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Decision 02-04-055 April 22, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company to Adopt a Performance Based Ratemaking Mechanism Effective January 1, 1995.	Application 93-12-029 (Filed December 23, 1993)
Order Instituting Investigation into Changing the Method, Timing and Process for Periodically Deriving a Reasonable Revenue Requirement for the Southern California Edison Company.	Investigation 94-04-003 (Filed April 6, 1994)

See Appendix A for List of Appearances

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DECISION GRANTING PETITION TO MODIFY SOUTHERN CALIFORNIA EDISON COMPANY'S PERFORMANCE BASED RATEMAKING MECHANISM

Summary

We grant in part the Expedited Petition for Modification of Decision (D.) 96-09-092 (Petition) filed by Southern California Edison Company (Edison) that seeks to extend and modify Edison's Performance Based Ratemaking (PBR) mechanism until superseded by its 2003 General Rate Case (GRC).[1] In particular, we adopt a methodology for setting a revenue requirement for the period from June 14, 2001 to December 31, 2001 and for subsequent calendar years. The adopted methodology increases Edison's distribution revenue requirement by the change in the Consumer Price Index (CPI) minus a productivity factor, X. In addition, the methodology increases Edison's revenue requirement to account for the additional costs produced by expanding the distribution network to connect new customers. Further, pursuant to Pub. Util. Code § 739.10,[2] we establish a balancing account to ensure that errors in estimates of electricity sales do not result in material over- or under-collections of the revenues authorized by the adopted methodology.

In addition, we examine other aspects of the PBR to determine if modifications are required. We do not change the financial "trigger mechanism," a process for changing Edison's authorized Return on Equity

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[1] Edison originally filed its motion in NOI 00-09-008, but served it on the parties to Edison's last GRC Application 93-12-025/Investigation (I.) 94-02-002. The Commission transferred the motion to the GRC docket.

[2] All subsequent statutory references are to the Public Utilities Code.

(ROE). In addition, we update the performance benchmark for the customer satisfaction, worker safety, and outage frequency programs to reflect recent trends in Edison's performance. We leave unchanged the incentive program concerning the duration of outages. Finally, we decline to supplement the revenues earmarked for conservation programs in this proceeding.

Procedural Background

On May 4, 2001, Edison filed its Petition. The Natural Resources Defense Council (NRDC), the Office of Ratepayer Advocates (ORA), and The Utility Reform Network (TURN) filed timely responses.

On June 14, 2001, the Commission adopted D.01-06-038 which extended Edison's PBR mechanism until superseded by Edison's next GRC. D.01-06-038 left unresolved how the Commission should modify Edison's PBR, if at all, in light of changes in California's electricity markets.

On August 23, 2001, the Commission held a prehearing conference (PHC) to determine the next steps in this proceeding. At that PHC, parties agreed to an aggressive schedule in an effort to resolve the issues in this proceeding by the end of 2001. That schedule was formalized in an Administrative Law Judge (ALJ) Ruling issued on August 30, 2001.

Working with the parties in this proceeding, Edison filed a case status statement on October 16, 2001 that delineated outstanding issues and proposed a plan for managing the evidentiary hearings. In addition, Edison filed revised testimony and additional testimony on October 16, 2001.

Evidentiary hearings were held on October 17 and October 18. Following oral argument, Edison's motion for the acceptance of the additional testimony filed on October 16, 2001 was denied because there was no way of accepting this additional testimony without extending the duration of the proceeding to permit parties to review and respond to the last minute filing. With the submission of reply briefs, the case was deemed submitted as of November 5, 2001.

Background – The Current PBR Mechanism

Edison's current PBR mechanism applies to the rates that Edison charges for electric distribution services. In D.96-09-092, the Commission adopted an Edison transmission and distribution PBR. The Edison transmission and distribution PBR was implemented on January 1, 1997 and the basic form of the PBR is scheduled to operate through December 31, 2001. Beginning in 1998, with the implementation of electric restructuring, the Edison PBR became applicable only to the distribution component of Edison's rates. Thus, the PBR mechanism now applies only to these distribution rates and charges. (68 CPUC2d 275.)

Edison's PBR mechanism makes an annual adjustment to rates. The new rates result from applying the percentage change in the CPI, less the Commission-established productivity factor (X) to last year's distribution rates and charges. The annual change in CPI is measured from one middle-of-year value to the next middle-of-year value. Annual values for the productivity factor were set in Edison's PBR decision as follows: 1.2% for 1997, 1.4% for 1998, and 1.6% for 1999 and later years.[3]

Each year, Edison calculates the ROE that results from distribution operations and sales in the previous year. The current PBR mechanism contains a "Net Revenue Sharing Mechanism" that shares with Edison's customers those net revenues above and below the Benchmark ROE, which is currently 11.6%.

[3] D.96-09-092, 68 CPUC 2nd 275, 296

The Revenue Sharing Mechanism has the following features:

- Shareholders bear 100% of the gains and losses relative to the Benchmark ROE within 50 basis points of the Benchmark ROE.
- There is a "progressive sliding scale" in the range between 50 basis points and 300 basis points around the Benchmark ROE. At 50 basis points, ratepayers receive 75% of the incremental gains or losses and their share declines to zero at 300 basis points.
- Between 300 basis points and 600 basis points, shareholders again bear 100% of the gains or losses.
- There is a potential off-ramp if earnings fall 600 basis points below the Benchmark ROE. There is a mandatory off-ramp if earnings exceed the Benchmark ROE by 600 basis points.

In addition to the mechanism for changing rates to assure the reasonableness of earnings, D.96-09-092 creates a second mechanism that alters the Benchmark ROE.[4] Changes in the authorized ROE are triggered when the last 12 months of Moody's Aa utility bond index (averaged from October through September of each year) show a cumulative change of 100 basis points from the index's base value, currently 7.5% (set in September 1996). D.96-09-092 establishes a deadband of plus or minus 100 basis points from the starting value, so the current trigger deadband is 8.5% on the upside and 6.5% on the downside.

If, at the end of September in a given year, the value of the trigger index lies within the deadband, both the Benchmark ROE and the trigger value remain the same. If the value of the trigger index lies outside the deadband, the Benchmark ROE is adjusted by one-half of the difference between the current

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[4] The current Benchmark ROE is 11.6%. See Resolution E-3478, pp. 6-8; see also D.96-11-060 (69 CPUC 2d 327, 350).

value of the 12-month trailing average of Moody's Aa utility bond rate and the value of the trigger index. A new value for the trigger index is then set at the then-current value of the index.

If the trigger mechanism results in a change in the ROE, a PBR rate change is made that corresponds to the revenue requirement change associated with the change in the benchmark ROE. Activation of the trigger mechanism does not alter either the embedded costs of long-term debt and preferred stock, nor the authorized ratemaking capital structure.

Finally, in addition to the operation of mechanisms for adjusting prices, reviewing earnings and adjusting the ROE from year-to-year, the PBR mechanism contains a number of elements that either reward or penalize Edison's performance in specific areas. Currently, these incentive programs focus on four areas of Edison's service quality: customer satisfaction, duration of outages, frequency of outages, and employee health and safety. In general, each mechanism establishes a method for measuring Edison's performance and a benchmark for that performance. In each mechanism, there is a deadband around the benchmark in which realized performance is neither rewarded nor penalized. Outside the deadband performance that is incrementally better or worse is rewarded or penalized. Each mechanism also contains a dollar limit on the maximum reward or penalty. We will discuss the details of each mechanism below.

Issues To Be Resolved

In D.01-06-038, the Commission elected to extend the PBR mechanism until superseded by Edison's next GRC. This interim decision established a memorandum account for booking contested revenues and costs attributable to electricity distribution, but did not determine whether and how to modify the existing PBR mechanism, whose elements were specified only through the year 2001.

In addition, on April 11, 2001, California enacted ABX1-29 (Stats. 2001, Ch. 8), which added § 739.10. ABX1-29 was effective as of April 12, 2001 (the date it was filed with the Secretary of State) because this legislation was enacted as an urgency statute. Section 739.10 states as follows:

> The commission shall ensure that errors in estimates of demand elasticity or sales do not result in material over or under collection of the electrical corporations.

Under the current PBR, which uses a rate index, variations in sales translate directly into variations in revenues. Thus, it is unclear whether changes in sales will result in material under- or overcollections. At a minimum, §739.10 requires that we examine the PBR mechanism to ensure that it complies with this newly enacted statute.

On October 16, 2001, the active parties in this proceeding filed a case status statement. This statement reaffirmed that the issues identified in the August 30, 2001 Scoping Memo remain unresolved. Based on these documents and the course of the proceeding, the outstanding issues for resolution may be grouped as follows:

1. Should the Commission modify Edison's PBR to adopt a distribution revenue requirement and balancing account to comply with § 739.10 in 2001? In 2002?
2. If the Commission elects to set a revenue requirement for distribution, how should it set the 2001 value? The 2002 value?
3. Should the Commission modify the trigger mechanism?
4. Should the Commission modify any of the performance incentive programs?

5. Should the Commission enhance the revenue requirement to increase Edison's budget for electricity conservation?
6. How should the Commission implement adopted changes?

We address each issue in turn.

Issue 1: How should the Commission modify Edison's PBR to comply with § 739.10?

Positions of Parties

A central issue in this proceeding is how to insure that Commission regulation conforms to the statutory requirements of § 739.10.

Concerning the period between June 14, 2001 and the end of 2001, the parties have widely divergent positions. Edison urges the Commission to alter the PBR mechanism, effective June 14, and adopt a revenue requirement for 2001 whose recovery is subject to balancing account treatment. Edison argues that unless the Commission adopts a revenue requirement not linked to sales in 2001, Edison will lack a reasonable opportunity to earn its authorized return.

Edison's argument echoes the language of § 739.10. In particular, Edison states that a failure to adopt a revenue requirement will result in a material undercollection of revenues, in contravention of § 739.10. This material undercollection occurs, in Edison's view, because during the summer months of 2001, 33% of all Edison customers reduced their consumption by at least 20% compared to the summer of 2001. Edison notes that the California Energy Commission estimates that weather adjusted peak loads for June, July, and August 2001 have "declined approximately 12.2%, 9.1% and 7.7% compared to the same months in 2000."[5] Edison further states that "billed revenues under the

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[5] Edison, Opening Brief, p. 11.

PBR rate-index mechanism are expected to be $67 million lower in 2001 (1.966 billion) rather than the recorded 2000 level of $2.033 billion."[6] Thus, Edison concludes that a material undercollection occurs because sales have dropped substantially below those implicit in the forecasts used to develop PBR. Therefore, Edison believes that, pursuant to § 739.10, the Commission must act to ensure that the material undercollection that it has identified is mitigated by regulatory action.

ORA, in contrast, argues that § 739.10 does not mandate that the Commission establish a retroactive rate indexing formula for 2001. Further, ORA contends that such a change is inappropriate as a matter of policy. ORA argues that the record in this proceeding fails to demonstrate that an undercollection will occur in 2001 in the absence of an adjustment. Therefore, in ORA's view, granting Edison's request will result in a windfall. ORA believes that Edison's decline in revenues is more than offset by a drop in capital spending and operations and maintenance spending.

TURN does not comment directly on the issue of whether to set a revenue requirement for 2001, but it indicates that it supports the analysis and recommendations of ORA.

For 2002, all parties agree that the Commission should adopt a revenue requirement for distribution expenses that is not linked to sales, and that this change should be implemented via a revenue requirement and balancing account. All parties agree that this approach would comply with § 739.10.

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[6] Edison, Opening Brief, p. 11.

Discussion: Adopting a revenue requirement for 2001 and 2002 ensures compliance with § 739.10.

Regarding the year 2001, we find that adopting a revenue requirement and establishing a balancing account offers the most straightforward way of complying with § 739.10. We find ORA's argument, that the Commission need take no action concerning Edison's 2001 revenues, unpersuasive. It is clear that § 739.10 directs that the Commission – not Edison – take action to ensure against under- and overcollections by Edison in the period covered by the statute. Adopting a revenue requirement to cover the period commencing with the establishment of the memorandum account on June 14, 2001, therefore, is a reasonable method for complying with § 739.10. It is also reasonable to convert the memorandum account into a balancing account to be effective as of June 14, 2001. This approach is consistent with the timeframe established by the statute, which was effective on April 12.

It is clear from a reading of the statute and the briefs of all parties that establishing a revenue requirement and balancing account to cover year 2002 utility operations would comply with the provisions of § 739.10. Indeed, setting a revenue requirement that a utility receives no matter the level of electricity sales ensures against both under- and overcollections. We find that this is clearly the preferred regulatory approach for 2002.

Issue 2: How should the Commission set revenue requirements?

Once we determine that the use of revenue requirements and balancing accounts offer the best way of complying with § 739.10, our task becomes one of setting this requirement. For the year 2002, even though all parties support the establishment of a revenue requirement and balancing account, the parties hold very different views on how to set the revenue requirement. For the period from

June 14, 2001 to December 31, 2001, the disagreement between parties is even greater. We briefly review the position of each party.

Position of Parties

Edison proposes very similar processes to set revenue requirements for both 2001 and 2002. For 2001, Edison recommends that the Commission apply the existing PBR formula, i.e. the change in the CPI less the productivity factor of 1.6% to the recorded 2000 PBR revenues. Edison also states that the revenue requirement should also provide for a forecast customer growth in 2001, with an allowance of $657 per new customer.[7] For 2002, Edison also proposes that the Commission escalate its proposed 2001 revenue requirement by the change in the CPI minus the productivity factor of 1.6% and add an allowance for forecast customer growth of $669 per new customer.

Concerning 2001, ORA argues that the Commission need not set a revenue requirement because "the record does not demonstrate that an undercollection will occur in the absence of such an adjustment."[8] Therefore, in ORA's view, the Commission need not set a revenue requirement for 2001, but simply leave the

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[7] In D.96-09-092 (68 CPUC 2nd 275), known as the Edison PBR decision, the Commission stated: "We accept Edison's incremental cost of $779 for its customer growth allowance." This figure of $779 was an estimate of the incremental non-generation cost of serving a new customer in 1996 and included transmission-related costs. In this Petition, Edison reduced the per customer figure to $630 (in 1996 dollars) by eliminating those costs (primarily transmission related) that no longer fall under this Commission's regulatory jurisdiction. Edison then developed a per customer growth allowance of $657 for 2001 and $669 for 2002 by applying CPI-X escalation factors to the 1996 figure of $630. No party contested either Edison's methodology or its calculation of this growth allowance.

[8] ORA, Opening Brief, p. 8.

current price cap mechanism in place. ORA believes that for 2001, Edison's estimated distribution expenditures and deferred investments have dropped $170 million more than its revenues, and that establishing the revenue index that Edison requests would result in overearnings. Moreover, ORA notes that adjustments will not have any effect on Edison's 2001 conservation actions, which are already complete.

ORA takes a different approach to establishing a revenue requirement for 2002. ORA recommends that the Commission adopt the recorded 2000 revenues of Edison as the revenue requirement for 2002. ORA supports its position by noting Edison's $237 million reduction in capital expenditures and operations and maintenance expenditures for 2001. ORA further notes that ORA has no firm information on the amount of capital investment program for 2002 that is embedded in current rates.

TURN cites ORA's testimony and states that it supports it. Further, TURN believes that the decrease in expenditures identified by ORA should affect revenue requirements in both 2001 and 2002.[9]

Discussion: Edison's proposal for 2001 requires adjustments to recognize reduced expenditures; Edison's proposal for 2002 is reasonable.

For the year 2001, we find a very complex situation. Edison's revenues were greatly affected by the efforts of its customers to conserve. Edison shows that without implementing a revenue balancing account effective June 14, 2001 Edison's earned return will fall far below its authorized level.[10] Edison's costs,

[9] TURN, Opening Brief, p. 1.

[10] Edison, Reply Brief, p. 7; Edison, Opening Brief, p. 21; Exhibit 2-A, p. 1.

however, were greatly affected by the steps Edison took to avert bankruptcy. As ORA has pointed out, the steps to avert bankruptcy included both reductions in operations and maintenance spending, and the deferral of planned infrastructure investments. Nevertheless, despite these reductions, we find that without some adjustment in revenues for 2001, a material undercollection will result.

Moreover, ABX1-29 became law on April 12, 2001 as an urgency measure effective immediately. Pursuant to the newly codified § 739.10, D. 01-06-038 established a memorandum account for distribution expenses and revenues as of June 14, 2001. Thus, the legislation that has guided our action has been in effect for only part of this year, and June 14, 2001 starts the period of company operations that are subject to our review.

Since Edison cut operating and maintenance expenditures and since ABX1-29 does not cover all of 2001, it would be inappropriate to apply the formula that we have adopted to establish a 2002 revenue requirement to 2001 without any adjustments. Therefore, we will establish a revenue requirement to cover the period from June 14, 2001 to the end of the year that reflects the standard movement of the PBR index, new customers, and Edison's one-time reductions in expenditures. This action is necessary to avoid material under collection of revenues.

On the other hand, Edison's deferral of capital expenditures should not affect the setting of a revenue requirement because during this period the distribution rate base continued to grow and because California's infrastructure will soon require Edison to make the deferred investments.

Taking these factors into account, a revenue requirement for period from June 14, 2001 to December 31, 2001 should include the following items:

1. A base revenue requirement that equals the year 2000 historic revenues escalated by the CPI-X formula and prorated to cover only the period from June 14, 2001 to the end of 2001.
2. A customer growth element that equals $657 times the number of new customers added in 2001, but prorated to cover only the period from June 14, 2001 to the end of the year.
3. A reduction to reflect Edison's decrease in operations and maintenance expenditures. In particular, since Edison reduced its operations and maintenance spending by $28 million over the year 2001, compared to year 2000, we will reduce the post-June 14 revenue requirement by $15.17 million using the standard prorating approach to reflect the expenditures avoided from June 14 to the end of the year.

Setting the revenue requirement for June 14 until the end of 2001 in this matter determines a reasonable revenue requirement for Edison and ensures that errors in estimates of sales do not result in material over- or undercollections during this period.[11]

[11] There is evidence in the record that allows us to estimate both the effects of continuing the current mechanism unchanged and the actions we take today on electricity prices for 2001. If the Commission takes no action concerning 2001, Exhibit 2a indicates that the projected Edison PBR distribution revenues for 2001 will equal $1.966 billion, which is less than the $2.016 billion in distribution revenues that Edison recorded in 2000. Under the methodology adopted in this proceeding and using the information filed in Edison's workpapers and Appendix B and reducing the resulting figure by the $15.17 million in avoided maintenance costs, we estimate that Edison's distribution revenue requirement for 2001 will equal approximately 2.008 billion, which is $8 million less than that recorded in 2000. Alternatively, this is $42 million or 2.1% higher than what Edison would likely receive under the policy of making no adjustments, which is the policy promoted by ORA. Concerning the additional impact on rates, since distribution costs currently total less than 25% of the cost of electricity delivered to the customer, under the adopted methodology, the cost of electricity would rise approximately 0.5% (.25 x 2.1%).

Turning now to the year 2002, Edison's proposal escalates the 2000 revenue requirement by applying the PBR index mechanism for two years plus an allowance based on a forecast of new customers added. We find Edison's proposal to calculate a revenue requirement reasonable for two reasons. First, the heart of the index mechanism is the CPI-X formula that the Commission has repeatedly used during the course of this PBR to ensure the reasonableness of rates. Absent any evidence to the contrary, it is reasonable to continue to use a productivity offset of 1.6%. Second, adding a revenue requirement to compensate Edison for the costs of new customers is reasonable because under the revenue requirement and the balancing account approach, increases in sales by Edison will not lead to increases in revenues. Therefore, it is reasonable to make a specific revenue requirement adjustment for customer growth. Finally the institution of a balancing account tied to an adopted revenue requirement essentially restores the "Energy Revenue Adjustment Mechanism (ERAM)" that was in place before the Commission's adoption of the PBR regulations. Like the ERAM, this proposed balancing account provides utilities with protection from all revenue reductions that arise from conservation while ensuring that the utility obtains adequate but not excessive revenues.

In contrast, ORA's recommendation to use the recorded year 2000 revenues to set a 2002 revenue requirement and to recover capital cost increases through the provisions of the SCE/CPUC settlement is not reasonable. First, it is clear from the evidence that Edison's reduction of operating and maintenance expenditures is only a temporary measure for 2001. Indeed, the reduction in both operational and capital spending was a response to a financial crisis and cannot reasonably become the basis for setting a revenue requirement in both 2002 and 2001. Second, the alleged $237 million reduction in distribution costs lumps together capital expenditures with operating expenses. This treatment of delayed capital investments as if they were expenditure reductions violates basic principles of cost-of-service ratemaking in which capital investments result in a revenue requirement that reflects a return on rate base and depreciation, not treatment as a one-time expense. Moreover, this policy also fails to note that Edison's weighted-average rate base has continued to increase. Under traditional ratemaking, this warrants an increase in revenue requirement. In particular, for the twelve months ending June 30, 2001, rate base increased $130 million from the end of year 2000 recorded value.[12] Third, the reductions in capital expenditures identified by ORA in 2001 resulted from the deferral of infrastructure replacement previously planned.[13] In order to avoid degradation and to maintain reliability, we find that Edison will need to resume capital expenditures. Indeed, a major purpose of the Commission's settlement with Edison is to restore its ability to "provide reliable electric service as a state regulated utility as it has in the past."[14] These three considerations make it clear that setting the 2002 revenue requirement at the year 2000 level is unreasonable.

We find that it is important that the Commission set Edison's 2002 distribution revenue requirement at a level that enables it to pursue normal

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[12] Exhibit 2-A, p. 1. Although the increasing rate base cannot be sustained without continued investment, the fact that ratebase increased through June 30, 2001 is not disputed. Moreover, since our goal is to enable Edison to make infrastructure investments at the levels California requires, we need not link revenue requirements to the anomalous investment profile of 2001.

[13] Tr. 29/3495

[14] C.00-12056-RSWL-Edison v. Lynch, et. al. – Final Settlement.

operations. We believe that the best way to determine such a figure is to use a two-step process applied to the recorded year 2000 revenues to derive a revenue requirement for 2002. The revenue requirement should be calculated using the two-step procedure that follows:

Step 1 – Calculate a 2001 "annualized revenue requirement ":

$\$\text{Annualized Rev. Req.}_{2001}=(1+(\Delta CPI_{2001}-X_{2001})) \times (\$\ \text{Revenues}_{2000}) + \$657 \times (\text{Number of New Customers}_{2001})$

Where ΔCPI = change in CPI

Step 2 – Calculate a 2002 Revenue Requirement:

$\$\text{Revenue Requirement}_{2002}=(1+(\Delta CPI_{2002}-X_{2002})) \times (\$\text{Annualized Rev. Req.}_{2001}) +\$669 \times (\text{Number of New Customers}_{2002})$

Where ΔCPI = change in CPI

Step 1 creates an intermediate number that does not correspond to an adopted revenue requirement, but this intermediate value is needed to calculate the revenue requirement for the year 2002.[15] This intermediate number escalates the year 2000 revenues via the CPI-X formula and adds a revenue requirement to reflect new customers added in 2001, with a revenue requirement value of $657 per new customer.[16]

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[15] Please note that this intermediate number is not the revenue requirement formula that we adopted above for 2001. We find that it is not reasonable to use the adopted 2001 revenue requirement in this new formula for two reasons. First, the adopted 2001 revenue requirement formula includes an offset that reflects the deferral of operating maintenance under taken by Edison to avoid bankruptcy. Incorporating such a reduction into the formula for calculating a revenue requirement for 2002 would lock in an unreasonably low level of infrastructure maintenance. Second, our 2001 formula also includes only those new customer costs attributable to the post-June 14th time period. Incorporating such a reduction into the formula for 2002 would fail to include the ongoing costs that arise from the additions of these customers – which will be paid throughout all of 2002. Failing to include these costs would similarly lock in a revenue requirement that was too low.

[16] The figure of $657 per customer is derived from the $770 per new customer discussed in D.96-09-029 on page 31. The $657 value arises from removing expenses not associated with electric distribution. In this case, these are principally transmission expenses.

Step 2 escalates the intermediate number via the CPI-X formula and adds in an incremental revenue requirement to reflect new customers added in 2002, with an added revenue requirement value of $669[17] per new customer. The result is the revenue requirement that we adopt for 2002.[18]

Although the adoption by the Commission of a GRC decision for Edison in 2003 will supersede this PBR program, it is reasonable to continue the PBR program until replaced. Thus, Edison shall file a distribution revenue requirement for 2003, consistent with the methodology adopted for 2002, which will remain in effect during 2003 until the adoption of a GRC decision. The productivity offset factor shall remain at 1.6%.

In conclusion, the methodology that we adopt to conform our PBR program to § 739.10 will result in reasonable revenue requirement increases that will enable Edison to recover its costs of distributing electricity and to make necessary investments in infrastructure.

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17 The 2002 figure of $669 reflects an escalation of the $657 figure for 2001 by the CPI-X formula.

18 Concerning the year 2002, if customer growth continues at approximately 61,000 customers per year and CPI-X_{2002} equals 1.76%, then the adopted methodology would yield a revenue requirement of $2.161 billion. This amount is approximately $153 million higher than that which will result from the adopted 2001 revenue requirement formula, which will likely lead to a $2.008 billion revenue requirement. This is an increase of 7.6% in the distribution revenue requirement. Once again, since distribution costs equal approximately 25% of the cost of electricity, the affect on prices will be approximately 1.9% (.25 x 7.6%). Modest increases in electricity sales, most likely through the addition of new customers, will further decrease the impact on prices of the adopted revenue requirement.

Issue 3: Should the Commission alter the "trigger mechanism" and/or earnings benchmark contained in the PBR?

Positions of Parties

As mentioned above, the "trigger mechanism" leads to changes in ROE and changes in rates depending on the movement of a "trigger" set at interest rates based on Moody's Aa utility bonds.

Edison states that the current "trigger mechanism" for modifying the ROE earnings benchmark contained in the PBR should continue unchanged during the limited period of the PBR extension.[19] In its testimony, Edison demonstrates that the trigger mechanism accurately tracks Edison's authorized return on common equity over the 20-year period from 1978 to 1997, a period prior to the adoption of the PBR. Edison further notes that:

> "If the trigger mechanism had been in place during this period, it would have reset the return on common equity six times over the 20-year period. On average, the return generated by the Trigger Mechanism would have been 13 basis points below the returns actually authorized by the Commission."[20]

Edison therefore concludes that this mechanism has rewarded shareholders and ratepayers with a predictable, stable, and reasonable return. Finally, Edison notes its current financial crisis, and argues that an examination of its ROE should take place in May 2002, when it expects to make a cost-of-capital filing.[21]

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[19] Exhibit 1, p. 23.

[20] Exhibit 1, p. 23.

[21] Exhibit 1, p. 25.

ORA recommends that the Commission adjust Edison's trigger mechanism by resetting the current benchmark value form 7.5% to 7.69%. ORA justifies this adjustment by stating that 7.69% is the 12-month trailing Moody's Aa utility bond rate calculated as of the end of September, 2001.[22]

TURN supports ORA's proposal, stating that adjusting the trigger index as proposed "increases the possibility of a lower rate of return under current market conditions and is an eminently fair response to the lowered utility risk."[23]

Discussion: No basis for change.

The PBR trigger mechanism should not be changed. Historically, the trigger was developed in a way that tied a specific Commission adopted ROE to a specific value of a 12-month trailing average of Moody's Aa utility bonds. In addition, the trigger mechanism and ROE were developed and modeled using utility financial data and Commission regulatory actions for the twenty years from 1978 to 1997. Any proposal for change should address why we should now break this link.

From its adoption in September of 1996 through June 2001, the trigger has moved within the deadband. Nevertheless, even if there were no deadband, and ROE was recalculated annually, Edison's ROE would have average 11.59%, only one basis point below the authorized level of 11.6%. Thus, we are confident that this trigger mechanism is operating fairly and need not be changed.

ORA's proposal does not explain why the Commission should change the current benchmark for the trigger mechanism at this time, nor does ORA explain

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22 Exhibit 100, p. 9; ORA, Opening Brief, p. 2.)

23 TURN, Opening Brief, p. 2.

what justifies breaking the established link between the trigger and ROE. In particular, ORA's arguments make no reference to historic data of any sort in their discussion of the trigger mechanism. Thus, ORA's recommendation to alter the trigger mechanism is unsupported.

TURN argues that establishing a revenue requirement and balancing account reduces a utility's financial risks and therefore change is justified. Nevertheless, there is no testimony from either TURN or ORA that explains why adjusting the mechanism in exactly this way is reasonable. Moreover, TURN's argument ignores the complex financial situation of Edison, which clearly calls for a comprehensive review before adopting a new ROE or financial structure.

In summary, the request for a change in the trigger mechanism has no empirical justification and we cannot find this change reasonable.

Issue 4: Should the Commission alter the "incentive mechanisms" contained in the PBR?

Position of Parties

Edison argues that the Commission should maintain the incentive mechanisms for employee safety, consumer satisfaction, outage frequency, and outage duration as they currently exist. In particular, Edison argues that achieving the current service quality benchmarks remains a significant challenge to Edison.[24] Edison believes that ratcheting up the standards in response to improved performance undercuts the incentive mechanisms. Edison also argues that changes to service quality standards should not be considered without

[24] Tr. 3482.

simultaneously considering the costs of achieving even more improved performance.

Taking another approach, Edison argues that ORA's proposed use of new standards using data only from 1999 and 2000 is inconsistent with the methodology previously adopted by the Commission. D.96-09-062 considered data covering many years in developing performance benchmarks. Edison notes, for example, that the proposal to create a safety index, which was adopted by the Commission, was based on seven years of data. Similarly, Edison points out that for reliability standards, the parties to this proceeding, including ORA's predecessor, the Division of Ratepayer Advocates, used ten years of data.

ORA opposes the continued use of the current worker safety standards, characterizing them as "lenient" and "no real challenge to Edison." ORA asks that the Commission take notice of I.01-08-029, in which the Commission is investigating Edison's safety practices. ORA recommends the Commission move the performance benchmark from 13 injuries per 200,000 hours worked to 5.8. Alternatively, ORA also states that "If the Commission is uncomfortable with establishing a new benchmark for a one-year period, the performance measure should simply be eliminated."[25]

ORA similarly argues that Edison's customer satisfaction benchmark should be changed. Currently the benchmark standard of 64% means that when customer responses to a survey on four aspects of customer service are averaged, 64% of responses indicated that customers are "completely satisfied" or "delighted" with service. ORA notes that recently Edison's performance has far

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[25] ORA, Opening Brief, p. 5.

exceeded the benchmark standard. ORA therefore recommends that the Commission use Edison's performance over the last two years and set a benchmark at 74%.[26] ORA concludes by stating that "It is time to either revise or eliminate Edison's customer satisfaction performance measures for 2002."[27]

ORA further recommends that the Commission should revise the outage frequency benchmark, reducing it from 10,900 to 9112, the average of the last two years data. ORA proposes this revision to give Edison "a strong incentive to improve its performance."[28]

TURN provides no specific comments concerning ORA's proposed modifications, but expresses general support for ORA's positions.

Discussion: The Commission should adjust the safety incentive, the customer satisfaction and the outage frequency incentive mechanisms.

There are four performance incentive mechanisms in Edison's current PBR: a worker safety incentive, a customer satisfaction incentive, an outage frequency incentive, and an outage duration incentive. We discuss each mechanism in turn.

Concerning the worker safety incentive program, we believe that it is reasonable to extend this program because it sends the signal to the company, to the workers, and to the public that this Commission remains interested in promoting worker safety. ORA, however, has made a persuasive case that the Commission should modify the current benchmark standard to reflect trends in

[26] Ex. 100, Table 1.

[27] ORA, Opening Brief, p. 6.

[28] ORA, Opening Brief, p. 7.

Edison's performance. We also agree with Edison that a benchmark should not reflect just two years data and that a dramatic ratcheting of performance criteria can discourage utility efforts to improve performance. Edison reminds us that in our 1996 decision the Commission decided that the best policy was to use seven years of data to develop the worker safety benchmarks. We therefore find that it is more reasonable approach to replace the current benchmark with one based on an average of recorded worker injuries for 1994-2000. Finally, we note that independent of any safety incentive program, it remains the policy of the state that utilities operate in a safe manner[29] and that various state and federal laws promote worker safety.

Concerning the consumer satisfaction incentive program, we believe that it is reasonable to extend this program for one year because it sends the signal to the company and to the public that this Commission remains critically interested in the satisfaction of utility customers. ORA has made a persuasive case that the Commission should modify the current benchmark standard to reflect trends in Edison's performance. We also agree with Edison that a benchmark should not reflect just two years data and that a dramatic ratcheting of performance criteria can discourage utility efforts to improve performance. Edison reminds us that in our 1996 decision the Commission decided that the best policy was to use several years of data whenever available. We therefore find that it is a more reasonable approach to replace the current benchmark with one based on an average of recorded satisfaction levels for 1992-2000.

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[29] § 399.2(a)(1).

We also plan to extend the incentive program to reduce Edison's frequency of outages for another year to signal our continuing interest in the reliability of electrical service. Once again, however, ORA has made a persuasive case that the Commission should modify the current benchmark standard. On the other hand, we agree with Edison that a benchmark should not reflect data from just two years and that a dramatic ratcheting of a performance benchmark, particularly when performance is heavily influence by weather, is inappropriate. Edison further notes that the methodology for setting this performance benchmark used ten years of historic data. For this reason, we find that it is reasonable to update this benchmark to reflect more recent performance, but to include data for more than two years. We therefore set the outage frequency benchmark based on the average for the performance recorded for the years 1991-2000.

Edison has recommended that the benchmark for the outage duration standard remain unchanged. ORA does not oppose retention of this standard, and notes that it has been revised over the course of the PBR. We find no reason for changing this benchmark. It is therefore reasonable to retain this incentive program without change.

Issue 5: Should the Commission increase the revenue requirement in this proceeding to produce more conservation activities by Edison?

Position of Parties

NRDC argues that unless the CPUC acts in this proceeding, funds for Commission-directed energy efficiency programs in Edison's service territory will "decrease by 18% in 2002 from budget levels in 2001."[30] NRDC notes that in 2001, the passage of Senate Bill X-5 resulted in a $19.2 million increase in conservation funding in Edison's service territory. Since this allocation of funds applied only in 2001, without Commission action, NRDC contends that conservation budgets will decrease. NRDC maintains that it is appropriate for the Commission to consider its request in this proceeding because Rulemaking (R.) 01-08-028 considers only how to spend conservation funds, not the funding level.

Edison opposes the NRDC request, stating that R.01-08-028 offers the appropriate venue for considering not only conservation expenses, but also the level of funding. Edison cautions that it would be "inappropriate to mix funding for energy efficiency programs with Edison's distribution rates."[31]

ORA opposes NRDC's proposal on several grounds. First, ORA states that NRDC has failed to justify the restoration of the conservation funding. Second, ORA argues that NRDC has "only the vaguest notions about what these funds will finance in the way of conservation programs."[32] ORA concludes that unless the Commission is willing to specify in this proceeding exactly how Edison should spend these funds, the Commission should deal with the funding issue in R.01-08-028.

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[30] NRDC, Opening Brief, p. 16; Exhibit 400, p. 21.

[31] Edison, Reply Brief, p. 13.

[32] ORA, Reply Brief, p. 11.

TURN also opposes NRDC's proposal, arguing that granting an increase in funds to one utility is "premature."[33] TURN recommends that the Commission examine Demand-Side Management (DSM) issues for all utilities "as part of the overall review of year 2002 programs and the rulemaking on DSM administration."[34] TURN opposes additional funding at this time in part because it believes that "Edison has done a miserable job of running DSM programs."[35]

Discussion: The Commission will consider the level of DSM expenditures in R.01-08-028.

We concur with the analysis of ORA, TURN, and Edison and agree that this is not the appropriate proceeding for setting the level of conservation spending for Edison.

Comments and Replies on Proposed Decision

The proposed decision of ALJ Sullivan in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. All parties to the proceeding have stipulated to a reduced comment period with comments due on February 1, 2002. No reply comments were accepted.

The Commission received timely comments from Edison, ORA, TURN and NRDC. Edison's comments sought clarification of several points and reargued its major positions seeking increases in the adopted distribution revenue requirements. ORA and TURN reargued their major points, seeking a reduction

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[33] TURN, Opening Brief, p. 4.

[34] TURN, Opening Brief, p. 4.

[35] TURN, Opening Brief, p. 3.

in the adopted revenue requirements to reflect Edison's 2001 temporary deferral of capital investments. NRDC, in contrast, urges adoption of the proposed decision as "consistent with state law, public policy, and the priorities set forth by the Commission."

We have clarified the decision as requested, but have declined to modify the major findings.

Findings of Fact

1. On June 14, 2001, the Commission adopted D. 01-06-038 which extended Edison's PBR mechanism until superseded by Edison's next GRC.

2. Edison's current PBR mechanism applies to the rates that Edison charges for electric distribution services.

3. On April 12, 2001, California enacted ABX1-29, which added Pub. Util. Code § 739.10.

4. Under Edison's current PBR, variations in sales translate into variations in revenues. In addition, errors in the forecast of electricity sales may result in material under- or overcollections.

5. The establishment of a revenue requirement for distribution costs and a balancing account to assure cost recovery can prevent material under-or over-collections that can arise from variations in electricity sales.

6. Without revisions to the PBR mechanism for the period from June 14, 2001 to December 31, 2001, Edison will suffer material undercollections in distribution revenues.

7. We will establish a revenue requirement for Edison's distribution costs for 2001 that considers changes in the CPI, a productivity adjustment, an adjustment to reflect expansion of the distribution network, and an adjustment to reflect one-time reduction in expenses.

8. We will establish a 2002 revenue requirement for Edison's distribution costs based on changes in the CPI, adjustments to reflect productivity gains, and adjustments to reflect the costs of extending the distribution network.

9. The PBR mechanisms adopted in D.96-09-092 should be revised to include the mechanism for setting a revenue requirement and balancing account for Edison's distribution system for the period following June 14, 2001 as described herein.

10. It is reasonable for Edison to use a productivity offset-factor for 2002 of 1.6%.

11. It is reasonable for Edison to use a productivity offset-factor for 2003 of 1.6%.

12. The financial trigger mechanism in Edison's PBR mechanism was developed using 20 years of financial data and information on Commission action. The resulting trigger mechanism linked changes in Moody's Aa utility bonds to Commission-authorized returns on investment.

13. There is no factual basis for changing the current trigger mechanism.

14. Performance data concerning worker safety indicates that Edison's performance currently exceeds the current safety benchmark by a wide margin.

15. Commission policy and law promote worker safety.

16. The PBR mechanism adopted in D.96-09-092 should be revised to require an updating of the benchmark for the safety incentive program for 2002. This updating should use recorded data for the seven years 1994-2000.

17. The PBR mechanism adopted in D.96-09-092 should be revised to require an updating of the benchmark for the consumer satisfaction incentive program for 2002. This updating should use recorded data for the years 1992-2000.

18. The PBR mechanism adopted in D.96-09-092 should be revised to require an updating of the benchmark for the incentive program to reduce the frequency of outages. This updating should use recorded data for the years 1991-2000.

19. There is no basis for changing the outage duration incentive program.

20. Edison's revenue requirement should not be modified to increase resources devoted to conservation programs in this proceeding.

Conclusions of Law

1. Pub. Util. Code §739.10 states that "The commission shall ensure that errors in estimates of demand elasticity or sales do not result in material over or under collection of electric corporations."

2. It is reasonable to revise the benchmark for Edison's worker safety incentive program based on the last seven years of injury data (1994-2000).

3. The PBR mechanism adopted in D.96-09-092 should be revised to require an updating of benchmark for the consumer satisfaction incentive program. This updating should use recorded data for the years 1992-2000.

4. It is reasonable to revise the consumer satisfaction benchmark for 2002 based on the historic experience from 1992-2000.

5. It is reasonable to revise the frequency of outages benchmark for 2002 based on the historic experience from 1991-2000.

6. The mechanism for setting a 2001 distribution revenue requirement for Edison described herein is reasonable and prevents material under- or overcollections by Edison.

7. The two-step procedure for setting a 2002 revenue requirement for Edison's distribution costs described herein produces reasonable rates and prevents material under- or overcollections by Edison.

8. The PBR updating procedure described herein should be extended into 2003, until superseded by the adoption of a GRC decision for Edison by the Commission.

9. Using the PBR procedure to set a 2003 revenue requirement for Edison's distribution costs produces reasonable rates and prevents material under- or overcollections by Edison.

10. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. We grant the Southern California Edison Company's (Edison) Expedited Petition for Modification of Decision (D.) 96-09-092 to the extent described herein, and denied in all other respects.

2. Because we have modified D.96-09-062, Edison shall take the following actions:

a. Edison shall establish a revenue requirement for the period from June 14, 2001 to December 31 including the following items:

- A base revenue requirement that equals the year 2000 historic revenues escalated by the CPI-X formula and prorated to cover only the period from June 14, 2001 to the end of 2001.
- A customer growth element that equals $657 times the number of new customers added in 2001, but prorated to cover only the period from June 14, 2001 to the end of the year.
- A reduction to reflect Edison's decrease in operations and maintenance expenditures. In particular, since Edison reduced its operations and maintenance spending by $28 million over the year 2001, we will reduce the post-June 14 revenue requirement by $15.17 million using the standard

prorating approach to reflect the expenditures avoided from June 14 to the end of the year.

b. The revenue requirement for 2002 should be calculated using the two-step procedure that follows:

- Step 1 – Calculate a 2001 "annualized revenue requirement ":

$Annualized Rev. Req.$_{2001}$=(1+($\Delta CPI_{2001}$-$X_{2001}$)) x ($ Revenues$_{2000}$) + $657 x (Number of New Customers$_{2001}$)

Where ΔCPI = change in CPI

- Step 2 – Calculate a 2002 Revenue Requirement:

$Revenue Requirement$_{2002}$=(1+($\Delta CPI_{2002}$-$X_{2002}$)) x ($Annualized Rev. Req.$_{2001}$) +$669 x (Number of \

New Customers$_{2002}$)

Where ΔCPI = change in CPI

c. The revenue requirement for 2003 should be calculated by applying the (1+(ΔCPI_{2003}-X_{2003})) factor to the 2002 revenue requirement and adding a revenue requirement adjustment to account for the number of new customers. The productivity offset factor, X_{2003}, shall remain at 1.6% and ΔCPI = change in CPI. The resulting distribution revenue requirement will remain in effect during 2003 until replaced by the regulatory program adopted by the Commission in Edison's General Rate Case proceeding.

3. Edison shall convert the memorandum account created pursuant to D.01-06-038 into a balancing account. The account should operate pursuant to the terms adopted herein.

4. Edison is authorized to establish by advice letter filing the Electric Distribution Revenue Adjustment Balancing Account applicable to service on or after June 14, 2001 as described in its testimony and as modified by the adopted Operations and Maintenance adjustment of $15.17 million for 2001 and as updated by more recent data consistent with this decision.

5. Edison shall file a new or amended advice letter no later than 15 days following the effective date of this decision consistent with the provisions of this decision. In particular, the tariffs should implement the changes in worker safety, customer satisfaction and outage frequency programs adopted in this decision. Those tariff changes shall be subject to confirmation by the Energy Division and shall be effective 30 days after filing unless the Energy Division believes modifications to Edison's proposed tariffs are necessary and so notifies Edison within the review period. Edison and the Energy Division shall attempt to resolve any differences to make the revised tariffs effective within the 45-day period following Edison's advice letter filing. If such differences cannot be resolved, the Commission will issue a resolution to ensure the terms of SCE's tariff comply with this decision. If needed, a similar procedure should be followed at the end of 2002 to set a revenue requirement for 2003 and to update the incentive programs consistent with the averaging procedures adopted in this decision.

6. This proceeding is closed.

This order is effective today.

Dated April 22, 2002, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners

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Appendix A

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