Decision 08-05-035 May 29, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U338E) for Authorized Cost of Capital for Utility Operations for 2008.	Application 07-05-003 (Filed May 8, 2007)
And Related Matters.	Application 07-05-007 Application 07-05-008

(See Decision 07-12-049 for List of Appearances.)

DECISION ESTABLISHING A MULTI-YEAR COST OF CAPITAL MECHANISM FOR THE MAJOR ENERGY UTILITIES

1. Summary

This decision establishes a uniform multi-year cost of capital mechanism (CCM) for Southern California Edison Company (SCE), San Diego Gas & Electric Company (SDG&E) and Pacific Gas and Electric Company (PG&E). SCE, SDG&E, and PG&E's next full cost of capital application is to be filed on April 20, 2010 for a test year 2011 returns on equity (ROE). Those first complete filings under the CCM shall also address the parties' experience with the CCM and whether modifications to the mechanism are warranted. Details of the CCM are set forth in Section 5.6 and examples of how the CCM would work are attached in Appendix A.

2. Background

Major energy utilities' capital structures and ROE were traditionally addressed in their respective general rate case (GRC) applications.[1] However, with the complexity of processing those GRC applications and the Commission's desire to ease a burden of issuing year-end decisions, a rulemaking proceeding, Rulemaking (R.) 87-11-012), was issued on November 13, 1987, to consider changes to the GRC process. That rulemaking resulted in transferring our review of major energy utilities' capital structure and ROE to annual cost of capital applications from GRC applications, effective January 1, 1990.[2]

In 1996, SDG&E was relieved of its obligation to file annual cost of capital applications upon adoption of a Market Indexed Capital Adjustment Mechanism (MICAM).[3] Since that date, SDG&E's MICAM has undergone several modifications, the most recent of which occurred in 2005.[4] SDG&E is currently required to file a complete cost of capital application every five years. However, if the difference between the current six-month average Aa bond rate and SDG&E's benchmark exceeds an off-ramp[5] of 260-basis points, SDG&E must file a complete cost of capital application in May following that off-ramp event.

While SCE and PG&E are required to file annual cost of capital applications, they have, on occasion, requested waivers from filing their annual cost of capital applications. Waivers were granted for their test years 2004 and

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[1] SCE, SDG&E, and PG&E were included in the major energy utilities category.

[2] 30 CPUC2d 576 at 594 (1989).

[3] 66 CPUC2d 568 at 573 (1996).

[4] D.05-03-023.

[5] Off-ramp is a trigger event that suspends the MICAM.

2007 upon a demonstration that financial conditions and associated risks likely to influence their ROEs have not materially changed from their prior year's authorized ROEs.[6]

SCE, SDG&E, and PG&E filed individual test year 2008 return on equity applications on May 8, 2007. These applications were consolidated into one proceeding at a June 14, 2007 Prehearing Conference (PHC). At that time, this consolidated proceeding was bifurcated. The first phase, addressing test year 2008 returns on equity, was resolved by D.07-12-049 on December 20, 2007. The second phase of the consolidated proceeding is being resolved by this decision.

3. Issue

The issue in this second phase of the consolidated ROE proceeding was to address cost of capital mechanisms that could replace annual cost of capital applications. This issue was raised to determine whether a mechanism could be adopted to maintain fair and reasonable capital structures and ROEs for the major energy utilities while reducing ROE proceedings and simplifying workload requirements and regulatory costs.

An evidentiary hearing on Phase II was held on January 29, 2008 and submitted upon receipt of reply briefs on February 21, 2008.

Although SCE and joint intervenors Aglet Consumer Alliance, The Utility Reform Network and Utility Consumers' Action Network, collectively referred to as ATU, preferred to continue with annual cost of capital applications, they acquiesced that a CCM could be adopted. Variations of a CCM that could defer filing of complete cost of capital applications for a period of two to five years

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[6] See, for example, D.03-08-063 and D.06-08-026.

were recommended by SCE, SDG&E, PG&E, ATU, and the Division of Ratepayer Advocates (DRA). However, SDG&E recommended that it be authorized to continue with its current MICAM mechanism.

4. SDG&E's MICAM

SDG&E testified that its MICAM has met its original objectives in a cost effective manner and has proven to be a mechanism that is simple, utilizes readily available historical data, does not produce frequent or abrupt changes, and provides timely, transparent ratemaking information for numerous stakeholders. That is because it not only contains an automatic safeguard in the form of an off-ramp provision that protects against extreme changes in interest rates, but it also gives the Commission latitude to suspend the entire mechanism and invite SDG&E to participate in a full cost of capital proceeding at any time within a regular five-year period.

Under the MICAM, SDG&E's ROE increases, decreases, or remains unchanged depending on movements in utility bond yields. Each September, SDG&E compares the March through August average of Mergent's Aa utility bond yield to a benchmark. The benchmark represents, depending on recent events, either (a) the March through August Aa bond yield average of the year SDG&E last participated in a cost of capital proceeding, or (b) the March through August Aa bond yield average of the year that a MICAM trigger event occurred. In any year in which the difference between the current six-month average and the benchmark exceeds 100-basis points, SDG&E's ROE is automatically adjusted as follows:

1. ROE is adjusted by one-half of the difference between the Aa utility bond average and the benchmark.
2. Long-term debt and preferred stock costs are updated to reflect actual August month-end embedded costs in that year.

3. There is no adjustment to the authorized capital structure.
4. On September 15 of such year, an advice letter is filed that updates the ROE and related rate adjustments to become effective on January 1 of the following year.
5. Any year that the six-month average triggers an automatic adjustment, that average becomes the new benchmark.

Irrespective of its requirement to participate in a full ROE proceeding once every five years, it actively participated in each of the last four annual cost of capital proceedings, test years 2003, 2005, 2006 and 2008.[7] It is not known whether SDG&E would have participated in test year 2004 and 2007 ROE proceedings because those proceedings were waived pursuant to the major energy utilities showing that risk had not materially changed in those test years. However, SDG&E also requested a waiver of a test year 2007 ROE filing.[8]

Although SDG&E sought to continue with its current MICAM, it acquiesced in its opening brief that if the Commission determines it necessary to adopt a single, standardized approach, that its MICAM should be the approach adopted and have a duration period of not less than three years.[9] A comparison of SDG&E's MICAM to the proposals of SCE, PG&E, ATU, and DRA show that the proposals are generally comparable to each other.

We find it appropriate to establish a uniform CCM for SCE, PG&E, and SDG&E that balances the interests of SCE, SDG&E and PG&E's shareholders and ratepayers while simplifying and reducing ROE proceedings, workload requirements, and regulatory costs.

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[7] See D.02-11-027, D.04-12-047, D.05-12-043, and D.07-12-049.

[8] See D.06-10-031.

[9] SDG&E Opening Brief, p. 7.

5. Cost of Capital Mechanism

Differences in the CCM proposals of SCE, SDG&E, PG&E, ATU, and DRA occurred in (1) duration, (2) capital structure, (3) debt and preferred stock, (4) dead band, and (5) adjustment ratio as addressed below.

5.1. Duration

Except for PG&E, the parties recommended that a CCM should be effective for a two to three year period prior to requiring the utilities to file complete cost of capital applications. PG&E proposed a five-year period based on experience with SDG&E's MICAM, in place since 1988, and its similarity in design to PG&E's proposal.[10]

DRA recommended a two-year cycle. However, that limited duration would not enable us to gather meaningful results or experience with the mechanism. PG&E's proposal, similar to SDG&E's MICAM that has been in existence for approximately 10 years, could provide us with meaningful results and experience. However, recent experience has shown that SDG&E's MICAM may not be working as designed because SDG&E opted to participate in the last four annual cost of capital proceedings as an active party to litigate its authorized cost of capital. Absent meaningful long-term experience it would behoove us to proceed with caution and gain results and experience with a shorter-term mechanism prior to adopting a longer-term mechanism.

We opt for a three-year cycle. Consistent with a majority of the parties, complete cost of capital applications should be required for every third test year. Consistent with DRA and SCE's proposal for an earlier filing date for full cost of

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[10] Exhibit 70, p. 6.

capital applications and given a two year hiatus from required cost of capital applications, the current May 8 filing date should be moved back to April 20. The utilities should file their first complete cost of capital applications for test year 2011 on April 20, 2010.[11] That first complete filing under the CCM should address the parties' experience with the CCM and whether modifications to the mechanism are warranted.

5.2. Capital Structure

SCE was the only party seeking capital flexibility in the CCM. It proposed to accomplish automatic capital structure flexibility through the use of an actual ratemaking equity ratio, calculated as a 13-month average, which could vary by up to three percentage points in either direction of its authorized equity ratio. It would also be accomplished through the filing of one application between the utility's full cost of capital applications for authority to adjust its capital structure for changes in factors, such as debt equivalence, that may impact utility credit ratings.

ATU opposed any capital structure flexibility in the CCM on the basis that changes to the capital structure should be considered in cost of capital proceedings, where all factors that determine a utility's overall costs of capital are considered.

Capital structure is but one component of determining a fair and reasonable ROE. We addressed the reasonableness of the utilities capital structures in the first phase of this proceeding and balanced the impact of debt equivalence and other factors that impact utility credit ratings in both the

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[11] To the extent that April 20th occurs on a Saturday, Sunday or holiday, the filing date shall be on the first business day after April 20th.

adopted capital structures and ROEs. There was no evidence on how this automatic capital structure adjustment would impact ratepayers. Further, capital structure and ROE cannot, and should not, be assessed independently.

Authorized capital structures should continue to be recalibrated in full cost of capital proceedings. However, while there will be a three-year interval between full cost of capital applications, we recognize that changes in credit ratings may require an adjustment to the utilities' capital structure within that time period. Hence, a provision should be included in the CCM for utilities to file a capital structure adjustment application that addresses ratepayer impacts within that time period.

ATU sought to require PG&E to file an application for review of its capital structure for the calendar year following the year in which it reaches an A level credit rating. Shortly after the issuance of a decision on the first phase of this proceeding PG&E attained that level of credit rating.[12] With that credit rating upgrade, Moody's noted the possibility of a future downgrade if the current trend on increased regulatory support were reversed, and the utility's ratio of cash flow to total debt fell below 22% or the ratio of the utility's cash flow to total interest fell below 4.5 times on a sustainable basis.[13] With PG&E only just attaining an A credit rating, Moody's subsequent downgrading discussion, and lack of history under an A credit rating, there is no basis for requiring PG&E to file an application for review of its capital structure at this time. Consistent with our prior capital structure adjustment discussion, any change to authorized

[12] On December 27, 2007, Moody's upgraded PG&E's credit rating from Baa1 to A3.

[13] Exhibit 70, p. 10.

capital structure should be addressed in PG&E's next full ROE proceeding scheduled for April 20, 2010.

5.3. Long-Term Debt and Preferred Stock

The utilities recommended adjustments to long-term debt and preferred stock costs. SDG&E sought to include an adjustment to long-term debt only if the tax exempt status for its industrial development bonds (IDB) were questioned by the Internal Revenue Service and SDG&E was required to effectively retire or refinance its low interest IDB bonds.[14]

SDG&E's concern on a potential loss of tax exempt bond status is premature. Any such refinancing should trigger an application pursuant to Public Utilities Code Section 818, to approve the issuance of new debt. Because a loss of IDB tax exempt status of issued and outstanding bonds may disproportionally impact SDG&E's common equity risk, SDG&E should address that impact as part of its application for authority to replace its IDB bonds.

SCE recommended that the embedded cost of debt and preferred equity be revised when the deadband is triggered as discussed below. Upon a trigger event the embedded cost of debt and preferred equity would be revised to reflect the latest available information and forecasted interest rates for the following year. We concur and will use August month-end data for the embedded measurement and forecasted interest rates for embedded variable debt and new debt issuance scheduled to be issued in the next year.

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[14] IDB are tax exempt bonds applicable to a two-county entity issued at a 100 to 130-basis point discount from traditional bonds, as discussed in reporter's Transcript Vol. 7, p. 859.

PG&E proposed to annually update long-term debt and preferred stock costs to the most recent recorded costs in September of each year. The update would be independent of a deadband adjustment mechanism applicable to ROE described in the following deadband discussion. PG&E proposed this annual update on the basis that the costs of debt and preferred stock are readily ascertainable from recorded costs.

In a full cost of capital proceeding, such as the first phase of this proceeding, adopted long-term debt and preferred stock costs are based on historical and forecasted interest rates. Historical rates are used for long-term debt and preferred stock actually issued. Changes in long-term debt and preferred stock costs result from new issuances and a change in the interest rate on variable long-term debt. Forecasted rates are applied to those new and variable rate issuances based on Global Insight forecasts that are updated just prior to issuance of a proposed decision. For the short-term interval where utilities are exempt from filing full cost of capital applications, the overall long-term debt and preferred stock costs should not materially change. Non-material changes in costs should not warrant a change in a utility's overall return on rate base. To the extent that it does materially change, a CCM deadband would be applicable as addressed in the following discussion. If we had adopted a longer interval between the times utilities are required to file full cost of capital applications, a procedure would have been appropriate for updating costs as well as reflecting a proportionate change in the ROE.

5.4. Deadband

A deadband is a range of change in interest rates than may occur without automatically triggering a change in embedded long-term debt and preferred stock costs and ROEs. The size of a deadband affects the rate at which an adjustment mechanism is activated. A deadband that is overly sensitive to interest rates cause needless volatility in revenues and rates. Conversely, a deadband that never triggers can impose unnecessary costs on shareholders or ratepayers, depending on which direction interest rates move.

PG&E proposed a 75-basis point deadband. Based on its proposed April through September average six-month interest rate measurement period the deadband would have triggered about half of the years between 1998 and 2006, four of which would have resulted in a reduction and one an increase in its authorized ROE. Those same results would have occurred under an 85-basis point deadband. Under a 100-basis point deadband it would have triggered twice, once to reduce and once to increase its authorized ROE.

SDG&E recommended that the 100-basis point deadband being used for its MICAM since 1998 continue to be used for a CCM deadband. That deadband, based on a March through August average six-month interest rate measurement, triggered only once during that 10-year period. ATU also proposed a 100-basis point deadband. However, it recommended a 12-month average measurement period ending September and clarified under examination that it considered a substantial change in interest rates to be in the 75 to 100-basis point range.[15] SCE also recommended a 100-basis point deadband with a 12-month average measurement period ending September. Under SCE's proposed features, including a 12-month measurement period, the deadband would have triggered five times between a 1986 and 2006, a 20-year period.[16]

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[15] Reporter's Transcript Vol. 7, p. 732.

[16] Exhibit 4, p. 46.

A deadband needs to strike a reasonable balance between triggering too often and not triggering often enough. The 75-basis point trigger under PG&E's six-month average measurement scenario would trigger too often and the 100-basis point trigger under SDG&E's average six-month scenario would not trigger often enough. However, a 100-basis point deadband under a 12-month average measurement period as proposed by SCE mitigates volatility of interest rates. Therefore, a 100-basis point deadband is adopted, having a 12-month ended September average measurement period. A rolling average index is not adopted.

Having resolved a deadband and measurement period we need to address the appropriate deadband index and data source.

5.4.1. Index

Two indices were proposed by the parties, 10-year Treasuries and Moody's utility bonds. ATU proposed 10-year Treasuries on the basis that Treasuries measure the general state of interest rates in the U.S. economy, do not reflect utility-specific business risks, and are used in conventional financial models such as the Capital Asset Pricing Model. PG&E proposed utility bonds on the basis of a Commission history of relying on utility bond rates to reflect current interest rates in arriving at a reasonable level of ROE and as a benchmark interest rate for the previously adopted performance-based ratemaking mechanism (PBR) for SCE and MICAM for SDG&E.

The purpose of an interest rate benchmark is to gauge changes in interest rates that also indicate changes in the equity costs of utilities. U.S. Treasuries are more sensitive to economic changes and risks in the international capital markets than utility bonds because they are bought and sold globally.[17] However, U.S. utility bonds are generally affected less than Treasuries as a result of major shifts of international capital because a majority of U.S. utility bonds are traded within the U.S.[18]

Consistent with our use of utility bond interest rates in ROE, PBR, and MICAM proceedings and desire to use an index that more likely correlates and moves with utility industry risk, utility bonds should be adopted for the CCM index. In this regard, the Moody's Aa utility bond index rates should be used for those utilities having an AA credit rating or higher and Moody's Baa utility bond interest rates for utilities having a BBB credit rating or lower. The initial Moody's AA benchmark is 5.87% and Baa benchmark is 6.26%.

5.4.2. Data Source

Historical Moody's monthly utility bond interest rate averages are available through subscription services from Moody's and Bloomberg. The same historical Moody's bond interest rates are available from Mergent Bond Record at no cost at some public libraries. To the extent that interested parties may not be able to access historical Moody's monthly utility bond interest rate averages from their local libraries or from Moody's and Bloomberg without paying a fee, the utilities shall make available and provide those monthly averages to DRA and interested parties upon request at no cost.

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[17] Exhibit 70, p. 5.

[18] *Id*.

5.5. Adjustment Ratio

An equity adjustment ratio is a percentage that is based on interest rate changes. That percentage is automatically applied to the utilities' authorized ROE in the same direction as the interest rate changes.

SCE proposed a 70% equity adjustment ratio, 20 percentage points higher than the 50% ratio that was authorized for its PBR. It proposed a 70% ratio on the basis that it is a closer match to a one-for-one sensitivity of equity returns to sustained long-run movements in interest rates, all else equal. Also, it is just above the one-half to two-thirds range normally used to adjust authorized ROEs in response to updated interest rate projections.

A majority of the parties, SDG&E, PG&E, and ATU recommended a 50% equity adjustment. Those recommendations were based on a consistent practice of only adjusting ROEs by one-half to two-thirds of the change in updated interest rate projections.

All of the parties that recommended an adjustment ratio used the same basis of one-half to two-thirds range normally used to adjust authorized ROEs in response to updated interest rate projections, in arriving at their respective adjustment ratio. As testified to by SDG&E, a 100-basis point change in bond rates correlated to changes in equity.[19] Hence, a major change in bond rates impacts equity investments. An adjustment ratio should be set at a point where a utility's debt cost and equity investment becomes volatile. Minor changes in debt cost and equity investment should not warrant any adjustment. Consistent with the majority consensus and goal of balancing shareholder and ratepayer

[19] Reporter's Transcript Vol. 7, p. 838.

interests, a 50% adjustment ratio should be adopted. This adjustment ratio should be applicable only when the 100-basis point deadband is exceeded and applied to the total basis point difference between the old interest rate benchmark and new interest rate benchmark.[20]

5.6. Summary

A uniform CCM shall be adopted for SCE, SDG&E, and PG&E. The CCM shall be based on:

a. A full cost of capital application due April 20 of every third year for the following test year.

b. Capital structure is the most recently adopted.

c. Long-term debt and preferred stock cost is the most recently adopted.

d. Deadband is equal to 100-basis points.

e. Index is Moody's Aa utility bonds for AA credit-rated utilities or higher and Moody's Baa utility bonds for BBB credit-rated utilities or lower.

f. Adjustment ratio is 50%.

In any year where the difference between the current 12-month October through September average Moody's utility bond rates and the benchmark exceeds a 100-basis point trigger, an automatic adjustment to the utilities' returns on equity (ROE) shall be made by an October 15 advice letter to become effective on January 1 of the next year as follows:

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[20] An application of the equity adjustment rate on only the basis points that exceeded a 100-basis point deadband would not reasonably reflect the volatility impact of interest rate changes on an equity investment. Such an application would also reverse the Commission's long-standing practice of changing authorized ROEs by one-half to two-thirds of the change in interest rates.

a. ROE is adjusted by one-half of the difference between the Aa utility bond average for AA credit-rated utilities or higher and Baa utility bond average for BBB credit-rated utilities or lower and the benchmark.

b. Long-term debt and preferred stock costs are updated to reflect actual August month-end embedded costs in that year and forecasted interest rates for variable long-term debt and new long-term debt and preferred stock scheduled to be issued.

c. The 12-month October through September average that triggered an ROE adjustment becomes the new benchmark.

This CCM streamlines the major energy utilities' cost of capital process while providing greater predictability of the utilities' cost of capital by eliminating the use of interest rate forecasts and disputes concerning interest rate levels and trends, as well as uncertainties associated with conflicting perceptions of financial markets and the return requirements of investors. The CCM also enables the utilities, interested parties, and Commission staff to reduce and reallocate their respective workload requirements for litigating annual cost of capital proceedings.

While streamlining the cost of capital process, the utilities have a right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and affects them differently than the overall financial markets.

6. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on May 19, 2008, and reply comments were filed on

May 27, 2008. To the extent changes were necessary due to comments and reply comments, those changes were incorporated into the body of this decision.

7. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Michael J. Galvin is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. The average AA utility Moody's rate at month-end from October 2006 to September 2007 is 5.87% and Baa utility rate is 6.20%.

2. The capital structures and ROEs of major energy utilities were traditionally addressed in GRC applications.

3. Review of SCE, SDG&E, and PG&E's capital structures and ROEs was transferred from GRC applications to annual cost of capital applications effective in 1990.

4. SDG&E was relieved of its obligation to file annual cost of capital applications upon adoption of a MICAM in 1996.

5. SDG&E participated in the last four annual cost of capital proceedings as an active party to litigate its authorized cost of capital.

6. SDG&E is currently required to file a complete cost of capital application every five years.

7. SCE and PG&E are required to file annual cost of capital applications.

8. SDG&E actively participated in each of the last four annual costs of capital proceedings and, upon its request, received a waiver from filing a test year 2007 filing.

9. Capital structure is but one component of determining a fair and reasonable ROE.

10. SDG&E sought to include an adjustment to long-term debt only if it was required by the IRS to retire or refinance its low interest IDB bonds.

11. Long-term debt and preferred stock costs were addressed in the first phase of this proceeding.

12. Under the CCM that we adopt in this decision, a range of change in interest rates that may occur without automatically triggering a change in embedded long-term debt and preferred stock costs and ROEs.

13. The size of a deadband affects the frequency at which an adjustment mechanism is activated.

14. A 75-basis point deadband under PG&E's proposal would have been triggered about half of the years between 1998 and 2006.

15. A 100-basis point deadband under SDG&E's proposal triggered only once during the past 10 years.

16. The purpose of an interest rate benchmark is to gauge changes in interest rates that also indicate changes in the equity costs of utilities.

17. Moody's monthly utility bond interest rate averages are available through subscription services from Moody's and Bloomberg.

18. Moody's monthly utility bond interest rate averages are available from the Mergent Bond Record at no cost from some of the public libraries.

19. An adjustment ratio is the percentage of the change in interest rates that should be reflected in the return on equity.

20. A one-half to two-thirds range is normally used by this Commission to adjust authorized ROEs in response to updated interest rate projections.

Conclusions of Law

1. Absent meaningful long-term experience it would behoove us to proceed with caution and gain results and experience with a shorter-term mechanism prior to adopting a longer-term mechanism.

2. Consistent with a majority consensus, complete cost of capital applications should be required every third test year.

3. The current May 8 filing date for cost of capital applications should be moved back to April 20.

4. Capital structure and ROE should not be addressed independently.

5. A loss of IDB tax exempt status for issued and outstanding bonds could trigger an application pursuant to Section 818 and may disproportionally impact SDG&E's common equity risk.

6. The utilities have a right to file a cost of capital application outside of the CCM process upon an extraordinary or catastrophic event that materially impacts their respective cost of capital and/or capital structure and impacts them differently than the overall financial markets.

7. A deadband needs to strike a reasonable balance between triggering too often and not triggering often enough.

8. A 100-basis point deadband was adopted for SDG&E's MICAM on a basis that the deadband would not be too volatile.

9. A 100-basis point deadband should be adopted having a 12-month ended September measurement period to mitigate any seasonal impact of interest rate changes.

10. Consistent with our use of utility bond interest rates in ROE, PBR, and MICAM proceedings and desire to use an index that more likely correlates and

moves with utility industry risk, utility bonds should be adopted for the CCM index.

11. Moody's Aa utility bond interest rates should be used for those utilities having an AA credit rating or higher, Moody's A utility bond interest rates should be used for those utilities having an A credit rating, and Moody's Baa utility bond interest rates for utilities having a BBB credit rating or lower.

12. The initial Moody's AA benchmark is 5.87% and Baa benchmark is 6.21%.

13. The utilities should make available and provide Moody's Bond interest rate averages to parties reviewing CCM filings upon request and at no cost.

14. A 50% equity adjustment ratio should be adopted and applied only when the 100-basis point deadband is exceeded to compensate for major changes in interest rates that impact equity investments.

15. The 50% equity adjustment should be applicable to the entire difference between the old benchmark and new benchmark to mitigate the volatility impact of interest rates on equity investments.

O R D E R

IT IS ORDERED that:

1. A uniform cost of capital mechanism (CCM) is adopted for Southern California Edison Company (SCE), San Diego Gas & Electric Company (SDG&E), and Pacific Gas and Electric Company (PG&E). The first full cost of capital application shall be due on April 20, 2010 for test year 2011 returns on equity (ROE). That first complete filing under the CCM should address the parties' experience with the CCM and whether modifications to the mechanism are warranted. The CCM shall be based on:

   a. A full cost of capital application due on April 20 of every third for the following test year.

b. Capital structure is the most recently adopted.
c. Long-term debt and preferred stock cost is the most recently adopted.
d. Deadband is equal to 100-basis points.
e. Index is Moody's Aa utility bonds for AA credit-rated utilities or higher and Moody's Baa utility bonds for BB credit-rated utilities or lower.
f. Data source is Moody's or Mergent Bond Record.
g. Measurement period is the average 12-month October through September period.
h. Adjustment ratio is 50%.

2. In any year where the difference between the current 12-month October through September average Moody's utility bond rates and the benchmark exceeds a trigger of 100-basis points, an automatic adjustment to the utilities' ROE shall be made as follows:

a. ROE is adjusted by one-half of the difference between the Aa utility bond average for AA credit-rated utilities or higher and Baa utility bond average for BBB credit-rated utilities or lower and the benchmark.
b. Long-term debt and preferred stock costs are updated to reflect actual August month-end embedded costs in that year and forecasted interest rates for variable long-term debt and new long-term debt and preferred stock scheduled to be issued.
c. Authorized capital structure is not adjusted.
d. On October 15 of such year, a Tier 2 advice letter is filed that updates the ROE and related rate adjustments to become effective on January 1 of the following year.
e. In any year where the 12-month October through September average Moody's utility bond rates triggers an automatic ROE adjustment, that average becomes the new benchmark.
f. Workpapers outlining the calculations required as set forth in Ordering Paragraphs 2(a), 2(b), and 2(e) shall be submitted with

the advice letter to the Energy Division and active parties to this proceeding, and shall be made available to any party upon request.

3. This consolidated proceeding remains open to address a violation of Rule 13.1 of the Commission's Rules of Practice and Procedure.

This order is effective today.

Dated May 29, 2008, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners

APPENDIX A

COST OF CAPITAL MECHANISM
IMPACT BASED ON THREE SCENARIOS

BASE CAPITAL STRUCTURE OF AN Aa Utility

	Ratio	Cost	Weighted Cost
Long-Term Debt	43.00%	6.40%	2.75%
Preferred Stock	9.00%	6.10%	.55%
Common Equity	48.00%	11.50%	5.52%
Return on Rate Base			**8.82%**

BASIC ASSUMPTIONS

1. A planned long term debt issuance at month-end August of the second year would not change the capital structure but would reduce the August 6.40% embedded rate to 6.30%.
2. No change in preferred stock ratio or cost.
3. No change in common equity ratio.
4. Initial benchmark interest rate of Moody's Aa utility bonds was 6.50%
5. Trigger is 100-basis points between the benchmark interest rate and twelve-month actual October through September Moody's Aa utility bond rate.

SCENARIO #1

Assumption: New actual October through September Moody's average Aa utility bonds was 6.80%.

Result:

1. Difference between the new benchmark (6.80%) and the initial benchmark (6.50%) is only 30-basis points. This is less than the trigger of 100-basis points.
2. Therefore, there is **no change**.
   a. Long-term debt remains 6.40% for purpose of calculating a return on rate base.
   b. No change in preferred stock rate of 6.10%.
   c. No change in common equity return of 11.50%.
   d. Authorized return on rate base remains 8.82%.

SCENARIO #2

Assumption: New actual October through September average Moody's Aa utility bonds was 5.00%.

Results:

1. Difference between the 6.50% initial benchmark and 5.00% average 12-month Moody's Aa utility bonds new benchmark was 150-basis points, or 50-basis points higher than the 100-basis point deadband, triggers an adjustment.
2. Long-term debt cost is adjusted to 6.30% from 6.40%.
3. No change to preferred stock ratio or cost.
4. A downward 75-basis point change (half of the 100-basis point deadband and half of the 50-basis points that exceeded the 100-basis point deadband) in the 11.50% cost of common equity.
5. New authorized return on common equity is 10.50%.
6. New authorized rate of return on rate base is 8.30%.
7. New Benchmark is 5.00%.

Trigger Impact: The overall authorized return on rate base would **decrease** 52-basis points to 8.30% from 8.82% as shown below.

	Ratio	Cost	Cost
Long-Term Debt	43.00%	6.30%	2.71%
Preferred Stock	9.00%	6.10%	.55%
Common Equity	48.00%	10.50%	5.04%
Return on Rate Base			**8.30%**

SCENARIO #3

Assumption – New actual October through September average Moody's Aa utility bonds was 8.00%.

Results –

1. Difference between the 6.50% initial benchmark and 8.00% average twelve-month Moody's Aa utility bonds new benchmark was 150-basis points, or 50-basis points higher than the 100-basis point deadband, triggers an adjustment.
2. Long term debt cost is adjusted to 6.30% from 6.40%.
3. No change to preferred stock ratio or cost.
4. A upward 75-basis point change (half of the 100-basis point deadband and half of the 50-basis points that exceeded the 100-basis point deadband) in the 11.50% cost of common equity.
5. New authorized return on common equity is 12.25%.
6. New authorized rate of return on rate base is 9.14%.
7. New benchmark is 8.00%

Trigger Impact: The overall authorized return on rate base would **increase** 32-basis points to 9.14% from 8.82% as shown below.

	Ratio	Cost	Cost
Long Term Debt	43.00%	6.30%	2.71%
Preferred Stock	9.00%	6.10%	.55%
Common Equity	48.00%	12.25%	5.88%
Return on Rate Base			**9.14%**

(END OF APPENDIX A)