a lower level of disallowances and incorporating the caps on shareholder liabilities adopted by AB 1054. The premium is evident by comparing the utilities' original base ROE requests to their ROE requests in supplemental testimonies, as illustrated below:

Table 7: The Utilities Include a Wildfire Risk Premium in Their ROE Requests

IOU	Current ROE	Base ROE Requested in Original Testimony	New Base ROE Requested in Supplemental Testimony	Wildfire Risk Premium (%)
SCE	10.30	10.60	11.45	0.85
PG&E	10.25	11.00	12.00	1.00
SDG&E	10.20	10.90	12.38	1.48
SoCalGas	10.05	10.70	10.70	0.00

[110] Scoping Memo, July 2, 2019, p. 3.

Even though the utilities no longer call it an "adder," it is effectively an adder, since the utilities have increased their original base ROE requests by an amount calculated based on the same methodologies. Although the utilities have significantly reduced their requested wildfire risk premium, **a majority of the increase in the requested ROEs compared to current ROEs is due to the revised wildfire risk premium**.[111] The base ROE increases over current ROEs range from 30 basis points (SCE) to 75 basis points (PG&E), while the additional wildfire risk premiums range from 85 basis points (SCE) to 148 basis points (SDG&E). Oddly, SDG&E originally requested the smallest wildfire adder of 340 basis points, but now requests the highest premium of 148 basis points, indicating that there is little consistency in the utility wildfire risk premium analyses.

In Section 3.3.1 above we found that there was consensus that modeling results incorporate all California risks. The utilities claim, however, that wildfire risks may not be embedded in the modeling, although their testimonies on this issue are confusing. For example, SCE witness Wood alleges that "because SCE's equity risks related to wildfires are not comparable to those of non-California electric utilities and cannot be assessed through conventional methods," SCE decided to hire consultants to model incremental equity returns based on an insurance model.[112] But SCE's actual modeling expert, Mr. Graves from the Brattle Group, explained that wildfire

[111] For all four utilities, the requested ROEs are in total 5.73% above current ROEs. The wildfire risk premium constitutes 3.33% of this increase. From data in Table 7.

[112] Exh. SCE-01, p. 7:3-4.

risk is an "asymmetric risk,"[113] but did not allege that this "asymmetric risk" is not incorporated in market data.[114] Dr. Morin, an academic who has written extensively about ROE modeling, readily agreed that SDG&E's "exposure to wildfires" is reflected in market data:

> That's [wildfire risk] embedded in the stock price, of Sempra. It's embedded in the bond ratings. It's also embedded in the beta risk figures.[115]

A basic assumption of the modeling is that all non-diversifiable risks are included in the selection of the proxy group, which includes a significant percentage of all the investor-owned energy utilities in the country.[116] Even if one believes that California wildfire risk is not fully captured in the proxy group data, the converse is that the proxy group also captures risks that are not encountered in California; and thus the ROE calculated based on the proxy group captures the overall magnitude of risk facing California utilities. This is the overall magnitude of risk for which investors expect to be compensated. Consequently, the Commission should be very careful about arbitrarily adjusting those results by any significant amounts, lest it provide a windfall to equity investors at the expense of utility ratepayers. The utilities in this case have

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[113] Exh. SCE-03, p. 1-2.

[114] TURN did not find any such claim in Mr. Graves' testimony.

[115] 2 RT 193:23 – 194:3, Morin, SDG&E and SCG.

[116] The proxy groups generally contain about 30 utilities (or parent holding companies), while there are about 170 investor-owned energy utilities in the country. Though some utilities may have the same parent holding company, so the number of companies with relevant stock data would be fewer. See, for example, Exh. EPUC/IS/TURN-01, ch. VI, Exh. MPG-1.

provided no credible evidence to demonstrate that California risks, including wildfire risk, are not already included in the modeling results.

3.4.4 The Utilities Readily Admit That Their ROE Wildfire Risk Premiums Are Intended to Compensate Shareholders for the Risk of Disallowances Due to Management Imprudence

In their original testimonies submitted on April 22, 2019, both PG&E and SCE hired the Brattle Group to quantify the risk to shareholders posed by wildfires in California. The Brattle Group consultants used historical data on wildfires to calculate a statistically expected claims amount, assuming shareholders would be found liable for the all the wildfire claims. Their recommended equity return premium[117] was intended to recover this entire shareholder liability due to third-party wildfire claims.

TURN believes that two fundamental assumptions embedded in the wildfire liability modeling conducted by all three electric utilities are undisputed. First, the third party claims that constitute the "shareholder liability"[118] portion of the calculations are solely and completely due to "disallowances," meaning claims arising from inverse condemnation that are "disallowed" by the Commission for recovery from ratepayers. Second, the only reason the Commission would

[117] TURN refers to this premium as the "wildfire ROE adjustment" or the "wildfire ROE premium" interchangeably.

[118] But the entire "risk" modeled by SCE and PG&E witnesses is due to "third party claims," not due to utility investments in their grid infrastructure or operations.

disallow utility wildfire liability costs arising from inverse condemnation is if the Commission finds that the utility acted imprudently.[119]

In other words, application of inverse condemnation in California shifts the risk of third party claims to utility ratepayers, and shareholders are only at risk if the Commission disallows costs due to a finding of imprudence or unreasonableness.[120] The newly-created Wildfire Fund creates liquidity and financial support by allowing the utility to use the funds to immediately pay claims, and to collect those payments from ratepayers after a reasonableness review pursuant to the new AB 1054 standards.

In their supplemental testimonies submitted after the passage of AB 1054, PG&E, SCE and SDG&E witnesses revised downwards their wildfire ROE premiums. But the fundamental assumptions remained the same – the shareholder liability was strictly due to disallowances based on utility imprudence. The primary analytical change was to replace the original assumption that 100% of wildfire claims would be disallowed, by the assumption that about 50% to 75% of the claims would be disallowed and become a shareholder liability.[121]

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[119] For example, 1 RT 49:21 – 50:1, Bijur, PG&E; 1 RT 71:7 – 14, Wood, SCE; 3 RT 514:1-7 and 524:21 – 525:7, Graves, PG&E and SCE. The various ratings agencies are also completely clear that cost recovery risk only extends to "disallowances," and that this liability is capped by AB 1054. See, for example, Exh. SDG&E-24-C, p. 2.

[120] A concise discussion of this issue can be found in the testimonies of TURN witness Gorman (Exh. EPUC/IS/TURN-01, p. V-7 to V-8) and DelMonte witness Knecht (Exh. DelMonte-01, p. 5).

[121] See, Exh. PG&E-02, p. 3-Atch1-15; Exh. SCE-01-A, p. A-8; Exh. SCE-03-A, p. A-16. See, also, 3 RT 523:10 -524:13, Graves, PG&E and SCE.

As discussed previously in Section 2.2, management imprudence is not a risk for which shareholders should be rewarded or shielded from by ratepayers. TURN witness Mr. Gorman summarized the concern about increasing ROEs due to a perceived wildfire risk:

> The existence of a prudent management standard is well known to investors; and considered in making investment decisions. As a result, the prudent management standard is a risk of investing in utilities, reflected in observable utility stock valuations, and therefore it is already included in the measurement of a fair Base ROE that is derived from market data applied to comparable risk samples. To the extent jurisdictions have unique risks that can be managed more efficiently with state or regulatory procedures/protocols, such as those addressed in California, the risk mitigation is implemented by the state or regulatory mechanisms. As I noted early, both the Legislature and the Commission have gone to great lengths to address these risks to the benefit of shareholders and customers.
> …
> Thus, as a rule the capital markets compensate investors via risk premium for assuming risks that may be avoided or eliminated by replacing ineffective management or by a management simply conducting itself prudently. Ratepayers should not be asked to fund a premium to offset the consequences of imprudent operations, because these risks can be avoided. Beyond the normal risk associated with the prudent manager standard as applied across the entire utility industry which is already reflected in the fair Base ROE, market efficiency prevents the inclusion of a risk premium for investors caused by poor management that results in cost disallowances which reduce earnings.[122]

EDF witness McCann made a similar point:

> These blatant and transparent proposals to recover disallowances by other means must be rejected by the Commission for obvious reasons. Disallowances are intended to incent shareholders to closely monitor their managers to prudently manage the utility and meet cost control targets. If shareholders can simply disregard these disallowances because they will be rolled into the ROE, then the incentive completely disappears. The Commission should take this opportunity when determining the ROE to fully align shareholder incentives with a proper safety culture and with the state's clean energy objectives. The utilities' proposals clearly do the opposite.[123]

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[122] Exh. EPUC/IS/TURN-02, p. V-3:19 – V-4:17.

[123] Exh. EDF-02, p. 3.

Given that all expert witnesses agreed that utility equity returns should not be increased to compensate for management imprudence, how is it that utility witnesses could in good faith calculate a risk premium based on the "risk" that some portion of wildfire liability claims will be disallowed by this Commission? The answer, as discussed in more detail in subsection 3.4.5 below, is that the utilities contend that while the general risk of "imprudent management" applies to all utilities and is included in modeling results, the California Commission's *application of the prudence standard* is so different from other jurisdictions that it represents a unique risk that warrants higher equity returns to attract investors.

3.4.5 The Utilities Identify Two Alleged Long-Terms Risks After the Passage of AB 1054

SCE and SDG&E contend that rating agencies have not increased their credit ratings because of continuing concerns about "long-term" risks remaining even after the passage of AB 1054. The utilities point to two remaining alleged risks identified by ratings agencies: the "implementation risk" related to uncertainty of how this CPUC will implement the revised prudence and burden of proof standards, and the risk of fund depletion due to the "lack of an automatic replenishing mechanism."[124] They claim that these risks justify increasing utility ROEs above current levels, despite the fact that they are already above national averages and that the market believes that California utility credit outlooks have been stabilized by AB 1054.

[124] See, for example, Exh. SDG&E-22-C, p. 1-2 (S&P July 30, 2019 Report).

The first risk apparently results from analysts' belief that this Commission is an "outlier" in the way it conducts prudence reviews, and that it may not apply the revised burden of proof and prudence standards in the same way FERC would apply them. As discussed in subsection 3.4.5.1, TURN suggests that this "implementation risk" is borne of a fundamental misunderstanding, or misrepresentation, of the two key cases addressing SDG&E's prudence with respect to the 2007 wildfires. Utilities continue to characterize the two decisions as being based on "the same facts," but even a cursory examination of the FERC and CPUC decisions[125] demonstrates that this claim is entirely specious.

The second risk is based on the notion that there is a small chance that use of the fund could exhaust all of it before the assume termination date of 2030. As discussed in subsection 3.4.5.2, it is more realistic to anticipate that potential utility wildfire mitigation work totaling more than ten billion dollars over the next few years will reduce the frequency and severity of catastrophic wildfires caused by utility equipment; and it is unrealistic to assume that California will do nothing if there are enough catastrophic wildfires to exhaust the large capitalization of the Wildfire Fund.

[125] The FERC SDG&E WEMA Decision is146 FERC ¶ 63,017; while the Commission's SDG&E WEMA decision is D.17-11-033.

3.4.5.1 It Is Unreasonable to Reward Shareholders for the "Perception" That This Commission Cannot Properly Apply the Prudence Standard, Especially Since this Perception Is Based on a Misrepresentation of the CPUC and FERC WEMA Decisions

3.4.5.1.1 The Utilities Allege That There Is a Risk that This Commission Will Not Apply the Burden of Proof and Prudence Standards of AB 1054 Correctly

The SDG&E WEMA decision clarified that if a utility is not prudent in maintaining and operating its power lines and equipment, any resulting wildfire liabilities would not be recoverable from ratepayers. Investors were apparently rattled by this decision, which came out after the wildfires of 2017. Rating agencies downgraded California utilities for the first time in mid-2018. As discussed in Section 3.4.1, AB 1054 addressed the perception of a different standard at the CPUC by requiring that the CPUC adopt the FERC "serious doubt" burden of proof standard, and also by modifying the prudence standard to require consideration of various factors outside of the utility control in evaluating the reasonableness of utility actions.

Nevertheless, various utility witnesses explain that there is continuing market concern regarding how the CPUC will "implement" the revised prudence standard, given that the CPUC allegedly applied the prudence standard so differently from other jurisdictions in its WEMA decision, and given utility allegations that the CPUC conducted the SDG&E prudence analysis unfairly.[126]

[126] See, for example, Exh. SDG&E-12, pp. 10:10 – 12:12 and 45:8 – 46:17; Exh. SCE-01, p. 42:8-13 ("SCE believes that the CPUC applied the standard incorrectly by engaging in an impermissible hindsight review, requiring perfection, and denying cost recovery based on conduct with no causal nexus to the fire.").

SCE witness Stern summarized this issue when responding to a question from ALJ Stevens:

> Q I want to follow up a little bit on that as well just so I can understand what the bright line is here. So you have said that the standard for prudence in California is different than other states. And one example you used was the federal government's treatment of this fire in San Diego.
>
> I understand that inverse condemnation was perceived as being a unique element to risk in California for investor-owned utilities. Is that what you refer to as well other -- other than the FERC example that you gave, are you referring to inverse condemnation or are you referring to other elements of the prudency standard?
>
> A So certainly inverse condemnation, even post-AB 1054 results in potential risk for disallowance for the utilities. And, again, some of that gets into this arguably confusing area where if that disallowance comes from a determination by the Commission of imprudence, then generally speaking negligence or imprudent actions shouldn't be rewarded with an ROE.
>
> On the other hand, if the standard that's being applied for prudence is uncertain or just different in California than elsewhere, then an investor has got to perceive that as being a greater risk associated with their investment. And if we want to continue to attract the investment, then a higher ROE, other things being equal, would be necessary.
>
> So these things are not fully independent of one another. Clearly, demonstrably, mismanaged, imprudent actions by a utility should not be rewarded with an ROE. The question is, well, what if there's a judgment associated with what that standard of prudence is that is fundamentally different in different parts of the country?[127]

SDG&E's witness Folkmann reiterated the same point:

> SDG&E's position is that AB 1054 is a significant step in the right direction. I might remind us that in 2017, Senate Bill 901 was passed. It was also viewed as a step in the right direction.

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[127] 2 RT p. 180:3 - 181:15, Stern, SCE.

> In my opinion, AB 1054 is more significant and more important with regard to transforming the way wildfires, liabilities are assessed in the state. There remain, however, very significant questions with regard to how the new prudency standard would be applied in a real fact situation.
>
> Wildfire assessments, unfortunately, do become charged, because there is clearly -- there has been loss of property, and potentially injury as well, to the public or others. So that entire context in the way the prudency standard is evaluated is part of what is unknown with regard to the way AB 1054 would be applied. Unfortunately, it may take a number of years. Hopefully, we never test this standard if there is not a wildfire. If there are, the process will take some time before there is greater clarity.

SDG&E witnesses Reed and Coyne are more direct in their explanation:

> However, this ignores that each jurisdiction's interpretation of the "prudent management standard" varies. As previously mentioned, we have direct evidence that the Commission's standard of "prudent management" has deviated from FERC, as demonstrated in the Company's WEMA application. …..[128]
>
> As discussed above, California's application of the prudence standard as it relates to wildfire liabilities has been materially different from other jurisdictions. AB 1054 offers a revised prudence standard, but it remains uncertain as to how that standard will be applied. As such, it is uncertain as to whether SDG&E will be able to recover liabilities associated with wildfires under the same standard that other jurisdictions would consider a reasonable and prudent manner.[129]

Wall Street analysts echo the concern that "if the commission does not implement AB 1054 in a credit-supportive manner, then much of the new law's credit-supportive elements related to the revised standards of a utility's reasonable conduct could potentially be negligible."[130]

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[128] Exh. SDG&E-12, p. 10:15 – 11:6 (citations omitted).

[129] *Id*., p. 19:11-17.

[130] For example, Exh. SDG&E-22-C, p. 2 (S&P July 30, 2019 Report).

In sum, the utilities' position in this case is that investors should be compensated with higher ROEs for taking on this risk of "uncertainty" in how the CPUC will apply the new prudent manager standard when conducting reasonableness reviews of wildfire costs.

3.4.5.1.2 The Utilities' Allegation Is Based on the Fiction That the SDG&E and FERC WEMA Cases Were Decided Differently Based on the Same Facts

The primary, and in fact the only, evidence for the utilities' and analysts' claim that this Commission applies the prudence standard differently from other jurisdictions is the allegation that the FERC reached the opposite conclusion from the CPUC in the same SDG&E case. Every utility witness addressing wildfire risk repeats the claim that the CPUC reached a very different decision in "settling the same cases" or "based on the same underlying facts."[131] SDG&E's main policy witness concludes that the CPUC applies the prudence standard in "a draconian fashion."[132]

Since AB 1054 specifically directed the CPUC to relax its prudence standard and to apply the FERC's burden of proof, all utility witnesses explain that investors still perceive an "implementation risk" because there is concern that the CPUC would apply the new standard differently from FERC, given how the Commission "deviated" so much from FERC in the past:

> However, this ignores that each jurisdiction's interpretation of the "prudent management standard" varies. As previously mentioned, we have direct evidence

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[131] See, for example, Exh. SCE-01, p. 42; SCE-01-A, p. 7; Exh. SDG&E-07, p. 7. It appears that this mantra of "same cases" and "same facts" has now been repeated so often, that it has become a truth within the echo chamber of rating agencies and utility witnesses.

[132] Exh. SDG&E-07, p. BAF-7:14.

> that the Commission's standard of "prudent management" has deviated from FERC, as demonstrated in the Company's WEMA application. **The Commission's precedent creates an incremental regulatory risk relative to the standard applied in other jurisdictions**, and therefore demonstrates that this risk is not reflected in Dr. Morin's proxy group companies.[133]

Wall Street echoes this same concern:

> In theory, California utilities can pass on their wildfire costs to ratepayers if the California Public Utilities Commission (CPUC) determines that the utilities had behaved prudently. However, in its first-ever wildfire cost recovery proceeding in 2017, the CPUC denied SD&GE's request to recoup wildfire costs that it had incurred in 2007, even though the Federal Energy Regulatory Commission (FERC) allowed full recovery on wildfire costs attributable to FERC jurisdiction assets. That decision threw into doubt the ability of utilities in the state to recover wildfire costs and raised questions about how incurring such costs would affect their financial stability.[134]

Why does Wall Street apparently believe the notion that this Commission used a very different analysis than FERC to reach a different outcome? The answer is shrouded in mystery. The rating agencies' language on this issue is limited, generally stating simply that "in the case of SDG&E's 2007 wildfires, while the CPUC denied recovery, the FERC ruled that SDG&E acted prudently and allowed the recovery of the wildfire costs."[135] In other words, the rating agencies do not go as far as to allege that the cases were tried "based on the same facts," as do the utility witnesses in this case. It is somewhat odd that, given the key importance of this issue, the rating

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[133] Exh. SDG&E-12, p. 10:16 – 11:3 (emphasis added).

[134] Exh. SDG&E-24-C. Moody's, *FAQ on the credit implications of California's new wildfire law*, August 6, 2019, p. 2. See, also, Fitch Ratings, July 17, 2019 (Exh. SDG&E-01-S, Appendix C).

[135] See, for example, Moody's July 12, 2019 Report. Exh. SDG&E-01-S, Appendix B. Very similar language is found in other ratings agencies reports.

agencies never say any more than this, and ignore the different evidentiary records, the different postures of the cases, or the fact that SDG&E requested only $23 million at FERC versus $379 million at the CPUC. The lack of analysis concerning this issue contrasts sharply with the analysts' detailed evaluations of many other risk factors.

TURN can only speculate regarding this example of the Wall Street echo chamber. The utilities provide various reports and briefings to analysts; those analysts then issue reports concerning investor uncertainty; and the utilities then use those reports for the purpose of requesting higher ROEs.

3.4.5.1.3 In Fact, the Outcomes at the FERC and the CPUC Did Not Reflect a Different Application of the Prudence Standard, But Simply Reflected that No Party Introduced Any Evidence in the FERC Case, and FERC Had to Find SDG&E Prudent Based on Its Burden of Proof Standard

The utility testimonies, as well as various rating agencies reports, either ignore the actual facts of the CPUC and FERC WEMA cases, or else are willfully blind to the differences in the records between the two proceedings. In reality, the FERC used a very similar "prudent manager" standard as the CPUC. The FERC articulated its standard as follows:

> In fact, one violation by a utility does not necessarily constitute imprudence, as utilities are not expected to be infallible. Instead, the Commission looks to things like standard utility practice to determine whether the utility's conduct was that of a reasonable, prudent utility, as set forth in New England Power Company: "[T]he appropriate test to be used is whether they are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time." The Commission's prudence standard "permits considerable latitude, in that the

> Commission, in reviewing a decision … does not look for a single correct result or require that every possible alternative be evaluated."[136]

The CPUC explains its prudence standard in very similar language:

> The term reasonable and prudent means that at a particular time any of the practices, methods and acts engaged in by a utility follows the exercise of reasonable judgment in light of the facts known or which should have been known at the time the decision was made. The act or decision is expected by the utility to accomplish the desired result at the lowest reasonable cost consistent with good utility practices. Good utility practices are based upon cost effectiveness, safety and expedition.[137]

The salient difference between these jurisdictions is that FERC does not place the burden of proof on the utility, but rather assumes that a utility showing of prudence is valid absent some party raising "a serious doubt" concerning the utility's request.[138] The CPUC, on the other hand, historically placed the burden on the utility to prove the reasonableness of its request based on a "preponderance of the evidence" standard.[139]

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[136] 146 FERC ¶ 63,017, ¶¶ 56, p. 14-15 (citations omitted).

[137] D.17-11-033, *mimeo.* at 10 (citing to D.87-06-021, 24 CPUC 2d 476, 486). TURN notes that while the Commission has at times applied a "clear and convincing" standard of proof, it has clarified that the utility must meet its burden of proof "by a preponderance of the evidence." See, for example, D.09-03-025, *mimeo.* at 8. AB 1054 amends this standard for the recovery of wildfire claims, as discussed in Section 3.4.1.

[138] 146 FERC ¶ 63,017, ¶¶ 46, 47, 48, 52, 57, 58 (for example, "The Commission presumes that a utility's expenditures are prudent in the absence of a challenge casting "serious doubt" on such prudence.") As discussed previously, AB 1054 mandates that the Commission use this FERC burden of proof standard in wildfire cases.

[139] See, for example, D.17-11-033, *mimeo.* at 9-10.

The different outcomes in the FERC and the CPUC cases, however, were not due to any major difference in the review of the evidence by the two commissions; but rather were due to the fact that the evidentiary record at FERC was non-existent, and FERC thus had to find SDG&E prudent based on its burden of proof standard. SDG&E filed its application at the FERC in 2012, and the California PUC requested that FERC put the case in abeyance, presumably to give the CPUC an opportunity to investigate the underling fires that formed the basis of the claims.[140] The FERC rejected the CPUC's request, and as a result the CPUC declined to participate in the case.[141] No other party intervened to provide evidence in the FERC case. The only testimony submitted was from FERC staff, and that testimony was extremely limited, and apparently accepted the utility contentions at face value.[142] The FERC granted SDG&E's request because it concluded that absolutely no evidence had been provided at all, thus there was no "serious doubt" cast on SDG&E's testimony, and FERC was obliged to find the request prudent based on its burden of proof standard.[143]

> 51. However, CPUC never formally raised a challenge, as required by the SDG&E TO3 Tariff and formula rate jurisprudence. Indeed, CPUC's Protest simply requested that "the CPUC and/or its staff (and other parties) should be given the opportunity to challenge the costs in question." Thus, on its face, the CPUC's Protest was not a challenge. The full text of Article I, section 1.4 of the

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[140] 146 FERC ¶ 63,017, ¶¶ 9.

[141] 146 FERC ¶ 63,017, ¶¶ 14, 44, and 51.

[142] 146 FERC ¶ 63,017, ¶¶ 34-42. For example, the staff testimony states "that SDG&E provided documents in response to discovery requests that indicate SDG&E had excellent vegetation management."

[143] 146 FERC ¶ 63,017, ¶¶ 52, 58.

TO3 Settlement makes it clear that the burden is triggered only "in the event of a challenge." That provision states:

> When SDG&E makes its annual Informational Filings, in the event of a challenge to any cost reflected in charges derived under Appendix VIII, SDG&E shall bear the burden of demonstrating:
>
> (a) that such costs and expenditures were prudently incurred,
> (b) the accuracy of the data and
> (c) consistency with the TO3 Formula.

52. Pursuant to Article I, Section 1.4 of the TO3 Settlement, a showing of prudence is only required if a challenge to any cost is made. There has been no formal challenge to the costs, much less one raising "serious doubt" as to the prudence of those expenditures.[144]

The situation was completely different in the CPUC proceeding, filed in 2015 more than a year after the FERC decision. At the CPUC, multiple parties, including the Office of Ratepayer Advocates and intervenors such as the Protect Our Communities Foundation, the Utility Consumers' Action Network, and Henricks, all provided extensive testimonies with facts concerning utility operations relating to the Witch, Rice and Guejito fires.[145] Those parties provided evidence of utility management imprudence in 1) tree trimming, 2) use of reclosers, and 3) inspection of wires and clearances.[146]

The record in the CPUC case thus contained facts never considered by FERC. The Commission found that the utility failed to demonstrate its prudence by a preponderance of the evidence based

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[144] 146 FERC ¶ 63,017, ¶¶ 51-52, p. 12-13 (citations omitted).

[145] D.17-11-033, *passim.*

[146] *Id.*

on the facts in the case. The different outcome in the FERC case did not reflect a different application of the prudence standard, but rather reflected the fact that absolutely no party introduced any evidence of imprudence, so FERC was forced to find that SDG&E was prudent based on its more lenient burden of proof standard.

The claim that the CPUC and FERC came to different decisions "based on the same underlying facts" is a canard. Indeed, SCE witness Stern agreed that what he meant by "the same underlying facts" is that both cases were looking at "actions relating to the same wildfire," but that "not all of the same facts were litigated in the two cases."[147] When further pressed to clarify, Mr. Stern agreed that he was "not making any such specific claim" concerning the similarity of the factual record in the FERC proceeding versus the CPUC proceeding.[148] A casual reader of the phrase "the same underlying facts" might not necessarily have understood that it meant that the cases addressed costs originating from the same fires, but that the records at FERC and the CPUC contained substantially different facts.

TURN does not presume to opine on whether the Commission can correctly apply the prudence standard adopted in AB 1054. What TURN can say is that the outcomes of the SDG&E WEMA cases at the FERC and the CPUC do not demonstrate a fundamentally different approach to evaluating utility prudence. The revisions adopted in AB further modify the legal standards to

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[147] 1 RT 96:6-27 and , Stern, SCE.

[148] 1 RT 102:14 – 103:11, Stern, SCE. The other utility witnesses similarly qualified their statements, though the underlying decisions speak for themselves and TURN did not attempt to walk each witness through the FERC and CPUC decisions on the stand.

reduce any potential finding of imprudence when utility equipment sparks a wildfire. The Commission should not allow the utilities and Wall Street to pressure it into granting higher ROEs by pointing to Wall Street fears that this Commission cannot conduct a reasonableness analysis in the same way as other jurisdictions.

3.4.5.2 The Risk of Fund Exhaustion Is Not Material, and It Is Likely that the State Would Take Further Action Rather than Allow the Electric System to Fail

The second risk identified by utilities is the risk that the Wildfire Fund will run out of money, and thus become "exhausted." The utilities rely on the Filsinger Report,[149] which calculates an 0.9% chance of fund exhaustion using its average case scenario; but utility witnesses emphasize that the underlying assumptions could prove to be erroneous, so that the risk of fund exhaustion could be even higher.[150] TURN does not dispute that the assumptions in the Filsinger Report could indeed prove to be erroneous. Filsinger modeled the worst case (no imprudence) and best case (total imprudence) outcomes with respect to fund exhaustions,[151] and Moody's picked the middle scenario, which in essence represents an average scenario.

But the risk of "exhaustion" is a remote possibility for at least two reasons. First, the utilities are planning on spending billions of dollars to replace conductor with covered conductor, replace thousands of other assets in high fire threat district areas, enhance their vegetation management

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[149] Exh. TURN-01. Filsinger Energy Partners, *California Wildfire Fund Durability Analysis*, June 26, 2019 (referred to as the "Filsinger Report" by various utility witnesses).

[150] For example, Exh. SDG&E-05-S, p. 10:10 – 11:7.

[151] 4 RT 680:16 – 681:1, Reed, SDG&E. See more discussion regarding the Filsinger modeling scenarios in Section 3.4.6.1 below.

practices, and enhance their situational awareness and weather monitoring.[152] It is unrealistic to anticipate that such spending would not meaningfully reduce the incidents of catastrophic wildfires. In that case, the IOU's requests for wildfire mitigation spending should be denied as the money would be better used to increase the capitalization or the Wildfire Fund. Indeed, the Filsinger "declining disallowance" scenario was quite possibly intended to model the reduced risk of ignitions over time "as the mitigation programs become more effective."[153]

Moreover, if it happens that the fund is exhausted sooner due to massive wildfire liabilities and no utility imprudence, it is much more likely in that scenario to assume that the State will pursue other legislative reforms, such as ending inverse condemnation or replenishing the fund, than to assume that the state will do nothing and allow the utilities to collapse.[154] Moreover, if the utilities are prudent, they can recover all liabilities from ratepayers absent any wildfire fund pursuant to § 1701.8(b)(1)(A).

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[152] For example, D.19-05-036, p. 3; D.19-05-037, *passim.*

[153] Exh. SDG&E-23-C (Moody's August 2, 2019).

[154] See, for example, Exh. FEA-02, pp. 27, 32-33.

3.4.6 Even If the Commission Agrees that Some Risk Premium is Warranted Due to Inverse Condemnation, the Utilities' Insurance Premium Analysis Is Factually Erroneous and Theoretically Unreasonable, and Mr. Gorman's Risk Premium Analysis is More Justified

3.4.6.1 The Utilities' Analyses Erroneously Assume Large Cost Disallowances in 2020

Witnesses Graves and Mudge for PG&E and SCE, and witnesses Reed and Coyne for SDG&E, all used sophisticated modeling to forecast the amount of potential "utility risk" due to wildfire claims. At a very high level, their methods used historical data on wildfire claims as a basis for forecasting the future.

As discussed in Section 3.4.4, the key input assumption that drives the result of their analyses is the amount of liability claims that would not be recovered from ratepayers due to a finding of imprudence. The utility witnesses all assume that the CPUC will disallow around 50% to 75% of any claims in 2020,[155] thereby quantifying fairly large shareholder exposure, and seeking ROEs to cover all of that exposure.

The assumption that the CPUC will disallow 75% of any wildfire claims has no basis in historical fact, and derives from a modeling scenario that was not intended to forecast the future. As explained by SDG&E witnesses Reed and Coyne, the 75% disallowance assumption is based on a modeling scenario used by Filsinger Energy Partners (Filsinger).[156] In their *California*

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[155] Exh. SCE-03, p. A-12, fn. 12; Exh. SDG&E-05-S, p. 19:13-17. See, also, 3 RT 525-526, Graves and Mudge, PG&E and SCE.

[156] Exh. SDG&E-05-S, p. 5, lines 16-20.

Wildfire Fund Durability Analysis presentation,[157] Filsinger used three assumptions concerning disallowances in order to model how long a fund with a certain amount of initial capitalization would last. Mr. Reed for SDG&E agreed that the three scenarios represented a worst case (no utility imprudence), best case (complete utility imprudence) and middle case (about 50% utility imprudence) scenarios from the standpoint of fund durability.[158] The Filsinger durability analysis made absolutely no representations concerning what might be the likely outcome in the future. Indeed, a declining disallowance scenario from 2020 to 2030 simply represents a future were wildfire claims decline over time, irrespective of the cause.

In discussing the risk of fund exhaustion, the ratings agencies focused their analyses on the middle case scenario, without explaining why they picked this scenario or even the fact that other scenarios were modeled. The ratings agencies' descriptions are relatively circumspect, as illustrated by the following representative example:

> We believe the size of the insurance fund should will account for all but the most extreme downside scenarios. Assuming that Pacific Gas & Electric Company participates, the fund will be capitalized with $21 billion of capital but has a gross claims paying capability of more than $40 billion. According to Filsinger Energy Partners, a consultant to California Governor Newsome's office, this funding level has only a 0.9% chance of being exhausted by 2030. **The calculation assumes** the wildfire experience of the past five years continues, utilities maintain $1 billion of wildfire liability insurance, **and 75% of wildfire costs are disallowed in 2020 but falling steadily to 25% by 2030**.[159]

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[157] In the record as Exh. TURN-01.

[158] 4 RT 680:16 – 681:1, Reed, SDG&E.

[159] Exh. SDG&E-01-S, Appendix B, Moody's, July 12, 2019 (emphasis added). Similar language is reproduced in other ratings agencies' reports.

While the rating agencies use relatively neutral language, the utility witnesses use language that strongly suggests that the middle case modeling scenario was actually Filsinger's forecast of the future:

> The Filsinger Energy Partners' Wildfire Fund Durability Analysis conducted for Governor Newsom's 'Strike Force' ("Filsinger**") assumes that only 25% of wildfire costs will be found prudent in 2020 – suggesting that alterations to the standard of review will not have a large impact on prudency review outcomes.**[160]
>
> As discussed in our response to Dr. McCann, we acknowledge that this is uncertain and consider a range of values based on **the Filsinger Report's expectation that an average of 70 percent of liabilities will be determined to be imprudent** over the first three years of the Wildfire Fund, and that the average likelihood of being found to be imprudent over the 2020 to 2030 period is 50 percent.[161]
>
> In particular, SCE relies on that analysis's assumption that 75 percent of wildfire costs will be disallowed in 2020 with the disallowance percentage "falling steadily" to 25 percent by 2030.[162]

The utilities' testimonies claiming that the Filsinger durability analysis was forecasting the actual outcome of CPUC prudence reviews in 2020 are not justified, especially as the utilities' witnesses understood that the Filsinger scenarios were not intended as forecast of the future:

> **Witness Reed (SDG&E)**
>
> Q Did the Filsinger -- does the Filsinger report indicate in any way what was -- what Filsinger assumed would be the likely outcome in terms of findings of prudence at the Public Utilities Commission?

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[160] Exh. SDG&E-03-S, p. 4:6-9 (Widjaja) (emphasis added, citations omitted).

[161] Exh. SDG&E-12, p. 46:11-15 (Reed and Coyne) (emphasis added).

[162] Exh. SCE-01-A, p. 8:19 – 9:1 (Wood).

A I don't think the report indicates a likely outcome. They tested a range of scenarios and we discussed the never prudent to always prudent and then the variable prudency between 25 and 75 with that changing over 10 years or over 15 years.[163]

Q Do you have any opinion as to which of those three scenarios regarding with different imprudence assumptions would be more likely to occur in reality in 2020?

A It's my view that all of those scenarios should be looked at as well as others that involve higher levels of claims being paid and reimbursed. Certainly I don't expect that you'll have a future of 10 years in which the utilities are never prudent or a future of 10 years in which the utilities would always be prudent. I think the range is somewhere between those extremes.[164]

Witness Wood (SCE)

Q And what the does word "assumption" mean to you? Does assumption mean that it is likely that it will be 75 percent?

A It could mean that. I think an assumption could change. The probability of an assumption is dependent on the person interpreting the assumption.

Q But just because this value was assumed in the report does not necessarily mean that that is the probability or likelihood that the disallowance will be 75 percent?

A That's correct.

Q Do you have any understanding at all of the assumptions used by the Filsinger Consulting Group to develop these values?

A No. Like I said, I didn't see the report.[165]

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[163] 4 RT 681:15-26, Reed, SDG&E.

[164] 4 RT 683:16-28, Reed, SDG&E.

[165] 1 RT 84:2-19, Wood, SCE.

It is just as likely that the CPUC might disallow 30% of any claims, or even 10%. Indeed, the wildfire risk modeling witnesses acknowledge that their assumed numbers are just based on the fact that Moody's picked this one scenario to discuss in its reports:

> For this analysis, we have assumed that those reimbursements would occur (up to the cap) 75% of the time in year 1 (2020), 5% less often in each subsequent year, declining to 25% of the time by 2030. This is not a forecast of the extent to which utilities will be found reasonable vs. not, but a schedule cited by Moody's that it deemed plausible for purposes of evaluating how much financial protection the Fund and its protocols create for utility lenders and investors.[166]

The Filsinger durability analysis offers no guidance on the likely amount of CPUC disallowances of wildfire claims in the future. Indeed, the average modeling scenario may have been intended to address the declining frequency of wildfires, rather than any impact of commission reasonableness reviews, as noted by Moody's:

> The calculation [of fund exhaustion in the Filsinger durability analysis] assumes that the wildfire experience of the past five years continues, utilities maintain $1 billion of wildfire liability insurance, and 75% of wildfire costs are disallowed in 2020, requiring utility replenishment, but this falls steadily to 25% by 2030 as the mitigation programs becomes more effective.[167]

The key point is that the utilities are requesting a specific premium in equity returns in order to equal the potential shareholder disallowances based on the assumption of 75% disallowances. If

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[166] Exh. SCE-03, p. A-12, fn. 12.

[167] Exh. SDG&E-23-C (Moody's August 2, 2019), p. 5.

the assumption proves wrong, shareholders will have gained additional returns for no reason at all.

In the end, it is unreasonable to calculate a "risk premium" for shareholders based on such highly uncertain assumptions regarding potential disallowances and resulting shareholder cost exposure. If the Commission wants to go down the path of calculating some additional "risk premium" due to inverse condemnation and a potential for utility imprudence, which TURN does not at all recommend, then a more reasonable method is the use of historical bond yield spreads as done by Mr. Gorman.

3.4.6.2 TURN Witness Gorman Calculated a More Appropriate Premium Based on Debt Yield Spreads

TURN witness Gorman explained that even though he does not believe a separate wildfire risk premium is warranted, as the market already factors in all risks in the projections of credit quality and in stock prices, there is a more appropriate method of estimating some risk premium than the "insurance reserve" method used by the utilities. Mr. Gorman explained that the downgrading of California utilities in 2018 by rating agencies reflects analysts' perceptions of the risks of inverse condemnation and wildfire claims. Mr. Gorman therefore calculated the historic spread between A-rated and Baa-rated utility bonds, and recommended that the average spread of 65 basis points (0.65%) be used as "as a ceiling on the increment for an authorized ROE available to a California utility to compensate it for wildfire damage cost risk, inverse

condemnation rule risk, or other risk of operating under conditions caused by extreme weather and natural disaster events."[168]

Utility witnesses applauded Mr. Gorman's "constructive effort to enrich understanding of wildfire risk," but claimed that his premium was insufficient. They argued that debt-investors and equity-investors have fundamentally different risks and require different returns, and that because equity returns are about twice debt returns, Mr. Gorman's calculated premium should to be doubled to measure equity risk.[169]

TURN does not at all disagree that shareholders and bondholders face different financial risks, most importantly because equity financing has no repayment obligation. However, that fact has nothing to do with how to calculate a risk premium using bond yields. For example, to calculate a premium using the risk premium model, actual historical Treasury bond yields are subtracted from actual equity returns.[170] The Treasury bond yield is a proxy for the risk-free rate, and represents the difference in yields between a government bond and no return (i.e., keeping your money under the mattress). But, as all of the modelers apparently agree, it would be entirely wrong to double the risk-free rate bond yield before subtracting it from the historical equity returns.[171] The risk premium is calculated by comparing actual returns against an actual bond

[168] Exh. EPUC/IS/TURN-01, p. V-11:1-6.

[169] Exh. PG&E-03, p. 2-16:18 – 2-17:9. See, also, Exh. SDG&E-12, p. 15-16.

[170] For example, Exh. SDG&E-04, p. 44.

[171] 2 RT 221:23 – 222:6, Morin, SDG&E and SCG.

yield. This is precisely what Mr. Gorman does by using a bond yield spread to approximate a risk premium.

3.4.6.3 The Utilities' Premise of Compensating Shareholders Using an "Insurance Reserve" Model Is Unreasonable, Since the Utilities Will Not Maintain a Reserve Account to Fund Any Potential Liabilities

The utilities' "insurance model" for calculating the wildfire risk premium quantifies the total liabilities for claims that would not be covered by ratepayers and then compensates shareholders annually so as to make up this entire amount.

Having utilities "self-insure" by collecting an amount intended to fully cover potential future liabilities that might be disallowed by the Commission is unreasonable, because the utilities are not proposing to create a reserve account that would hold all of the extra money from additional equity returns to pay out if and when a liability incurs. There are at least two problems. First, if the utility does incur actual liabilities, there may not be sufficient funds on hand to pay those liabilities. Second, if actual liabilities are less than forecast, then utility shareholders would simply earn extra profits. As Mr. Gorman explained:

> Relying on Wildfire Premiums would compensate shareholders whether or not they incurred any actual liability, thus creating a potential for shareholder windfalls to the detriment of ratepayers. If a Wildfire Premium is added to the Base ROE, it will produce additional earnings and will be available to the utility and its parent company without any restrictions.
> …
> There is no guarantee that the billions collected every year under the wildfire ROE premiums will be retained in the utility in a reserve account that will be available to pay wildfire damage claims made against the utilities. If wildfire damage claims are made against the utility, the utility will still need to fund the damage award using the utility's internal cash flows, or issue a special debt security. When this happens, the utility will again be faced with potential

> uncertainty that its internal cash flows cannot fund wildfire damage claims, and the utility may not be able to fund operating requirements and make needed capital expenditures to maintain service quality and reliability. Under the utility's proposal, the utility will not have a reserve account or insurance fund to draw upon to pay the abnormal non-recurring and potentially material wildfire damage obligations, and avoid financial distress if a claim is made.[172]

EDF witness McCann raised the same issues and concluded that "Commission is simply awarding free money to shareholders who can simply walk away from the utilities, withdrawing their equity through dividends and selling shares to avoid paying their share of the costs."[173]

In rebuttal testimonies the utilities dismiss these concerns because they explain that the purpose of the ROE premium is **not** to create a pool of money to fund liabilities, but rather to compensate shareholders for the risk of incurring extra liabilities.[174] The utilities' explanation fails to justify the nature and amount of their calculated ROE premiums. The utilities' experts calculated the ROE premium based on the amount of potential liabilities that would need to be "self-insured." But if the purpose is simply to reward shareholders for potential risk, there is little logical basis to calculate the ROE premium based on some assumed future utility liability for disallowances, especially given that the fundamental assumption – that the CPUC will disallow 75% of any utility claims in 2020 – has no factual basis and is wrought with uncertainty.

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[172] Exh. EPUC/IS/TURN-01, p. V-6:3-23.

[173] Exh. EDF-01, p. 19:16 – 20:6.

[174] For example, Exh. SDG&E-12, pp. 13-14, 25, 37.

The Commission should not adopt any ROE premium for wildfire risk, but if it does, the Commission should reject the utility calculations of an additional 85 to 148 basis points of remaining "wildfire risk," since those calculations are based on very weak assumptions and result in improper windfalls for shareholders. Any wildfire risk premium should be capped at the 65 basis points Mr. Gorman calculated using actual historical bond yield spread data for California.

3.5 Recommended ROEs for the Utilities

In the last litigated cost of capital proceeding, the Commission selected a reasonable range of ROEs from the modeling results and authorized ROEs toward the top of that range, based on "the evidence on market conditions, trends, creditworthiness, interest rate forecasts, quantitative financial models, additional risk factors, and interest coverage presented by the parties and applying our informed judgment."[175] The Commission noted "as a reality check" that the authorized ROEs for the three electric and combined utilities were within 10 basis points (up or down) of "the 10.36% average ROEs granted United States electric utilities during the first six months of 2012."[176]

Putting together all of the evidence and information in this case, TURN encourages the Commission to use its "judgment" in the same way it has done in the past, so as to set an appropriate ROE for each utility. The following sections provide more detail on the modeling

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[175] D.12-12-034, pp. 39 (SCE), 40 (SDG&E), 42 (SCG), 43 (PG&E).

[176] *Id.*

results for each utility, and recommend a reasonable point ROE based on the totality of the evidence. TURN places significant weight on the fact that national ROE numbers have declined steadily to about 9.6% over the past five years, that all of the non-utility experts calculate ROEs at or below 9.0%,[177] and that interest rates have declined during this year and are forecast to stay low. TURN considers closely whether a premium for inverse condemnation risk, capped at 0.65%, is warranted, based on any remaining risks after the passage of AB 1054.

In this case, TURN's witness Mike Gorman selected 9.0%, the high end of his modeling range as his recommendation for utility ROEs, and explained that the Commission could add up to 0.65% to that number as a premium for inverse condemnation.[178] As explained previously, TURN continues to believe that inverse condemnation shifts all risk to ratepayers, not shareholders, and that the only risk to shareholders is due to management imprudence, which should not be rewarded by higher ROEs. However, TURN acknowledges that the sheer size of the potential liabilities due to wildfires in California result in perceived risk by investors, and that there is continued market uncertainty given that there has been no experience to date with the new regulatory paradigm of AB 1054.

TURN believes that this "uncertainty" risk warrants authorizing ROEs higher than the modeling results would justify, but still lower than the currently authorized ROEs; and slightly lower than national averages, as those include the risk profiles of vertically integrated utilities.[179] As shown in

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[177] FEA witness O'Donnell recommend a 9.75% ROE for electric utilities by adding an 0.75% premium for inverse condemnation risk.

[178] Exh. EPUC/IS/TURN-01, p. VI-1:8-15, p. VII-1:2-7.

[179] See, Exh. EPUC/IS/TURN-01, p. II-2, Tagble 2.

Table 1, TURN recommends ROEs of between 9.40% and 9.65% for the electric utilities, and 9.0% for Southern California Gas Company. These recommendations are in line with the national average of about 9.6% to 9.65% authorized in 2018 and 2019 for electric and gas utilities.[180]

As noted previously, TURN does not attempt to comprehensively review all of the modeling twists and turns. In the subsections below, TURN presents what we believe are the relevant results for each party. TURN witness Gorman selected an average for each of his modeling methods, so that TURN presents a point average for his results. Most other witnesses presented ranges for each method, and then selected a specific ROE recommendation based on consideration of the ranges from multiple modeling efforts. Different witnesses gave different weights to different methods. And the witnesses did not always present one range for each method. For example, PG&E witness Vilbert used various permutations of modeling methods and proxy groups. TURN has attempted to capture the recommended ranges for each party, but we caution that the results presented in all the tables in this Section 3.5 are intended to be approximate, and are not a complete representation of the modeling results for each party.

3.5.1 PG&E

The modeling results and recommendations for PG&E's equity returns made by the different parties are approximated as follows:

[180] Exh. EPUC/IS-3-C, Table 1.

Table 8: Modeling Results and Recommendations of All Witnesses for PG&E[181]

Party	DCF	CAPM	Risk Premium	Comparable Earnings	Proposed ROE
TURN	8.70	8.50	9.00		9.00
PAO	7.51 - 8.72	6.77 - 9.33			8.49
FEA	8.0 - 9.0	5.0 - 7.0		9.5 - 10.5	9.75
DelMonte	7.37	6.64			7.11
PG&E	8.3 - 9.8	8.7 - 10.1	10.4 - 10.6		11.00

Based on a consideration of all of the evidence, TURN recommends that the Commission authorize a return on equity of 9.50% for PG&E. TURN notes that the choice for PG&E is clouded by the fact we are calculating a number that is important mostly in theory. Whether investors will desire to purchase PG&E stock in 2020 will be driven primarily by the results of the bankruptcy proceeding and the terms of any adopted plan of reorganization, especially given that PG&E cannot issue new shares until after it emerges from bankruptcy.[182] A high ROE is more likely to impact the struggles between current bondholders and current shareholders in the bankruptcy process than the ability to raise equity capital after bankruptcy.

[181] TURN has attempted to cull what we believe are the estimates proposed by each witnesses. Since some witnesses used various permutations of each model, it is not always easy to determine the best input for each model, and we do not claim that these numbers reflect the most accurate estimate from each witness. We apologize for any inadvertent misrepresentation of a party's position.

[182] Exh. PG&E-01, p. 4-7:1-7.

3.5.2 SCE

The modeling results and recommendations for SCE's equity returns made by the different parties are as follows:

Table 9: Modeling Results and Recommendations of All Witnesses for SCE[183]

Party	DCF	CAPM	Risk Premium	Comparable Earnings	Proposed ROE
EPUC/IS/TURN	8.70	8.50	9.00		9.00
PAO	7.51 - 8.72	6.77 - 9.33			8.65
FEA	8.25 - 9.25	5.0 - 7.0		9.5 - 10.5	9.75
SCE	9.5 - 10.75	9.5 - 10.5	10.5 - 10.6		10.60

SCE's witness Villadsen claims that the ratings downgrades that occurred in 2018 demonstrate that SCE is riskier now than in 2017, and thus requires an ROE increase.[184] However, the rating downgrades of SCE, as well as of SDG&E and PG&E, occurred as a result of the market reaction to the Commission's SDG&E WEMA decision, which established that imprudent utility costs would not be recovered, even in the presence of inverse condemnation. The passage of AB 1054, however, has resolved most of the risk, especially by modifying the burden of proof and capping any risk exposure for imprudence.

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[183] TURN has attempted to cull what we believe are the estimates proposed by each witnesses. Since some witnesses used various permutations of each model, it is not always easy to determine the best input for each model, and we do not claim that these numbers reflect the most accurate estimate from each witness. We apologize for any inadvertent misrepresentation of a party's position, and we will attempt to amend the table if necessary in reply briefs.

[184] Exh. SCE-02, p. 3.

Ms. Villadsen' results are biased upward, especially due to her use of a risk-free rate above 4%. As discussed previously, the Commission should reject this attempt to bias results by picking a "forecast for 2020" that is at odds with market conditions.

Based on consideration of all the evidence, TURN recommends that the Commission authorize a return on equity of 9.65% for SCE.

3.5.3 SDG&E

The modeling results and recommendations for SCE's equity returns made by the different parties are as follows:

Table 10: Modeling Results and Recommendations of All Witnesses for SDG&E[185]

Party	DCF	CAPM	RP	Comparable Earnings	Proposed ROE
TURN	8.60	8.50	9.00		9.00
PAO	7.51 - 8.72	6.77 - 9.33			8.49
FEA	8.5 - 9.5	5.5 - 7.5		9.25 - 10.25	9.50
UCAN/POC	8.80	9.00	9.71		9.15
SDG&E					10.90

During cross examination on the stand, SDG&E's witness Dr. Morin asserted that SDG&E is "more risky" than other utilities based on the DCF results for Sempra Energy, and then Dr.

[185] TURN has attempted to cull what we believe are the estimates proposed by each witnesses. Since some witnesses used various permutations of each model, it is not always easy to determine the best input for each model, and we do not claim that these numbers reflect the most accurate estimate from each witness. We apologize for any inadvertent misrepresentation of a party's position, and we will attempt to amend the table if necessary in reply briefs.

Morin made the off-the-cuff assertion that SDG&E must be dragging down the Sempra Energy ratings because it is more risky than other Sempra Energy affiliates.[186] Dr. Morin's off-the-cuff evaluation does not comport with Sempra Energy's own assessments or the market evidence. A cursory review of Sempra's 2018 10-K shows that the majority of risks identified for investors are "related to our businesses other than the California utilities."[187] More importantly, the same 10-K shows that the credit ratings as of December 31, 2018 from all three bond rating agencies were one or two notches higher for SDG&E than for the consolidated parent Sempra Energy,[188] indicating that other affiliates of Sempra Energy were considered more risky than SDG&E and SCG and were, in fact, dragging down the ratings of Sempra Energy. The passage of AB 1054 has allayed market fears and the credit outlook for SDG&E has improved. Dr. Morin's off-the-cuff evaluation should be afforded very little weight. As previously illustrated in Table 6, both SDG&E and SCG have over-earned by an average of 272 basis points in each year 2013-2018. SDG&E managed to reach this level of over-earnings despite taking a $208 million write-off in 2017 due to the SDG&E WEMA decision.[189]

Based on consideration of all the evidence, TURN recommends that the Commission authorize a return on equity of 9.40% for SDG&E. This level is slightly lower than the ROE TURN

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[186] 2 RT 192:8 – 194:3, Morin, SDG&E.

[187] Exh. TURN-05 (Sempra 2018 10-K), p. 36-65.

[188] Exh. TURN-05, p. 130.

[189] 4 RT 700:25 – 701:17, Widjaja, SDG&E. Mr. Widjaja explained that the write-off was only $208 million due to the tax impacts of the $379 million disallowance. 4 RT 762:1-6, Widjaja, SDG&E. See, also, Exh. TURN-05 (Sempra 2018 10-K), p. 71.

recommends for PG&E and SCE. It is based at least in part on the consistent and large over-earning by the company since 2011. Of course, continued and consistent over-earning more likely reflects authorized revenue requirements that are significantly higher than those needed to earn the authorized rate of return.

3.5.4 SCG

In addition to SCG witness Morin, TURN/IS and PAO experts modeled the appropriate ROE estimate for SCG, as summarized below.

Table 11: Modeling Results and Recommendations of All Witnesses for SCG[190]

Party	DCF	CAPM	RP	Proposed ROE
IS/TURN	8.60	8.50	9.00	9.00
PAO	7.51 - 8.72	6.77 - 9.33		8.49
SCG	9.44-10.91	9.0-9.6	10.3-10.5	10.70

Much of the discussion in the previous sections of this brief concerning utility risk applies only to the three electric utilities, since the primary risks were either wildfire liabilities due to inverse condemnation, or risks due to certain policies affecting electric utilities. SCG would like us to believe that inverse condemnation likewise taints it with "litigation risk"; and that it faces risks due to the need for large capital investments for the PSEP program; or, that it faces an

[190] TURN has attempted to cull what we believe are the estimates proposed by each witnesses. Since some witnesses used various permutations of each model, it is not always easy to determine the best input for each model, and we do not claim that these numbers reflect the most accurate estimate from each witness. We apologize for any inadvertent misrepresentation of a party's position, and we will attempt to amend the table if necessary in reply briefs.

operational and political risk due to the State's goal of electrification and future reduction in the use of natural gas.[191]

The Commission should give little weight to SCG's vague assertions of risk. SCG provides no evidence that it really faces any risks that might impact shareholders, or that it is at all differently positioned from other natural gas utilities in the country. For example, while SCG complains of its large forecast for capital spending in the next five years, it offers no evidence that its capital needs are unique. Moreover, the ratings agency reports that it quotes state that they expect "financial measures to reflect the middle of the range for the financial risk profile,"[192] which does not sound like the prognosis of a utility that is riskier than the national average.

Due to a lack of any enhanced risk, TURN recommends that the Commission adopt an equity return of 9.2% for SCG.

4 CAPITAL STRUCTURE

Table 12 below summarizes the currently authorized equity ratios, the utility requested ratios, and TURN's recommended equity ratios. There is no dispute regarding PG&E, as it is not seeking a change while in bankruptcy. TURN recommends a smaller increase in the equity ratio for SCE, and no change for SDG&E and SCG.

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[191] See, generally, Exh. SCG-03, p. 3-16.

[192] Exh. SCG-03, p. 10 (quoting S&P, October 30, 2018).

Table 12: Summary of Requested and Recommended Equity Ratios[193]

Equity Ratios	PG&E	SCE	SDG&E	SCG
Current Authorized	52%	48%	52%	52%
Utility Requested	52%	52%	56%	56%
TURN Recommended	52%	50%	52%	52%

SCE seeks to modify its capital structure by reducing is current 9% preferred equity to 5% preferred equity, and increasing common equity by 4%. Mr. Gorman explained that SCE has been fully able to fund its capital expenditures and maintain an investment grade credit rating while keeping its actual capital structure at 48%-51% over the past five years.[194] Increasing common equity increases costs to ratepayers, since equity is about twice as expensive as debt under current market conditions, particularly during the current low interest rate environment.[195] An equity ratio of 50% for SCE effectively balances the utility's interest in lower leverage for credit rating purposes with ratepayer interest in lower cost of capital, and overall supports an investment grade rating for the utility.

The Sempra utilities request a large increase in their equity ratios from an existing 52% to 56% based on their contention that this would better align with their actual capital structures. As Mr. Gorman explains, the current regulatory equity ratio has been entirely sufficient to maintain an investment grade credit rating for both SDG&E and SCG. Their request would result in

[193] Source: Exh. EPUC/IS/TURN-01, pp. II-4, Table 3 and II-5, Table 4.

[194] Exh. EPUC/IS/TURN-01, p. VII-8.

[195] Exh. EPUC/IS/TURN-01, pp. VII-8:8 – VII-9:21.

significantly lower debt leverage than typical for A-rated utilities.[196] Authorized equity ratios have averaged about 50.03% for electric utilities and 51.5% for gas utilities over the time period 2010-2019.[197] The Commission should reject this request, which unnecessarily raises utility rates.

5 EMBEDDED COST OF DEBT AND PREFERRED EQUITY

TURN does not comment on this issue at this time, but reserves the right to respond in its reply brief.

6 COST OF CAPITAL ADJUSTMENT MECHANISM

TURN does not comment on this issue at this time, but reserves the right to respond in its reply brief.

7 CUSTOMER DEPOSITS (PG&E ONLY)

7.1 Introduction

PG&E, as well as the other utilities, requires the payment of a deposit by customers applying for service who have not otherwise established credit with the utility, pursuant to tariff Rules 6 and 7.[198] The utility must return deposits to customers in no less than twelve months pursuant to

[196] Exh. EPUC/IS/TURN-01, pp. VIII-8 to VIII-10.

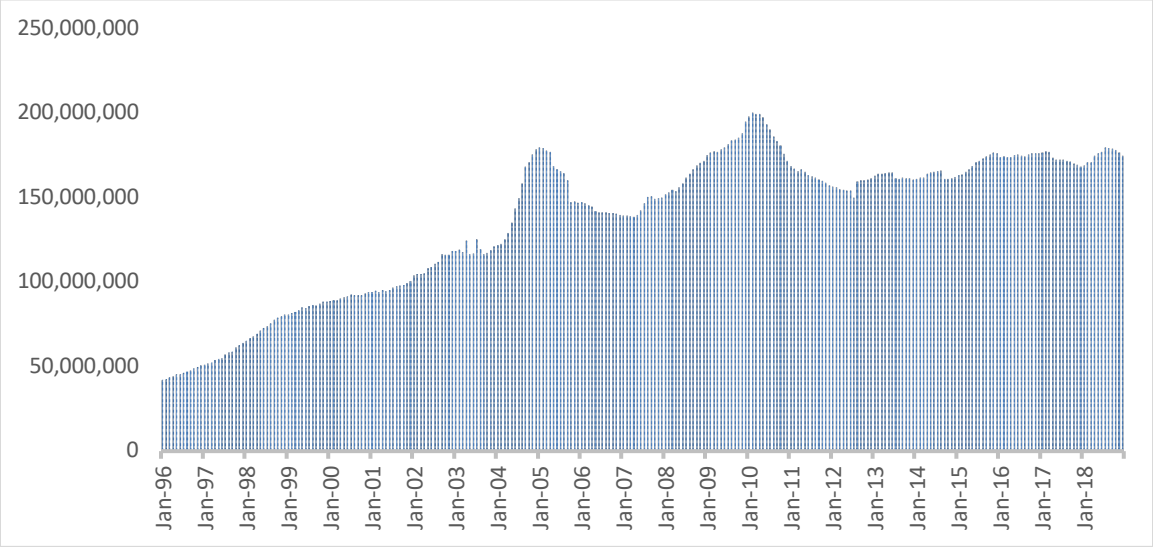
[197] Exh. EPUC/IS/TURN-01, p. VIII-10, Table 34.

[198] These same rules permit the utilities to additionally request an existing customer to re-establish credit with the utility under certain circumstances by similarly paying a deposit.

Rule 7, with interest paid at the commercial paper rate, as long as the customer's service has not been temporarily or permanently discontinued due to nonpayment. The utilities are not always obligated to pay interest on customer deposits, since Rule 7 provides that "no interest will be paid if service is temporarily or permanently discontinued for nonpayment of bills."

Although customer deposits must be returned, the utility constantly obtains new deposits, so that the utility continually has on hand a substantial, permanent amount of money that is a source of working capital. For PG&E, those amounts increased steadily from 1996 to about 2010, and have remained constant at between $160 and $180 million since 2012, as illustrated in Figure 2 below.

Figure 2: PG&E's Customer Deposits Balances (1996-2018)



The issue of whether customer deposits should be treated as an offset to rate base in the calculation of working cash has been hotly contested in every major energy utility rate case over the past two decades. For SCE the Commission has treated the balance of customer deposits as a

consistent source of working capital and thus an offset to rate base,[199] while for PG&E the Commission treated customer deposits as a source of long-term debt:

> For purposes of this proceeding, as an interim measure, it is reasonable to reflect customer deposits in the capital structure as a form of low-cost debt, resulting in an interest rate difference of 5.5% - 0.4%, and thereby yielding a $7 million reduction in revenue requirement. In the next cost of capital proceeding, the impact on PG&E's cost of capital and capital structure as a result of customer deposits as a source of capital can be fully considered and reflected in rates.[200]

In that PG&E 2014 rate case decision, the Commission ordered a full review of the issue in the "next cost of capital proceeding." The Test Year 2016 cost of capital proceeding has been postponed three times, and this cost of capital case is the "next proceeding" since D.14-08-032.

7.2 PG&E Switched Its Position in Rebuttal Testimony, After TURN Had Agreed with Its Recommendations

As with many issues relating to PG&E, this one has taken some strange twists and turns. In its original testimony, PG&E proposed that 1) there be no special treatment for customer deposits during its bankruptcy proceedings, because PG&E no longer comingles customer deposits with other cash to fund operations,[201] and 2) PG&E is unsure how it will hold cash from customer deposits after bankruptcy, and therefore the issue should be relitigated in the next cost of capital after PG&E exits bankruptcy.[202] In the testimony of TURN witness William Marcus, TURN

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[199] See, D.04-07-022, p. 254; D.15-11-021, pp. 470-474; and D.19-05-020, pp. 310-311.

[200] D. 14-08-032, Finding of Fact 310, page 720. See, also, D.14-08-032, p. 627-630.

[201] Exh. PG&E-01, p. 7-6, lines 13-22.

[202] Exh. PG&E-01, p. 7-6, lines 23-30.

accepted PG&E's explanation that during the pendency of bankruptcy proceedings customer deposits should not offset long-term debt, but TURN recommended that the Commission revert to the current treatment in the first electric and gas true-up after PG&E exits bankruptcy court.[203] TURN agreed that the issue should be litigated in the next cost of capital, and even suggested that it might be appropriate to review the issue for all utilities.[204]

However, in its rebuttal testimony, PG&E changed its recommendation and recommended that this issue not be reviewed in the next cost of capital proceeding because "PG&E believes now that such a review is no longer necessary, and that its proposal in this rebuttal testimony resolves the ratemaking treatment of CDs for the foreseeable future."[205] PG&E did not in any way address TURN's proposal that the treatment of CDs revert to the one adopted in D.14-08-032 in the first true-up proceeding after PG&E exits bankruptcy. In other words, PG&E wants the Commission to not use customer deposits as a rate base offset (for either equity or debt) and to just continue such treatment indefinitely.

7.3 The Commission Should \Not Change the Ratemaking Treatment of Customer Deposits Adopted in D.14-08-032

TURN can only assume that PG&E is hoping that this issue of customer deposits will get lost in the shuffle of much higher profile issues in this proceeding. Apparently PG&E hopes that the Commission will, in this proceeding, rescind the ratemaking treatment of customer deposits

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[203] Exh. TURN-02, p. 2:27 – 3:6.

[204] Exh. TURN-02, p. 3:7-11.

[205] Exh. PG&E-03, p. 3-7, lines 8-11.

adopted in D.14-08-032 and then simply forget all about it, and allow PG&E to use customer deposits as free cash even after it exists bankruptcy.

The Commission should not allow this to happen. While it may not be a big issue in the scheme of things, customer deposits are a large sum, and reducing the working cash requirement by the cost of debt or the cost of equity can reduce revenue requirements by a few million dollars without impairing any important program spending. The Commission should not pass up this opportunity to reduce by at least a tiny bit the steady upward climb of PG&E's electric and gas rates.

There is great hope and expectation that PG&E will exit Bankruptcy Court by June 30, 2019, so that it can take full advantage of the Wildfire Fund. Any new rates authorized in this case would not go into effect until January 1, 2019. Given that short potential duration of time, and given that PG&E has reneged on its original proposal, TURN recommends that the Commission **not change the ratemaking of customers deposits in this case.** In other words, PG&E's long-term debt costs should be reduced based on the average amount of customers deposits in 2018 and the difference between PG&E's cost of debt for 2020 and the commercial interest rate.

Alternatively, if the Commission adopts PG&E's proposal not to account for customer deposits for the short duration of bankruptcy in 2020, it should order PG&E to file a Tier 2 Advice Letter within thirty days of exiting Bankruptcy Court that implements the ratemaking treatment of customer deposits adopted in D.14-08-032.

7.4 If The Commission Chooses to Amend the Ratemaking Adopted in D.14-08-032, then It Should Treat Customers Deposits as an Offset to Rate Base

PG&E's testimony argues in support of not using customer deposits as an offset to equity or debt rate base. PG&E explained that customer deposits are similar to "variable rate long-term debt"[206] and conceded that they are a permanent source of cash;[207] but then alleged, without any evidentiary or theoretical support, that customer deposits are unlikely to be used to fund plant or equipment and instead "it would be reasonable in such situations to assume that CDs are financing balancing accounts." PG&E thus claimed that since customer deposits are not used to finance permanent assets, they cannot be treated as a permanent source of cash.

PG&E's tortured argument ignores the relevant evidence that customer deposits are a permanent source of cash, and is based on the unsupported allegation that customer deposits are not used to finance plant or equipment. This assertion runs counter to PG&E's admission that it comingles cash from different sources. TURN did not engage in extensive financial testimony on these issues, since we generally agreed with PG&E's original recommendation to relitigate this issue in the next cost of capital proceeding. The Commission should not condone PG&E's sandbagging by adopting its position without any further review.

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[206] Exh. PG&E-01, p. 7-1.

[207] Exh. PG&E-01, p. 7-5:23-28.

TURN believes that the evidence on the record not only supports using customer deposits as an offset to long-term debt, but even supports finding that customer deposits are a permanent source of cash and should be an offset to total rate base.

8 SHOULD PG&E BE ORDERED TO FILE A NEW COST OF CAPITAL APPLICATION WHEN IT EMERGES FROM CHAPTER 11 BANKRUPTCY?

Absolutely, at least to update the forecast cost of debt for purposes of authorizing the debt portion of the rate of return. PG&E's forecast of the cost of debt in this case is higher "primarily due to the higher cost of debt from PG&E's $5.5 billion, court-approved Debtor-In-Possession facilities."[208] While the market experiences declining interest rates, PG&E is locked out of issuing new bonds for debt equity. PG&E's debt financing should stabilize after exiting bankruptcy. It should be required to file an application within three months of exiting bankruptcy to update its debt cost forecast. PG&E should not be allowed to collect higher than necessary returns for debt costs if its actual costs of debt decline after bankruptcy.

9 CONCLUSION

This is the first litigated cost of capital proceeding since new equity returns and capital structures were authorized for the start of 2013. The utilities are proposing increases to their "base" ROEs of 30 to 75 basis points based on modeling results that allege equity returns should be higher than 10.0%. On top of that, the three electric utilities are requesting even greater increases of 85

[208] Exh. PG&E-01, p. 5-1.

to 148 basis points to account for alleged remaining wildfire risks even after the passage of AB 1054.

All of the experts hired by third parties recommended ROEs below 10% based on their modeling results. Average national ROEs dipped below 10% in 2014, and, at least for electric utilities, have consistently declined since then to about 9.6% in both 2018 and 2019. Since the beginning of January 2019, interest rates have declined, after previously increasing for several years, and forecasts are now for a contuining low interest era. All of these factors indicate that utility modeling results are unreasonable and too high. The Commission should adopt base ROEs for all of the utilities below 10.0% to properly account for shareholder risk.

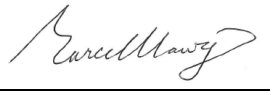
Much of this brief addressed wildfire risks used to justify large ROE premiums. There is universal agreement that AB 1054 substantially reduced any shareholder risk. Any remaining shareholder risk reflects only the potential for Commission disallowances of utility wildfire liabilities, that could occur only if the Commission finds the utility imprudent under the new prudence and burden of proof standards adopted by AB 1054. This brief documents that the utility allegations that this Commission conducts prudence reviews out of synch with other jurisdictions is based on a gross misrepresentation of the nature of the FERC review of SDG&E's WEMA application, since the FERC case had almost no relevant facts in the record, and so FERC was obliged to find SDG&E prudent based on its "serious doubt" burden of proof. In contrast, the CPUC had ample evidence of SDG&E's imprudence on which to disallow costs. The Commission should not allow the utilities to perpetuate the fiction that this Commission

does not know how to conduct proper reasonableness reviews, and to reward shareholders with higher returns based on this erroneous "perception."

Nevertheless, TURN acknowledges that there is market uncertainty about the implementation of the new regulatory paradigm under AB 1054, and the large potential liabilities associated with wildfires and inverse condemnation. As a result, TURN recommends that the Commission adopt equity returns higher than 9.0% maximum modeling result calculated by TURN witness Gorman. TURN recommends that the Commission adopt equity returns of 9.50% for PG&E, 9.65% for SCE, 9.40% for SDG&E, and 9.20% for SCG.

Date: September 30, 2019

Respectfully submitted,

By: 

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APPENDIX – TABLE OF ACRONYMS

ACRONYM	FULL TERM
Cal PA	Public Advocates Office
CAPM	Capital Asset Pricing Model
CCA	Community Choice Aggregation or Aggregator
DCF	Discounted Cash Flow
EPUC	Energy Producers and Users Coalition
FEA	Federal Executive Agencies
FERC	Federal Energy Regulatory Commission
IOU	Investor Owned Utility
IS	Indicated Shippers
PCIA	Power Charge Indifference Adjustment
ROE	Return on Equity, or the profit on the equity portion of rate base
RP	Risk Premium
RRA	Regulatory Research Associates, a group within S&P Global Market Intelligence
TURN	The Utility Reform Network
UCAN/POC	Utility Consumers' Action Network, Protect Our Communities Foundation
WEMA	Wildfire Event Memorandum Account