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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ITEM # 17
ID# 11249

ENERGY DIVISION **RESOLUTION E-4484(rev.1)**
May 10, 2012

R E S O L U T I O N

Resolution E-4484. San Diego Gas & Electric Company (SDG&E) requests to increase its electric revenue requirement by $28.029 million over revenues authorized in SDG&E's 2008 General Rate Case (GRC) decision (D. 08-07-046) to recover unanticipated increases in liability insurance costs associated with the 2011-2012 policy period, pursuant to the Z-factor provisions of the decision.

PROPOSED OUTCOME: This resolution approves SDG&E's request to increase revenue requirement by $28.029 million above its 2008 General Rate Case authorized revenues to recover insurance costs it incurred in 2011 for the 2011-2012 policy year.

ESTIMATED COST: An increase of approximately $28.029 million above the revenue requirements authorized in SDG&E's 2008 General Rate Case, amortized over 24 months, resulting in an annual increase of $14.015 million.

By Advice Letter 2285-E filed on September 9, 2011.

SUMMARY

This Resolution approves Advice Letter (AL) 2285-E and grants SDG&E's request to recover $28.029 million for increased insurance costs for policy year 2011-12 covering the period of June 26, 2011 to Dec 31, 2011.

D.10-12-053 granted SDG&E's request to recover unanticipated insurance cost increases for policy year 2009-2010 under the Z-factor mechanism and directed SDG&E to file a Tier 3 advice letter to recover insurance cost increases under the

Z-factor mechanism for subsequent years prior to its next GRC. Resolution E-4450 approved SDG&E's requested recovery of insurance cost increases for policy year 2010-2011, which included procurement of a reinsurance product.

SDG&E filed AL 2285-E to recover unanticipated insurance cost increases associated with policy year 2011-2012, for expenses incurred since the effective date of its 2011-2012 policy period, June 26, 2011, to the end of 2011. The cost of SDG&E's entire 2011-2012 insurance package is $80.4 million. To recover insurance costs incurred in 2011 for half of the 2011-2012 policy year, after accounting for a $5 million Z-factor deductible, SDG&E proposes to increase revenue requirement by $28.029 million above 2008 GRC authorized revenues, to be amortized over 24 months, resulting in an annual revenue requirement increase of $14.015 million.

The insurance package for policy year 2011-2012 for which AL 2285-E seeks recovery is similar to the insurance package SDG&E procured in policy year 2010-2011 and approved by the Commission in Resolution E-4450. Similar to how D.10-12-053 and Resolution E-4450 found that insurance cost increases for policy periods 2009-2010 and 2010-2011 qualify for Z-factor ratemaking treatment, this resolution also finds that the increase cost increases associated with policy year 2011-2012 also qualify for Z-factor treatment.

This resolution approves Advice Letter 2285-E, granting SDG&E an increase of $28.029 million above its 2008 GRC revenue requirement to recover unexpected increases in insurance expenses associated with policy year 2011-2012. This resolution finds that the unexpected insurance expenses meet the eight Z-factor criteria and, hence, qualify for recovery under the Z-factor mechanism.

BACKGROUND

In 2009, SDG&E experienced significant increases to its liability insurance premiums and deductible expenses.

For policy year 2009-2010, SDG&E's insurance premium cost was $47 million, which was approximately 1000% greater than the $4.5 million SDG&E was authorized to recover in its previous Test Year 2008 GRC. Deductible expense also increased from $1 million in 2008 to $5 million in 2009.

On April 17, 2009, SDG&E sent a letter to the Commission's Executive Director to notify its intent to record the unexpected insurance cost increases as a Z-factor event.

Z-factor events are exogenous events that are unforeseen at the time the GRC revenue requirement is established and authorized by the Commission, largely uncontrollable by management, and have a material and disproportionate impact on the utility.[1] The decision in SDG&E's 2008 GRC allowed SDG&E to continue its Z-factor mechanism through 2011. Subsequently, SDG&E established a subaccount of the Z-factor Memorandum Account (ZFMA) to record insurance costs above its 2008 GRC authorized level.

SDG&E filed A.09-08-019 to recover the increased insurance costs for 2009-2010 as a Z-factor event.

In August 2009, SDG&E filed Application (A.) 09-08-019 to recover increased insurance costs as a Z-factor event. SDG&E explained that it experienced difficulty in procuring insurance at historic rates because of over a billion dollars of claims into the insurance market after wildfires blazed in SDG&E's service territory in 2007, and insurers were increasingly concerned over "inverse condemnation" for California utilities.[2] Unlike previous years where the general liability insurance also included wildfire coverage, insurers separated wildfire coverage from the general liability insurance.[3] Thus, SDG&E procured two separate policies for its wildfire insurance and general liability insurance for policy year 2009-2010.[4]

To seek recovery under the Z-factor mechanism, SDG&E must prove that the event satisfies eight criteria.

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

2 Inverse condemnation is a legal doctrine under which liability is imposed without regard to fault.

3 Decision (D.) 10-12-053 in A.09-08-019, mimeo, pp. 13-14.

4 SDG&E's liability insurance is procured on an annual basis on the 26th of each June (see AL 2285-E, pp. 1, 2).

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

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

D.10-12-053 authorized SDG&E to recover 2009-2010 insurance cost increases as a Z-factor event and to file advice letters to recover insurance increases for subsequent years prior to its next GRC.

D.10-12-053 in A.09-08-019 found that the unforeseen insurance premium increases satisfy the eight criteria. The decision authorized SDG&E to recover unforeseen 2009-2010 insurance premium expenses as a one-time Z-factor event. Subject to a single $5 million Z-factor deductible, D.10-12-053 allowed SDG&E to increase its electric and natural gas revenue requirement by $28.9 million, amortizing it over a period of not less than 12 months beginning January 1, 2011.[6]

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

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

D.10-12-053 also authorized SDG&E to file insurance cost increases in subsequent years prior to its next GRC for Z-factor treatment through a Tier 3 advice letter. SDG&E must demonstrate in the advice letter how the eight Z-factor criteria are met and provide details of the insurance costs and efforts by SDG&E to seek competitive rates.

SDG&E filed Advice Letter 2251-E to recover increased 2010-2011 insurance costs and updated 2009-10 insurance costs.

Pursuant to D.10-12-053, SDG&E filed AL 2251-E in April 2011 to request recovery of increases in insurance premium and deductible expenses for policy year 2010-2011. As with the 2009-2010 insurance, SDG&E procured a two tower insurance product for 2010-2011: a tower for general liability and a tower for wildfire liability.

In addition to the traditional wildfire liability, SDG&E also procured an additional reinsurance for wildfires. At the time, the reinsurance product was a new product. It is an alternative risk transfer (ART) mechanism to supplement SDG&E's traditional wildfire insurance. Historically, SDG&E had $1.17 billion in liability coverage that includes wildfire coverage. Since wildfire insurance coverage decreased and premiums shot up in 2009, SDG&E has been able to procure only $400 million in traditional wildfire coverage.

The reinsurance product provides $600 million in wildfire property damage coverage. Coverage from the reinsurance product is more limited than the traditional wildfire insurance, covering only damages, destruction, or loss of use of property caused by wildfires. The premium for the reinsurance product was $32.2 million.

Altogether, the insurance premium and deductible expenses for SDG&E's traditional general liability and wildfire insurance and reinsurance for policy year 2010-2011 would increase revenue requirement by $61.038 million above the $4.5 million authorized in SDG&E's 2008 GRC. Additionally, SDG&E requested to recover $2.3 million in updated insurance costs for the 2009-2010 policy period in the advice letter.

Resolution E-4450 approved SDG&E's requested recovery of increased insurance costs for policy year 2010-2011.

Resolution E-4450, adopted by the Commission on December 15, 2011, approved SDG&E's request to recover increased costs for its 2010-2011 insurance, which includes the traditional general liability and wildfire insurance and the wildfire reinsurance, as a Z-factor event. Resolution E-4450 determined that the increased insurance costs met the eight Z-factor criteria. The resolution also approved SDG&E's request to recover $2.3 million in updated insurance costs for the 2009-2010 policy year.

Resolution E-4450 noted that the reinsurance costs that SDG&E forecasted in its revenue requirement for test year 2012 and the attrition years is contested in the GRC, A.10-12-005. Resolution E-4450 stated that it does not prejudge the Commission's decision in A.10-12-005 on the reasonableness of including any reinsurance expenses in test year 2012 and the attrition years in the GRC.

SDG&E filed Advice Letter AL 2285-E to request recovery of increased insurance costs covering the period from June 26, 2011 to December 31, 2011 of the 2011-2012 policy year as a Z-factor event.

On September 9, 2011, SDG&E filed AL 2285-E to request recovery of increased insurance costs for policy year 2011-2012 as a Z-factor event. SDG&E's request would cover insurance expenses incurred from the effective date of the 2011-2012 policy period, June 26, 2011, through the end of 2011. Liability insurance costs incurred in 2012 are addressed in SDG&E's current 2012 GRC proceeding. To recover insurance costs incurred in 2011 for half of the 2011-2012 policy year, after accounting for a $5 million Z-factor deductible, SDG&E proposes to increase revenue requirement by $28.029 million above 2008 GRC authorized revenues, to be amortized over 24 months, resulting in an annual revenue requirement increase of $14.015.

SDG&E's insurance package for policy year 2011-2012 is similar to the insurance package it procured for policy year 2010-2011.

Like the previous year, SDG&E's insurance for policy year 2011-2012 has two towers of coverage: one tower for general liability coverage and one tower for wildfire liability coverage.

Compared to the previous years, SDG&E increased general liability coverage to $822.5 million, which is slightly above the $800 million of coverage in 2009-2010 and 2010-2011 levels. The insurance premium for coverage of general liability at this level is $7.3 million which is comparable to the premium costs of the previous two years.[7] SDG&E also increased its traditional wildfire liability coverage by a small amount to $425 million, slightly higher than 2010-2011 levels ($400 million) and 2009-2010 levels ($399 million), at a premium cost of $42.5 million, comparable to the premium costs of the previous two years.[8]

In addition to the traditional wildfire coverage, SDG&E also maintained the wildfire reinsurance as a part of its wildfire liability insurance coverage. The wildfire reinsurance for this policy year is similar to the reinsurance product that was approved in Resolution E-4450 for the last policy year, providing $600 million in wildfire property damage reinsurance coverage. The premium cost of the reinsurance product is comparable to last year.[9]

SDG&E states in the advice letter that the insurance market conditions it faced in the 2011-12 policy period were very similar to the market conditions that affected SDG&E during the past two years. SDG&E continues to experience reduced availability of insurance coverage and increases in insurance premium costs because of the continued use of "inverse condemnation" for all California utilities, insurer "payback" for SDG&E's liability claims, particularly from 2007 wildfires, and general market pressures experienced by insurers.

SDG&E states that its insurance procurement process for the 2011-2012 renewal was similar to that for the 2009-2010 renewal. It aimed to secure adequate insurance at reasonable cost by exploring Alternative Risk Transfer (ART) mechanisms for its wildfire tower, reducing premiums, and improving coverage terms and conditions to develop a comprehensive and cost-effective insurance

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[7] SDG&E's premium costs for the traditional general liability insurance were $7.1 million in 2009-2010 and $7.6 million in 2010-2011.

[8] SDG&E's premium costs for the traditional wildfire insurance were $39.9 million in 2009-2010 and $40.2 million in 2010-2011.

[9] Premium costs allocated to SDG&E for the wildfire reinsurance is $30.6 million for 2011-2012 and was $32.1 million in 2010-2011.

package. Insurance was procured on SDG&E's behalf by SE Insurance & Risk Advisory, a shared service at the Sempra Energy parent company. SE Insurance & Risk Advisory procured its traditional insurance through global insurance brokerage firm, Marsh USA, and the reinsurance product through reinsurance broker, Guy Carpenter and Company (GCC). As it did in the renewal processes for the previous two policy years, SDG&E states that it canvassed the insurance markets globally to find as many qualified insurers as possible.

In addition to procuring a comprehensive and cost effective insurance package, SDG&E states that it continues to proactively reduce wildfire risks inherent in its service territory to improve its risk profile. According to SDG&E, it has since expanded its "Community Fire Safety Program," which is a multi-pronged program to reduce the likelihood of power line fires caused by strong winds. SDG&E states that the significant wildfire mitigation efforts reflected in SDG&E's Fire Safety Plan have contributed to its success in obtaining an increase in coverage limits in the 2011-2012 renewal compared to the previous two years.

D.10-12-053 and Resolution E-4450 were challenged in the California Appellate Court of Appeal but the challenge was denied.

On December 29, 2011, Ruth Henricks filed a Petition for Writ of Review to the Court of Appeal of the State of California, Fourth Appellate District, to challenge D.10-12-053 and Resolution E-4450. The Commission answered the Petitioner's Writ of Review on February 1, 2012, recommending that the Court dismiss Ruth Henricks' petition. On April 6, 2012, the Court denied the Petition.

NOTICE

Notice of AL 2285-E was made by publication in the Commission's Daily Calendar. SDG&E states that a copy of AL 2251-E was mailed and distributed in accordance with Section 3.14 of General Order 96-B.

PROTESTS

DRA timely protested AL 2285-E on September 29, 2011.

DRA states that the request sought in this advice letter is identical to the request in AL 2251-E, except the request sought in this advice letter is for the policy period that is one year later than the one sought in AL 2251-E. DRA protested AL 2251-E on May 31, 2011, questioning the reasonableness of the $32 million premium paid for the 2010-2011 wildfire reinsurance that provides $600 million in wildfire property coverage. DRA protests recovery of the $31 million premium paid for the 2011-2012 wildfire reinsurance on the same grounds as DRA protested AL 2251-E. DRA's protest to AL 2151-E claims that the reinsurance product with a $32 million premium is significantly and materially different from items discussed in A.09-08-019 and D.10-12-053. Because of these material differences, DRA asserts that the Energy Division and the Commission cannot rely on D.10-12-053 to assess the reasonableness of the reinsurance product. In addition, DRA claims that there is the appearance of self-dealing between SDG&E and its affiliated insurance brokers in procuring its reinsurance product. In summary, DRA questions whether SDG&E procured the reinsurance product reasonably, which is necessary to satisfy the eighth criterion for the reinsurance product to qualify as a Z-factor.

Similar to DRA's protest to AL 2251-E, DRA recommends that the revenue requirement increase requested in this advice letter for the recovery of the reinsurance product be denied, that SDG&E be required to file an application and submit testimony for the request and that the request be subject to hearings and other fact gathering.

SDG&E asserts that DRA's protest should be rejected.

SDG&E replied to DRA's protest to AL 2285-E on October 6, 2011. In its reply, SDG&E reiterates many of the points included in its reply to DRA's protest to AL 2155-E.

First, SDG&E states that the wildfire reinsurance is consistent with the Commission's policy in favoring utilities' procurement of adequate liability insurance coverage. SDG&E explains that the reinsurance product helps fill the gap in wildfire coverage between its current $425 million traditional wildfire insurance coverage and the $1.2 billion wildfire coverage it had prior to the 2009-2010 renewal. SDG&E needed to procure such coverage to protect against the significant wildfire risk exposure inherent in its service territory.

Second, SDG&E argues that the procurement process of the reinsurance product was reasonable and consistent with the strategy approved in D.10-12-053. SDG&E disputes DRA's claim that the reinsurance product is materially different from the insurance products discussed in SDG&E's Z-factor application, A.09-08-019, noting that the reinsurance product is an ART product. ART products were introduced in the Z-factor proceeding. SDG&E notes that the Commission expressly endorsed the consideration of ART products as a reasonable component of its insurance procurement strategy in D.10-12-053.

Furthermore, SDG&E explains that the reinsurance is an ART product closest in type to traditional insurance and procurement of the product allowed it to obtain adequate wildfire coverage. SDG&E maintains that the procurement of the reinsurance product was reasonable and consistent with the strategy approved by D.10-12-053, and thus satisfies the eighth Z-factor criterion.

SDG&E contends that there is no rational basis for the notion of self-dealing between Marsh and Guy Carpenter and Company (GCC, Marsh's affiliate). SDG&E states that there was no direct benefit to Marsh conferred by GCC acting as the broker for the reinsurance product; that Marsh's client executive, Joseph Phillips, did not handle the reinsurance placement because he is not licensed as a reinsurance broker; and that GCC, a prominent and well-respected licensed broker, was a prudent choice to handle the reinsurance product.

Finally, SDG&E maintains that the reinsurance product should be approved without the need for hearings. SDG&E notes that D.10-12-053 declined to require SDG&E to file applications for Z-factor recovery in insurance policy years after 2009-2010, which was suggested by DRA. SDG&E asserts that DRA's request for testimony, depositions and hearings should be rejected as a collateral attack on D.10-12-053.

DISCUSSION

Resolution E-4450 approved recovery of the costs of the insurance package for the entire policy year of 2010-2011, from June 26, 2010 to June 26, 2011. In this advice letter (AL 2285-E), SDG&E requests recovery of costs for the June 26-December 31, 2011 period of the policy year of 2011-2012.

The cost of SDG&E's entire 2011-2012 insurance package is $80.4 million, which amounts to a revenue requirement increase of $66.4 million. For half of the policy year of 2011-2012, from June 26, 2011 to December 31, 2011, which SDG&E requests to recover in this advice letter, the revenue requirement increase is $31.9 million. After accounting for a $5 million Z-factor deductible and adding in interest, franchise fees and uncollectible expenses, the final amount that SDG&E proposes to increase revenue requirement by is $28.029 million above 2008 GRC authorized revenues. SDG&E proposes to amortize the requested $28.029 million revenue requirement increase over 24 months, resulting in an annual revenue requirement increase of $14.015.

SDG&E's requested insurance costs associated with policy year 2011-2012 are very similar to the insurance package which the Commission approved for cost recovery in Resolution E-4450 for policy year 2010-2011 and meet the eight Z-factor criteria.

The insurance package that SDG&E procured for this policy year, 2011-2012, is very similar to the insurance package which the Commission approved for cost recovery in Resolution E-4450 for policy year 2010-2011. Resolution E-4450 determined that the requested insurance cost increases for policy year 2010-2011 met the eight Z-factor criteria. D.10-12-053 and Resolution E-4450 found that the cost increases for the 2009-2010 and the 2010-2011 insurance packages meet the eight Z-factor criteria. This resolution similarly finds that the insurance cost increases requested in AL 2285-E for the 2011-2012 insurance package also meet the eight criteria for Z-factor recovery. The eight criteria are addressed below.

1. **SDG&E's insurance cost increases associated with the 2011-2012 policy year are exogenous to SDG&E.**

D.10-12-053 determined that the significant increases in insurance costs for policy year 2009-2010 were exogenous to SDG&E. The decision stated that the increases were the result of insurance market changes caused by external factors that are outside of SDG&E's control, such as claims resulting from the 2007 wildfires, insurers' concerns over inverse condemnation, and the financial market meltdown. The decision determined that SDG&E was a price taker that had to accept the increased costs and lower availability of insurance caused by these external factors.[10]

In AL 2251-E, SDG&E stated that the external factors affecting the 2009-2010 insurance market that caused the decrease in availability and increases in insurance costs continued to affect the 2010-2011 market. Given that the market conditions in policy year 2010-2011 continued to affect SDG&E similarly as it did during policy year 2009-2010, Resolution E-4450 also determined that the increases in insurance expenses for policy year 2010-2011 were exogenous for the same reasons.

In AL 2285-E, SDG&E states that the insurance market conditions in policy year 2011-2012 are similar to that of the past two years. SDG&E continues to experience reduced availability of insurance coverage and increases in insurance premium costs because of the continued concern over inverse condemnation for all California utilities, insurer "payback" for SDG&E's liability claims, particularly from 2007 wildfires, and general market pressures experienced by insurers. Since the insurance market conditions that affected SDG&E during policy years 2009-2010 and 2010-2011 continue to affect SDG&E similarly during policy year 2011-2012, SDG&E's insurance cost increases associated with policy year 2011-2012 are exogenous to SDG&E.

2. The insurance cost increases associated with policy year 2011-2012 occurred after implementation of rates (adoption of SDG&E's 2008 GRC revenue requirement).

The last GRC decision (D.08-07-046), which authorized SDG&E's Test Year 2008 GRC revenue requirement, granted SDG&E $4.5 million for insurance expenses. The amount authorized was comparable to the historical average level for insurance expenses. The significantly higher insurance costs for policy year 2011-2012, compared to the amount SDG&E was authorized in 2008 GRC, was unknown to SDG&E until August 2011, after its annual traditional liability insurance renewed in June 2011 and the reinsurance policy was secured. Hence,

10 D.10-12-053, mimeo, pp. 29-30.

the increases in insurance costs occurred after the implementation in rates in 2008.

3. The increases in SDG&E's insurance costs associated with the policy year 2011-2012 were beyond the control of the utility management.

As discussed in D.10-12-053, an event satisfies the beyond control criterion if the utility cannot significantly control the outcome. D.10-12-053 stated that SDG&E did not have control over the pricing imposed by insurers or the terms of coverage offered even though it actively sought to procure as much insurance as was reasonably available. The decision determined that the increases in insurance costs and decreases in coverage for policy year 2009-2010 were the result of insurance market changes caused by factors outside of SDG&E's control. Hence, D.10-12-053 found that the control criterion was met for the 2009-2010 liability insurance cost increase.[11]

In AL 2251-E, SDG&E stated that the insurance market conditions in the 2010-2011 renewal period were essentially unchanged from when it was procuring insurance for the 2009-2010 policy period. For policy year 2010-2011, SDG&E actively sought to procure reasonable levels of insurance at reasonable prices, but SDG&E did not have control over the level of insurance coverage and the insurance premiums offered. The decreases in coverage and increases in prices of insurance in the 2010-2011 policy period were caused by the same external market factors that affected SDG&E in the 2009-2010 policy period and were determined by D.10-12-053 to be out of SDG&E's control. Thus, Resolution E-4450 determined that the increases in general liability and wildfire insurance costs for the 2010-2011 policy period were beyond SDG&E's control.

In AL 2285-E, SDG&E states that the insurance market conditions causing the increases in insurance prices in policy year 2009-2010 continued to affect SDG&E in policy year 2011-2012. Furthermore, for policy year 2011-2012, SDG&E undertook aggressive efforts to find the most favorable insurance package, but insurance prices were controlled by the insurance carriers and SDG&E was merely a price taker. The insurance market conditions continue to affect the

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11 Id., pp. 30-32.

pricing of insurance available to SDG&E during policy year 2011-2012. D.10-12-053 found that the control criterion was met because the insurance cost increases were the result of insurance market changes caused by factors outside of SDG&E's control. Thus, this resolution also finds that the increases in insurance costs SDG&E incurred for policy year 2011-2012 also meet the control criterion.

4. The insurance costs associated with the 2011-2012 policy year are not a normal part of doing business.

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

For policy year 2010-2011, SDG&E's general liability and wildfire insurance premiums increased by almost 1670% above the amount forecasted in its 2008 GRC.[12] In AL 2251-E, SDG&E stated that it continued to have a heightened risk profile because the same factors contributing to its high risk profile in 2009-2010 still existed in the 2010-2011 policy year. Again, SDG&E's insurance cost

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

increases were a result of factors that impact SDG&E specifically. Hence, Resolution E-4450 determined that SDG&E's insurance cost increases in 2010-2011 were not a normal part of doing business.

In AL 2285-E, SDG&E also claims that the dramatic increases in insurance costs during the 2011-2012 renewal were again caused by the same factors that impacted SDG&E for the past two years. These factors affected SDG&E in particular. The spike in insurance costs was not the result of general economic conditions. Hence, the increased insurance costs SDG&E incurred for the 2011-2012 policy are not a normal part of doing business.

5. The insurance costs associated with the 2011-2012 policy year had a disproportionate impact on SDG&E.

D.10-12-053 cites D.94-06-011 and D.00-01-021, both of which ruled that the disproportionate impact test is simply a restatement of the requirement that the cost at issue be something other than a normal cost of doing business.[13] The Commission determined that if the cost was not a normal cost of doing business, then the costs also had a disproportionate impact on the utility. Since D.10-12-053 determined that the insurance cost increases in 2009-2010 were not a normal part of doing business, the cost increases also had a disproportionate impact on SDG&E. Similarly, since the insurance cost increases for the 2010-2011 renewal year were not a normal part of doing business for SDG&E, Resolution E-4450 also determined that the cost increases had a disproportionate impact on SDG&E. Given that Resolution E-4450 earlier determined that the insurance cost increases in 2011-2012 were not a normal part of doing business, the insurance cost increases in 2011-2012 also had a disproportionate impact on SDG&E.

6. SDG&E's insurance costs for 2011-2012 had a major impact on overall costs.

D.10-12-053 found that the insurance cost increases in 2009-2010 had a major impact on SDG&E's overall cost because the 1000% increase in SDG&E's premium would consume almost the entire attrition increase SDG&E received for normal inflation and operations in its 2008 GRC. SDG&E was authorized

[13] D.10-12-053, mimeo, p. 33.

$4.5 million in its 2008 GRC for its 2009-2010 insurance renewal. In contrast, the cost of insurance for the 2009-2010 renewal was $47 million. The increase was approximately 8 percent of SDG&E's 2008 net operating income and over 10 percent of its 2008 total administrative and general expenses.[14]

The cost for SDG&E's 2010-2011 general liability and wildfire insurance was $80.0 million.[15] The cost of this insurance is much higher than the cost for the 2009-2010 renewal period, and is nearly 1670% above the amount authorized in SDG&E's 2008 GRC. Hence, Resolution E-4450 determined that the 2010-2011 insurance costs had a major impact on SDG&E's overall cost.

SDG&E's insurance costs for 2011-2012 are $80.4 million, approximately 12 percent of its 2010 Net Operating Income on a pretax basis and approximately 15 percent of the total administrative and general expenses reported in 2010. The insurance costs for 2011-2012 are approximately 1690% above the amount authorized in the 2008 GRC. Thus, SDG&E's insurance costs for 2011-2012 have a major impact on overall costs.

7. The cost impact of SDG&E's 2011-2012 insurance is measureable.

As noted above, the cost of SDG&E's 2011-2012 insurance is $80.4 million. Thus, the cost impact of the insurance cost increases is measurable.

8. SDG&E's 2011-2012 insurance costs are reasonable in light of the determination made by the Commission in D.10-12-053 for the 2009-2010 insurance costs and Resolution E-4450 for the 2010-2011 insurance costs.

For the 2009-2010 policy year, D.10-12-053 determined that SDG&E incurred the insurance cost increases reasonably because of the reasons set forth below. First, D.10-12-053 determined that SDG&E took aggressive steps to procure liability insurance in a prudent and reasonable manner, canvassing the global insurance market for insurers. The decision also determined that SDG&E, given limited insurance availability due to its high wildfire risk, had a comprehensive and

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[14] Id., p. 34.

[15] See SDG&E AL 2251-E, Table II, p. 25.

cost-effective insurance package. Second, the decision also acknowledged that SDG&E had reasonably explored other alternatives in building its insurance package, such as ART mechanisms which were determined to be infeasible at the time by SDG&E because they were not cost effective. Third, the decision also noted SDG&E's proactive efforts in improving its risk profile, including implementing a multi-pronged "Community Fire Safety Program."[16]

For the 2010-2011 policy year, SDG&E procured an additional reinsurance product for its wildfire coverage in addition to the traditional general liability and commercial wildfire insurance it procured the year before. Resolution E-4450 determined that the 2010-2011 insurance package SDG&E procured was reasonable and met the eighth Z-factor criteria.

Resolution E-4450 determined that the 2010-2011 traditional general liability and wildfire insurance was reasonable because SDG&E followed the same strategy in procuring insurance for the 2010-2011 policy year as it did the prior year. SDG&E claimed that it sought to procure as much insurance as was reasonably available, aiming to maximize coverage and reduce premiums. SDG&E hired the same insurance broker it hired during the 2009-2010 renewal, who, as he did for the 2009-2010 renewal, canvassed the global insurance market on behalf of SDG&E to put together a comprehensive and cost-effective insurance package. In addition, SDG&E noted that it proactively sought to improve its risk profile by continually building upon its "Community Fire Safety Program" by including more fire prevention measures.

Resolution E-4450 also determined that the cost of the wildfire reinsurance product that SDG&E procured in its 2010-2011 insurance package is reasonable. The resolution noted that SDG&E procured the reinsurance product, an ART mechanism that was not available prior to the 2010-2011 policy period, as a cost-effective option for extending liability coverage so that wildfire liability could be at a level equivalent to what SDG&E had prior to the 2009-2010 policy year. The resolution explained that D.10-12-053 found SDG&E's exploration of ART

[16] D.10-12-053, mimeo, pp. 36-37.

mechanisms during its 2009-2010 insurance procurement process to be reasonable. The resolution also determined that the reinsurance product is cost effective, given the lower average rate per dollar of coverage for reinsurance as compared to that of the final $100 million layer of the traditional wildfire insurance.

In AL 2285-E, SDG&E states that its insurance procurement strategy is similar to that of the previous two years. SD&E sought to procure as much insurance as was available at a reasonable cost. Again, SDG&E used seasoned brokerage firms, Marsh and GCC, to canvass the global insurance market to develop a comprehensive and cost-effect insurance package. SDG&E also explored ART mechanisms. The reinsurance product procured in 2011-2012 is very similar to the reinsurance product procured in 2010-2011. SDG&E notes that of all the various ART products available in the market, the reinsurance product is the closest in type to traditional commercial liability insurance and is the most cost effective. The reinsurance product provides $600 million in wildfire property damage and has a price per dollar of coverage lower than that of the final $100 million layer of the traditional wildfire insurance. In addition, SDG&E actively took steps to improve its risk profile, including expanding its existing "Community Fire Safety Program" to further reduce the likelihood of strong winds causing power line fires. Thus, for the same reasons that D.10-12-053 and Resolution E-4450 determined that SDG&E's insurance package from the previous years are reasonable, this resolution also determines that the cost increases SDG&E incurred for its 2011-2012 insurance package are reasonable.

DRA's protest is denied.

DRA protests SDG&E's recovery of costs for the 2011-2012 wildfire reinsurance, based on the same grounds as its protest to AL 2251-E on SDG&E's requested cost recovery of the 2010-2011 wildfire reinsurance. DRA's protest on AL 2155-E questioned whether SDG&E procured the reinsurance product reasonably, a condition which is necessary for the reinsurance product to satisfy the eighth criterion and qualify for Z-factor treatment.

In DRA's protest to AL 2251-E, DRA also claimed that the reinsurance product purchased in the 2010-2011 policy year was significantly and materially different from items discussed in the Z-factor application and D.10-12-053. Because of these material differences, DRA asserted that the Energy Division or the Commission cannot rely on D.10-12-053 to assess the reasonableness of the reinsurance product. In addition, DRA claimed that there was the appearance of self-dealing between the two insurance brokers (Marsh and GCC) that SDG&E used to procure its reinsurance product.

Resolution E-4450 denied DRA's protest on AL 2251-E and determined that the reinsurance product was reasonable and, thus, satisfied the eighth Z-factor criterion. In response to DRA's claim that the reinsurance product was materially different from items discussed in SDG&E's Z-factor application and D.10-12-053, Resolution E-4450 noted that the reinsurance was an ART product which D.10-12-053 determined that SDG&E reasonably explored. The resolution found that the reinsurance cost-effectively increased SDG&E's wildfire liability coverage and brought wildfire coverage to comparable levels obtained before 2009. Based on the aftermath of the 2007 wildfires, the resolution noted that the additional wildfire coverage was justified.

Resolution E-4450 also determined that there was no basis for DRA's suggestion that there may have been self-dealings between affiliated insurance brokers, i.e. Marsh and GCC, in procuring the reinsurance product. It found that there was no direct benefit to Marsh when its affiliate, GCC, acted as the broker for the reinsurance product. The resolution stated that GCC was a prudent choice to handle the procurement of the reinsurance for SDG&E.

For the reasons set forth by Resolution E-4450, this resolution also denies DRA's protest regarding SDG&E's recovery of costs associated with the reinsurance product.

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

In phase 1 of its 2012 GRC, A.10-12-005, SDG&E states that it anticipates a continuing need for the reinsurance product. Its forecast for test year 2012 includes $35.8 million for wildfire property damage reinsurance.[17] SDG&E's forecasted expense for this reinsurance product is currently contested in the GRC.[18]

Although Resolution E-4450 granted recovery of the reinsurance for policy year 2010-2011, it made clear that its approval of the reinsurance product costs does not prejudge the Commission's decision in A.10-12-005 on the reasonableness of the reinsurance product going forward. Similarly, this resolution does not prejudge the Commission's decision in A.10-12-005 on the reasonableness of including any expenses for reinsurance in test year 2012 and the attrition years addressed in the GRC.

SDG&E is authorized to increase revenue requirement by $28.029 million above 2008 GRC revenues, amortized over 24 months, to recover insurance costs incurred in 2011 for the 2011-2012 policy year.

In AL 2285-E, SDG&E requests to increase revenue requirement by $28.029 million above 2008 GRC revenues to recover insurance cost increases incurred from June 26, 2011 through the end of 2011. The cost of the entire policy year of 2011-2012 is $80.4 million. After subtracting a $5.0 million Z-factor deductible from one-half of the 2011-2012 insurance expense SDG&E incurred in excess of the $4.5 million insurance expense authorized in the 2008 GRC and adding in interest, franchise fees, and uncollectible expenses, SDG&E proposes to increase revenue requirement by $28.029 million. The proposed revenue requirement increase is to be amortized over 24 months, resulting in a $14.015 million annual increase over 2 years. SDG&E proposes that the incremental revenue requirement be transferred from the ZFMA subaccount to the Electric Distribution Fixed Cost Account for amortization into rates in connection with SDG&E's annual regulatory account balance update filing.

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

[18] See the Prepared Testimony of Robert Sulpizio on behalf of Utility Consumers Action Network in A.10-12-005, September 22, 2011, and the Litigation Comparison Exhibit of SDG&E in A.10-12-005, March 2, 2012, p. 442.

SDG&E's request for cost recovery is granted. SDG&E is authorized to transfer the incremental revenue requirement from the ZFMA subaccount to the Electric Distribution Fixed Cost Account and to amortize the revenue requirement over a 24-month period ($14.015 million annually) in its annual consolidated electric rate change advice letter.

COMMENTS

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

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

On April 26, 2012, SDG&E submitted comments on the draft resolution.

SDG&E supports the findings set forth in the draft resolution, stating that it upholds established Commission policy and is consistent with Commission precedent. SDG&E also suggests some minor clarifying revisions, which have been incorporated into the resolution.

FINDINGS AND CONCLUSIONS

1. D.08-07-046 in SDG&E's 2008 general rate case approved SDG&E's current Z-factor mechanism which allows SDG&E to seek recovery of costs associated with exogenous events that were unforeseen at the time of ratemaking, largely uncontrollable by management, and have a material and disproportionate impact on SDG&E.
2. The Commission has adopted the following criteria for Z-factor recovery for SDG&E:
    a. The event must be exogenous to SDG&E;
    b. The event must occur after implementation of rates;
    c. The costs are beyond control of SDG&E management;

d. The costs are not a normal part of doing business;

e. The costs must have a disproportionate impact on SDG&E;

f. The costs must have a major impact on overall costs;

g. The cost impact must be measurable; and

h. SDG&E must incur the costs reasonably.

3. On April 2009, SDG&E sent a letter to the Commission's Executive Director to notify the Commission of its intent to record unexpected insurance cost increases as a Z-factor event.

4. In August 2009, SDG&E filed A.09-08-019 to request recovery of unanticipated insurance cost increases for policy year 2009-2010 as a Z-factor event.

5. D.10-12-053 determined that the 2009-2010 insurance cost increases met the eight Z-factor criteria and approved SDG&E's request to recover $28.9 million in increased general liability and wildfire insurance costs for the 2009-2010 policy period.

6. D.10-12-053 authorized SDG&E to file a Tier 3 advice letter to request Z-factor treatment and recovery of unforeseen liability insurance premiums and deductible expense increases in subsequent years prior to its next GRC.

7. SDG&E filed AL 2251-E in April 2011 to request recovery of increased insurance costs for the 2010-2011 policy year as a Z-factor event.

8. The requested recovery of insurance cost increases for policy year 2010-2011 included the recovery of a new ART product, which is a reinsurance product that provides an additional $600 million in wildfire property coverage at a premium of $32 million.

9. Resolution E-4450 approved AL 2251-E and determined that SDG&E's request to recover $61.0 million in insurance cost increases for policy year 2010-2011, including costs of the wildfire reinsurance, met all eight criteria for Z-factor treatment. Resolution E-4450 also approved SDG&E's request to recover $2.3 million in updated insurance costs for the 2009-2010 policy period.

10. The insurance package Resolution E-4450 approved for cost recovery included general liability insurance, traditional wildfire insurance, and wildfire reinsurance.
11. SDG&E filed AL 2285-E in September 2011 to request recovery of insurance cost increases for half of the policy year 2011-2012, incurred from the effective date of the policy until the end of 2011, as a Z-factor event.
12. The insurance package SDG&E procured in 2011-2012 is similar in coverage and price to the insurance package that SDG&E procured in 2010-2011, approved by Resolution E-4450.
13. DRA protested AL 2285-E, recommending that the Commission disallow recovery of the wildfire reinsurance on the same grounds as its protest to AL 2251-E.
14. The general liability insurance costs, traditional wildfire insurance costs, and reinsurance costs incurred by SDG&E for the 2011-2012 policy year meet all eight criteria identified in Finding and Conclusion 2 for Z-factor recovery.
15. SDG&E's request to increase revenue requirement by $28.029 million above 2008 GRC levels, amortized over 24 months, to recover insurance cost increases incurred for half of the policy year 2011-2012 is approved.
16. SDG&E's request to recover costs for reinsurance is an issue in its 2012 GRC A.10-12-005.
17. This resolution does not prejudge the Commission's decision in A.10-12-005 on recovery of reinsurance costs.
18. On December 29, 2011, Ruth Henricks filed a Petition for Writ of Review with the Court of Appeal of the State of California, Fourth Appellate District, to challenge D.10-12-053 and Resolution E-4450.
19. The Commission answered the Petitioner's Writ of Review on February 1, 2012, recommending that the Court dismiss the petition.
20. On April 6, 2012, the California appellate court denied the Petition for Writ of Review of D.10-12-053 and Resolution E-4450 filed by Ruth Henricks.
21. The protest of DRA is denied.

THEREFORE IT IS ORDERED THAT:

1. SDG&E's Advice Letter 2285-E is approved.
2. SDG&E is authorized to increase revenue requirement by $28.029 million above 2008 GRC revenues to recover insurance cost increases incurred from June 26, 2011 through December 31, 2011 for the 2011-12 policy period.
3. The $28.029 million revenue requirement increase is to be amortized over 24 months, resulting in a $14.015 million annual revenue requirement increase.
4. SDG&E is authorized to transfer the incremental revenue requirement associated with the costs it requests to recover in Advice Letter 2285-E from the ZFMA subaccount to the Electric Distribution Fixed Cost Account for rate amortization over a 24-month period in its next annual consolidated electric rate change.

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 May 10, 2012; the following Commissioners voting favorably thereon:

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Paul Clanon
Executive Director