**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

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.	A.19-04-014
And Related Matters	A.19-04-015 A.19-04-017 A.19-04-018

**REPLY BRIEF OF
SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)**

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I. INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

In accordance with Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission ("Commission") and Judge Stevens' October 4, 2019 email ruling modifying the procedural schedule to allow for a deadline of October 10, 2019 to serve and file this document, San Diego Gas & Electric Company ("SDG&E" or "Company") submits this reply brief.

This case comes down to a matter of straightforward logic. Intervenors admit that a return on equity ("ROE") must be set commensurate with risks.[1] That is, a utility of above-average risk must have an above-average return. The record is replete with extensive evidence – including from intervenors – that inverse condemnation and uncertainty surrounding Assembly Bill ("AB") 1054's implementation make SDG&E and other California utilities riskier than the average utility outside the State.

[1] Unless otherwise defined, all definitions from SDG&E's opening brief apply to this reply brief.

Multiple intervenors agree that Regulatory Research Associates' ("RRA") reported national average of allowed electric utility returns for 2019 should be used and/or heavily considered here in setting SDG&E's ROE, just as it was by the Commission in 2012. That average for 2019 is 9.66 percent. It follows that, if the average allowed ROE for an electric utility in 2019 is 9.66 percent, and returns must be set commensurate with risks, the ROE for an above average-risk utility such as SDG&E must be set above that national average.

Various intervenors admit some or all of the above points. Yet every single intervenor proposes ROEs for SDG&E that are significantly below the national average – in other words, a return that would only be appropriate for a utility with significantly below average risks. The intervenors' results driven approach would provide one of the riskiest utilities with one of the lowest ROEs.

In the Commission's 2012 decision, the Commission noted that they were setting SDG&E's ROE around the national average – when the Company had an 'A' credit rating from S&P. The risks cited in that 2012 decision have only increased. And they have been joined by the recently exacerbated threat posed by California's wildfire liability regime.

The Company is now at a BBB+ rating, having been downgraded at least two notches by each credit rating agency. Although those agencies have repeatedly lauded SDG&E's operational excellence and wildfire mitigation programs, they have found the benefit from those programs are outweighed by the uncertainties created by the legal and regulatory environment. Although AB 1054 was a significant improvement, market participants see ongoing risks from inverse condemnation's continuation and uncertainty regarding AB 1054's implementation – reflected in the fact that credit rating agencies have not restored SDG&E's former 'A' rating. As TURN correctly notes:

> 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.[2]

The Company's credit rating downgrades occurred while it was at its current 10.2 percent ROE. Lowering SDG&E's current ROE (which still sits within the range of ROEs allowed in 2018-2019) or not granting the Company its actual capital structure – despite SDG&E facing lowered credit ratings and increased cost of capital from the regulatory environment through no fault of its own – would send exactly the wrong signal to credit rating agencies and investors. Even accepting EPUC-IS and TURN's construct of relying upon the 2019 ROE national average, a more appropriate approach would be to start from that average (which is also largely consistent with where Dr. Morin believes the current average for his peer group would be) and then add a risk premium such as proposed by EPUC-IS and TURN's own expert to account for SDG&E's additional risks.

Similarly, credit rating agencies have noted the importance of SDG&E maintaining its actual capital structure. And this Commission has repeatedly supported adopting a utility's actual capital structure. Allowing SDG&E an above-average ROE and 56 percent common equity ratio for its above-average and unique risks is consistent with the Supreme Court and this Commission's precedent.

II. SDG&E SHOULD RECEIVE AN ABOVE-AVERAGE ROE TO ACCOUNT FOR ITS ABOVE AVERAGE RISKS

ROE must be set commensurate with risks. That is, the greater the risk, the greater the return. Here, there is extensive record evidence – including from intervenors – that SDG&E is

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2 TURN Opening Brief ("Br.") at 4.

riskier than the average utility. SDG&E's ROE must thus be set above the current 2019 national average to adequately reflect those risks.

A. SDG&E Continues to Face Unique Wildfire Liability Risks Following AB 1054's Passage

1. Certain Intervenors Correctly Acknowledge SDG&E's Ongoing Risks

The Commission has long held that financial models are the starting point before the agency considers additional risk factors that are not adequately captured by those models.[3] The risk to return relationship is generally direct – the higher the risk, the higher the return required.[4] That is, as Kevin O'Donnell states for FEA, "if you're above average risk, you should be above the national average."[5]

As TURN notes, this cost of capital case is unique from "the financial repercussions of the application of inverse condemnation in California."[6] The record here is replete with evidence – including from intervenors – that SDG&E faces higher and unique risks that are not shared by its peer companies nationwide; principally from catastrophic wildfire liability. As TURN states, while AB 1054 was an improvement in the regulatory environment, credit rating agencies and market participants see two ongoing risks:

- "The sheer size of the potential liabilities due to wildfires in California" from inverse condemnation's strict liability; and

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3 *See* D.12-12-034 at 28.

4 *See* Morin/SDG&E Exh. SDG&E-04 at 55.

5 O'Donnell/FEA Tr. V.3:363:26-28; *accord* Gorman/EPUC-IS/TURN Tr. V.3:393-394.

6 TURN Br. at 10.

- The "continued market uncertainty given that there has been no experience to date with the new regulatory paradigm of AB 1054."[7]

To take each in turn, inverse condemnation's strict liability shifts the burden for wildfire damages from property owners onto utilities and ratepayers.[8] As TURN notes, this greatly increases the amount of liability at stake compared to when a party must prove that their damages were caused by a utility's negligence, resulting in a "disallowance risk [that] is unusually large."[9] In other words, strict liability increases both the number of times that a utility will have to seek cost recovery for wildfire liability and the amount that is at stake. And inverse condemnation's cost shifting means that, even if SDG&E is consistently found prudent, it places a significant amount of costs onto ratepayers once AB 1054's wildfire fund goes insolvent, potentially crowding out needed investments.[10]

With regards to AB 1054, SDG&E concurs with TURN that the Commission should be guided by "analyst evaluations of the impacts of" that legislation.[11] And although credit rating agencies and other analysts see AB 1054 as significantly improving the potential for cost recovery relative to the environment prior to the Bill's passage, TURN correctly notes that there

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[7] TURN Br. at 75; *see also* Moody's Mar. 5, 2019 Report, Exh. SCE-15 ("California is in a unique situation because its wildfires are on average much more destructive because of higher population density compared to other western states.").

[8] S&P Jan. 21, 2019 Report, Exh. PAO-03-C at 3.

[9] TURN Br. at 37; *accord id.* at 12 ("TURN appreciates that the potential scale of any liabilities due to wildfire disallowances may be larger than typical disallowance risks.").

[10] *See* Folkmann/SDG&E Tr. V.5:853-54; *see also* S&P Sept. 5, 2018 Report, Exh. PAO-02-C (noting that, even if utilities are able to recover costs under inverse condemnation, "the burden on customers would eventually become unsustainable should the pace and intensity of destructive wildfires persist at current levels.").

[11] TURN Br. at 15.

is ongoing market uncertainty regarding AB 1054's impact.[12] As TURN adds, investors "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."[13]

TURN rightly notes two ongoing risks regarding AB 1054 – uncertainty regarding AB 1054's implementation, and how long the wildfire fund will remain solvent.[14] Much of the uncertainty surrounding AB 1054 implementation's is regarding how the Bill's revised prudence standard will be applied. As TURN cites from S&P, "'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.'"[15] Specifically, intervenors fear that California will apply the revised prudence standard in a way that continues to make it more difficult to recover wildfire costs than it would be at other jurisdictions such at FERC, based upon:

- Lingering fears from the 2017 WEMA decision where the Commission disallowed SDG&E's entire request for cost recovery from the same 2007 wildfires that FERC allowed full cost recovery for;[16] and

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12 *Id.*

13 *Id.* at 12; *see also* Gorman/EPUC-IS/TURN Tr. V.3:398:19 – 399:21 (stating that it was a "stretch" to say that AB 1054 fully mitigated wildfire risk); *Id.* at V.3:401:24-25 (acknowledging that SDG&E's credit rating is "still rated lower today than it was in 2017.").

14 TURN Br. at 38.

15 *Id.* at 55 (quoting S&P July 30, 2019 Report, Exh. SDG&E-22-C at 2).

16 Moody's Aug. 6, 2019 Report, Exh. SDG&E-24-C at 2.

- The concern that "utilities in California tend to receive a higher level of scrutiny and attention from both the media and the public, such that issues can quickly become contentious."[17]

This means that it will likely take a "show-me" kind of result in the application of the revised prudency standard before investor concerns are allayed.[18] Contrary to EPUC-IS's assertion, the statutory language alone is not enough to reduce uncertainty.[19] AB 1054 contains broad terms such as "good faith" that will remain undefined until applied by the Commission. Moody's notes another such vague term in "serious doubt," stating that it "remains to be seen how challenging it will be for the intervenors to create serious doubt (to flip the burden of proof to the utility), an undefined term and subject to the CPUC's interpretation."[20] FERC has specified that the agency's "presumption of prudence is not easily refuted."[21] AB 1054, on its face, does not provide any similar assurance.

FERC has similarly provided that, even if SDG&E's presumption of prudence was not dispositive, the recovery of SDG&E's wildfire costs was valid because SDG&E would likely be held responsible for such costs under inverse condemnation regardless of fault.[22] The revised prudency statute, on its face, does not take strict liability into account. In fact, EPUC-IS's

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[17] Moody's Aug. 2, 2019 Report, Exh. SDG&E-23-C at 6; *see also* Folkmann/SDG&E Tr. V.5:794 (noting that wildfire cost recovery proceedings are "charged" events).

[18] Coyne/Reed/SDG&E Tr. V.4:719:27; *see also* Moody's Aug. 2, 2019 Report, Exh. SDG&E-23-C at 5 (noting that the *application* of the revised prudency standard in a credit-supportive manner would "strengthen [Moody's] view of the credit supportiveness of the California regulatory environment but that is "likely to take some time.").

[19] EPUC-IS Br. at 109.

[20] Moody's Aug. 2 Report, Exh. SDG&E-23-C at 5.

[21] *San Diego Gas & Electric Co.*, 146 FERC ¶ 63,017, P 57 (2014).

[22] *Id.* at P 60.

statement that the revised prudency standard statutory language reduces uncertainty is belied by its own admission that the Commission in the 2017 WEMA decision read additional terms into the pre-existing prudence standard, requiring a utility to exercise "*the best practices* of the era," and specifying that "*compliance with 'accepted industry practices,' while relevant, 'is not dispositive.*'"[23] Investors are concerned a similar process could occur here.

It is these aspects of the WEMA decision that have "contributed to investor unease."[24] In contrast to EPUC-IS's assertions that AB 1054 "*materially* improves the chances than an IOU's conduct will be found prudent,"[25] TURN contends that concerns about the Commission's WEMA decision are overblown and asserts that the Commission in WEMA applied a similar standard as FERC.[26] Putting aside for the moment that this would suggest that there is little actual change between the pre and post-AB 1054 prudence standard (which would only increase investors' fears), TURN and EPUC-IS cannot even agree whether the standard applied in the WEMA decision was materially different to AB 1054's revised prudency standard.[27] This underscores the ongoing uncertainty surrounding the Commission's prudence review process and how much will come down to the revised standard's actual application.

TURN is also incorrect regarding the procedural posture of SDG&E's litigation regarding the 2007 wildfires at FERC.[28] The CPUC was an active party. But after the FERC ALJ declined

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23 EPUC-IS Br. at 107 (quoting D.17-11-033, COL 1, 8).

24 TURN Br. at 37.

25 EPUC-IS Br. at 109.

26 TURN Br. at 58-59.

27 *Compare id.*, *with* EPUC-IS Br. at 106-107 (asserting that the standards "articulated in [the WEMA] decision are materially more rigorous than the new statutory standard.").

28 TURN Br. at 60.

the Commission's request for additional time, the Commission apparently chose not to participate further even though it had an opportunity to do so.[29] But FERC trial staff participated throughout as an "impartial representative of the public interest."[30] FERC still had a statutory duty to determine that SDG&E's request for cost recovery was just and reasonable.[31] And even if TURN is correct that the WEMA decision was more litigious, that simply underscores investors' concerns that cost recovery will be more difficult in California because of the State's "high political risk and public scrutiny."[32]

Moreover, even if TURN is correct that such fears about the WEMA decision are overblown, what matters to the cost of capital is how investors perceive the situation, whether right or wrong. And TURN repeatedly notes investor concerns regarding prudency review in California:

- "investors were apparently rattled by [the WEMA] decision, which came out after the wildfires of 2017" resulting in rating agency downgrades beginning in 2018;[33]
- WEMA "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;"[34]

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[29] *SDG&E*, 146 FERC ¶ 63,017, P 9 (noting that the CPUC filed a Ninth Circuit petition for review of the agency's motion).

[30] *Conservation of Power and Water Resources,* 18 C.F.R. § 385.102(b).

[31] Contrary to TURN's contention, FERC authorized SDG&E to recover about $80 million in FERC-jurisdictional rates. *Compare* Widjaja/SDG&E Exh. SDG&E-03 at 5 (noting recovery for $80 million), *with* TURN Br. at 58. The $23 million cited by TURN was only for one cycle of SDG&E's FERC Transmission owner formula rate.

[32] Moody's Aug. 2 Report, Exh. SDG&E-23-C at 9.

[33] TURN Br. at 53.

[34] *Id.* at 57 (citing Moody's Aug. 6 Report, Exh. SDG&E-24-C at 2).

- WEMA "contributed to investor unease."[35]

Investor uncertainty regarding AB 1054's application are also undergirded by Moody's reliance upon Filsinger's "variable prudence" assumption that 75 percent of request for cost recovery will be denied in 2020, falling to 25 percent by 2030.[36] Such a frequency of disallowance under AB 1054 would be a significantly different outcome than what is expected at FERC.[37] TURN may be correct in saying that it "is just as likely that the CPUC might disallow 30% of any claims, or even 10%."[38] But such an outcome would still be materially different than investor expectations for FERC.

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[35] TURN Br. at 37.

[36] EPUC-IS's hearsay argument regarding the Filsinger report can be readily discarded. EPUC-IS Br. at 117. Contrary to EPUC-IS (and UCAN-POC claims), the Filsinger Report is in the record, as it was introduced by TURN. Exh. TURN-01; *see* Tr. V.5:950-51 (moving exhibit into the record). More importantly, the Filsinger assumptions about prudency review outcomes are not hearsay because they are not being cited for the truth of the matter asserted; *i.e.* that 75 percent of wildfire claims will in fact be disallowed in 2020. *See* Reed/Coyne Tr. V.5:687-88 (stating those assumptions could be wrong and the need to consider multiple scenarios). Those assumptions are instead being cited for the way they are shaping the perception of investors – given Moody's citation to those figures – regardless of whether they turn out to be accurate. *See* EPUC-IS Br. at 99 (citing Graves/Mudge Tr. V. 3. 495:9-14). Moreover, there is ample evidence discussing the Filsinger assumptions, including multiple credit reports, so there is not concern about the *residuum* rule. The Filsinger analysis – and the Moody's credit reports relying upon them – are cited by multiple intervenors, including EPUC-IS's witness Mr. Gorman. And even if the Filsinger report was hearsay, the wildfire premiums themselves result from expert analyses. Not only is hearsay permissible at the Commission, but it has long been recognized that expert witnesses can rely upon the hearsay work of other experts to inform and support their informed judgment. *See Continental Airlines, Inc. v. McConnell Douglas Corp.*, 216 Cal. App.3d 388, 414-416 (1989) ("experts may rely upon hearsay in forming opinions"). In fact, even if the Filsinger report was excluded, the applicants' experts would still have the Moody's reports to rely upon as their basis for assuming the variable prudency scenario. *See*, e.g., Folkmann/SDG&E Exh. SDG&E-01-S at Appendix B (Moody's July 12 Report) at 1.

[37] *See* O'Donnell/FEA Tr. V.3:370-71, 377 (acknowledging that he is not aware of FERC denying cost recovery for wildfires).

[38] TURN Br. at 69.

And utilities being found prudent more often under AB 1054 increases the other risk cited by TURN – that the wildfire fund goes away more quickly.[39] FEA is incorrect to say that the Commission should not rely upon the risk that the Commission "may set an unduly high bar for wildfire prudence OR that the wildfire fund has only a 0.9% chance of being insolvent in the next ten years."[40] As their own expert notes, that 0.9% chance is directly tied to Filsinger's variable prudency assumption. A 75 percent chance of cost disallowance suggests a significantly higher risk of cost disallowance compared to other jurisdictions. But if an analyst assumes that the Commission will approve a far higher percent of cost recovery, than they must accept that it increases the likelihood of the fund being extinguished more quickly.[41]

In short, as TURN states, AB 1054 likely avoided SDG&E and other California electric utilities losing investment grade credit rating status.[42] But as FEA notes:

- "inverse condemnation d[oes] add a layer of risk to the IOUs;"[43] and
- "AB 1054 does not resolve all risk and liability for IOUs in regard to wildfire or other disaster claims."[44]

This is reflected in credit rating agencies not restoring SDG&E's 'A' credit rating status. In fact, as noted, on August 15, RRA reduced its ranking of California's regulatory environment

39 *See* O'Donnell/FEA Tr. V.3:377, 380 (acknowledging that how long the fund lasts is tied to the rate of imprudence findings).

40 FEA Br. at 16.

41 *See* Filsinger Jun. 26, 2019 Report, Exh. TURN-01 at 2 (noting that if an analyst assumes that the utilities will always be found prudent, and keeping all other assumptions the same, the risk of the fund being exhausted by 2030 increases from 0.9% to 9.5%).

42 TURN Br. at 43.

43 FEA Br. at 10.

44 *Id.* at 11.

from Average/1 to Average/2. In lowering this rating, RRA found that the "'constructive aspects of California's regulatory framework'" are outweighed by: 1) the continuation of "'inverse condemnation;'" and 2) the fact that it is unclear whether "'the funding mechanisms outlined in [AB 1054] will avert'" utilities facing significant damages and that the frequency of ongoing wildfires in California require a more "comprehensive approach."[45]

2. Other Intervenors Ignore Reality

What is worse, however, are the intervenors that completely ignore the record evidence of the risks to SDG&E from California's wildfire liability regime. For instance, PAO scarcely mentions wildfire liability risks – despite asserting in a contemporaneous proceeding that it cannot be assumed that AB 1054's Wildfire "Fund will reduce costs to ratepayers by dint of a lower cost of capital," as evidenced by S&P not changing its credit rating for SDG&E.[46]

Instead, certain intervenors attempt to assert the logical fallacy that wildfire risks (or utility risks more generally) are solely about cost recovery, cost recovery is solely an issue of utility imprudence, and so cost recovery disallowances are simply a function of utility mismanagement.[47] In other words, obtaining cost recovery is merely a matter of utility management and utilities should not be rewarded for the risk of mismanagement.[48]

But this simplistic argument collapses upon itself upon further inspection. Under this theory, there is no such thing as a difference in business or regulatory risks between any utility

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[45] TURN Br. at 31 (quoting RRA Report Aug. 15, 2019, Exh. SDG&E-20-C, at 1-2).

[46] Rulemaking ("R.") 19-07-017, Opening Comments of the Public Advocates Office (August 29, 2019), Exh. SDG&E-27 at 16-17 (citation omitted).

[47] *See, e.g.*, UCAN-POC Br. at 23 ("Fundamentally, SDG&E's arguments concerning additional risk considerations all reduce to the threat to its operating cash flow posed by disallowed costs.").

[48] EPUC-IS Br. at 113 ("Shareholders are responsible for imprudent behavior. But shareholders are not responsible for prudent behavior.")

anywhere because the risk of cost disallowance or other adverse action are solely about the management of the utility. But this misses the entire point. It wrongly assumes that the review for cost recovery is exactly the same across every jurisdiction. That is self-evidently not the case. Credit rating agencies explicitly assess the differences in risk based upon the regulatory environment and consistency of cost recovery.[49] What is being assessed is how difficult or uncertain is it to recover costs for the same activities compared to in other jurisdictions.[50] The Commission has described this regulatory risk as the inability to "*fairly* and *consistently* recover its costs in a timely manner."[51]

The risk being discussed, therefore, is what it takes to be found prudent – the standard, the process, and the consistency in application of prudency review – all aspects of a prudency finding that are "beyond the control of the utility."[52] As John Reed from Concentric described, investors "look at the entirety of the risk of operating a utility in the state and the likelihood of recovery on their capital," compared to the ability to recover for the same actions in other jurisdictions.[53] And regardless of accuracy, market actors currently believe that:

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49 *See* RRA Aug. 15, 2019 Report, Exh. SDG&E-20-C at 1 (describing RRA's evaluation of state regulatory climates as assessing "the probable level and quality of the earnings to be realized by the state's utilities as a result of regulatory, legislative, and court actions."); Moody's Aug. 2 Report, Exh. SDG&E-23-C at 9 (providing their grid for assessing regulatory framework).

50 *See* Concentric/SDG&E, Exh. SDG&E-05 Ch. 2 at 9 ("The nature and pace of the process of recognizing an incurred cost for recovery through rates is the paramount business risk concern of a utility credit analyst."); *id.* at 10 ("Another fundamental principle of evaluating regulatory risk is the high value placed on consistency and transparency.").

51 D.12-12-034 at 32 (emphasis added).

52 UCAN-POC Br. at 23. *See also* Coyne/Reed/SDG&E Tr. V.4:748:18-22 ("did you refer to a finding that the company failed to operate according to the standard? Or a finding that the Commission determined so? Because that really is the issue.").

53 Coyne/Reed Tr. V.4:750-2-4.

- California is going to make it more difficult to recover wildfire costs than other jurisdictions, such as FERC, will for the same activity;
- Inverse condemnation means that there will be more such cost recovery proceedings for far greater amounts in damages than under a negligence standard; and
- Each proceeding is going to be more contentious and politically charged than elsewhere.[54]

Credit rating agencies' rationale for downgrading SDG&E's credit ratings underscore that it is this perception of a risky regulatory environment – and not Company management actions – that have led to SDG&E's credit rating downgrades. Again, SDG&E has not experienced a substantial wildfire since 2007.[55] As S&P stated in its January 21, 2019 report, it believes that SDG&E's "operational management of wildfire mitigation [is] exceptional."[56] Nevertheless, the rating agency downgraded both the Company's credit rating and business risk profile from 'excellent' to 'strong' because it found that beneficial management outweighed by "the insufficient regulatory protections to deal with the unique risks of inverse condemnation," including the lack of a "direct means to collect the wildfire costs from [] ratepayers."[57] Even following AB 1054's passage, Moody's still only gives SDG&E a "Baa" for "Consistency and

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[54] *See, e.g.*, Moody's Aug. 6 Report, Exh. SDG&E-24-C at 2; Moody's Aug. 2 Report, Exh. SDG&E-23-C at 6; S&P Feb. 19, 2019 Report, Exh. SCE-16 at 5 ("In our view, California's regulatory process to recover these material wildfire costs is still unpredictable, relatively untested, and lacks transparency and [contains] uncertain[t]y regarding the timeliness of cost recovery."); *see also* Concentric/SDG&E Exh. SDG&E-12, Ch. 2 at 5 ("Only three other jurisdictions of the other fifty-plus U.S. jurisdictions are judged by S&P to harbor more innate regulatory risk than California.").

[55] *See* SDG&E Br. at 73.

[56] S&P Jan. 21, 2019 Report, Exh. PAO-03-C at 1.

[57] *Id.*; *see also* Morin/SDG&E Tr. V.2:200 – 201 (noting that it is a "rare unusual" event when a utility's business risk profile is downgraded from "excellent.").

Predictability of Regulation" and "Timeliness of Recovery of Operating and Capital Costs," based upon "the high political risk and public scrutiny" in California.[58]

The flimsiness of EPUC-IS's argument that wildfire liability risk is simply a matter of utility prudence is further belied EPUC-IS's separate contention that AB 1054 "*materially* improves the chances that an IOU's conduct will be found prudent and thus mitigates the risk of shareholder disallowances."[59] If there are two different standards – with one being "materially more rigorous" than the other – it logically follows that there are circumstances where cost recovery will be allowed under one standard when it would not be under the other. That is the very definition of what is meant by comparing risks inherent in the different chances for cost recovery in different regulatory environments. And although AB 1054 mitigates those risks to cost recovery, it does not eliminate them.

Nor is it even accurate to say that the risk to SDG&E and other California utilities is just about cost recovery.[60] Inverse condemnation is a good example. This doctrine increases the costs that a utility has to incur in the first place. The risk of incurring those large costs impacts market pricing.[61] As the last several years have demonstrated, the potential for the liability for a wildfire to be attached to an electric utility has had significant impacts on share prices well before any cost recovery determination is even considered.[62] And, as noted, by shifting the

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58 Moody's Aug. 2 Report, Exh. SDG&E-23-C at 9.

59 EPUC-IS Br. at 109.

60 *Id.*

61 *See, e.g.*, Hern Tr. V.4:587; Coyne/Reed/SDG&E Tr. V.4:719.

62 *See, e.g.* McCann/EDF Exh. EDF-01 at 14; *cf.* Morin Tr. V.2 272-73 (noting that utility holding company stock prices have recently gone up for macroeconomic reasons, namely lower interest rates, which create a "surge towards dividend-paying utility stocks, and that the stock market's recent volatility has caused a rush to utility stocks.").

burden for damages onto utilities and ratepayers, it creates rate pressures on customers even if the utility is always found prudent.[63]

EPUC-IS's statement that inverse condemnation is a "red herring" is thus itself a red herring.[64] As TURN notes, it and EPUC-IS's own expert Mr. Gorman calculated a wildfire risk premium, based on the fact that "the downgrade of California utilities in 2018 by rating agencies reflects analysis' perceptions of the risks of inverse condemnation and wildfire claims."[65] Notably, EPUC-IS is happy to cite RRA's August 15, 2019 report when they believe it beneficial – while ignoring RRA's overall conclusion of downgrading its rating of the State's regulatory environment because of inverse condemnation and the need for a more "comprehensive solution" to California's wildfire liability regime.[66]

And EPUC-IS's claim that inverse condemnation is irrelevant is undermined by EPUC-IS simultaneously straining to argue that the doctrine of inverse condemnation no longer imposes strict liability. But contrary to EPUC-IS's claim,[67] there is no indication from the California Supreme Court in *City of Oroville v. Superior Court* that the Court was altering the inverse

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[63] *See* SDG&E Br. at 28.

[64] EPUC-IS Br. at 109.

[65] TURN Br. at 70; *accord* Gorman/EPUC-IS/TURN Exh. EPUC-IS/TURN-01 at V-10 (SDG&E and other California utilities have faced credit rating downgrades as a result of "wildfire risk unique to California.").

[66] EPUC-IS's quote of Mr. Gorman regarding California's regulatory environment is notably outdated. EPUC-IS Br. at 96 (citing Gorman/EPUC-IS/TURN Exh. EPUC-IS/TURN 01 at IV:5). As Mr. Gorman stated at hearings, the cited statement was largely based upon two credit rating agency assessments – a June 25, 2018 Report from S&P, and a May 9, 2019 Report from RRA. Gorman EPUC-IS/TURN Tr. V. 3:396-98. And as Mr. Gorman admitted, the June 25, 2018 Report was over a year old and issued prior to any of SDG&E's credit rating downgrades, while the May 9, 2019 RRA Report was superseded by the August 15, 2019 RRA report, which downgraded its rating of California's regulatory environment. *Id.*

[67] EPUC-IS Br. at 111.

condemnation doctrine.[68] To the contrary, the Supreme Court held that it was merely clarifying the terminology; that the "substantial causation" approach "aligns with how we have previously analyzed inverse condemnation liability cases."[69] To the extent that *Oroville* did meaningfully reform the application of the inverse condemnation doctrine, SDG&E would obviously welcome that outcome just as it would welcome a credit-supportive application of AB 1054's prudence standard.[70] But at this time such arguments are completely speculative.[71]

Unable to gain purchase ignoring credit rating agency statements – and thus ignoring reality – intervenors instead engage in *ad-hominem* attacks on those rating agencies.[72] Yet as Mr. Gorman testified on behalf of EPUC-IS, IS, and TURN, "[o]ne of the most direct pieces of information available to the equity market are the credit analysts' assessment of the credit standing of the utilities."[73] By statute, credit rating agencies are independent actors, subject to

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[68] 7 Cal. 5th 1091, 1105-1110.

[69] *Id.* at 1105.

[70] Or certain intervenors' wistful thinking that the California legislature would authorize another wildfire fund if the one under AB 1054 goes insolvent.

[71] EPUC-IS's argument that inverse condemnation does not result in a different legal standard than in states without inverse condemnation does not pass the straight-face test. *See* EPUC-IS Br. at 112. Liability attaches under inverse condemnation whenever property is damaged, regardless of fault. *See Barham v. Southern California Edison Co.*, 74 Cal. App.4th 744, 752 (1999). With negligence, the plaintiff must demonstrate that their damages were caused by the defendant's negligent conduct. EPUC-IS's focus on the *Oroville* case undercuts their own premise that the difference in standard is meaningless.

[72] *See, e.g.*, TURN Br. at 63 ("The Commission should not allow the utilities and Wall Street to pressure it into granting higher ROEs by pointing to Wall Street fears."); UCAN-POC Br. at 19 ("While the utilities rely heavily on the views of Wall Street in their arguments for higher than average ROE"); EDF at 2 (arguing to "afford no weight to the statements of credit rating agencies.").

[73] Gorman/EPUC-IS/TURN Tr. V.3:458:13-16.

regulation by the Securities and Exchange Commission.[74] The Commission has repeatedly relied upon credit rating agency assessments in cost of capital proceedings.[75]

And regardless of whether one agrees with their analysis, the cost of debt – and the cost of capital more generally – are altered by credit rating agency ratings and opinions.[76] Cost of capital is based upon the investment market. If "Wall Street" is disappointed with SDG&E having a below average ROE for above-average risks – such that it leads to further credit rating downgrades and a higher cost of capital – that harms ratepayers in the form of higher costs.[77] Intervenors' apparent willingness to settle for "investment grade ratings"[78] is inconsistent with the Commission's longstanding focus on "strong" credit ratings **and** the impact that lower credit ratings have on ratepayers.[79] As Dr. Morin notes, accepting SDG&E's downgraded credit rating means charging ratepayers millions of dollars more going forward for SDG&E to raise the same amount of money.[80] As UCAN-POC states, "it is going to cost a lot to ensure safety and

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74 15 U.S.C. § 78o-7.

75 *See, e.g.* D.12-12-034 at 30-31.

76 *See* Pavlovic/UCAN-POC Tr. V.6:997; *see also* Concentric/SDG&E Exh-05, Ch. 2 at 12 (noting that credit ratings directly affect the cost of debt and indirectly affect the cost of equity because stock holders "also use credit ratings as a risk guide to help them decide the terms on which they will offer their capital to a utility.").

77 *See* Morin/SDG&E Tr. V.2:249:16-22 ("[w]e got to do everything we can to get [SDG&E] back to a single A bond rating because it's costing ratepayers an extra 10 million bucks for every hundred million dollars of capital raised. And these utilities, they are going to be rais[ing] [] billions of dollars.").

78 *See* TURN Br. at 42.

79 *See* D.12-12-034 at 7 ("SDG&E's requested capital structure is intended to preserve its strong 'A' investment grade credit rating.").

80 Morin/SDG&E Tr. V.2:249:16-22; *accord* Morin/SDG&E Exh. SDG&E-04 at 62 ("single A bond rating generally results in the lowest pre-tax cost of capital for regulated utilities, and therefore the lowest ratepayer burden.").

reliability, much less develop a clean and green twenty-first century smart infrastructure."[81] The funding for those capital-intensive projects come from investors.[82] A sufficient return consistent with risks is necessary to get private investment into such projects benefitting the public.

B. Intervenors Underestimate the Significant Threats Incremental to Wildfire Liability Risk that Exists for SDG&E

In its Opening Brief, SDG&E described the factors impacting its risk profile that are separate from wildfire liability; these risks have increased markedly since the 2012 decision.[83] SDG&E emphasized the systemic nature of the risk it faces, which arises from the combination of several elements, including California's aggressive policy mandates and the uncertainty created by the utility's changing role due to the advent of Community Choice Aggregation ("CCA") and Direct Access ("DA"). Intervenors seek to downplay these risks. TURN, for example, argues that the utilities "can point to no specific risks to shareholders,"[84] and that the risks described are "so vague and ill-formed that it is difficult to even discern what the claimed risk might be."[85] EPUC-IS similarly argues that while the factors identified as impacting the risk profile of the California utilities involve "some degree of risk," they are neither new nor unique, and their effect is "overblown."[86] This attempt to discount the significant risks faced by SDG&E and the potential shareholder impacts, which are detailed with specificity in SDG&E's Opening

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81 UCAN-POC Br. at 24.

82 Morin/SDG&E Exh. SDG&E-04 at 7 ("SDG&E must secure outside funds from capital markets to finance required utility plant and equipment investments.").

83 SDG&E Br. at 32-53.

84 TURN Br. at 31-33.

85 *Id.* at 32.

86 EPUC-IS Br. at 72.

Brief, lacks credibility – it is plain from the record of this proceeding that SDG&E faces substantial uncertainty and increased near-term risks.

EPUC-IS also asserts that the Commission should disregard the risks facing the California utilities since the credit rating agencies are aware of these risks and because the risks have not been quantified.[87] But this reinforces the conclusion that SDG&E faces increased risks and requires an authorized ROE that is commensurate with this risk. It is true that the credit rating agencies are well aware of the risk posed by the State's bold policy initiatives. Indeed, Moody's specifically cites "demanding public policy goals" as a credit challenge.[88] It recently underscored the investment risk for SDG&E associated with the State's clean energy and other mandates, characterizing California's renewables procurement requirement as "aggressive" and pointing out "the significant demands that are placed on the California utilities, including many ambitious public policy initiatives that are implemented through utility operations."[89] But this awareness of the risks faced by the California utilities and the characterization of such risk as a "credit challenge" contradicts the claims made by EPUC-IS; the focus on these issues by credit ratings agencies illustrates their negative impact on SDG&E's risk profile, and reinforces the importance of setting an ROE that is sufficient to compensate for these risks and allow SDG&E to continue to attract investment.

Similarly, the fact that the risks described by SDG&E cannot be quantified does not diminish their relevance or offer a rationale for ignoring them, contrary to EPUC- IS'

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[87] *Id.* at 73, 74.

[88] Moody's Aug. 2 Report, Exh. SDG&E-23-C at 2.

[89] *Id.* at 6.

suggestion.[90] Rather, the impossibility of quantifying the potential impact of these risks is the *reason* they are so concerning. The current lack of clarity regarding what the future holds for SDG&E from an operational and regulatory standpoint has created significant uncertainty, which translates into a perception of heightened investment risk. The challenge – and more to the point, risk – presented by the State's ambitious new policy mandates is exacerbated by the complexities of achieving those mandates in an environment of increased load departure. The State's rapid evolution toward the utilities serving a minority of customer load – SDG&E predicts, for example, that it could be serving *less than 25 percent* of the load in its service territory within the next few years[91] – is a significant change to California's regulatory and market framework. Even more momentous is the State's shift toward a construct involving *multiple* entities (*e.g.*, the utility, multiple CCAs, and multiple energy service providers in a service territory) performing the procurement function in a disaggregated manner with potentially *no* provider individually serving a majority of load.[92] It is not at all clear how this transformation, which is already well underway, will be managed.

As previously noted in SDG&E's Opening Brief, the lack of a well-formed strategy to guide this fundamental transformation of the market and regulatory framework is readily acknowledged by the Commission, which has remarked that '"California may well be on the path towards a competitive market for consumer electric services but is moving in that direction

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[90] *See* D.12-12-034 (specifying that the Commission will consider additional risk factors that cannot be quantified by financial modeling).

[91] Widjaja/SDG&E Exh. SDG&E-03 at 22; *see also* California Public Utilities Commission, *2018 California Renewables Portfolio Standard Annual Report* (November 2018) at 45 (estimating that IOUs could lose 60-80 percent of their current demand within the next decade).

[92] Folkmann/SDG&E Exh. SDG&E-07 at 12.

without a coherent plan to deal with all the associated challenges that competition poses, ranging from renewable procurement rules to reliability requirements and consumer protection.'"[93] Thus, TURN and EPUC-IS wrongly suggest that the current regulatory and market environment is "business-as-usual" and that little or no risk exists for investors. This is demonstrably inaccurate. The Commission *itself* has warned that the rapid changes occurring in California's electric sector and lack of a comprehensive regulatory framework to address disaggregation of load are "creating unintended adverse consequences."[94]

As SDG&E has noted, investors in the California utilities need only to look to the energy crisis of 2001 to understand the potential havoc wreaked by the "unintended adverse consequences" of the State's policy experiments. Indeed, the Commission's own 2018 report noted that "[w]ithout a coherent and comprehensive plan, the current policies in place may drift California to an unintended outcome and breakdown in services like the Energy Crisis."[95] The Commission's self-diagnosed lack of an overarching strategy guiding the current transformation, and its acknowledgement of the potential dysfunction that could result, plainly leads to the conclusion that the California utilities are riskier than other utilities that are not attempting to implement "aggressive" policy mandates at the same time that the regulatory framework in

93 Folkmann/SDG&E Exh. SDG&E-07 at 13 (citing California Public Utilities Commission Staff White Paper, *Consumer and Retail Choice, the Role of the Utility, and an Evolving Regulatory Framework* (May 2017)) at 3, *available at* http://www.ourenergypolicy.org/wp-content/uploads/2017/05/Retail-Choice-White-Paper-5-8-17.pdf.

94 California Public Utilities Commission*, California Customer Choice Project, Choice Action Plan and Gap Analysis* (December 2018) at 6.

95 California Public Utilities Commission, *California Customer Choice: An Evaluation of Regulatory Framework Options for an Evolving Electricity Market* (August 2018) at 5.

which they operate is undergoing a rapid, *ad hoc* transformation with unpredictable outcomes. By suggesting otherwise, TURN and EPUC-IS undermine their own credibility.

Intervenors further argue that the capital investments needed to achieve the State's policy goals will benefit utility investors and therefore do not constitute a risk. TURN claims, for example, that "many of the so-called 'risks' are really opportunities for increased capital expenditures."[96] Similarly, EPUC-IS suggest that capital investment by the utilities will add to their profitability and therefore should be viewed as a benefit rather than a risk.[97] As SDG&E has noted, it is committed to achieving the policy goals established by the State and the Commission. The capital investment SDG&E intends to make over the next five years to modernize transmission and distribution infrastructure, and to implement fire hardening measures to protect public safety, will benefit both the utility and its customers.[98] Yet intervenors' focus on who may ultimately benefit from these capital investments misses the point. The more appropriate question is what Commission action is required to ensure that SDG&E has access to the capital necessary to attain the State's objectives.

SDG&E's capital investments over the next five years are expected to be in the range of $6.4 to $7.1 billion, which will require SDG&E to access the capital markets.[99] As discussed by Mr. Widjaja, the regulatory cost recovery process imposes risk of under-recovery or delayed recovery of invested capital; an elevated level of capital investment increases this risk.[100] Mr.

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96 TURN Br. at 24.

97 EPUC-IS Br. at 74-75.

98 *See* SDG&E/Widjaja Exh. SDG&E-03 at 27.

99 *See id*.

100 *Id.*

Widjaja noted that "[c]redit rating agencies and investors consistently analyze and focus on the effect that elevated capital investments may have on cash flows and corresponding pressure on credit metrics."[101] Thus, in order to attract the capital investment necessary to allow SDG&E to achieve these benefits and meet the State's policy objectives, SDG&E's ROE must provide investors a return commensurate with the higher risk profile caused by the embedded risk in SDG&E's businesses.

Finally, as noted, EPUC-IS suggests that the only risk faced by investors is the risk of disallowance, and that this risk does not justify an increase in ROE.[102] TURN, likewise, claims that the utility's investment risk comes from "three potential factors: disallowances, ineffective management (meaning actual costs exceeding authorized forecasts), or fines and penalties."[103] This overly-narrow characterization of the nature of the risk faced by SDG&E is rebutted by the detailed explanation set forth in SDG&E's Opening Brief.[104] As discussed above, in addition to ignoring that the assessment of the risk of cost disallowance is actually an assessment of the risk of California's regulatory environment – namely, that the State will make it more difficult to recover costs in a consistent framework given the contentious atmosphere as compared to other jurisdictions, regardless of the actions of the utility[105] – intervenors ignore certain risks identified by SDG&E and mischaracterize others, as demonstrated below.

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[101] *Id.*

[102] EPUC-IS Br. at 73-74.

[103] TURN Br. at 27.

[104] SDG&E Br. at 43-52.

[105] *See* Moody's Aug. 2 Report, Exh. SDG&E-23-C at 2, 6, 9.

1. Renewable Portfolio Standard ("RPS")/ Clean Energy Goals

PAO disputes the contention that California's relatively high RPS requirement creates risk, arguing that "the program was designed to ensure that the utilities do not incur any costs they would not have otherwise incurred in the normal operations of their business, if they did not have an RPS target," and further that all three California utilities have procured RPS contracts in excess of the annual targets and that the cost of RPS resources has decreased over time.[106]

TURN asserts that RPS (and conventional) contracts involve lower risk of stranded cost than ownership of generation resources, and that AB 57 insulates utilities from procurement cost reasonableness reviews and "guarantees" timely recovery of balancing account under-collections.[107] EPUC-IS contends that investors have been aware of California RPS standards for over a decade, and that credit rating agencies do not view the existence of an RPS as a factor that increases investment risk.[108] These arguments miss the mark.

While RPS contracts may arguably involve less risk than ownership of resources, as PAO asserts, RPS power purchase agreements ("PPAs") present debt equivalence risk,[109] which is addressed in detail in SDG&E's Opening Brief.[110] In addition, even with the cost recovery

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[106] PAO Br. at 25-26.

[107] TURN Br. at 32.

[108] EPUC-IS Br. at 77, 78.

[109] UCAN-POC "objects to the treatment of all the PPAs as debt equivalents." UCAN-POC Br. at 56. Nevertheless, since debt equivalence is a tool used by the credit rating agencies to evaluate the risk posed by utility PPAs, it is properly considered by the Commission in determining SDG&E's ROE. *See* D.12-12-034 at 29; Mekitarian/SDG&E Exh. SDG&E-02 at 13 (citing California Public Utilities Commission, *An Introduction to Debt Equivalency* (August 4, 2017)), *available at* http://www.cpuc.ca.gov/uploadedfiles/cpuc_public_website/content/about_us/organization/divisions/policy_and_planning/ppd_work/ppd_work_products_(2014_forward)/ppd%20-%20intro%20to%20debt%20equivalency(1).pdf.

[110] *See* SDG&E Br. at 36-39.

protection cited by PAO and TURN, utilities face risk related to RPS due to the contested nature of the utilities' Energy Resource Recovery Account ("ERRA") proceeding, which creates regulatory lag.[111] Further, increased reliance on renewable resources presents operational risks related to the integration of intermittent resources and grid reliability.[112] The need to integrate unprecedented levels of new renewable generation onto the grid could involve significant capital investments and operations and maintenance ("O&M") costs.

Together, these factors negatively impact SDG&E's balance sheet, cash flow and credit metrics – which increase investment risk. Even though EPUC-IS asserts that other states have comparable RPS goals, they identify several states with much lower RPS goals or goals that are voluntary rather than mandatory – undercutting their own argument.[113] In opining on the issue of regulatory lag, EPUC-IS disputes the notion that a delay in cost recovery would pose a challenge, offering the flippant observation that the "California utilities should surely understand how to run their business in a way that accounts for their regulated business model."[114] This discounting of what is a real risk is not constructive or helpful to the Commission's consideration of this issue. SDG&E manages its operations in accordance with its objective of providing clean, reliable and safe electric service to its customers. For investors, however, the financial impacts of the typical delay in recovery of procurement (and other) costs is a material consideration that operates to heighten the perception of risk.

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[111] *See id.* at 39-40.

[112] *See id.* at 35-36.

[113] EPUC-IS Br. at 76-77.

[114] *Id.* at 96.

Moreover, by focusing narrowly on RPS goals and largely ignoring the broader clean energy targets established by the State, intervenors misconstrue the nature of the risk faced by SDG&E. While EPUC-IS may be correct that RRA takes a neutral view of the RPS programs that exist in several states,[115] EPUC-IS do not acknowledge the credit rating agencies' perception of the mandates included in California's Senate Bill ("SB") 350 and SB 100, which establish aggressive new clean energy, clean air and greenhouse gas ("GHG") reduction goals for 2030 and beyond.[116] Moody's recently emphasized the investment risk for SDG&E associated with the State's new requirement, pointing out "the significant demands that are placed on the California utilities, including many ambitious public policy initiatives that are implemented through utility operations."[117] As a practical matter, achievement of the State's 100 percent clean energy goal may involve reliance on newly-developed technologies since it is not clear that existing renewable technologies such as wind and solar, even with battery storage, will be sufficient by themselves to achieve the 100 percent zero-carbon objective.[118] This will create operational risk (which could result in higher O&M costs) and financial risk for utility investors. While these risks may be more long-term in nature, it is reasonable to expect investors seeking a long-term investment to consider this type of future risk.

2. Advanced Technologies

Intervenors similarly dispute the notion that distributed energy resources ("DERs") serve to increase the risk profile of the utilities. EPUC-IS asserts, for example, that "all utilities across

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[115] *Id.* at 78.

[116] Folkmann/SDG&E Exh. SDG&E-07 at 10-11, 12.

[117] Moody's Aug. 2, 2019 Report, Exh. SDG&E-23-C at 6; Folkmann/SDG&E Exh. SDG&E-07 at 10.

[118] SDG&E Br. at 36.

the nation" experience issues relating to DERs and grid modernization.[119] EPUC-IS and TURN also assert that cost-shift risk associated with net energy metering ("NEM") impacts other customers, but does not create revenue recovery risk for the utility.[120] These arguments ignore the investor concerns regarding reduced load volume and under-recovery from NEM customers detailed in SDG&E's Opening Brief.[121] Specifically, shrinking customer load volume results in cost shift to customers without DERs and puts upward pressure on customer rates. This is viewed negatively by credit rating agencies since increased rates "reduce the headroom available to recover other costs."[122] In addition, higher levels of DERs on the system can potentially increase operational risk and cause unanticipated increases in capital and O&M costs, which has a direct impact on cash flow, balance sheet and credit metrics.

3. Changing Role of the Utility

TURN acknowledges that the rapid growth of CCAs in recent years poses challenges for the energy sector, but maintains that this development presents no risk to the utilities.[123] TURN asserts that the Power Charge Indifference Adjustment ("PCIA") will ensure recovery of the above-market costs of utility procurement procured on behalf of customers prior to their departure, and that to the extent PCIA creates a cost shift, this risk is not a concern to investors. TURN's minimization of the risk posed by the State's current seismic shift to a multi-LSE environment with increasingly fragmented load is misguided. As SDG&E demonstrated in its

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[119] EPUC-IS Br. at 80.

[120] *Id.* at 90-91; TURN Br. at 33.

[121] SDG&E Br. at 41-43.

[122] Moody's Aug. 2, 2019 Report, Exh. SDG&E-23-C at 6.

[123] TURN Br. at 34-36; *see also* EPUC-IS Br. at 87-90; PAO Br. at 26-27.

Opening Brief, while the reform of the PCIA methodology is a positive development, the Commission's actions in the context of the PCIA proceeding have sent mixed signals to utility investors.[124] Moreover, the State's new construct plainly has major implications for, among other things, implementation of system reliability and clean energy policy requirements.[125] This is particularly true given the speed and scale of the current evolution and the lack of an overarching strategy guiding this change, as discussed above.

TURN further claims that the potential for a CCA to default on its procurement obligation is not a material risk to utility investors since the Commission is currently considering mechanisms for backstop procurement, including a central procurement entity.[126] As SDG&E pointed out in its Opening Brief, the Commission is currently considering *many* potential options for realignment of the existing regulatory framework to address the issues that arise from the new market dynamic; the central procurement entity concept is but one of them.[127] The ultimate success of these efforts remains to be seen. In the meantime, however, significant investor uncertainty regarding the impacts of the current changes and the effectiveness of proposed solutions continues to exist, which creates a perception of heightened risk for California utilities.

Finally, PAO asserts that there are "safeguards in place for CCA[s]" that operate to protect a utility with Provider of Last Resort ("POLR") responsibility from risks related to the unanticipated procurement obligation that would arise if a large number of CCA customers

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[124] *See* SDG&E Br. at 40-41, 47.

[125] *Id.* at 47-52.

[126] TURN Br. at 35, citing Gorman/EPUC-IS/TURN Exh. EPUC-IS/TURN-01, p. IV-21:11 – 22:7.

[127] SDG&E Br. at 46.

unexpectedly returned to bundled service.[128] PAO is incorrect. While the Commission has adopted a financial security requirement ("FSR") intended to "ensure that existing customers of an electric utility are protected from potential costs resulting from a mass involuntary return of CCA customers to the utility," the FSR does not serve to protect utility investors.[129] Although the FSR may allow a utility to *eventually* recover certain costs associated with an unplanned return of customers to bundled service, the Commission made clear in D.18-05-022 that the bond requirement is not intended to protect the utility's cash flow, noting that "the purpose of [Section 394.25(e)] appears to be *more about basic financial security – ensuring that money is available – rather than liquidity*."[130]

For example, D.18-05-022 allows CCAs to utilize surety bonds to meet the FSR intended to ensure cost recovery.[131] Collecting on a surety bond is similar to collecting on an insurance claim; it could involve a litigious and delayed claim resolution process that would not provide the immediate liquidity required to procure the additional resources necessary to serve the unexpectedly-returned CCA customers.[132] Thus, contrary to PAO's suggestion, it is highly likely that a sudden exit or failure of a CCA would create "unplanned procurement obligations that could put a strain on SDG&E's balance sheet and cashflows."[133] While the Commission is aware of the concerns regarding the viability of the utilities' POLR obligation in a customer

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[128] PAO Br. at 27.

[129] *See* D.18-05-022 at 2.

[130] *Id.* at 9.

[131] *Id.*

[132] *Id.*

[133] *See* Widjaja/SDG&E Exh. SDG&E-03 at 23.

choice environment, there is little certainty at this point regarding what mechanism might serve as a solution. As SDG&E noted in its Opening Brief, this uncertainty makes it difficult to accurately quantify the potential impact of a mass return of departed load to bundled service, heightening the perception of SDG&E as relatively high-risk.[134]

C. SDG&E Should be Allowed an Above-Average Return Commensurate with Risks

1. Intervenors lack support for proposing ROEs significantly below the national average

After assessing risks, EPUC-IS and TURN both emphasize reliance on RRA's 2019 national average of allowed returns for electric utilities of 9.66 percent. As TURN states "[t]he Commission has historically put considerable weight on data concerning national authorized ROEs, and the Commission should closely consider such evidence in this case" – noting that, in the 2012 decision, the Commission consciously set SDG&E and the other California utilities' ROE based upon the "average ROEs granted United States electric utilities during the first six months of 2012" as reported by RRA.[135] EPUC-IS goes further, eschewing their expert's recommendation to make an entirely new proposal that the Commission adopt RRA's 2019 electric utility average of 9.66 percent for Pacific Gas and Electric Company ("PG&E") and Southern California Edison Company ("SCE").[136]

Yet despite all the evidence cited above regarding SDG&E's above-average risks – much of it from the intervenors themselves – the intervenors all propose ROEs significantly below this

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[134] SDG&E Br. at 51-52.

[135] TURN Br. at 19, 74; *accord id.* at 10 ("the Commission has closely considered ROEs recently adopted in other jurisdiction[s]" as "[n]ational ROE data and market evidence are unbiased and observable indicators on the capital market conditions facing California IOUs.").

[136] EPUC-IS Br. at 11.

2019 national average for SDG&E. For instance, TURN asserts that the ROE average is "about 9.6 over the past five years"[137] But then TURN notes that "all the non-utility experts calculate [ROEs] at or below 9.0%."[138] This is a significant difference that would result in an ROE well below the national average. As Dr. Marlon Griffing for UCAN-POC admits, his recommended ROE would put SDG&E "among the low end of ROEs for U.S. electric operating companies."[139]

TURN and other intervenors' attempts to justify placing SDG&E significantly below the national average despite the Company's high risks all fall flat. For example, as noted above, TURN acknowledges SDG&E's ongoing risks.[140] TURN states that, because of these risks, it recommends an ROE above its own expert's Mr. Gorman's modeling. TURN then argues that AB 1054 enables placing "ROEs to levels that more closely correspond to the ROEs that have been authorized across the country." [141] But TURN then goes far beyond that, ignoring both the risks it identified and its own expert to make an entirely new recommendation of a 9.4 percent ROE for SDG&E; well below the national average.[142] TURN does not provide any basis in its brief as to why SDG&E's ROE should be below national average – which would only be appropriate for a utility of below-average risks.

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[137] TURN Br. at 75. According to RRA data, the average for the last five years is actually 9.65 percent.

[138] *Id*.

[139] Griffing/UCAN-POC Exh. UCAN-POC-01 at 47; *see also* Rothschild/PAO Tr. V.4:639-41 (admitting that he is not aware of *any* ROE set at 8.49% for an electric or combined gas and electric utility in 2018 or 2019 and agreeing that such an ROE would be over 100 basis points *below* the current allowed national average). Perhaps it is for this reason EPUC-IS eschews its own expert Mr. Gorman's "base ROE" recommendation that EPUC-IS admits "falls below" the RRA reported average for the first half of 2019 to recommend the Commission use the national average.

[140] *See* TURN Br. at 75.

[141] *Id.* at 31, 44.

[142] *Id.* at 5; *see also id.* at 10 (noting that the national average is well above the modeling results of Mr. Gorman).

TURN instead curiously focuses on the fact that "investors can reduce such risks by diversifying their portfolio."[143] While this is true for investors, it does not apply to the California utilities who are seeking to obtain the investment. Investors diversifying their investment by not investing in California utilities is the exact problem that SDG&E is trying to prevent by seeking an ROE that is commensurate with its risks.

In addition, TURN argues that SDG&E's ROE should be slightly lower because California electric utilities are "no longer in the generation business" and so "not vertically integrated."[144] This is false. The Commission has defined vertically integrated as one that owns generation, transmission, and distribution.[145] As other intervenors have acknowledged, SDG&E is vertically integrated because it does all three, including owning generation assets.[146] Indeed, TURN admits the same.[147] Moreover, SDG&E has procurement responsibilities. So it is not analogous to a utility that solely undertakes transmission and distribution.[148]

TURN also asserts that SDG&E's ROE should be lower because the Company has been "over-earning" its authorized ROE. But TURN does not have a basis for that statement. The

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143 *Id.* at 25.

144 *Id.* at 22.

145 *See* D.99-10-065 at 60.

146 *See* Discovery responses of UCAN-POC Exh. SDG&E-29 at 30 ("Q: Is it your understanding that California investor-owned utilities are vertically integrated? A: Yes – it is understood that SDG&E is vertically integrated. Page 13 of SDG&E's 10-K Report from 2018 included here indicates that SDG&E owns generation, transmission, and distribution facilities"); *see also* See UCAN-POC Br. at 35 (stating their proxy group of "vertically-integrated electric service provider and natural-gas distribution service provider" most closely tracked SDG&E.).

147 TURN Br. at 22, n.49.

148 *See* SDG&E Br. at 32-52 (discussing risks to SDG&E from its procurement responsibilities).

data TURN cites to support that argument is inapposite.[149] As SDG&E made clear in the data request response accompanying the spreadsheet cited by TURN, the ROE figures that TURN cites to include total Company earnings; *i.e.* ROE and ROR data from *both* FERC and the CPUC.[150] The Company has a separate ROE at FERC, making this an apples-to-oranges comparison. TURN also ignores periods when SDG&E has under-earned its authorized ROE.

And TURN and other intervenors' focus on the nationwide decline in the ROE average and/or interest rates overstates the case.[151] For instance, TURN's argument that RRA's 2019 national average is outdated and does not sufficiently reflect declining national ROE averages is not supported by evidence. In fact, the average allowed ROE for electric utilities increased slightly between 2018 and 2019, as Mr. O'Donnell admits.[152] Moreover, the average allowed ROE for the last five years has been relatively steady; generally, at or above 9.6 percent.[153]

And in 2012, the Commission expressly relied upon the RRA data from the first six months of the application year – undermining TURN's contention the 2019 national reported average from RRA is outdated. Instead, that RRA data is consistent with Dr. Morin statement during hearings that the average of his proxy group would likely be around 9.7 percent if he re-ran his study.[154] As Dr. Morin notes, the effect on ROE of a decline in interest rates is

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[149] *See* TURN Br. at 36.

[150] *See* TURN Exh. TURN-06. *See also* Widjaja/SDG&E Tr. V.4:696:17:18 (noting the information came from "FERC Form 2," indicating that it contains FERC data).

[151] TURN Br. at 4; *see also* FEA Br. at 7 ("Utility regulators around the country have recognized the lower cost of capital and have been consistently setting lower ROEs to incorporate the lower cost of capital experienced in the marketplace.").

[152] *See* O'Donnell/FEA Tr. V.3:362.

[153] *See* RRA Jan. 31, 2019 Report at 7.

[154] Morin/SDG&E Tr. V.2:263; *accord id.* at 270:6-16

moderated by the risk premium increasing as interest rates decline.[155] Just as is the case here, there is no reason to think that other utility commissions did not take the current market conditions into account before approving ROEs.

EDF's argument to set separate ROEs for SDG&E's gas and electric operations can also be quickly dispensed with. The proposal is contrary to Supreme Court precedent to set ROE commensurate with a *company's* risks, and this Commission's precedent to only set one ROE for a combined gas and electric utility.[156] As EDF acknowledges, only 12 percent of SDG&E's depreciated capital investment percentage derives from natural gas.[157] To the extent it is implicated, Concentric already "attributed no incremental risk to [SDG&E's] gas assets" in their calculation, "which has the effect of reducing" SDG&E's ROE proposal.[158] Notably, no other intervenor proposes setting separate gas and electric ROEs for SDG&E. As UCAN-POC correctly states in opposing EDF's proposal, "SDG&E is one company with a unified management and a unified workforce," and "disassociating the integrated departments of a single utility would be extremely problematic."[159] As UCAN-POC continues, "the blended return on equity that now is authorized for this one company, SDG&E, should continue unless and until SDG&E formally disaggregates its corporate form into two separate entities."[160]

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155 *See* SDG&E Br. at 68.

156 *See* D.99-06-057 at 64 (citing D.93-12-022 at 43).

157 EDF Br. at 7.

158 Concentric/SDG&E Exh-12, Ch.1 at 31-32.

159 UCAN-POC Br. at 52.

160 *Id.*

2. Intervenors' criticisms of SDG&E's modeling also do not support Intervenors' below-average ROE requests

Nor do critiques of Dr. Morin's modeling justify intervenors' significantly below-average ROE proposals. Instead, those critiques are misplaced.

Proxy Group: UCAN-POC strangely targets Dr. Morin for not picking a proxy group that had "similar risk to that faced by SDG&E."[161] But that is the whole point. Such a proxy group of regulated utility holding companies does not exist because only California utilities face this unique wildfire liability regime.

EDF is simply incorrect to say that Dr. Morin "cherry pick[e]d" his peer group because he excluded companies undergoing mergers and acquisitions.[162] CPUC precedent explicitly instructs that companies undergoing mergers and acquisitions should be excluded.[163] Other intervenors who actually produced ROE models in this matter similarly exclude such companies.[164] It was not inconsistent of Dr. Morin to include Sempra because the Commission only excludes companies "*undergoing* a restructuring or merger."[165] And the acquisition of Oncor had been completed for almost a year before Dr. Morin conducted his analysis.[166]

Flotation Costs: Although SDG&E acknowledges that Commission precedent excludes the consideration of flotation costs unless a utility demonstrates that it issued new stock in the

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161 UCAN-POC Br. at 30.

162 EDF Br. at 11.

163 D.12-12-034 at 19.

164 UCAN-POC Br. at 34 (asserting Dr. Griffing's information "w[as] not affected by an impending merger or acquisition.").

165 D.12-12-034 at 19.

166 *See* Morin/SDG&E Exh. SDG&E-04 at Exhibit RAM-2 (only excluding companies with ongoing mergers and acquisitions).

test year and that its stock is trading below book value,[167] the Company suggests that the Commission reconsider this precedent. Because utility stocks have been trading well above book value for decades, this test can never be satisfied.[168] Yet flotation costs are legitimate costs that a utility's holding company must incur that require it to earn slightly more on its reduced equity base in order to produce a return equal to that required by shareholders.[169] Similarly, as Dr. Morin notes, the focus on a test year stock issuance is inapt because "the equity capital raised in a given stock issue remains on the utility's common equity account and continues to provide benefits to ratepayers indefinitely."[170] Notably, Dr. Griffing also supports including flotation costs.[171]

DCF: Along with multiple intervenor experts, Dr. Morin relies upon analyst growth rates because they are embedded in stock prices.[172] As noted, the sustainable growth method is inadequate for a regulated utility because it is circular, requiring an analyst to assume an ROE that is different than the recommended authorized ROE.[173] Perhaps for this reason it was given

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[167] D.12-12-034 at 24.

[168] *See* Morin/SDG&E Tr V.2:211:2-3; *accord id*. at 298:20-23.

[169] *See* SDG&E Br. at 66; Morin/SDG&E Exh. SDG&E-09 at 30.

[170] Morin/SDG&E Exh. SDG&E-04 at 51; *see also id.* at 49 (stating that flotation costs are analogous to amortization over the life of a bond).

[171] UCAN-POC Br. at 35.

[172] Oddly, EPUC-IS criticizes Dr. Morin's use of analysts' growth rates. EPUC-IS Br. at 61. As Dr. Morin notes, Mr. Gorman criticizes Dr. Morin's analyst growth forecasts as too high – but then uses analysts' growth forecasts himself and ignores other DCF methods. Morin/SDG&E Exh. SDG&E-09 at 84-86; *see also id.* at 8 (noting that most "analysts, including all the other ROE witnesses in this proceeding, rely upon analysts' growth forecasts to implement the DCF model.").

[173] SDG&E Br. at 65.

little weight by most intervenors.[174] Nor is it accurate to state that the Commission applied the sustainable growth method in D.18-03-035.[175]

CAPM: As discussed, Dr. Morin ably explains why the ECAPM method is more accurate.[176] Because Mr. Gorman confuses the adjustment of beta with the ECAPM method, Mr. Gorman's criticisms of the ECAPM method are off-base.[177] Dr. Morin also extensively explained why he applied long-term interest rate forecasts for the CAPM risk-free rate.[178] Again, these are professional forecasts. And because of that, academic studies have shown that those forecasts are embedded in investor expectations of future stock prices.[179]

Risk Premium Method: As noted above – and contrary to EPUC-IS's misleading characterization[180] – Dr. Morin repeatedly emphasized in both direct testimony and at hearings the inverse relationship between interest rates and risk premium.[181] EPUC-IS misquotes Dr. Morin's testimony where he agreed that inflation "can influence interest rates and required

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[174] Morin/SDG&E Tr. V.2:205:8-10.

[175] *Compare* PAO Br. at 16, *with* D.18-03-035 at 18 ("We find no reason to adopt the financial modeling results of any one party.").

[176] *See* SDG&E Br. at 64-65.

[177] Morin/SDG&E Exh. SDG&E-09 at 90-91. It is unclear why the Commission should give Mr. Gorman's modeling any weight since it is ultimately rejected by both EPUC-IS and TURN; the intervenors that sponsored his testimony.

[178] SDG&E Br. at 67-68.

[179] *Id.* at 67; *see also* Morin/SDG&E Exh. SDG&E-04 at 20; Morin/SDG&E Exh. SDG&E-09 at 17-18, 43, 69.

[180] *See* EPUC-IS Br. at 66.

[181] Morin/SDG&E Exh. SDG&E-09 at 94 (stating that Mr. Gorman's allowed risk premium analysis does not account for the inverse relationship between allowed returns and the level of interest rates, understating returns by *70 basis points*."); *see also* Morin/SDG&E Tr. V.2:309:3-5 ("So there is an inverse relationship between the risk premium and interest rates. I mean, it's obvious.").

returns in the same direction."[182] Dr. Morin agrees that interest rates and required returns often move in the same direction; which is why he opined that recent reductions in interest rates would reduce the average ROE of his proxy group by 20 basis points, from 9.9 to 9.7 percent.[183] But a "return" does not equal a "risk premium." And Dr. Morin noted that the effect of a decline in interest rates on the return is somewhat offset by resulting increase in the risk premium, which moderates any such movement.[184] As Dr. Morin notes, the Commission has similarly recognized this inverse relationship.[185]

Upward Risk Adjustment: As intervenors note, Dr. Morin acknowledges that his 100-basis point risk premium for SDG&E (making his overall recommendation 10.9 percent) includes some wildfire risk to the extent that risk is captured in Sempra Energy's high beta and DCF figures.[186] But Dr. Morin specifies that his risk premium adjustment is "barebones" and does not fully capture SDG&E's wildfire liability risk (which is why Concentric Energy Advisors' analysis is necessary) for two reasons. First, Dr. Morin's 100 basis point risk adjustment is based off the spread in beta between Sempra and the average for the proxy group – even though none of the latter face wildfire risks.[187] Analyzing just Sempra Energy's DCF result

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[182] Morin/SDG&E Tr. V.2:309:22-38.

[183] *See* SDG&E Br. at 68-69.

[184] In addition, as Dr. Morin continued, inflation is currently at very low levels, only "1.5 to 2 percent." Morin/SDG&E Tr. V.2:310:6-7.

[185] Morin/SDG&E Exh. SDG&E-09 at 92; *see* D.99-06-057 at 49-50 ("the Commission has had a practice of only adjusting rate of return by one half to two thirds of the change in the benchmark interest rate.") (citing D.94-11-076); D.97-12-089 at 12 ("Our consistent practice has been to moderate changes in ROE relative to changes in interest rates in order to increase the stability of ROE over time.").

[186] *See* TURN Br. at 47; EPUC-IS Br. at 114; *see also* Morin/SDG&E Tr. V.2:193-94.

[187] *See* SDG&E Br. at 56.

would produce a larger result.[188] Moreover, Dr. Morin's ROE recommendation is predicated upon adoption of SDG&E's proposed capital structure. If the Company was granted a lower common equity ratio than its current actual common equity ratio then Dr. Morin's proposal would be understated.

Second, as Dr. Morin states, his recommended risk premium is understated because Sempra is a diversified multi-activity company; whereas he believes that SDG&E would have a higher beta as a standalone entity.[189] Intervenors' complaints about this opinion miss the mark. It is misleading by TURN to assert that the "majority" of risks identified in Sempra Energy's 2018 10-K related to business other than California utilities.[190] Sempra Energy's 10-K does not state that. Instead, even the excerpt TURN included as an exhibit lists extensive risks to California utilities, including wildfire risks.[191]

UCAN-POC similarly misunderstands Dr. Morin's risk premium adjustment. Dr. Morin's risk premium based off beta is not 'derived' from unregulated industries – it is based off a comparison of Sempra's beta to the proxy group.[192] UCAN-POC's critique of Dr. Morin's

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188 *See* Morin/SDG&E Exh. SDG&E-04 at 55.

189 SDG&E Br. at 56 (citing Morin/SDG&E Tr. V.2:193; McCann/EDF Tr. V.6:1030:25-26 (stating that "SDG&E is a relatively minor factor in Sempra's overall holdings")); *see also* Hern/IEI Tr. V.4:608:12-13 (noting that SDG&E is less than 40 percent of Sempra Energy's revenue).

190 TURN Br. at 80.

191 TURN Exh. TURN-05 at 44-52.

192 *See* SDG&E Br. at 56. Nor did Concentric rely upon their analysis of unregulated industries for their recommendation, contrary to UCAN-POC's statement. *Compare* UCAN-POC Br. at 31, *with* SDG&E Br. at 57. It is also incorrect by TURN to state that Concentric's analysis was based off an assumption that 75% of wildfire costs would be found imprudent by the Commission. TURN Br. at 69. Concentric instead assumed two scenarios of prudency findings that were both lower than 75%: 70% (blended 3-years of the Filsinger variable prudency assumption); and 50% (blended 10 years of the same assumption). *See* SDG&E Br. at 58.

failure to quantify the relationship between Sempra and SDG&E's beta is equally non-sensical. SDG&E is not publicly traded so it cannot have a beta.[193]

Similarly, UCAN-POC's statement that Sempra Energy is riskier than SDG&E because Sempra Energy has a higher ROE than what Dr. Morin estimates as the average ROE for the peer group is an inapt comparison – because it is attempting to compare Sempra Energy's actual returns with the average authorized return for a group of regulated utilities. [194] Dr. Morin specifically notes that SDG&E faces higher risks than other regulated utility business owned by Sempra, such as Oncor.[195] UCAN-POC thus misses how Dr. Morin actually calculates risk analysis – he is comparing the beta of Sempra to the average beta of the proxy group – a like to like comparison between utility holding companies.

UCAN-POC's statement about Dr. Morin not considering "balancing and memorandum accounts" is both misleading and false.[196] As the Commission has recognized – and as Dr. Morin likewise notes – regulatory mechanisms like memorandum and balancing accounts are already captured by proxy group.[197] By contrast, the Commission previously declined in D.12-12-034 to consider wildfire liability risk because it was not discussed at that time by credit rating agencies.[198] That is obviously the exact opposite situation to today, where credit rating agencies

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[193] Morin/SDG&E Tr. V.2:196:9-10.

[194] UCAN-POC Br. at 31.

[195] Morin/SDG&E Tr. V.2:192-94.

[196] UCAN-POC Br. at 27.

[197] D.12-12-034 at 34; Morin/SDG&E Tr. V.2:238-39.

[198] D.12-12-034 at 31.

repeatedly discuss this risk as "unique" to California utilities; demonstrating that this is a risk not captured by the proxy group.[199]

D. SDG&E's ROE Needs to Be Set Above the National Average for Allowed ROEs

In short, TURN and EPUC-IS are focused on the 2019 RRA national average of 9.66 percent. But then intervenors make bottom-basement ROE recommendations for SDG&E that are inconsistent with the risks replete throughout the record – including those identified by intervenors – and the need to set ROE commensurate with risks. For instance, as noted, TURN repeatedly cites SDG&E's ongoing risks from the continuation of inverse condemnation and uncertainty surrounding AB 1054's implementation.[200] But then TURN ignores those risks in making a new proposal of 9.4 percent that is well below the national average.[201]

To authorize a below-average ROE necessitates a conclusion that the utility faces below-average risks. But TURN and other intervenors acknowledgement of the risks from inverse condemnation and uncertainty surrounding AB 1054 indicate the exact opposite.[202] Again, 9.66 percent is only the 2019 average; meaning that there are ROEs being allowed above that figure for utilities with lower risks than SDG&E. Even TURN and EPUC-IS's expert Mr. Gorman recognizes that California electric utilities are facing a wildfire risk premium from credit rating

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[199] *See, e.g.*, S&P Report Jan. 21, 2019, Exh. PAO-03-C at 1 (noting that California faces "unique risks" from inverse condemnation and the inability to directly recover those costs); *see also* D.12-12-034 at 28 ("We also consider additional risk factors not specifically included in the financial models.").

[200] *See, e.g.*, TURN Br. at 75.

[201] *Id.* at 5.

[202] TURN states that because of these risks it is recommending an ROE above Mr. Gorman's modeling. *Id*. at 31. But that is only because Mr. Gorman's modeling is well below the national average. *Id.* at 10.

downgrades that result in a higher cost of capital.[203] As Mr. O'Donnell for FEA similarly concludes, "I do believe that California utilities are at a higher risk and deserve a higher return."[204]

Even if the Commission were to accept TURN's and EPUC-IS's construct of basing off RRA's 2019 allowed national average, the more appropriate way to set SDG&E's ROE commensurate with its risks would be to add a risk premium to the 9.66 percent national average to reflect those above-average risks. Intervenors and applicants' experts have estimated a risk premium range for SDG&E of anywhere between 0.5 percent to 2.48 percent.[205] For instance, if the Commission added Mr. Gorman's 0.65 percent risk premium to the 9.66 percent national average, it would place SDG&E's ROE at 10.31 percent – near the Company's current ROE and alternatively within the modeling range identified by Dr. Morin.[206]

By contrast, lowering SDG&E's current 10.2 percent ROE (which was set when SDG&E had an 'A' credit rating and still sits within the range of ROEs allowed in 2018-2019)[207] – despite the Company facing lowered credit ratings and increased cost of capital from the regulatory environment despite being lauded for operational excellence – would send exactly the

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203 *See id.* at 70 ("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," before calculating a risk premium based upon the spread between A-rated and Baa-rated utility bonds.).

204 O'Donnell/FEA Tr. V.3:364:7-9.

205 *See id.* Tr. V.3:361:6-8 (continuing to support a risk premium adder of 0.5%); Gorman/EPUC-IS/TURN Exh. EPUC-IS/TURN-01 at V-11:1-6 (noting Mr. Gorman's proposed 0.65% risk adder); Morin/SDG&E Exh. SDG&E-04 at 59 (proposing a 1.0% adder); Concentric/SDG&E Exh. SDG&E-05-S, Ch. 1 at 21 (proposing a 1.48% adder); Folkmann/SDG&E Exh. SDG&E-01-S at 14 (proposing increasing SDG&E's ROE by 2.48% in total above the average from Dr. Morin's proxy group).

206 *See* Morin/SDG&E Exh. SDG&E-04 at 54.

207 *See* RRA Jan. 31, 2019 Report, Exh. SDG&E-25-C at 11-12 (collecting decisions).

wrong signal to credit rating agencies and investors.[208] In other words, in 2012, the Commission granted SDG&E a 10.3 percent ROE – when SDG&E had a higher credit rating and in what was viewed as a more favorable regulatory environment. The risks identified in that decision have only increased. And they have been exacerbated by the high threat from the State's wildfire liability regime. SDG&E is thus self-evidently riskier today. The Commission should rely on this strong record evidence to find that a ROE above the "industry" average for SDG&E is appropriate.

Otherwise, a lowered ROE could put further downward pressure on SDG&E's credit ratings and increase the Company's cost of capital. TURN's statement that SDG&E's current ROE is "already above national averages" in fact demonstrates the risk.[209] If SDG&E faced repeated credit rating downgrades and an increased cost of capital with an above average ROE, further pressure on the Company's credit rating is likely if SDG&E's ROE is set as if SDG&E is a utility facing average or below-average risks.[210]

E. Intervenors' Capital Structure Proposals Are Not Supported by the Record

SDG&E's capital structure proposal similarly responds to the current risk environment. SDG&E's currently-authorized capital structure of 52 percent common equity, 45.25 percent debt, and 2.75 percent preferred stock was adopted in 2012 and has not changed in seven

[208] *See, e.g.*, Moody's Aug. 2 Report, Exh. SDG&E-23-C at 2 (noting that a credit challenge to SDG&E is "regulatory uncertainty" regarding this pending cost of capital proceeding).

[209] TURN Br. at 51.

[210] *See, e.g.*, Folkmann/SDG&E Exh. SDG&E-01-S at Appendix C (Fitch July 17 Report) at 4 (noting that "meaningful improvement in rate regulation" could support further positive credit rating actions) and Appendix E (Moody's July 29 Report) (noting that its current positive outlook "assumes" "credit supportive" outcomes in this proceeding).

years.[211] In order to offset increases in the business risks faced by SDG&E during this period, SDG&E has been consistently operating above its currently-authorized common equity ratio. Since 2015, its equity layer has been at or around 56 percent.[212] This higher than authorized common equity ratio has improved SDG&E's credit metrics by limiting its financial risk and allowing SDG&E to access the debt markets at more reasonable rates.[213] In order to ensure alignment between its authorized and actual capital structure and to enable continued prudent management of its financial risks, SDG&E requests a modification of its currently-authorized capital structure to 56 percent common equity, 44 percent debt, and zero percent preferred stock.[214]

TURN, FEA, PAO and UCAN-POC oppose SDG&E's capital structure proposal and recommend instead that the Commission adopt an authorized capital structure for SDG&E of 52 percent common equity and 48 percent debt. The proposals offered by these parties ignore Commission precedent establishing that a utility's authorized capital structure should track its actual ratios.[215] They, likewise, disregard the Commission's guidance that "[b]ecause the level

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[211] *See* D.12-12-034 at Ordering Paragraph 2.

[212] Folkmann/SDG&E Exh. SDG&E-01 at 14.

[213] Mekitarian/SDG&E Exh. SDG&E-02 at 6-7.

[214] PAO suggests that the Commission has issued "policy guidance" that common equity ratios of regulated utilities must fall within a range of 45 to 50 percent. PAO Br. at 29, citing D.09-05-019 at 9. However, this statement, which is in the nature of dicta, has not been repeated or cited in any electric or gas utility case in the decade since this decision was adopted and PAO's own capital structure recommendation is not aligned with it. Moreover, the Commission has not been bound by this statement in adopting water utilities' capital structures. Indeed, the capital structures adopted in D.09-05-019 fell outside this range. *See* D.09-05-019 at Ordering Paragraphs 1-3.

[215] *See, e.g.*, D.12-12-034 at 11 ("SDG&E seeks a common equity ratio for its revenue requirement which is the same as its actual common equity ratio. We concur with SDG&E and find a 46.25% long-term debt, 2.75% preferred stock and 52.00% common equity capital structure reasonable and we adopt it."); D.18-03-035 at 22 (concluding that it is reasonable to adopt authorized capital structures that reflect the utilities' actual equity and debt ratios); California Public Utilities

of financial risk that the utilities face is determined in part by the proportion of their debt to permanent capital, or leverage, we must ensure that the utilities' adopted equity ratios are sufficient to maintain reasonable credit ratings and to attract capital."[216]

As discussed in more detail below, given SDG&E's current risk profile, adoption of a 52 percent equity ratio and 48 percent debt ratio would cause SDG&E to become too financially leveraged. Its credit rating would further suffer as a result. SDG&E's authorized capital structure must include a ratio of debt to equity that is designed to provide a reasonable return in order to attract necessary capital. Thus, the Commission should adopt SDG&E's proposed capital structure of 56 percent equity and 44 percent debt in order to ensure consistency with Commission precedent, send a credit-supportive signal to the credit rating agencies, and preserve SDG&E's ability to access the capital markets. In addition, as noted above, Dr. Morin's proposed ROE assumes a 56 percent equity ratio.

1. Adoption of a 52 Percent Equity Ratio Would Negatively Impact SDG&E's Credit Metrics

TURN argues that the proposed increase in SDG&E's authorized equity ratio is not justified, asserting that the current 52 percent regulatory equity ratio "has been entirely sufficient" to maintain SDG&E's investment grade credit rating.[217] This claim is manifestly incorrect. TURN ignores the fact that SDG&E has managed its actual capital structure at a

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Commission, *Utility General Rate Case – A Manual for Regulatory Analysts* (November 13, 2017) at 29, *available at* https://www.cpuc.ca.gov/uploadedFiles/CPUC_Public_Website/Content/About_Us/Organization/Divisions/Policy_and_Planning/PPD_Work/PPD_Work_Products_(2014_forward)/PPD%20General%20Rate%20Case%20Manual.pdf.

[216] D.12-12-034 at 5.

[217] TURN Br. at 83.

higher-than-authorized common equity ratio for the past several years.[218] A downward adjustment of SDG&E's current, actual 56 percent common equity ratio to 52 percent – and an increase in its debt ratio to 48 percent – would almost certainly have a major negative impact on SDG&E's credit metrics and its ability to prevent future downgrades.

As a threshold matter, SDG&E notes that TURN's analysis of the impact of its proposed 52 percent common equity ratio is flawed and incomplete. TURN implies that its capital structure proposal is aligned with SDG&E's current authorized capital structure and preserves the status quo. For example, it supports its own proposal by claiming that SDG&E's authorized 52 percent common equity ratio has been "entirely sufficient" to date to maintain the Company's investment grade credit rating.[219] However, TURN's analysis ignores the fact that SDG&E's authorized debt ratio has been 45.25 percent – *not* the 48 percent recommended under TURN's capital structure proposal. In other words, assuming *arguendo* (but erroneously) that TURN is correct and that recent credit ratings agency assessments have been based upon SDG&E's currently-authorized rather than actual capital structure, this would mean that the credit ratings agencies' assessment of SDG&E also assumes a 2.75 percent preferred stock layer and a 45.25 debt layer. TURN's proposal, however, would eliminate the preferred stock component and increase the debt ratio in SDG&E capital structure to 48 percent. TURN fails to effectively analyze the impact of this proposed change in SDG&E debt-to-equity ratio on SDG&E's credit metrics or address what the credit ratings agencies' reaction might be to this increase in the debt ratio. These are critical considerations that TURN simply ignores.

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[218] Mekitarian/SDG&E Exh. SDG&E-08 at 6.

[219] TURN Br. at 83.

Other intervenors, including FEA, PAO and UCAN-POC, likewise all propose a 52 percent common equity and 48 percent debt capital structure and likewise all suffer from the same deficiency. These parties' proposals neither reflect SDG&E's currently-authorized capital structure nor its proposed capital structure and lack analytical support.[220] PAO, for example, supports its proposed 52 percent common equity and 48 percent debt capital structure by mistakenly asserting that SDG&E has "enjoyed strong credit ratings since 2012 *under the* *<u>same</u>* *capital structure*."[221] Intervenors admit that their capital structure proposals would alter the Company's current authorized capital structure by increasing the Company's debt-to-equity ratio (*i.e.*, making SDG&E more leveraged),[222] but do not meaningfully address the impact of their proposals on SDG&E's credit metrics or its ability to access capital. Thus, the record of this proceeding is insufficient to support adoption of a capital structure of 52 percent common equity and 48 percent debt.

More to the point, TURN's suggestion that the credit ratings agencies evaluate SDG&E on the basis of its authorized capital structure rather than its actual capital structure is erroneous. As Ms. Mekitarian explained, "[t]he credit rating agencies assess the financial risk of SDG&E based on its *actual* capital structure rather than its *authorized* capital structure. That is why it is so important to Moody's and other credit rating agencies that SDG&E's authorized structure is changed to match the Company's actual structure so that SDG&E can continue at its current

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220 *See* FEA Br. at 17; PAO Br. at 29; UCAN-POC Br. at 52-54.

221 PAO Br. at 32 (emphasis added).

222 *See, e.g.*, Gorman/EPUC-IS/TURN Tr. V.3:394; O'Donnell/FEA Tr. V.3:366; Griffing/UCAN-POC Tr. V.6:984.

equity ratio – the one that rating agencies are considering."[223] Mr. O'Donnell for FEA similarly admits that credit rating agencies assess SDG&E's capital structure on the basis of its actual capital structure.[224]

SDG&E's 56 percent equity and 44 percent debt actual capital structure is viewed positively by credit ratings agencies. Since this proceeding is the Commission's first opportunity to authorize revised capital structure ratios that align with SDG&E's current 56 percent equity layer, "they are paying attention to the risk that, if not authorized, the equity layer could be reduced."[225] Commission rejection of the requested 56 percent equity ratio in this case could create significant negative impacts to SDG&E credit rating. As Ms. Mekitarian explained, "if the Commission were to approve an equity ratio below the 56 percent that we're currently operating under, it would send a really strong signal to the credit rating agencies that potentially the Commission is not supporting the credit of the company."[226] Such action by the Commission could likewise be interpreted by SDG&E's management as not supportive of SDG&E's efforts to manage the business prudently and prevent further downgrades.[227] The perception by credit ratings agencies that SDG&E would respond to the Commission's direction by lowering its common equity ratio and becoming more leveraged would likely have a direct negative impact the Company's credit rating.

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[223] Mekitarian/SDG&E Exh. SDG&E-08 at 6.

[224] O'Donnell/FEA Tr. V.3:367:4-7 ("What's more important is what the actual numbers that the company has in its books. That's what credit-rating agencies are looking at.").

[225] Folkmann/SDG&E Tr. V.5:849:21-23.

[226] Mekitarian/SDG&E Tr. V.5:941:14-20.

[227] *Id.* at Tr. V.5:941.

Moody's, for example, has indicated that SDG&E's current credit rating and outlook of "Baa1" and "positive" *assumes* a "credit supportive" outcome in the instant proceeding. It has indicated that it may downgrade SDG&E further if a 56 percent equity ratio is not approved and SDG&E's debt ratio increases.

Specifically, in its July 12, 2019 Report, Moody's stated:

> Importantly, the Baa1 rating assumes a credit supportive outcome of SDG&E's ongoing 2019 general rate case and cost of capital proceeding where the utility requested an *increase in its equity layer to 56%* (effective January 2020) from currently 52%. The outcome of these regulatory proceedings ***will be important for SDG&E's ability to further generate a ratio of CFO pre-W/C to debt that comfortably exceeds 20% on a sustained basis***.[228]

Moody's reiterated this point on July 29, cautioning that "[t]he positive outlook *assumes . . . credit supportive outcomes* of the utility's ongoing regulatory proceedings. These proceedings include its 2019 general rate case *and the cost of capital,* w[here] a decision [is] anticipated before year-end 2019."[229] Moody's further noted in its "Factors that Could Lead to a Downgrade" discussion that "[d]ownward pressure is also likely if SDG&E records credit metrics *that are weaker than currently anticipated* for example due to outcomes of pending regulatory proceedings that are not credit supportive."[230] On August 2, Moody's listed "[r]egulatory uncertainty with delayed rate case and pending cost of capital proceedings" as one of SDG&E's top "credit challenges," again listing non-credit supportive outcomes in pending regulatory proceedings as potentially leading to downgrades.[231]

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[228] Folkmann/SDG&E Exh. SDG&E-01-S at Appendix B (Moody's July 12 Report) at 2 (emphasis added).

[229] *Id.* at Appendix E (Moody's July 29 Report) at 1 (emphasis added).

[230] *Id.* at 2 (emphasis added).

[231] Moody's Aug. 2, 2019 Report, Exh. SDG&E-23-C at 2.

In sum, a decision in the instant case to maintain SDG&E's current 52 percent equity layer would send a message that the Commission is not supportive of the actions SDG&E has taken to date to preserve its credit rating. Commission approval of SDG&E's proposed 56 percent equity ratio, on the other hand, "would send a strong signal to credit rating agencies [and] investors in the market that the Commission is supportive of SDG&E's strong credit rating."[232] Accordingly, the Commission should authorize SDG&E's continued use of a 56 percent common equity ratio in order to ensure a credit-supportive outcome of this proceeding.

2. SDG&E's Proposed 56 Percent Equity Ratio is Reasonable Given Company-Specific Analysis and Compared to an Appropriate Proxy Group

Relying on analysis presented by Mr. Gorman, TURN asserts that SDG&E's proposed capital structure would result in "significantly lower debt leverage than typical for A-rated utilities."[233] Similarly, FEA cites conclusions offered by Mr. O'Donnell to argue that the proposed capital structure is "excessive and unwarranted relative to national averages."[234] The analyses performed by Messrs. Gorman and O'Donnell are flawed and unreliable, and their claims are erroneous. The record of this proceeding demonstrates clearly that SDG&E's proposed capital structure is reasonable and necessary to avoid further credit downgrades.

As Ms. Mekitarian pointed out, Mr. Gorman's analysis improperly relies on generic, industry-wide information rather than SDG&E-specific analyses.[235] She explained that credit rating agencies provide company-specific analysis to support the credit ratings they assign,

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[232] *See* Mekitarian/SDG&E Tr. V.5:942:9-12.

[233] TURN Br. at 83-84.

[234] FEA Br. at 17.

[235] Mekitarian/SDG&E Exh. SDG&E-08 at 4-5.

including identification of conditions necessary to support the company's current rating as well as factors that could lead to upgrades or downgrades.[236] This explicit, company-specific information is plainly more relevant to the question of SDG&E's appropriate capital structure than the broad industry-wide survey data offered by Mr. Gorman. As noted above and in SDG&E's Opening Brief, it is clear that the credit ratings agencies will react negatively if the Commission approves a common equity ratio lower than SDG&E's current 56 percent equity layer, which could result in further downgrades on SDG&E.

Mr. O'Donnell's analysis is, likewise, inapposite. To support his capital structure proposal, Mr. O'Donnell provided analysis that improperly compared SDG&E's capital structure to: (i) the capital structure of SDG&E's parent company, Sempra Energy; and (ii) the capital structure of the parent companies of SDG&E's proxy group, as defined by Dr. Morin.[237] Plainly, however, the capital structures of Sempra Energy and the parent companies of SDG&E's proxy group are not relevant to SDG&E as an operating regulated utility. These utility holding companies, including Sempra Energy, manage a wide variety of businesses, have diversified risk, and are not comparable peer companies of SDG&E.[238] Accordingly, as Dr. Morin explained, the more relevant comparison is with the capital structure of the operating utility companies (as opposed to the holding companies), where the average capital structure of 53-54 percent is largely consistent with SDG&E's 56 percent proposal, and "[t]he slightly higher common equity ratio of SDG&E is not surprising in view of its much higher business risks."[239]

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[236] *Id.* at 5.

[237] *See* Mekitarian/SDG&E Exh. SDG&E-08 at 12; Morin/SDG&E Exh. SDG&E-09 at 26.

[238] Folkmann/SDG&E Exh. SDG&E-07 at 18; Mekitarian/SDG&E Exh. SDG&E-08 at 12.

[239] Morin/SDG&E Exh. SDG&E-04 at 61-62.

Rather than comparing SDG&E's capital structure to those of the relevant operating utility companies, Mr. O'Donnell compares SDG&E's capital structure to the average authorized equity ratio granted to utility companies as a whole in 2018.[240] Again, this is an overly-broad and inappropriate comparison, as Ms. Mekitarian pointed out, since "no consideration is given to the similarity of these companies to SDG&E."[241] In response to Mr. O'Donnell's inapplicable proxy group comparison, Ms. Mekitarian provided the authorized and actual capital structure of more appropriate peer companies.[242] The average authorized and actual capital structure of these peer companies is summarized in Table 1 below.

Table 1 – Peer Group Capital Structure Averages[243]

	Current Authorized Common Equity Ratio Average	2018 Recorded Common Equity Ratio Average
Non-California Vertically Integrated Utility	51.0%	53.1%
Non-California Non-Vertically Integrated Utility	50.5%	51.6%
California Utility	53.5%	54.6%

As noted above, the average authorized capital structure for the utilities in Dr. Morin's proxy group is between 53-54 percent – which is similar to SDG&E's proposal. Ms. Mekitarian

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240 O'Donnell/FEA Exh. FEA-01 at 56.

241 Mekitarian/SDG&E Exh. SDG&E-08 at 13.

242 *See id.* at 13 n.42 ("The non-California utility peer group includes the electric and electric and gas operating utility companies from the proxy group identified in Dr. Morin's testimony (Morin/SDG&E Exh. SDG&E-04, Exhibit RAM-3). The California utility peer group was obtained from the California Board of Equalization 2018 Capitalization Rate Study. However, Pacific Gas and Electric Company (due to recent wildfires and capital structure waiver request), Southern California Edison Company (due to recent wildfires and capital structure waiver request), private companies (because data is not available), and companies that operate primarily outside of California were excluded.").

243 *Id.* at 13, Table 2.

pointed out that "[o]n average, the California utilities have a higher authorized and recorded common equity percentage than utilities outside of California, which is indicative of the recognition that California utilities face increased business and regulatory risks."[244] SDG&E has sought to mitigate these risks, as well as its financial risks, by strengthening its balance sheet via a higher common equity percentage.[245] If the Commission approves a 52 percent equity ratio, and SDG&E were to reduce its actual equity ratio from its current 56 percent to 52 percent, credit rating agencies will assess SDG&E as being in a weakened financial position relative to its current position.

3. Sempra Energy's Capital Structure is not Driven by SDG&E's Capital Structure

PAO notes that the capital structure of SDG&E's parent company, Sempra Energy, has a lower level of common equity than the 56 percent equity ratio proposed for SDG&E.[246] It repeats the incorrect assertion made by its witness, Mr. Rothschild, that "SDG&E might be using a higher common equity ratio to support the consolidated capital structure of the parent company, leaving their ratepayers to bear the cost," and further claims that "Mr. Folkman[n] concedes this relationship between SDG&E['s] . . . capital structure and [its] parent company capital structure."[247] PAO's claim is manifestly false; Mr. Folkmann did not agree with Mr. Rothschild's baseless assertion. Rather, Mr. Folkmann made clear that SDG&E's capital structure has minimal impact on Sempra Energy. He explained that "Sempra Energy is a diversified holding company that owns several regulated and non-regulated subsidiaries," and

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[244] *Id.* at 13.

[245] *Id.* at 13-14; Mekitarian/SDG&E Exh. SDG&E-02 at 7.

[246] PAO Br. at 31.

[247] *Id.* (citing Tr. pp. 868:5-16; 872:7 – 873:4).

that "Sempra Energy's consolidated capital structure and financials are comprised of all its subsidiaries – including not only the two Commission-regulated utility subsidiaries (Southern California Gas Company ("SoCalGas") and SDG&E) – but also out-of-state and international subsidiaries that are not regulated by this Commission and do not impact the operations of SDG&E (or SoCalGas)."[248] Sempra Energy's various subsidiaries have different risk profiles and business models; thus, Sempra Energy's consolidated risk profile is very different from that of any of its subsidiaries.[249]

Put simply, the notion asserted by Mr. Rothschild that SDG&E's capital structure would be set in a manner intended to prop up or unduly benefit Sempra Energy's capital structure is not credible – not only is there no evidence in the record of this proceeding of such intent, but it is clear as a practical matter that while the financial statements of SDG&E contribute to its parent company's capital structure, as is the case with *any* subsidiary company, in the case of Sempra Energy, there are numerous subsidiaries outside of SDG&E that also impact Sempra Energy's consolidated capital structure.[250] Thus, the impact of SDG&E by itself on Sempra Energy's capital structure is marginal. Accordingly, Mr. Rothschild's spurious claim must be rejected.

4. PAO Ignores Long-Term Ratepayer Benefits of SDG&E's Proposed Capital Structure

PAO raises the concern that SDG&E has not separately evaluated the cost to ratepayers of its proposed capital structure.[251] SDG&E notes that cost of capital applications typically do not separately analyze the rate impacts of each individual component of the request since doing

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[248] Folkmann/SDG&E Exh. SDG&E-07 at 18.

[249] *Id.*

[250] Folkmann/SDG&E Tr. V.5:872-873.

[251] PAO Br. at 30.

so would be unduly burdensome and would serve little purpose. More to the point, Mr. Rothschild's analysis ignores an important consideration regarding the ratepayer costs associated with SDG&E's proposed capital structure. Namely, the long-term benefit associated with authorizing a capital structure that is credit-supportive and allows the utility to achieve an optimal credit rating. As Ms. Mekitarian explained, "SDG&E's overall capital structure proposal is consistent with the Commission's desire to adopt capital structures that prudently and proactively support strong credit ratings, which in turn reduces costs to ratepayers."[252]

Dr. Morin described the relationship between a utility having a single 'A' bond rating and the capital costs borne by ratepayers: "A single A bond rating generally results in the lowest pre-tax cost of capital for regulated utilities, ***and therefore the lowest ratepayer burden***, especially under adverse conditions."[253] Thus, "[l]ong-term achievement/retention of a single A bond rating is in both a utility's and ratepayers' best interests."[254] As noted by Ms. Mekitarian, the utility company debt ratio benchmark set by Moody's for a single 'A' bond rating is 35 percent to 45 percent (*i.e.*, a common equity range of 55 percent to 65 percent).[255] SDG&E's proposed common equity ratio of 56 percent is near the low end of this range; 52 percent would be outside of this range and would, therefore undermine SDG&Es ability to regain a single 'A' bond rating. It is *this* outcome – adoption of the 52 percent equity ratio proposed by PAO – that would harm ratepayers and impose unnecessary costs. As Dr. Morin made clear, "the Company's requested common equity ratio is reasonable as a partial offset to its heightened business risk and a

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[252] Mekitarian/SDG&E Exh. SDG&E-08 at 9; *see also* Mekitarian/SDG&E Exh. SDG&E-02 at 7.

[253] Morin/SDG&E Exh. SDG&E-04 at 62 (emphasis added).

[254] *Id.* at 62-63.

[255] Mekitarian/SDG&E Exh. SDG&E-02 at 10; *see also* Morin/SDG&E Exh. SDG&E-04 at 61.

necessary financial metric to regain a single A or above bond rating, which I consider optimal and cost efficient."[256]

Furthermore, the costs arising from of a downgrade from a single 'A' bond rating to 'BBB' can be accurately estimated. Mr. Gorman estimated that the "market-based impact on the utilities moving from a bond rating of A down to BBB would increase their cost of debt by approximately 0.65 percentage points."[257] SDG&E plans to issue $600 million of 30-year first mortgage bonds in 2020.[258] Hence, the additional cost to ratepayers of issuing $600 million of long-term debt at a 'BBB' rating instead of at an 'A' rating would be $117 million over the entire 30-year period.[259] As Mr. Rothschild points out, these costs apply to new debt issued.[260] Thus, these costs would increase and compound each year after 2020 as SDG&E issues additional debt in 2021 and beyond.[261] Moreover, this estimate is conservative since it does not consider the increase in common equity capital costs.[262] Thus, SDG&E's recommended capital structure supports SDG&E's strong credit profile and, in doing so, improves SDG&E's ability to achieve

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[256] Morin/SDG&E Exh. SDG&E-09 at 47.

[257] Gorman/EPUC-IS/TURN Exh. EPUC-IS-TURN-01 at II-8:1-2.

[258] Mekitarian/SDG&E Exh. SDG&E-02 at 17 and Appendix A. UCAN-POC question the impact of SDG&E's capacity contract with Otay Mesa Energy Center ("OMEC") on its cost of capital application. UCAN-POC Br. at 56. A summary of the history of the OMEC transaction is set forth at D.19-08-020 at 2-3. Because SDG&E anticipated when it was preparing its financial plan in early 2019 that it would enter into a contract for OMEC capacity rather than buying the resource, its financial plan does not assume the purchase of OMEC. Mekitarian/SDG&E Tr. V.5:896. Accordingly, the fact that SDG&E will not purchase the OMEC resource does not impact its application in this case.

[259] $600 million times 0.65 percent is $3.9 million, $3.9 million times 30 years is $117 million.

[260] Rothschild/PAO Exh. PAO-01 at 39:12-13.

[261] Mekitarian/SDG&E Exh. SDG&E-08 at 10.

[262] *Id.* at 10.

an optimal single 'A' credit rating. As Dr. Morin points out, this will result in lower overall costs and benefit ratepayers in the long-term.

F. Intervenors Fail to Demonstrate that the Existing CCM Achieves the Commission's Objectives

SDG&E supports continued reliance on the cost of capital mechanism ("CCM") mechanism and proposes limited modification and clarifications to the CCM intended to ensure that the goals underlying adoption of the mechanism are fully achieved. Specifically, SDG&E proposes that the Commission:

1) Narrow the dead band trigger to 50 basis points from the currently authorized 100 basis points;

2) Clarify the method for selection of a CCM benchmark index when the utility has split ratings;

3) Clarify the process for filing of a capital structure adjustment application to address a credit rating change between full cost of capital applications; and

4) Provide guidance regarding actions to be taken if a utility's credit rating is downgraded to non-investment grade.[263]

PAO and PG&E do not support SDG&E's proposal to reduce the dead band trigger from 100 to 50 basis points.[264] PG&E asserts that that the proposed change is not necessary,[265] while PAO argues that SDG&E failed to show that the current cost of capital mechanism "has produced adverse consequences for shareholders or ratepayers."[266] Both claims lack merit. SDG&E did not attempt to demonstrate that the current CCM had "adverse consequences" because this is not the criterion to be applied to determine whether a change to the CCM is

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[263] SDG&E Br. at 90-97.

[264] PAO Br. at 34-35.

[265] PG&E Br. at 38.

[266] PAO Br. at 35.

warranted. Rather, the question is whether the current 100 basis point dead band offers the most optimal approach to achieving the objectives of the mechanism outlined by the Commission.

The Commission explained that the CCM is designed to "balance[] the interests of [utility] shareholders and ratepayers while simplifying and reducing ROE proceedings, workload requirements, and regulatory costs."[267] As SDG&E has explained, its proposed modification to the CCM is necessary to achieve the goal of a CCM that is neither excessively sensitive nor unresponsive.[268] The Commission has made clear that a dead band that fails to trigger in order to protect ratepayers and shareholders is problematic, noting that "[a] deadband that is overly sensitive to interest rates cause needless volatility in revenues and rates. *Conversely, a deadband that never triggers can impose unnecessary costs on shareholders or ratepayers, depending on which direction interest rates move*."[269] Thus, to be effective, the dead band must be set to achieve *both* of the aims described by the Commission – *i.e.*, it must provide a reasonable level of stability, while being sensitive enough that it can serve its intended purpose of adjusting the ROE/ROR when appropriate. As Mr. MacNeil pointed out, "[a] CCM that never triggers or does so only very rarely is tantamount to having no CCM at all."[270] The analysis provided by SDG&E's demonstrates that its 50-basis point dead band would improve the sensitivity of the CCM without a material reduction in stability.

PAO suggests that the symmetric nature of the CCM – *i.e.*, that it operates to lower or raise the ROE depending on utility bond yields – is a reason to keep the dead band at 100 basis

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[267] D.08-05-035 at 5.

[268] SDG&E Br. at 92-95.

[269] D.08-05-035 at 11 (emphasis added).

[270] MacNeil/SDG&E Exh. SDG&E-10 at 3-4.

points. Specifically, PAO argues that Mr. MacNeil' analysis showing that since 2001, 'all additional triggers using a 50 basis point dead band . . . were downward triggers that would have led to a timelier reduction in ROE benefitting ratepayers,' is one-sided.[271] PAO asserts that Mr. MacNeil "only focuses on the benefits that ratepayers could have incurred under a 50 basis point dead band in the case of downward triggers from 2012 – 2018 . . . [and] neglects to elaborate on the adverse impacts to ratepayers had the upper dead band been triggered in this same time period," pointing out that today's low interest rates could cause an upward trigger.[272]

This mischaracterizes Mr. MacNeil's testimony. His point is simply that a 50 basis point dead band would have been more responsive than a 100 basis point dead band; applying a 50 basis point dead band to data from 2001 to the present produces the conclusion noted in Mr. MacNeil's testimony that ROE adjustments would have been mostly downward and would have largely (but not exclusively) benefitted ratepayers.[273] The fact that had bond ratings moved in another direction, it might have been shareholders that benefitted is self-evident; the operation of the CCM and the potential for it to impact ROE upward or downward is not a novel aspect of the CCM. In any event, the fact that under a different set of circumstances, a 50-basis point dead band might have operated to benefit shareholders rather than ratepayers is not a valid basis for rejecting the proposal. It is clear that a 50-basis point dead band would strike a more effective balance between responsiveness and stability. Thus, the Commission should adopt the dead band modification proposed by SDG&E.

[271] PAO Br. at 35, citing MacNeil/SDG&E Exh. SDG&E-10 at 4.

[272] *Id.*

[273] MacNeil/SDG&E Exh. SDG&E-06 at 8.

With regard to SDG&E's requested clarifications to the CCM, PAO notes that it does not take issue with SDG&E's proposed clarifications.[274] PG&E, however, objects to SDG&E's suggested clarifications regarding the approach to be used when a utility has a split credit rating and/or a non-investment grade credit rating.[275] PG&E provides no rationale for its objection to these rating, noting only that "PG&E does not support those requests at this time."[276] As Mr. MacNeil explained, the proposed clarifications "simply seek more explicit guidance on how the CCM should be understood by the Commission and all stakeholders. Such direction is necessary to avoid after-the-fact questions and later requests for clarification."[277] Adoption of SDG&E's proposed clarifications now will reduce administrative burden and provide regulatory certainty. Accordingly, the Commission should adopt the clarifications requested by SDG&E.

G. The Commission Should Reject EDF's Cost of Debt Proposal

In D.12-12-034 the Commission noted that long-term debt cost is based on the company's "actual, or embedded, costs."[278] SDG&E's currently-authorized embedded cost of long-term debt is 4.59 percent; this is also SDG&E's forecasted embedded cost of long-term debt.[279] Thus, SDG&E requests no change to its currently-authorized cost of long-term debt.

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[274] PAO Br. at 34.

[275] PG&E Br. at 38.

[276] *Id.*

[277] MacNeil/SDG&E Exh. SDG&E-10 at 5.

[278] D.12-12-034 at 13.

[279] Mekitarian/SDG&E Exh. SDG&E-02 at 16.

Prior to the evidentiary hearing, EDF agreed to stipulate to SDG&E's proposed 4.59 percent cost of debt.[280] In its opening brief, however, EDF appears to propose that the Commission set SDG&E's cost of debt at "the rate equal to the cost of debt of California's bellwether utility – Metropolitan Water District of Southern California (MWDSC)," or, alternatively, that it adjust SDG&E's proposed cost of debt "to reflect the substantial decrease in the treasury bill rate."[281] EDF offers no rationale for this proposal and appears to misunderstand the difference between calculating the embedded cost of debt and the risk-free rate in the CAPM cost of equity analysis.[282] No other party supports this proposal, as SDG&E's cost of debt can be directly measured. Since adoption of EDF's proposal would violate the direction set forth in D.12-12-034 and the stipulation agreed to by EDF, the Commission should reject EDF's proposal and set the authorized cost of debt for SDG&E at its proposed 4.59 percent, which is equal to the forecasted embedded cost of debt during Test Year 2020.[283]

III. CONCLUSION

It is a basic principle that ROE must reflect investors' expectations about the risks facing the company. The higher the risks, the higher the return necessary to induce investment. Although AB 1054 somewhat lowered SDG&E's risks, those risks remain elevated – reflected

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280 *See* Joint Filing to Report Results of Meet-and-Confer to Identify Stipulated Facts (August 29, 2019) at 3-4.

281 EDF Br. at 17.

282 *See id.* at 17, n.51(citing Dr. Morin's discussion of how the recent decline in interest rates would likely change the average of his proxy group from 9.9 percent to 9.7 percent). EDF also incorrectly cites the testimony of Dr. Morin, claiming that he contemplated a decrease in SDG&E proposed ROE of approximate 100 basis point. *Id.* Dr. Morin clarified during re-direct examination that he had misspoken and intended to refer to a 20-basis point decrease in ROE, *i.e.* that it would change the average of his proxy group from 9.9 to 9.7 percent, and his recommendation for SDG&E from 10.9 to 10.7 percent. Morin/SDG&E Tr.V.2 at 270.

283 Mekitarian/SDG&E Exh. SDG&E-02 at 16-17 (reflecting the trading level of SDG&E's most recently issued 30-year bond).

by the Company's depressed credit ratings. This downgraded position is not based upon any actions of SDG&E, but instead reflects the increased risks from the State's wildfire liability regime and ambitious public policy objectives. And these downgrades occurred at SDG&E's present ROE. To engage in intervenors' fiction and lower the Company's current ROE and instead set it below the national average would likely only further harm SDG&E and stakeholders' overall view of the State. Similarly, not granting the Company's current actual capital structure would adversely affect SDG&E's credit ratings. SDG&E's 12.38% ROE request and 56 percent common equity ratio accurately responds to the Company's ongoing risks.

Respectfully submitted,

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