ALJ/WRS,LTC/tcg

Decision 87 12 064 DEC 22 1987 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company (U904G) to Implement its Attrition Allowance and to Establish a Return on Equity for 1988.	Application 87-07-048 (Filed July 31, 1987)

(See companion decision in A.87-07-050 et al. for appearances.)

OPINION

I. Background

On July 31, 1987 Southern California Gas Company (SoCal Gas) filed this application requesting authority to decrease its rates for natural gas service by $74,000 annually beginning January 1, 1988, pursuant to the Rate Case Plan previously adopted by the Commission. D.87-05-027 authorizes SoCal Gas to file a general rate case for Test Year (TY) 1990, instead of TY 1988, and to file Attrition Rate Adjustment (ARA or attrition) applications for 1988 and 1989. D.85-12-076 provides specific guidelines for attrition filings and requires a review of return on common equity for each utility filing an ARA advice letter. The Commission has required the filing of applications for financial attrition in order to allow for a full airing of any factual disputes that may arise in connection with this review. This application complies with those guidelines, as augmented for SoCal Gas' 1988 and 1989 attrition reviews by the Commission's directives in D.87-05-027 that:

a. The special ratemaking procedure applicable to Hazardous Waste Costs/Manufactured Gas Plant Sites set forth in Pacific Gas and Electric Company's 1987 general rate case decision, D.86-12-095, shall be applicable for SoCal Gas' Toxic Waste Cleanup Program.

b. SoCal Gas' authorized return on equity for 1988 and 1989 shall be reviewed and established annually.

c. Rate base estimates used to calculate the 1988 and 1989 attrition allowance shall be based on $325 million of additional gross capital expenditures during calendar years 1988 and 1989. The revenue requirement attributable to any shortfall in such authorized investment shall be refunded to SoCal Gas' customers.

d. A one-time downward productivity adjustment equal to 2% of adopted labor costs shall be made in the attrition adjustment to be effective January 1, 1988.

e. The cost of gas inventory stored underground shall be removed from rate base effective January 1, 1988.

f. To the extent the amortization period associated with certain abandoned gas supply projects terminates in either 1988 or 1989, necessary adjustments will be made during those years to prevent over-recovery of the costs associated with the relevant gas supply projects.

The annual return on equity review may be accomplished informally through settlement between SoCal Gas, Division of Ratepayer Advocates (DRA) and other interested parties or through evidentiary hearings. This annual review may be consolidated with similar annual reviews ordered by the Commission for other energy utilities.

DRA filed a motion dated August 21, 1987 requesting that attrition filings of several energy utilities be consolidated for the purposes of the return on equity review. A prehearing conference was properly noticed and held before ALJs Stalder and Carew on September 8, 1987, for this application and the following other 1988 attrition applications:

Application 87-08-025, Southwest Gas Corporation

Application 87-08-006, Pacific Gas and Electric Company

Application 87-07-050, San Diego Gas and Electric Company

At the PHC, the ALJs heard argument on DRA's Motion to Consolidate from all parties, including Sierra Pacific Power Company, which appeared voluntarily at the PHC, despite the fact that its attrition application had not yet been accepted for filing. Thereafter, these matters were consolidated for purposes of hearing the rate of return reviews (PHC Tr. 18). By ALJ Ruling dated October 9, 1987, A.87-09-013 of Sierra Pacific Power Company was also consolidated with these matters. Hearings on the consolidated rate of return reviews were held October 21 through 27 before ALJ Carew in San Francisco. This decision disposes of all issues raised by SoCal Gas' attrition application, including rate of return. The other consolidated rate of return reviews are addressed in a separate decision.

II. Undisputed Issues

Regarding issues other than return on equity in this application, DRA reviewed the SoCal Gas filing and found an error which, when corrected, resulted in an additional revenue requirement reduction of $361,000, for a total requested 1988 attrition year revenue requirement reduction of $435,000, premised on SoCal Gas' requested rate of return. SoCal Gas agreed that the filing was in error and submitted revised Tables 1 and 2 and Schedule A with cover letter dated September 14, 1987, to correct the error.

Staff Counsel Rood sent a letter dated September 25, 1987 to ALJs Carew and Stalder and to all parties indicating that DRA had reviewed the application, found the error, and recommended that no hearings were necessary. No party requested hearing, or responded to the letter. Therefore, no hearings were held on issues other than return on equity.

The following table itemizes the components of the attrition year 1988 adjustments which are undisputed,[1] albeit based on SoCal Gas' requested rate of return:

1 In both its brief and in a November 16, 1987 letter to ALJ Stalder, SoCal Gas requests permission to update its attrition filing using the November 1987 DRI forecast. This results in a requested $1.887 million revenue requirement increase in lieu of the $435,000 decrease presently before us.

SOUTHERN CALIFORNIA GAS COMPANY
ATTRITION YEAR 1988 ALLOWANCE

(DOLLARS IN THOUSANDS)

LINE NO.		1988
	ATTRITION RELATED TO O & M INFLATION	
1	LABOR	13,726
2	NONLABOR	11,753
3	SUBTOTAL	25,479
	ATTRITION RELATED TO RATE BASE INCREASES	
4	AD VALOREM TAXES	1,893
5	DEPRECIATION	11,204
6	RETURN	5,930
7	INCOME TAXES RELATED TO RETURN	4,009
8	SUBTOTAL	23,036
	ATTRITION RELATED TO CHANGES IN TAX DEDUCTIONS AND OTHER TAX EFFECTS	
9	INCOME TAXES	(3,176)
10	ADJ TO FIT BASE FOR TAX RATE CHANGE	(34,248)
11	SUBTOTAL	(37,424)
	FINANCIAL ATTRITION	
12	RETURN	(1,372)
13	INCOME TAX	(928)
14	SUBTOTAL	(2,300)
	OTHER 1988 ATTRITION ITEMS	
15	PRODUCTIVITY ADJUSTMENT	(6,970)
16	INTERVENOR FUNDING	25
17	SUBTOTAL	(6,945)
18	TOTAL BEFORE F & U	1,846
19	F & U @ 2.2%	41
20	TOTAL INCLUDING F & U	1,887

III. Attrition Year Rate of Return

A. Procedural Background

As noted, SoCal Gas' 1988 attrition year rate of return review was heard on a consolidated record with four other related applications, from October 21-27, 1987. There were four active parties: SoCal Gas, DRA, the City of Los Angeles (Los Angeles), and the City of San Diego (San Diego).

SoCal Gas presented the testimony of two witnesses. Its president Jonel C. Hill testified on policy issues and its Vice President and Controller James D. Bailey presented an attrition year cost of capital study. DRA presented the testimony of Edwin Quan. Los Angeles presented the testimony of consulting engineer Manuel Kroman. San Diego presented no affirmative case, but participated through cross-examination of the various witnesses. Los Angeles and San Diego opted to present oral argument on October 27th, in lieu of filing briefs; SoCal Gas, DRA, and TURN filed concurrent briefs on November 5, 1987, and the matter was submitted on that date. The parties' positions are summarized in the table below, and are subsequently discussed as a prelude to our disposition of the issues.

B. Rate of Return Recommendations for Attrition Year 1988

SoCal Gas' presently authorized rate of return is depicted in the following table:

SoCal Gas (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	10.06%	4.62%
Preferred Stock	9.10	6.91	0.63
Common Equity	45.00	13.90	6.26
Total	100.00%		11.51%

This present authorization contrasts with the recommendations of the active parties for the 1988 attrition year, depicted in the following three tables:

SoCal Gas (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	13.90	6.30
Total	100.00%		11.45%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.25*	5.55
Total	100.00%		10.70%

* Midpoint of 11.75%-12.75% range.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.862%	4.527%
Preferred Stock	8.80	6.903	.607
Common Equity	45.30	12.85	5.821
Total	100.00%		10.955%

A review of these recommendations demonstrates that there is no dispute among the parties over the capital ratios to be used for the attrition year. SoCal Gas' last rate case decision did not specify a particular capital structure for use during the attrition year; thus DRA reviewed the last authorized capital structure and SoCal Gas' updated financing plans as a prelude to making its recommendation (DRA Brief, p. 4), and there is general consensus among the active parties as to the appropriateness of this result. Therefore, we will adopt the agreed-upon capital ratios for 1988.

SoCal Gas does not plan to issue new preferred stock during 1988. Based on a review process similar to that undertaken in the area of capital ratios, SoCal Gas and DRA have reached agreement on a cost figure for SoCal Gas' existing preferred stock (6.93%); Los Angeles' figure (6.903%) is very close to this agreed upon figure. Given the virtual consensus, we will adopt 6.93% for attrition year 1988.

C. Cost of Debt

SoCal Gas' long-term debt is now rated A. Both DRA's Quan and SoCal Gas' Bailey agree that it is appropriate to add 50 basis points to DRI's forecast of AA utility bonds to arrive at the forecast cost of long-term debt for new bond issues during 1988 (Exh. 14, p. 46).

It was agreed by all parties at the conclusion of evidentiary hearings, and at the request of the applicants, that the most recent DRI control forecast (November 1987) would be used to update debt costs for purposes of this decision. This forecast was furnished by PG&E's counsel to all parties by letter dated November 2, 1987. It shows a decline in the forecasted level of interest rates for 1988, to 9.68%. The comparable DRI October 1987 forecast, available to the parties during hearings, showed a 10.48% figure. Thus SoCal Gas requests adoption of a 10.18% figure (9.68 + .50), to reflect the cost of new debt issues during 1988.

(SoCal Gas Brief, p. 15.) We will adopt this figure premised on the agreement to use the November DRI update for this purpose.

In its brief, DRA updated its initial recommended 9.85% embedded debt cost figure (Exh. 14, Table 27), to 9.90% to account for the November DRI forecast. SoCal Gas calculates the same 9.90% embedded debt cost figure as a result of using the November DRI forecast (SoCal Gas November 16, 1987 letter to ALJ Stalder, Table 5). Los Angeles has used a slightly different figure, 9.862%, which does not reflect the November DRI control forecast. We will adopt the 9.90% figure as more reflective of current conditions.

D. Return on Equity

In this proceeding the chief contested issue is the appropriate return on common equity for 1988. The following table summarizes the positions of the parties.

Summary of ROE Recommendations

Party	ROE
SoCal Gas	13.90%
DRA	11.75%-12.75%
Los Angeles	12.85%
San Diego	12.25%-12.75%
TURN	12.00%

SoCal Gas, DRA, and Los Angeles submitted testimony showing the results of various financial models as the starting point for establishing ROE, but they cautioned that the model results are an analytical guide, whose results must be tempered by judgment. SoCal Gas presented three discounted cash flow (DCF) studies and two risk premium analyses. DRA, which relied on three financial models (DCF, risk premium, and the capital asset pricing model (CAPM)) in its review of these consolidated applications, does not recommend use of SoCal Gas specific inputs to the DCF and CAPM models. DRA favors analysis of comparable gas group data, given recent diversification efforts which raise doubts whether the stock price of SoCal Gas' parent Pacific Lighting Corporation (PLC) can be used as an accurate input to DCF and CAPM. DRA does use SoCal Gas specific data in connection with its risk premium analysis. Los Angeles made an analysis of comparable gas distribution utilities (Exh. 13, Table 24). San Diego and TURN did not present independent analyses, but made arguments in support of their recommended ranges. The following table summarizes the results of the models presented by witnesses Bailey, Quan, and Kroman.

ROE Model Results

Party	Model	ROE
SoCal Gas	DCF	13.54%-15.19%
	Risk Premium	13.35%-13.66%
DRA	DCF	11.54%-12.60%
	Risk Premium	12.72%-13.66%
	CAPM	11.61%
Los Angeles	Comparable Earnings	12.85%

Because these models are only used to establish a range for ROE, we will not repeat the detailed descriptions of each model contained in this record. Additionally, the parties have advanced arguments in support of their analyses and in criticism of the input assumptions used by other parties. These arguments are not extensively addressed in this decision, given our assessment that they do not alter the model results shown above. These models provide a reasonable range from which to choose, and we will use them as a rough guidepost in selecting SoCal Gas' 1988 ROE. Nonetheless, in the final analysis, it is the application of judgment, not the precision of these models, which is the key to our decision.

In applying this judgment, we assess the arguments presented by SoCal Gas that it faces increased business and financial risk during 1988.

The utility views elimination of SAM for the noncore market (first announced by this Commission in D.86-12-010) as the most significant of these additional risks, since the noncore market comprises over 50 percent of sales. This market includes utility electric generation (UEG) customers and other large industrial customers who have the capacity to use alternative energy sources such as fuel oil, out-of-state electric purchases and hydroelectric energy.

SoCal Gas posits that notwithstanding the Negotiated Revenue Stability Account (NRSA), or safety-net provision established by the Commission, there is very little real protection. It maintains that even with NRSA it can possibly lose up to $31 million of net income per year due to elimination of SAM for the noncore market (Exh. 1, p. 6). In short, SoCal Gas believes the merits of NRSA, as a risk minimization mechanism, are overstated. (SoCal Gas Brief, p. 7.) Further, the utility asserts that the elimination of SAM for noncore customers caused Standard & Poors to reduce its long-term debt rating from AA to A, thus further underscoring these adverse impacts.

SoCal Gas also argues that the benefits of the new regulatory framework adopted in OII 86-06-005 and OIR 86-06-006 (the "OII/OIR"), are overstated by DRA's Quan, since "SoCal Gas can only negotiate rates to noncore customers below the costs allocated to such customers." (SoCal Gas Brief, p. 8.)

SoCal Gas makes additional risk arguments based on its initial review of the ALJ's Proposed Decision in the OII/OIR, which was served on the parties the same day briefs were filed in this matter in early November. These arguments are not considered, in fairness to all other parties, given the fact that the Proposed Decision in the OII/OIR was released after hearings in this proceeding had concluded.

DRA acknowledges that risk (in terms of earnings variability) may increase as a result of the Commission's SAM-related decisions. However, it urges the Commission not to lose sight of the underlying intent of these decisions, which was to enable the utilities to respond to changes in the marketplace keyed to competition and bypass concerns. The Commission recognized, according to DRA, that in such an environment, SAM operates to both reduce the utilities' incentive to compete and to penalize them when they compete successfully.

Further, in eliminating SAM, the Commission acted very carefully, opting for a two-year transitional period, and retaining the mechanism for core customers. The purpose of this policy, according to DRA, was to encourage the utility to make sales to noncore customers and to purchase gas at marketable prices. At the same time the Commission adopted the NRSA during the two-year transitional period as a "...floor to limit losses so that they cannot grow to disastrous proportions due to wholly unforeseen circumstances." (D.87-05-046, mimeo., p. 14.)

In short, DRA believes SoCal Gas has painted an overly bleak picture of the impacts of the Commission's actions, which were designed to instill confidence, rather than produce uncertainty in the marketplace.

Finally, DRA points to Exhibit 10, PG&E's 1987 second quarter letter to shareholders wherein the Chairman of the Board provides an assessment of the positive side of competition. This demonstrates, in DRA's view, that the utility applicants (presumably including SoCal Gas) often present somewhat varying views of the competition issue to shareholders and regulators.

As further evidence of the increased risks it faces during 1988, SoCal Gas cites FERC Order No. 500 as an example of what it views as the increasing trend at the federal level to shift risks from interstate pipeline companies and natural gas producers to local distribution companies. SoCal Gas views Order 500's gas inventory charge as a minimum bill in disguise. SoCal Gas also views FERC Order No. 436 as establishing a presumption favoring bypass, which is being used by proponents of the proposed Mojave interstate pipeline to further that proposal.

Finally, SoCal Gas argues that it faces increased financial risk during 1988 due to the Tax Reform Act of 1986 and the removal of gas storage inventory from rate base, which it believes will decrease its interest coverage ratios significantly (Tr., pp. 59-60).

We acknowledge that SoCal Gas may indeed be experiencing some additional risk in connection with the restructuring of the natural gas industry taking place in the gas OII/OIR, including the partial elimination of SAM, that is not entirely counterbalanced by the protective measures taken to date. Whether that increased risk requires an increase in the return on equity is another matter, however. We are in essential agreement with the observation of Los Angeles' Kroman that the SoCal Gas witnesses have presented a somewhat flawed risk analysis, which failed to differentiate between changes on <u>absolute</u> risks and changes in <u>relative</u> risks:

> "In an absolute sense, it may well be true that natural gas distributors are now facing increased risks, largely from increased competitive pressures and changing regulatory procedures. However, in a relative sense, this is no different from the arguments being made by the telecommunications and electric utilities.
>
> * * *
>
> "As for the unregulated sector, it is hardly necessary to point to the plight of the steel, automobile, oil, machine tool, computer and farm sectors, all of which are severely impacted by fiercely competitive pressures.
>
> "Thus, applicant's failure to consider its increased risk exposure in the context of increased risks being faced by virtually all segments of the economy results in an incomplete showing which falls short of providing a basis for authorizing any specific rate of return." (Exh. 12, pp. 22-23.)

However, even if we accept the notion of increased risk, and the fact that interest rates have reversed their mid-1987 downward trend, the fact remains that SoCal Gas has not requested an increased ROE for the 1988 attrition year. It simply seeks maintenance of its 1987 authorized ROE of 13.90%. DRA argues, persuasively in our view, that this implies a recognition of the reality of lower required equity allowances (DRA Brief, p. 19.)

Los Angeles also argues that, in assessing SoCal Gas' request to maintain its currently authorized 13.90% ROE, we should be mindful of the fact that that ROE determination has no precedential value for attrition year 1988, since it was not based upon record evidence and was a compromise figure negotiated between SoCal Gas and DRA. In addition, the decision adopting the 13.90% figure explicitly provided that "...none of the parties are to use the agreements in evidence in this proceeding or any other proceeding." (D.86-08-025, mimeo., p. 14.) Los Angeles further argues that any Commission authorized ROE for 1988 must reflect the reality that the cost of money has decreased 200-500 basis points since the close of hearings in A.84-02-025, SoCal Gas' 1985 test year rate case (Tr. 611: 24). Given these facts, Los Angeles' comparable earnings analysis leads it to recommend a 12.85% ROE for 1988 (Exh. 12, p. 36).

The other parties' ROE recommendations, with the exception of SoCal Gas, are below the 12.85% recommended by Los Angeles, as reflected in the preceding summary table. San Diego's recommended range is premised on its critique of SoCal's risk premium and DCF analyses (Tr. 607-609). TURN's 12% recommendation in keyed principally to the November DRI forecast, which it believes warrants a downward adjustment of 25 basis points to all DRA recommendations.

DRA's recommended range of 11.75%-12.75% is premised on the argument that current authorizations have not been fully adjusted to reflect the downward trend in interest rates since 1982

(Exh. 14, p. 52). For support, it points to the quantitative model results, and to the fact that recent returns for comparable gas utilities clearly evidence the downward trend. (Exh. 14, Table 5). It also points to Exhibit 15, an American Gas Association document provided by SoCal Gas, which indicates that for the first six months of 1987, seven gas distribution utilities' returns were reviewed and revised to new ranges of 11.7% to 13.5%, averaging 12.6%. None of the utilities listed in Exhibit 15 were authorized returns as high as the 13.90% SoCal Gas seeks to retain.

Thus, while we agree with SoCal Gas that increased risk associated with regulatory changes, specifically the restructuring of the natural gas industry, will be considered by investors to some extent, we believe this consideration is counterbalanced by the evidence that the cost of money has substantially diminished since SoCal Gas' ROE was last formally reviewed. The financial models and the economic indicators (e.g., Exh. 14, Table 1, "Trends in Interest Rates") support a reduction in SoCal Gas' authorized ROE.

After considering all the evidence of market conditions, trends, and the quantitative models presented by the parties, we believe that an ROE of 12.75% is just and reasonable for attrition year 1988. This adopted ROE produces an overall rate of return of 10.93% for the attrition year, as shown in the following table depicting the adopted cost of capital.

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.75	5.78
Total	100.00%		10.93%

We have recently concluded a lengthy investigation (I.86-06-005) into the gas industry regulatory and rate design structure. In that case we conclude that the public is best served by avoiding frequent rate changes, and thus we provide that gas rate changes which recognize several upcoming revenue requirement effects should be deferred to May 1, 1988. Today's order will effect a revenue requirement decrease, although the precise amount is unclear pending the filing of an advice letter by SoCal Gas, as ordered herein. Once this decrease is ordered and effective, however, the rates presently in effect will overcollect the authorized revenue, until changed on May 1, 1988. Therefore, the difference in the revenue requirement stemming from this decision and revenues at present rates should be placed in the consolidated balancing accounts, for disposition in accordance with our upcoming decision in I.86-06-005.

SoCal Gas was the only party to file comments. We have reviewed the comments and with the exception of allowing SoCal Gas to use the November 1987 DRI forecast to update its attrition filing, we do not believe any change to the proposed decision is warranted.

Findings of Fact

1. SoCal Gas filed an attrition adjustment application on July 31, 1987 for a rate decrease for natural gas service of $74,000 annually beginning January 1, 1988.

2. D.85-12-076 sets forth specific guidelines for attrition applications.

3. D.87-05-027 authorized SoCal Gas to file an attrition application for 1988 and 1989.

4. D.87-05-027 specified exceptions to the guidelines in D.85-12-076 for 1988 and 1989 attrition adjustments.

5. D.87-05-027 provided for SoCal Gas' return on equity to be adjusted in 1988 and 1989.

6. A duly noticed prehearing conference was held on September 8, 1987 to discuss this application and A.87-08-025, Southwest Gas Corporation; A.87-08-006, Pacific Gas and Electric Company; and A.87-07-050, San Diego Gas and Electric Company.

7. At the above prehearing conference the ALJ granted a motion to consolidate the above applications for purposes of considering return on equity issues for attrition year 1988; by ruling dated October 9, 1987, the ALJ consolidated Sierra Pacific Power Company's A.87-09-013 with these matters as well.

8. DRA discovered an error in SoCal Gas' attrition application that, when corrected, resulted in an additional reduction of $361,000 for a total requested revenue requirement reduction of $435,000, based on SoCal Gas' requested rate of return.

9. A letter from staff counsel dated September 25, 1987 was sent to the assigned ALJs and to the parties notifying them of the above error, stating that no other issues were found, and recommending no hearings be held on these operational attrition issues.

10. No party requested a hearing on operational attrition issues, and no party responded to the above letter; the financial attrition issues raised in SoCal Gas' application proceeded to hearing on a consolidated record.

11. There is no disagreement among the active parties as to SoCal Gas' appropriate capital ratios for the 1988 attrition year. The agreed-upon figures are 45.90% (long-term debt); 8.80% (preferred stock); and 45.30% (common equity).

12. SoCal Gas and DRA agree that the appropriate cost figure for SoCal Gas' preferred stock for the 1988 attrition year is 6.93%.

13. Prior to the conclusion of evidentiary hearings, the parties agreed to use the November DRI control forecast to update debt costs for purposes of this decision. The November DRI

forecast shows a decline in the forecasted level of interest rates for 1988 to 9.68%.

14. SoCal Gas and DRA agree that 50 basis points should be added to DRI's forecast of AA utility bonds, given SoCal Gas' A rating, to arrive at the forecast of long-term debt for new bond issues during 1988. This calculation results in a 10.18% cost for incremental long-term debt for the 1988 attrition year.

15. SoCal Gas and DRA have updated their figures for the embedded cost of debt for attrition year 1988, based on the November DRI forecast; both parties calculate that this cost is 9.90%.

16. Investors can be expected to consider increased risk associated with regulatory changes, specifically the restructuring of the natural gas industry. But such consideration is counterbalanced by the substantial decrease in the cost of money since SoCal Gas' ROE was last reviewed formally. This substantial decrease militates against SoCal Gas' retention of the currently authorized 13.90% ROE, in favor of a reduced ROE of 12.75% which is more consistent with current economic indicators and the results of the financial models reviewed during this proceeding.

<u>Conclusions of Law</u>

1. Public hearing is necessary only for the financial attrition issues raised in SoCal Gas' application.

2. The agreed-upon capital ratios for attrition year 1988 should be adopted as reasonable, consistent with the relevant finding of fact.

3. The agreed-upon cost figure (6.93%) for SoCal Gas' preferred stock for attrition year 1988 should be adopted as reasonable.

4. The agreed-upon cost figure (10.18%) for incremental debt for attrition year 1988 should be adopted as reasonable.

5. The agreed upon cost figure (9.90%) for embedded long-term debt for attrition year 1988 should be adopted as reasonable.

6. A 12.75% ROE should be adopted as just and reasonable for attrition year 1988, based upon all of the evidence considered in this proceeding.

7. SoCal Gas should file an advice letter pursuant to General Order 96-A to implement its 1988 attrition allowance effective January 1, 1988, based on the calculation shown in the table appearing at page 5 of this decision, but adjusted to reflect the impacts of the rate of return adopted herein for attrition year 1988. SoCal Gas may use the November DRI forecast it submitted on November 16, 1987 when making this filing.

8. The difference in the revenue requirement flowing from today's decision and revenues at present rates should be placed in the consolidated balancing accounts, on a monthly basis, as of January 1, 1988, for disposition in accordance with our future decision in I.86-06-005, as previously discussed.

9. The amounts in the above consolidated balancing accounts should accrue interest at the 90-day commercial paper rate until ultimately reflected in rates, pursuant to further order of this Commission.

O R D E R

IT IS ORDERED that:

1. The following cost of capital is adopted for SoCal Gas for attrition year 1988.

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.75	5.78
Total	100.00%		10.93%

2. Within seven days after the effective date of this order, SoCal Gas shall file an advice letter pursuant to General Order 96-A to implement its 1988 attrition allowance effective January 1, 1988, based on its operational attrition showing as corrected, and its financial attrition showing as adjusted to reflect the rate of return adopted herein.

3. SoCal Gas shall place the difference between the revenue requirement flowing from this decision and revenues at present rates in the consolidated balancing accounts, on a monthly basis, to accrue interest at the 90-day commercial paper rate, beginning January 1, 1988, for disposition in accordance with our future order in I.86-06-005.

This order is effective today.

Dated DEC 22 1987, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser, Executive Director

ALJ/WRS,LTC/tcg

Decision ___________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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OPINION

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d. A one-time downward productivity adjustment equal to 2% of adopted labor costs shall be made in the attrition adjustment to be effective January 1, 1988.

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f. To the extent the amortization period associated with certain abandoned gas supply projects terminates in either 1988 or 1989, necessary adjustments will be made during those years to prevent over-recovery of the costs associated with the relevant gas supply projects.

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Application 87-08-006, Pacific Gas and Electric Company

Application 87-07-050, San Diego Gas and Electric Company

At the PHC, the ALJs heard argument on DRA's Motion to Consolidate from all parties, including Sierra Pacific Power Company, which appeared voluntarily at the PHC, despite the fact that its attrition application had not yet been accepted for filing. Thereafter, these matters were consolidated for purposes of hearing the rate of return reviews (PHC Tr. 18). By ALJ Ruling dated October 9, 1987, A.87-09-013 of Sierra Pacific Power Company was also consolidated with these matters. Hearings on the consolidated rate of return reviews were held October 21 through 27 before ALJ Carew in San Francisco. This decision disposes of all issues raised by SoCal Gas' attrition application, including rate of return. The other consolidated rate of return reviews are addressed in a separate decision.

II. Undisputed Issues

Regarding issues other than return on equity in this application, DRA reviewed the SoCal Gas filing and found an error which, when corrected, resulted in an additional revenue requirement reduction of $361,000, for a total requested 1988 attrition year revenue requirement reduction of $435,000, premised on SoCal Gas' requested rate of return. SoCal Gas agreed that the filing was in error and submitted revised Tables 1 and 2 and Schedule A with cover letter dated September 14, 1987, to correct the error.

Staff Counsel Rood sent a letter dated September 25, 1987 to ALJs Carew and Stalder and to all parties indicating that DRA had reviewed the application, found the error, and recommended that no hearings were necessary. No party requested hearing, or responded to the letter. Therefore, no hearings were held on issues other than return on equity.

The following table itemizes the components of the attrition year 1988 adjustments which are undisputed,[1] albeit based on SoCal Gas' requested rate of return:

1 In both its brief and in a November 16, 1987 letter to ALJ Stalder, SoCal Gas requests permission to update its attrition filing using the November 1987 DRI forecast. This results in a requested $1.887 million revenue requirement increase in lieu of the ($435,000) presently before us. However, in addition to the legal notice problems the increased revenue requirement poses, the agreement to use the November 1987 DRI forecast, as discussed in more detail, infra, was limited to an update of debt costs, and consequently, for this reason alone, we deny SoCal Gas' request to use the forecast to update other indices.

SOUTHERN CALIFORNIA GAS COMPANY
ATTRITION YEAR 1988 ALLOWANCE

(DOLLARS IN THOUSANDS)

	1988
ATTRITION RELATED TO O & M INFLATION	
LABOR	14,496
NONLABOR	8,958
SUBTOTAL	23,454
ATTRITION RELATED TO RATE BASE INCREASES	
AD VALOREM TAXES	1,893
DEPRECIATION	11,204
RETURN	5,930
INCOME TAXES RELATED TO RETURN	4,009
SUBTOTAL	23,036
ATTRITION RELATED TO CHANGES IN TAX DEDUCTIONS AND OTHER TAX EFFECTS	
INCOME TAXES	(3,024)
ADJ TO FIT BASE FOR TAX RATE CHANGE	(34,248)
SUBTOTAL	(37,272)
FINANCIAL ATTRITION	
RETURN	(1,601)
INCOME TAX	(1,082)
SUBTOTAL	(2,683)
OTHER 1988 ATTRITION ITEMS	
PRODUCTIVITY ADJUSTMENT	(6,986)
INTERVENOR FUNDING	25
SUBTOTAL	(6,961)
TOTAL BEFORE F & U	(426)
F & U @ 2.2%	(9)
TOTAL INCLUDING F & U	(435)

III. Attrition Year Rate of Return

A. Procedural Background

As noted, SoCal Gas' 1988 attrition year rate of return review was heard on a consolidated record with four other related applications, from October 21-27, 1987. There were four active parties: SoCal Gas, DRA, the City of Los Angeles (Los Angeles), and the City of San Diego (San Diego).

SoCal Gas presented the testimony of two witnesses. Its president Jonel C. Hill testified on policy issues and its Vice President and Controller James D. Bailey presented an attrition year cost of capital study. DRA presented the testimony of Edwin Quan. Los Angeles presented the testimony of consulting engineer Manuel Kroman. San Diego presented no affirmative case, but participated through cross-examination of the various witnesses. Los Angeles and San Diego opted to present oral argument on October 27th, in lieu of filing briefs; SoCal Gas, DRA, and TURN filed concurrent briefs on November 5, 1987, and the matter was submitted on that date. The parties' positions are summarized in the table below, and are subsequently discussed as a prelude to our disposition of the issues.

B. Rate of Return Recommendations for Attrition Year 1988

SoCal Gas' presently authorized rate of return is depicted in the following table:

SoCal Gas (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	10.06%	4.62%
Preferred Stock	9.10	6.91	0.63
Common Equity	45.00	13.90	6.26
Total	100.00%		11.51%

This present authorization contrasts with the recommendations of the active parties for the 1988 attrition year, depicted in the following three tables:

SoCal Gas (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	13.90	6.30
Total	100.00%		11.45%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.25*	5.55
Total	100.00%		10.70%

* Midpoint of 11.75%-12.75% range.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.862%	4.527%
Preferred Stock	8.80	6.903	.607
Common Equity	45.30	12.85	5.821
Total	100.00%		10.955%

A review of these recommendations demonstrates that there is no dispute among the parties over the capital ratios to be used for the attrition year. SoCal Gas' last rate case decision did not specify a particular capital structure for use during the attrition year; thus DRA reviewed the last authorized capital structure and SoCal Gas' updated financing plans as a prelude to making its recommendation (DRA Brief, p. 4), and there is general consensus among the active parties as to the appropriateness of this result. Therefore, we will adopt the agreed-upon capital ratios for 1988.

SoCal Gas does not plan to issue new preferred stock during 1988. Based on a review process similar to that undertaken in the area of capital ratios, SoCal Gas and DRA have reached agreement on a cost figure for SoCal Gas' existing preferred stock (6.93%); Los Angeles' figure (6.903%) is very close to this agreed upon figure. Given the virtual consensus, we will adopt 6.93% for attrition year 1988.

C. Cost of Debt

SoCal Gas' long-term debt is now rated A. Both DRA's Quan and SoCal Gas' Bailey agree that it is appropriate to add 50 basis points to DRI's forecast of AA utility bonds to arrive at the forecast cost of long-term debt for new bond issues during 1988 (Exh. 14, p. 46).

It was agreed by all parties at the conclusion of evidentiary hearings, and at the request of the applicants, that the most recent DRI control forecast (November 1987) would be used to update debt costs for purposes of this decision. This forecast was furnished by PG&E's counsel to all parties by letter dated November 2, 1987. It shows a decline in the forecasted level of interest rates for 1988, to 9.68%. The comparable DRI October 1987 forecast, available to the parties during hearings, showed a 10.48% figure. Thus SoCal Gas requests adoption of a 10.18% figure (9.68 + .50), to reflect the cost of new debt issues during 1988.

(SoCal Gas Brief, p. 15.) We will adopt this figure premised on the agreement to use the November DRI update for this purpose.

In its brief, DRA updated its initial recommended 9.85% embedded debt cost figure (Exh. 14, Table 27), to 9.90% to account for the November DRI forecast. SoCal Gas calculates the same 9.90% embedded debt cost figure as a result of using the November DRI forecast (SoCal Gas November 16, 1987 letter to ALJ Stalder, Table 5). Los Angeles has used a slightly different figure, 9.862%, which does not reflect the November DRI control forecast. We will adopt the 9.90% figure as more reflective of current conditions.

D. Return on Equity

In this proceeding the chief contested issue is the appropriate return on common equity for 1988. The following table summarizes the positions of the parties.

Summary of ROE Recommendations

Party	ROE
SoCal Gas	13.90%
DRA	11.75%-12.75%
Los Angeles	12.85%
San Diego	12.25%-12.75%
TURN	12.00%

SoCal Gas, DRA, and Los Angeles submitted testimony showing the results of various financial models as the starting point for establishing ROE, but they cautioned that the model results are an analytical guide, whose results must be tempered by judgment. SoCal Gas presented three discounted cash flow (DCF) studies and two risk premium analyses. DRA, which relied on three financial models (DCF, risk premium, and the capital asset pricing model (CAPM)) in its review of these consolidated applications, does not recommend use of SoCal Gas specific inputs to the DCF and CAPM models. DRA favors analysis of comparable gas group data, given recent diversification efforts which raise doubts whether the stock price of SoCal Gas' parent Pacific Lighting Corporation (PLC) can be used as an accurate input to DCF and CAPM. DRA does use SoCal Gas specific data in connection with its risk premium analysis. Los Angeles made an analysis of comparable gas distribution utilities (Exh. 13, Table 24). San Diego and TURN did not present independent analyses, but made arguments in support of their recommended ranges. The following table summarizes the results of the models presented by witnesses Bailey, Quan, and Kroman.

ROE Model Results

Party	Model	ROE
SoCal Gas	DCF	13.54%-15.19%
	Risk Premium	13.35%-13.66%
DRA	DCF	11.54%-12.60%
	Risk Premium	12.72%-13.66%
	CAPM	11.61%
Los Angeles	Comparable Earnings	12.85%

Because these models are only used to establish a range for ROE, we will not repeat the detailed descriptions of each model contained in this record. Additionally, the parties have advanced arguments in support of their analyses and in criticism of the input assumptions used by other parties. These arguments are not extensively addressed in this decision, given our assessment that they do not alter the model results shown above. These models provide a reasonable range from which to choose, and we will use them as a rough guidepost in selecting SoCal Gas' 1988 ROE. Nonetheless, in the final analysis, it is the application of judgment, not the precision of these models, which is the key to our decision.

In applying this judgment, we assess the arguments presented by SoCal Gas that it faces increased business and financial risk during 1988.

The utility views elimination of SAM for the noncore market (first announced by this Commission in D.86-12-010) as the most significant of these additional risks, since the noncore market comprises over 50 percent of sales. This market includes utility electric generation (UEG) customers and other large industrial customers who have the capacity to use alternative energy sources such as fuel oil, out-of-state electric purchases and hydroelectric energy.

SoCal Gas posits that notwithstanding the Negotiated Revenue Stability Account (NRSA), or safety-net provision established by the Commission, there is very little real protection. It maintains that even with NRSA it can possibly lose up to $31 million of net income per year due to elimination of SAM for the noncore market (Exh. 1, p. 6). In short, SoCal Gas believes the merits of NRSA, as a risk minimization mechanism, are overstated. (SoCal Gas Brief, p. 7.) Further, the utility asserts that the elimination of SAM for noncore customers caused Standard & Poors to reduce its long-term debt rating from AA to A, thus further underscoring these adverse impacts.

SoCal Gas also argues that the benefits of the new regulatory framework adopted in OII 86-06-005 and OIR 86-06-006 (the "OII/OIR"), are overstated by DRA's Quan, since "SoCal Gas can only negotiate rates to noncore customers <u>below</u> the costs allocated to such customers." (SoCal Gas Brief, p. 8.)

SoCal Gas makes additional risk arguments based on its initial review of the ALJ's Proposed Decision in the OII/OIR, which was published shortly before briefs were filed in this matter in early November. These arguments are not considered, in fairness to all other parties, given the fact that the Proposed Decision in question was released after hearings had concluded.

DRA acknowledges that risk (in terms of earnings variability) may increase as a result of the Commission's SAM-related decisions. However, it urges the Commission not to lose sight of the underlying intent of these decisions, which was to enable the utilities to respond to changes in the marketplace keyed to competition and bypass concerns. The Commission recognized, according to DRA, that in such an environment, SAM operates to both reduce the utilities' incentive to compete and to penalize them when they compete successfully.

Further, in eliminating SAM, the Commission acted very carefully, opting for a two-year transitional period, and retaining the mechanism for core customers. The purpose of this policy, according to DRA, was to encourage the utility to make sales to noncore customers and to purchase gas at marketable prices. At the same time the Commission adopted the NRSA during the two-year transitional period as a "...floor to limit losses so that they cannot grow to disastrous proportions due to wholly unforeseen circumstances." (D.87-05-046, mimeo., p. 14.)

In short, DRA believes SoCal Gas has painted an overly bleak picture of the impacts of the Commission's actions, which were designed to instill confidence, rather than produce uncertainty in the marketplace.

Finally, DRA points to Exhibit 10, PG&E's 1987 second quarter letter to shareholders wherein the Chairman of the Board provides an assessment of the positive side of competition. This demonstrates, in DRA's view, that the utility applicants (presumably including SoCal Gas) often present somewhat varying views of the competition issue to shareholders and regulators.

As further evidence of the increased risks it faces during 1988, SoCal Gas cites FERC Order No. 500 as an example of what it views as the increasing trend at the federal level to shift risks from interstate pipeline companies and natural gas producers to local distribution companies. SoCal Gas views Order 500's gas inventory charge as a minimum bill in disguise. SoCal Gas also views FERC Order No. 436 as establishing a presumption favoring bypass, which is being used by proponents of the proposed Mojave interstate pipeline to further that proposal.

Finally, SoCal Gas argues that it faces increased financial risk during 1988 due to the Tax Reform Act of 1986 and the removal of gas storage inventory from rate base, which it believes will decrease its interest coverage ratios significantly (Tr., pp. 59-60).

We acknowledge that SoCal Gas may indeed be experiencing some additional risk in connection with the restructuring of the natural gas industry, including the partial elimination of SAM, that is not entirely counterbalanced by the protective measures taken to date. Whether that increased risk requires an increase in the return on equity is another matter, however. We are in essential agreement with the observation of Los Angeles' Kroman that the SoCal Gas witnesses have presented a somewhat flawed risk analysis, which failed to differentiate between changes on <u>absolute</u> risks and changes in <u>relative</u> risks:

> "In an absolute sense, it may well be true that natural gas distributors are now facing increased risks, largely from increased competitive pressures and changing regulatory procedures. However, in a relative sense, this is no different from the arguments being made by the telecommunications and electric utilities.
>
> * * *
>
> "As for the unregulated sector, it is hardly necessary to point to the plight of the steel, automobile, oil, machine tool, computer and farm sectors, all of which are severely impacted by fiercely competitive pressures.
>
> "Thus, applicant's failure to consider its increased risk exposure in the context of increased risks being faced by virtually all segments of the economy results in an incomplete showing which falls short of providing a basis for authorizing any specific rate of return." (Exh. 12, pp. 22-23.)

However, even if we accept the notion of increased risk, and the fact that interest rates have reversed their mid-1987 downward trend, the fact remains that SoCal Gas has not requested an increased ROE for the 1988 attrition year. It simply seeks maintenance of its 1987 authorized ROE of 13.90%. DRA argues, persuasively in our view, that this implies a recognition of the reality of lower required equity allowances (DRA Brief, p. 19.)

Los Angeles also argues that, in assessing SoCal Gas' request to maintain its currently authorized 13.90% ROE, we should be mindful of the fact that that ROE determination has no precedential value for attrition year 1988, since it was not based upon record evidence and was a compromise figure negotiated between SoCal Gas and DRA. In addition, the decision adopting the 13.90% figure explicitly provided that "...none of the parties are to use the agreements in evidence in this proceeding or any other proceeding." (D.86-08-025, mimeo., p. 14.) Los Angeles further argues that any Commission authorized ROE for 1988 must reflect the reality that the cost of money has decreased 200-500 basis points since the close of hearings in A.84-02-025, SoCal Gas' 1985 test year rate case (Tr. 611: 24). Given these facts, Los Angeles' comparable earnings analysis leads it to recommend a 12.85% ROE for 1988 (Exh. 12, p. 36).

The other parties' ROE recommendations, with the exception of SoCal Gas, are below the 12.85% recommended by Los Angeles, as reflected in the preceding summary table. San Diego's recommended range is premised on its critique of SoCal's risk premium and DCF analyses (Tr. 607-609). TURN's 12% recommendation in keyed principally to the November DRI forecast, which it believes warrants a downward adjustment of 25 basis points to all DRA recommendations.

DRA's recommended range of 11.75%-12.75% is premised on the argument that current authorizations have not been fully adjusted to reflect the downward trend in interest rates since 1982

(Exh. 14, p. 52). For support, it points to the quantitative model results, and to the fact that recent returns for comparable gas utilities clearly evidence the downward trend. (Exh. 14, Table 5). It also points to Exhibit 15, an American Gas Association document provided by SoCal Gas, which indicates that for the first six months of 1987, seven gas distribution utilities' returns were reviewed and revised to new ranges of 11.7% to 13.5%, averaging 12.6%. None of the utilities listed in Exhibit 15 were authorized returns as high as the 13.90% SoCal Gas seeks to retain.

Thus, while we agree with SoCal Gas that increased risk associated with regulatory changes, specifically the restructuring of the natural gas industry, will be considered by investors to some extent, we believe this consideration is counterbalanced by the evidence that the cost of money has substantially diminished since SoCal Gas' ROE was last formally reviewed. The financial models and the economic indicators (e.g., Exh. 14, Table 1, "Trends in Interest Rates") support a reduction in SoCal Gas' authorized ROE.

After considering all the evidence of market conditions, trends, and the quantitative models presented by the parties, we believe that an ROE of 12.75% is just and reasonable for attrition year 1988. This adopted ROE produces an overall rate of return of 10.93% for the attrition year, as shown in the following table depicting the adopted cost of capital.

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.75	5.78
Total	100.00%		10.93%

We have recently concluded a lengthy investigation (I.86-06-005) into the gas industry regulatory and rate design structure. In that case we conclude that the public is best served by avoiding frequent rate changes, and thus we provide that gas rate changes which recognize several upcoming revenue requirement effects should be deferred to May 1, 1988. Today's order will effect a revenue requirement decrease, although the precise amount is unclear pending the filing of an advice letter by SoCal Gas, as ordered herein. Once this decrease is ordered and effective, however, the rates presently in effect will overcollect the authorized revenue, until changed on May 1, 1988. Therefore, the difference in the revenue requirement stemming from this decision and revenues at present rates should be placed in the consolidated balancing accounts, for disposition in accordance with our upcoming decision in I.86-06-005.

Findings of Fact

1. SoCal Gas filed an attrition adjustment application on July 31, 1987 for a rate decrease for natural gas service of $74,000 annually beginning January 1, 1988.

2. D.85-12-076 sets forth specific guidelines for attrition applications.

3. D.87-05-027 authorized SoCal Gas to file an attrition application for 1988 and 1989.

4. D.87-05-027 specified exceptions to the guidelines in D.85-12-076 for 1988 and 1989 attrition adjustments.

5. D.87-05-027 provided for SoCal Gas' return on equity to be adjusted in 1988 and 1989.

6. A duly noticed prehearing conference was held on September 8, 1987 to discuss this application and A.87-08-025, Southwest Gas Corporation; A.87-08-006, Pacific Gas and Electric Company; and A.87-07-050, San Diego Gas and Electric Company.

7. At the above prehearing conference the ALJ granted a motion to consolidate the above applications for purposes of

considering return on equity issues for attrition year 1988; by ruling dated October 9, 1987, the ALJ consolidated Sierra Pacific Power Company's A.87-09-013 with these matters as well.

8. DRA discovered an error in SoCal Gas' attrition application that, when corrected, resulted in an additional reduction of $361,000 for a total requested revenue requirement reduction of $435,000, based on SoCal Gas' requested rate of return.

9. A letter from staff counsel dated September 25, 1987 was sent to the assigned ALJs and to the parties notifying them of the above error, stating that no other issues were found, and recommending no hearings be held on these operational attrition issues.

10. No party requested a hearing on operational attrition issues, and no party responded to the above letter; the financial attrition issues raised in SoCal Gas' application proceeded to hearing on a consolidated record.

11. There is no disagreement among the active parties as to SoCal Gas' appropriate capital ratios for the 1988 attrition year. The agreed-upon figures are 45.90% (long-term debt); 8.80% (preferred stock); and 45.30% (common equity).

12. SoCal Gas and DRA agree that the appropriate cost figure for SoCal Gas' preferred stock for the 1988 attrition year is 6.93%.

13. Prior to the conclusion of evidentiary hearings, the parties agreed to use the November DRI control forecast to update debt costs for purposes of this decision. The November DRI forecast shows a decline in the forecasted level of interest rates for 1988 to 9.68%.

14. SoCal Gas and DRA agree that 50 basis points should be added to DRI's forecast of AA utility bonds, given SoCal Gas' A rating, to arrive at the forecast of long-term debt for new bond

issues during 1988. This calculation results in a 10.18% cost for incremental long-term debt for the 1988 attrition year.

15. SoCal Gas and DRA have updated their figures for the embedded cost of debt for attrition year 1988, based on the November DRI forecast; both parties calculate that this cost is 9.90%.

16. Investors can be expected to consider increased risk associated with regulatory changes, specifically the restructuring of the natural gas industry. But such consideration is counterbalanced by the substantial decrease in the cost of money since SoCal Gas' ROE was last reviewed formally. This substantial decrease militates against SoCal Gas' retention of the currently authorized $13.90% ROE, in favor of a reduced ROE of 12.75% which is more consistent with current economic indicators and the results of the financial models reviewed during this proceeding.

Conclusions of Law

1. Public hearing is necessary only for the financial attrition issues raised in SoCal Gas' application.

2. The agreed-upon capital ratios for attrition year 1988 should be adopted as reasonable, consistent with the relevant finding of fact.

3. The agreed-upon cost figure (6.93%) for SoCal Gas' preferred stock for attrition year 1988 should be adopted as reasonable.

4. The agreed-upon cost figure (10.18%) for incremental debt for attrition year 1988 should be adopted as reasonable.

5. The agreed upon cost figure (9.90%) for embedded long-term debt for attrition year 1988 should be adopted as reasonable.

6. A 12.75% ROE should be adopted as just and reasonable for attrition year 1988, based upon all of the evidence considered in this proceeding.

7. SoCal Gas should file an advice letter pursuant to General Order 96-A to implement its 1988 attrition allowance

forecast shows a decline in the forecasted level of interest rates for 1988 to 9.68%.

14. SoCal Gas and DRA agree that 50 basis points should be added to DRI's forecast of AA utility bonds, given SoCal Gas' A rating, to arrive at the forecast of long-term debt for new bond issues during 1988. This calculation results in a 10.18% cost for incremental long-term debt for the 1988 attrition year.

15. SoCal Gas and DRA have updated their figures for the embedded cost of debt for attrition year 1988, based on the November DRI forecast; both parties calculate that this cost is 9.90%.

16. Investors can be expected to consider increased risk associated with regulatory changes, specifically the restructuring of the natural gas industry. But such consideration is counterbalanced by the substantial decrease in the cost of money since SoCal Gas' ROE was last reviewed formally. This substantial decrease militates against SoCal Gas' retention of the currently authorized $13.90% ROE, in favor of a reduced ROE of 12.75% which is more consistent with current economic indicators and the results of the financial models reviewed during this proceeding.

Conclusions of Law

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3. The agreed-upon cost figure (6.93%) for SoCal Gas' preferred stock for attrition year 1988 should be adopted as reasonable.

4. The agreed-upon cost figure (10.18%) for incremental debt for attrition year 1988 should be adopted as reasonable.

5. The agreed upon cost figure (9.90%) for embedded long-term debt for attrition year 1988 should be adopted as reasonable.

effective January 1, 1988, based on the calculation shown in the table appearing at page 5 of this decision, but adjusted to reflect the impacts of the rate or return adopted herein for attrition year 1988. In no event shall SoCal Gas use the updated calculations it submitted on November 16, 1987, since the impacts of using the November DRI forecast are included, to the extent permissible, in our adopted rate of return for 1988.

8. The difference in the revenue requirement flowing from today's decision and revenues at present rates should be placed in the consolidated balancing accounts, on a monthly basis, as of January 1, 1988, for disposition in accordance with our future decision in I.86-06-005, as previously discussed.

9. The amounts in the above consolidated balancing accounts should accrue interest at the 90-day commercial paper rate until ultimately reflected in rates, pursuant to further order of this Commission.

ORDER

IT IS ORDERED that:

1. The following cost of capital is adopted for SoCal Gas for attrition year 1988.

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	45.90%	9.90%	4.54%
Preferred Stock	8.80	6.93	.61
Common Equity	45.30	12.75	5.78
Total	100.00%		10.93%

2. Within seven days after the effective date of this order, SoCal Gas shall file an advice letter pursuant to General Order 96-A to implement its 1988 attrition allowance effective January 1, 1988, based on its operational attrition showing as corrected, and

its financial attrition showing as adjusted to reflect the rate of return adopted herein.

3. SoCal Gas shall place the difference between the revenue requirement flowing from this decision and revenues at present rates in the consolidated balancing accounts, on a monthly basis, to accrue interest at the 90-day commercial paper rate, beginning January 1, 1988, for disposition in accordance with our future order in I.86-06-005.

This order is effective today.

Dated ____________________, at San Francisco, California.