

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION

**RESOLUTION E-4994
February 21, 2019**

R E S O L U T I O N

Resolution E-4994. Southern California Edison (SCE) requests Z-factor recovery of the revenue requirement for wildfire-related liability insurance costs.

PROPOSED OUTCOME:

- This resolution grants SCE’s request in Advice Letter 3768-E and allows SCE to recover \$107 million in incremental wildfire-related liability insurance.

SAFETY CONSIDERATIONS:

- There are no specific safety concerns with this request.

ESTIMATED COST:

- This resolution approves recovery of approximately \$107.156 million.

By Advice Letter 3768-E, Filed on March 14, 2018.

SUMMARY

This Resolution approves Southern California Edison (SCE)’s Advice Letter (AL) 3768-E requesting Z-factor treatment for wildfire-related liability insurance costs in the amount of \$107.156 million.

BACKGROUND

Z-Factor History

The Commission has established a process for rate adjustments for unexpected and uncontrollable events in post-test year ratemaking. The adopted mechanism, called a “Z-factor,” is designed to protect both the utility and customers by allowing for rate increases and decreases in the period between General Rate Cases (GRC). The Commission has addressed the Z-factor in multiple proceedings beginning with Decision

(D.) 89-10-031. In that decision, the Commission adopted the Z-factor to allow rate adjustments for exogenous factors outside of the inflation index adopted for the utility. Subsequent decisions provided a comprehensive framework for Z-factor analysis establishing whether an alleged Z-factor event meets specific criteria. If it meets all the criteria, the cost in question is eligible for Z-factor cost recovery.

In the early 1990s, telecommunication companies on a number of occasions sought recovery for costs they considered to meet the definition of a Z-factor event. In considering these cases, the Commission established nine specific criteria for evaluating Z-factor events. These criteria were summarized in D.94-06-011. In D.04-07-022, the Commission established a Z-factor mechanism for SCE based on the nine criteria first identified in D.94-06-011. This mechanism included a \$10 million deductible for each Z-factor event.

In Decision D.15-11-021, the Commission addressed the Test Year 2015 GRC application of SCE. This decision authorized SCE's existing Z-factor mechanism to continue through at least 2017.

In accordance with the decisions just described, nine criteria must be satisfied for an event affecting SCE to qualify for Z-factor treatment:

1. The event must be exogenous to the utility;
2. The event occurred after late 1989;
3. The costs are beyond the control of the utility management;
4. The costs are not a normal part of doing business;
5. The costs must have a disproportionate impact on the utility;
6. The costs must not be reflected in the escalation factors used in the GRC;
7. The costs must have a major impact on overall costs;
8. The cost impact must be measurable; and
9. The utility must incur the cost reasonably.

Advice Letter 3768-E

SCE's Preliminary Statement AAA, Section 5 requires the utility to provide a notification letter addressed to the Commission's Executive Director in response to a potential Z-factor. On December 29, 2017, SCE submitted a letter to the Executive Director notifying the Commission of its intention to seek Z-factor recovery of wildfire insurance premium costs.

In response, the Utility Reform Network (TURN) sent a letter to the Commission's Executive Director recommending that SCE file an application requesting recovery of the insurance premium cost.

On March 14, 2018, Southern California Edison filed Advice Letter 3768-E seeking Commission approval to recover approximately \$107 million incurred to obtain a 12-month, \$300 million wildfire insurance policy for 2018. In support of its request SCE presented a declaration from Edison International's Director of Risk Management, John Butler. Mr. Butler described the history and function of the Z-factor mechanism and explained why SCE believes the liability insurance premium qualifies for recovery under the mechanism.

According to its filing, SCE obtains insurance from various insurers, purchasing increasing amounts of coverage and progressively building a "tower" of overall coverage to meet its needs. SCE maintained approximately \$1 billion of wildfire coverage for wildfire events occurring from June 2017 through May 2018. SCE explains its experience with the current market for wildfire liability coverage is that insurance companies are reducing or eliminating their wildfire liability coverage for investor-owned utilities, premiums are increasing, and available insurance is decreasing. SCE states this trend began in recent years and has accelerated due to the 2017 wildfires. The utility contends the changes in the wildfire liability coverage market are primarily due to two key factors: 1) the increased frequency and severity of wildfires in California; and 2) the legal doctrine of inverse condemnation under which strict liability may be imposed on utilities for wildfire damage regardless of fault.

SCE points to the Thomas Fire, which began on December 4, 2017, as a catalyst for seeking additional wildfire coverage. According to the filing, SCE learned while the fire was still active that the California Department of Forestry and Fire (Cal Fire) was investigating SCE as a possible cause. If causation was later tied to SCE electrical equipment, the utility believes the size of the Thomas Fire has the potential to exhaust its existing coverage, leaving little to no coverage for wildfires in 2018. SCE therefore concluded the prudent course of action would be to purchase additional wildfire coverage to the extent available in the market.

SCE ultimately obtained a 12-month policy beginning December 31, 2017, with a limit of \$300 million in excess of a \$60 million retention, which could be met through self-insurance.¹ The total cost of the premium was \$124.5 million. The CPUC-jurisdictional portion of this cost is \$117.156 million.² SCE proposes to recover this cost in its CPUC-jurisdictional revenue requirement through its Z-factor mechanism, subject to a one-time deductible of \$10 million. SCE's Preliminary Statement specifies "SCE will bear the risk

¹ Under self-insurance, the utility assumes financial responsibility for costs.

² SCE AL 3768-E, page 11, Table 1.

of all potential Z-Factors which do not have a financial impact on SCE of more than \$10 million.” The total amount SCE seeks to recover through this advice letter is therefore \$107.156 million.

NOTICE

Notice of AL 3768-E was made by publication in the Commission’s Daily Calendar. SCE states that a copy of the Advice Letter was mailed and distributed in accordance with Section 4 of General Order 96-B.

PROTESTS

SCE’s Advice Letter 3768-E was timely jointly protested by The Utility Reform Network (TURN) and the Public Advocates Office of the Public Utilities Commission (Cal Advocates)³ on April 3, 2018.

SCE responded to the protest of TURN and Cal Advocates on April 10, 2018.

TURN and Cal Advocates’ protest of Advice Letter 3768-E focuses on their recommendation that SCE’s request should be addressed through an application. TURN and Cal Advocates raise several issues in support of their recommendation:

1. The magnitude of the amount at issue;
2. Cost allocation between customers and shareholders; and
3. Concerns about reasonableness of rate recovery.

Protest to the Magnitude of the Costs

TURN and Cal Advocates assert that an advice letter is an inappropriate procedural vehicle to consider a request for such significant costs. The protest suggests that the Commission should consider SCE’s pending GRC application for Test Year 2018, where SCE forecasted approximately \$92.4 million of total liability insurance costs, including wildfire liability insurance costs for 2018. The protest also states that SCE recently filed Application (A.) 18-03-004 seeking recovery through its Catastrophic Event Memorandum Account (CEMA) of \$46.7 million of expenses from drought mitigation efforts in 2015-2016, as well as the cost associated with \$17.6 million of capital expenditures in 2016 for its response to wildfires. TURN and Cal Advocates argue that

³ Cal Advocates was known as the Office of Ratepayer Advocates (ORA) at the time of the joint protest. ORA was renamed the Public Advocates Office of the Public Utilities Commission by PU Code 309.5 as of August 31, 2018.

the incremental liability insurance costs requested for Z-factor recovery should similarly be considered in an application setting, to comprehensively examine the circumstances surrounding the selected plan and to consider the full range of relevant issues.

SCE Response: SCE argues that denying recovery based on the magnitude of the costs would be inconsistent with prior Commission decisions. SCE states that in its GRC D.04-07-022 the Commission established a requirement that if the post-test year ratemaking revenue requirement increase exceeded \$150 million or 5%, the utility would be required to request recovery through an application filing instead of an advice letter. The reply goes on to say that requirement was removed from subsequent decisions. Therefore, SCE believes there is no authority to enforce a dollar cap into the advice letter requirements.

Cost allocation between customers and shareholders

The protest contends that the purchased wildfire liability insurance benefits both shareholders and ratepayers because it would cover liability claims arising out of acts of utility negligence or imprudence. TURN and Cal Advocates assert that ratepayers should not bear the premium associated with covering damages attributable to utility negligence and imprudence. The protest concludes the costs should be allocated appropriately between SCE's ratepayers and shareholders, not entirely funded by ratepayers.

SCE Response: In its reply, SCE argues cost-sharing is built into the Z-factor mechanism, through the \$10 million deductible specified in its tariffs. The reply goes on to state that SCE is absorbing a substantial portion of the cost of reinsurance. SCE further asserts that the Commission has a long-standing practice of authorizing recovery of all costs for liability insurance. As a more appropriate form of recourse, the protest response suggests that the Commission has authority to undertake a prudence review of the utility's conduct after an event has occurred.

Reasonableness of Rate Recovery

Finally, the protest addresses the reasonableness of the costs. TURN and Cal Advocates suggest that the Commission needs to determine whether it is reasonable to spend \$120 million to attain incremental insurance coverage of \$300 million for a one-year period. The protestors argue that their proposed review should explore the options SCE considered, but did not select.

SCE Response: SCE reiterates the arguments in its advice letter filing that obtaining additional insurance was necessary to mitigate the risk of uninsured fire claims in the event of another fire, and that no alternative insurance was available.

DISCUSSION

We begin this discussion section by first addressing the joint protesters' argument that SCE's request should be made through an application instead of an advice letter.

In support of their request, TURN and Cal Advocates argue the magnitude of the costs necessitates an application process. The Z-factor process is designed to request cost recovery for unanticipated events that have a significant financial impact on the company. We agree with SCE that the Commission has not established a ceiling for the amount that SCE can recover through its Z-factor mechanism. The Z-factor process created in D.94-06-011 and adopted in subsequent SCE GRCs outlined nine criteria for recovery and does not include a dollar cap in its criteria. D.04-07-022 established a requirement that if the post-test year ratemaking revenue requirement increase exceeded \$150 million or 5%, the utility would be required to request recovery through an application filing instead of an advice letter. Although this requirement was removed from subsequent decisions, SCE's request would still be allowable under D.04-07-022. There is no basis to deny recovery solely based on the amount of the request.

Additionally, TURN and Cal Advocates argue that an application process is necessary to determine the insurance premium cost allocation between customers and shareholders. As SCE notes, a share of the costs has already been covered by SCE through the \$10 million deductible required in the terms of Preliminary Statement AAA, Section 5. Furthermore, the Commission routinely authorizes ratepayer recovery of liability insurance costs through GRCs without requiring cost-sharing.

TURN and Cal Advocates also assert that an application process is needed to review the reasonableness of rate recovery. One of the criteria for Z-factor is a demonstration the costs were incurred reasonably. An examination of each Z-factor criterion, including SCE's demonstration of reasonableness, is discussed in more detail below.

Based on the discussion below, we conclude that under the circumstances present in AL 3768-E, SCE is permitted to make its request for Z-factor recovery through an advice letter and the joint protest is denied.

For the Commission to approve this advice letter, SCE must demonstrate that its purchase of supplemental wildfire liability insurance meets all nine Z-factor criteria:

1. The event must be exogenous to the utility;
2. The event occurred after late 1989;
3. The costs are beyond the control of the utility management;
4. The costs are not a normal part of doing business;
5. The costs must have a disproportionate impact on the utility;

6. The costs must not be reflected in the escalation factors used in the GRC;
7. The costs must have a major impact on overall costs;
8. The cost impact must be measurable; and
9. The utility must incur the cost reasonably.

Application of Z-factor Criteria

- A. The event must be exogenous to the utility and beyond the control of management

Similar arguments apply to the analysis of these two criteria and they will therefore be discussed together. We agree with SCE that the need to purchase replacement wildfire insurance and the increase in liability insurance costs are the result of an exogenous event, namely the magnitude of the 2017 wildfires in California. We also agree with SCE that it had no control over changes in the liability insurance market that caused premiums to increase. The global insurance market is affected by factors outside of SCE's control, including the number and severity of recent wildfires and insurers' perception of risk in the California market. The availability and cost of wildfire insurance is beyond SCE's control, because SCE cannot dictate the price of premiums or deductibles. To the extent that SCE can negotiate these costs, it cannot control the negotiation positions of others. The effort SCE undertook with its broker to find the most cost-effective plan available does not equate to a high degree of control over the costs. We conclude SCE has met the criteria demonstrating that costs were exogenous and beyond utility management control.

- B. The event occurred after late 1989

Considered in the context of D.94-06-011 and subsequent Commission interpretation,⁴ this criterion refers to the requirement the Z-factor event occurred after the revenue requirement was last updated.⁵ In this instance, the events giving rise to this insurance expense took place in the post-test year of SCE's 2015 GRC and were unknown at the time rates were last implemented.

- C. The costs are not a normal part of doing business

Although SCE has forecasted increasing insurance premiums over prior GRCs, it could not have predicted the need to replenish its wildfire insurance in the aftermath of the

⁴ D.10-12-053, page 32.

⁵ D.94-06-011.

Thomas Fire in late 2017. Nor could SCE have predicted the decrease in the number of insurers willing to provide coverage or that those who do would provide a reduced level of coverage at increasing prices as the insurance market tightens. While the possibility of wildfire damage is a foreseeable expense, the magnitude of the 2017 wildfires coupled with SCE's potential exposure could not have been anticipated at the time of SCE's 2015 GRC.

D. The costs must have a disproportionate impact on the utility and a major impact on overall costs

We combine the discussion of these criteria given the criteria involve similar arguments. The \$107.156 million premium is significantly more than SCE has had to pay in the past for such insurance. SCE asserts incurring these kinds of incremental expenses for future wildfire occurrences could impair the utility's ability to conduct previously planned work on the electric system or drive up financing costs for company operations. Accordingly, we find these criteria have been met.

E. The costs must not be reflected in the escalation factors used in the GRC

The costs are not within the escalation factors adopted by the Commission in D.15-11-021, SCE's test year 2015 GRC. SCE's AL 3768-E states that the requested Z-factor costs are not duplicative of its forecast insurance costs in its 2018 GRC A.16-09-001. The utility notes that any revenue requirement authorized in SCE's 2018 GRC will be used to buy additional coverage in a shrinking and increasingly expensive insurance market.

F. The cost impact must be measurable

We agree the documentation of the amount of the supplemental liability insurance costs were clearly measurable and sufficient to meet this criterion.

G. The utility must incur the cost reasonably

In response to the 2017 wildfires, SCE considered the possibility that its existing coverage could be exhausted, leaving little or no coverage for 2018. SCE concluded that failing to purchase sufficient insurance coverage could force the utility to pay future claims on a dollar-for-dollar basis from authorized revenues, rather than seeking reimbursement from its insurers. SCE retained a seasoned insurance broker for a series of discussions regarding coverage alternatives. The utility learned that the replacement coverage would not likely be available to purchase in 2018. SCE and its broker negotiated with a carrier to obtain the best available price for the policy in December 2017. We agree this was a reasonable procurement strategy under the circumstances.

We approve Z-factor treatment for costs incurred to purchase supplemental wildfire insurance in the amount of \$107.156 million. While we find that SCE has met the Z-factor criteria based on the circumstances described in this advice letter, future advice letter Z-factor requests may be rejected without prejudice in favor of an application by the utility. The Commission previously reviewed a Z-factor request for liability insurance cost recovery by San Diego Gas & Electric (SDG&E) in an application process, including served testimony and evidentiary hearings conducted on the contested issues underlying SDG&E's request.⁶ An application may be required in response to future Z-factor requests in order to fully evaluate the merits of cost recovery.

After SCE filed AL 3768-E, the utility filed A.18-04-001 seeking establishment of a Wildfire Expense Memorandum Account (WEMA). As proposed by SCE, the new account would, among other things, record incremental unreimbursed wildfire liability costs that were not authorized in its GRC, including payments made for wildfire insurance. In D.18-11-051, the Commission authorized the account, with rate recovery of recorded costs subject to review in a separate proceeding.

We note this resolution first appeared as Draft Resolution E-4959 when issued on January 15, 2019. To address a clerical error, it has been renamed Resolution E-4994.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review. Please note that comments are due 20 days from the mailing date of this resolution. Section 311(g)(2) provides that this 30-day review period and 20-day comment period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day review and 20-day comment period for the draft of this resolution was neither waived nor reduced. Accordingly, this draft resolution was mailed to parties for comments on January 15, 2019.

The Utility Reform Network (TURN) and SCE submitted comments on February 6, 2019. The comments are summarized below.

⁶ A.09-08-019.

SCE commented in support of the draft resolution. SCE recommends the Commission promptly approve the draft resolution at the February 21, 2019 Commission meeting.

TURN filed comments recommending several revisions. First, TURN recommends revisions to acknowledge that SCE's Wildfire Expense Memorandum Account (WEMA) will track future wildfire insurance expenditures not covered by GRC-authorized revenue requirement. We accept this suggestion; the Discussion and Findings sections are revised to acknowledge the WEMA.

TURN also recommends revisions related to its concern that approving SCE's request could serve to protect SCE's shareholders from financial consequences arising from negligence. TURN requests language be included to state that the \$10 million deductible applies to all Z-factor events, regardless of whether questions of the costs have any potential ties to the utility's negligence or imprudence. We deny this request. The deductible is included in the Z-factor mechanism to ensure the utility is at risk for events that do not have a revenue requirement impact of more than \$10 million. The deductible results in shareholders absorbing a portion of the liability insurance costs. As mentioned in the draft resolution, if there are questions of utility negligence, the Commission has authority to undertake a prudence review of the utility's conduct after an event has occurred.

Further, TURN proposes language that affirms the circumstances of this request are comparable to Directors and Officers (D&O) liability insurance. We deny this request. D&O insurance is often viewed as a perquisite for executives that benefits individual utility employees and therefore the cost is routinely split between shareholders and ratepayers. Liability insurance for the company is typically recognized as an accepted cost of doing business and is not split between shareholder and ratepayers.

TURN requests language be added to Finding 20 to state SCE's request meets the Z-factor criteria "to the extent it is not reasonably allocated to shareholders in recognition of the fact that the insurance could apply whether the underlying event is caused by utility negligence or imprudence." We reject this suggestion. As described above, the Commission recognizes a utility's purchase of insurance as a reasonable expense. At the time insurance is purchased, it cannot be determined what portion, if any, applies toward a claim that is the result of utility negligence.

TURN recommends Ordering Paragraph 1 specify the amount authorized in this resolution is subject to refund. As discussed, the Commission has the authority to open an Order Instituting an Investigation and issue fines in response to utility misconduct. Therefore, we deny this request.

Finally, TURN suggests this resolution state that the Commission will review the question of cost allocation between ratepayers and shareholders in the next GRC. We reject this suggestion. Issues of cost-sharing and reasonableness are already within the scope of GRCs. TURN is permitted to undertake discovery and file testimony to raise this issue in SCE's next GRC.

FINDINGS

1. SCE's Z-factor mechanism was most recently authorized by the Commission as part of a SCE's last general rate case.
2. The Commission has previously adopted the following criteria for Z-factor recovery for SCE:
 - a. The event must be exogenous to the utility;
 - b. The event occurred after late 1989;
 - c. The costs are beyond the control of the utility management;
 - d. The costs are not a normal part of doing business;
 - e. The costs must have a disproportionate impact on the utility;
 - f. The costs must not be reflected in the escalation factors used in the GRC;
 - g. The costs must have a major impact on overall costs;
 - h. The cost impact must be measurable; and
 - i. The utility must incur the cost reasonably.
3. In response to the Thomas Fire's potential to exhaust SCE's wildfire insurance coverage, SCE sought to obtain replacement wildfire insurance for 2018.
4. The severity of recent fires and the tightening of the insurance market is exogenous to SCE and beyond the control of SCE.
5. The availability, price and scope of insurance coverage is exogenous to SCE and beyond its control.
6. Recent fires and SCE need for additional insurance occurred after late 1989.
7. The impact of the Thomas Fire on SCE's wildfire insurance coverage was not known at the time SCE filed its last GRC.
8. The impact of the Thomas Fire on hardening of the insurance market was not known at the time SCE filed its last GRC.
9. The need for additional wildfire insurance was not a normal part of doing business.
10. The costs at issue will have a disproportionate impact on SCE due to its magnitude being so large that if it is covered by previously authorized revenues it may impair SCE's ability to conduct previously planned work and/or drive up financing costs.
11. The costs are not within the escalation factors adopted in SCE's last GRC.
12. The costs will have a major impact on overall costs due to their large amount and non-inclusion in previously authorized revenues.
13. SCE used insurance broker Marsh to assess the wildfire insurance market and negotiate with a carrier to obtain the best available price for supplemental coverage.

14. SCE did not decide the pricing imposed by the insurers or the terms of the coverage available.
15. On December 29, 2017, SCE wired payment of \$120.9 million for 12-month policy with a limit of \$300 million in excess of a \$60 million retention.
16. The total cost of the premium including taxes and broker fees was \$124.5 million. The CPUC-jurisdictional portion of this cost is \$117.156 million.
17. SCE shareholders are responsible for a \$10 million deductible applied to Z-factor costs per the terms of Preliminary Statement AAA, Section 5.
18. SCE seeks to recover \$107.156 million for its purchase of this supplemental wildfire insurance coverage.
19. Given the risks at hand, SCE's costs were reasonably incurred.
20. The wildfire liability insurance premium cost meets the Z-factor criteria for inclusion in regulated revenue requirement and recovery from ratepayers.
21. In D.18-11-051, the Commission authorized a Wildfire Expense Memorandum Account for SCE, in which SCE can record payments made for wildfire insurance to the extent such costs are not authorized in its GRC. Any costs recorded in the WEMA will be subject to review in a separate proceeding.

THEREFORE IT IS ORDERED THAT:

1. Southern California Edison's request for Z-Factor recovery of \$107.156 million for incremental wildfire-related liability insurance in Advice Letter 3768-E is approved.
2. Southern California Edison shall file a Tier 1 Advice Letter to recover from ratepayers \$107.156 million amortized over the remainder of 2019. This filing may be consolidated with other revenue requirement changes and shall be filed no later than 90 days from the date of this resolution.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on February 21, 2019; the following Commissioners voting favorably thereon:

/s/ALICE STEBBINS
ALICE STEBBINS
Executive Director

MICHAEL PICKER

President

LIANE M. RANDOLPH

MARTHA GUZMAN ACEVES

CLIFFORD RECHTSCHAFFEN

GENEVIEVE SHIROMA

Commissioners