ALJ/MJG/tcg

ORIGINAL

Decision 88 12 094 DEC 19 1988

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

| | |
|---|---|
| In the Matter of the Application of Southern California Edison Company (U-338-E) for authority to (i) increase its authorized rate of return on common equity, (ii) adjust its authorized capital structure, (iii) adjust cost factors for imbedded debt and preferred stock, and (iv) related substantive and procedural relief. | Application 88-07-023 (Filed July 25, 1988) |
| Application of Pacific Gas and Electric Company for adoption of authorized rate of return for 1989 pursuant to attrition rate adjustment mechanism. (U-39-M) | Application 88-07-037 (Filed July 20, 1988) |
| In the Matter of the Application of San Diego Gas & Electric Company for authority to decrease its rates and charges for Electric, and to increase its rates and charges for gas and steam service. (Cost of Capital Phase) (U-902-M) | Application 87-12-003 (Filed December 1, 1987) |
| Order Instituting Investigation into the rates, charges and practices of San Diego Gas and Electric Company. | I.88-01-006 (Filed January 13, 1988) |
| In the Matter of the Application of Sierra Pacific Power Company to authorize a return on equity for calendar year 1989 pursuant to attrition rate adjustment mechanism. (U-903-E) | Application 88-07-052 (Filed July 28, 1988) |
| In the Matter of the Application of Southern California Gas Company (U-904-G) to implement its attrition allowance and to establish a return on equity for 1989. | Application 88-08-001 (Filed August 1, 1988) |

(See Appendix A for appearances.)

# INDEX

# INDEX

# OPINION

## I. Summary

These proceedings were consolidated to address Southern California Edison Company's (Edison), Pacific Gas & Electric Company's (PG&E), San Diego Gas & Electric Company's (San Diego), Sierra Pacific Power Company's (Sierra Pacific), and Southern California Gas Company's (SoCalGas) 1989 rate of return attrition filings. This opinion also authorizes SoCalGas an 1989 operational attrition allowance.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that the utilities should be authorized a return on common equity and an overall return on rate base as follows:

| Utility | Common Equity | Rate Base |
|---|---|---|
| Edison | 13.00% | 10.91% |
| PG&E | 13.00 | 11.04 |
| San Diego | 13.00 | 10.90 |
| Sierra Pacific | 13.15 | 10.48 |
| SoCalGas | 13.00 | 10.96 |

## II. Background

Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas filed their respective applications pursuant to Decision (D.) 85-12-076, which requires the energy utilities to address return on equity issues for their respective attrition years. Order Instituting Rulemaking (OIR) 87-11-012's assigned administrative law judge (ALJ) issued a proposed schedule for future annual cost of capital reviews to be moved from a calendar year basis to a fiscal year basis. Accordingly, the ALJ in OIR 87-11-012 requested the energy utilities to file their 1989 cost of capital reviews on a calendar year basis and on a 15-month basis. Subsequently, the ALJ issued his proposed decision recommending that the cost of capital reviews continue on a calendar year basis.

This opinion addresses and authorizes a calendar year basis cost of capital because the utilities' respective filings show that there are no significant differences between a calendar year basis and a 15-month basis. However, if an OIR 87-11-012 opinion adopts the 15-month period, then the cost of capital authorized for the respective utilities in this opinion should continue for the three additional months, through March 31, 1990.

On August 10, 1988, a prehearing conference on the energy utilities' cost of capital applications was held before ALJ Galvin in Los Angeles. At the prehearing conference, the ALJ consolidated the applications into one proceeding, pursuant to Rule 55 of the Commission's Rules of Practice and Procedure which allows such consolidation of proceedings with related questions of law or fact.

Hearings were held from October 3 to October 7 in Los Angeles. Concurrent briefs were filed on October 17, 1988, and the consolidated proceeding was submitted on November 10, 1988 upon the receipt of Late-Filed Exhibit 30 which updates the embedded cost of long-term debt estimates with a cost factor equivalent to Data Resources, Inc.'s (DRI) November 1988 "control" interest rate forecast.

Letters of protest to the applications concerning the objection to any increase in rates because of ratepayers' limited income and the idea that shareholders should share risk with the utilities were received from approximately 500 ratepayers. Received as Item 1 is a petition signed by approximately 40 of Edison's ratepayers opposing any increase in Edison's rates because they believe that any additional increase in rates to the average residential user could make basic comforts more difficult to acquire. The following table summarizes the number of protest letters placed in the respective utility's formal file:

| Utility | Letters |
|---|---|
| Edison | 159 |
| PG&E | 61 |
| San Diego | 185 |
| Sierra Pacific | 0 |
| SoCalGas | 95 |

This opinion addresses the issues raised in Edison's, PG&E's, San Diego's, Sierra Pacific's, and SoCalGas' application on an individual utility basis. However, an issue pertaining to the uniform recovery of the tax savings from deducting premiums paid to retire high cost debt is addressed as a generic issue.

## III. Recovery of Premiums Paid to Retire High Cost Debt

The Commission Division of Ratepayer Advocates (DRA) witness, Quan, testified that the utilities have exercised a prudent management decision to retire, prematurely, bonds issued in the early 1980's when interest rates were at all time highs even though the utilities are required to pay premiums to the existing bond holders of the high cost debt. However, DRA takes issue with the method that the utilities use to pass the tax savings generated from deducting these premiums in the year the high cost bonds are retired to their ratepayers. DRA estimates that SoCalGas' premium for high cost bonds prematurely retired, alone, is projected to be approximately $1.5 million in 1990.

DRA raises this tax issue because the utilities use different methods to pass these tax savings back to the ratepayers. Some utilities include the entire premium in the embedded debt cost calculation with an offset for the tax savings in the deferred tax reserve account as a reduction to rate base. Other utilities include the entire premium in the embedded debt cost, however, with no offset for tax savings reflected in the deferred tax reserve.

These are only two of the many methods used by the utilities. The result is an inconsistent flow of tax benefits to the ratepayers.

DRA recommends that the utilities should use one consistent method for treating premiums associated with the retirement of high cost debt and pass back the associated tax savings to the ratepayers. DRA did not recommend any specific method. Instead, DRA recommends that workshops be held with DRA and the utilities to establish a consistent method for all utilities.

DRA, citing D.88-08-061, where General Telephone Company of California was ordered to establish a balancing account to record the potential tax savings associated with the premiums paid to retire high cost debt pending resolution of the issue, recommends that the energy utilities establish a memorandum account effective January 1, 1989 to track the amounts currently recovered in rates related to these retirements. DRA recommends that this memorandum account be adjusted to reflect the impact of the final method decided in the workshops.

The utilities do not oppose DRA's workshop proposal. However, San Diego opposes the establishment of a memorandum account because it believes it is unnecessary and will create a new business risk. San Diego argues that its method of accounting for such tax benefits was previously approved by the Commission, and that DRA's witness acknowledged that he found no fault with San Diego's method.

The premature retirement of high cost bonds is not restricted to the energy utilities. As DRA points out, it is also happening in the telephone industry, and is probably happening in the water industry. This issue is generic to all California utilities. DRA's proposal has merit. However, we can not expect or require DRA and the five energy utilities in this consolidated proceeding to set policy for all electric, gas, telephone, and water utilities. Nor would it be fair to require the five energy utilities in this proceeding to establish memorandum accounts subject to adjustment without establishing the fact that the energy utilities are improperly accounting for the tax benefits, particularly since their respective methods have previously been used to set rates. For the above reasons, we will not require the utilities to establish a memorandum account to track the tax benefits earned from the premature retirement of high cost bonds.

We will consider issuing a generic utility OII (Order Instituting Investigation) on this issue. However, in the interim, the Commission Advisory and Compliance Division (CACD) should schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost bonds. CACD should notify DRA and other parties CACD believes may be interested in participating in the workshops. Although we will not keep this proceeding open to address the workshop results, we will expect the energy utilities and DRA to present testimony on the method and/or alternative method established at the workshops in the respective utility's first rate or attrition proceeding following the final workshop. If we issue a generic utility OII on this issue prior to the workshops, the workshops should be cancelled and the energy utilities should actively participate in the OII.

## IV. Edison's Application

### A. Background

On July 15, 1988, Edison filed an application for authority to increase its authorized return on common equity from 12.75% to 13.75%, to adjust its authorized capital structure, to adjust its cost factors for embedded debt and preferred stock, and to reflect the impact of such changes (approximately $80 million) in its 1989 operational attrition Advice Letter filing.

Edison's presently authorized rate of return and requested rate of return is depicted in the following tables:

**Edison's Present Authorization**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 47.00% | 9.22% | 4.33% |
| Preferred Stock | 7.00 | 7.88 | 0.55 |
| Common Equity | 46.00 | 12.75 | 5.87 |
| TOTAL | 100.00% | | 10.75% |

**Edison's Recommendation**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.35%* | 4.49% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 13.75 | 6.33 |
| TOTAL | 100.00% | | 11.29% |

* Revised from the 9.31% cost factor in Edison's application to reflect DRI's October 1988 interest forecast.

Edison presented two witnesses, Alan J. Fohrer, Assistant Treasurer and Manager of Cost Control, and Alex C. Miller, Manager of Financial Planning. Fohrer testified on Edison's financial policy and Miller testified on Edison's cost of capital methodology. DRA presented the testimony of Edwin Quan. Federal Executive Agencies (FEA) presented the testimony of John B. Legler. Edward Duncan, representing himself, participated in examination of the witnesses.

B. Capital Structure

The difference between Edison's authorized and requested capital structure is a nominal decline (1%) in the amount of preferred stock as a percentage of total capitalization.

There is no dispute on Edison's capital structure. DRA concludes that Edison's requested capital structure is reasonable, based on DRA's review of Edison's capital requirements and financing plans through 1989. FEA also accepts Edison's proposed capital structure for the purpose of estimating the weighted average cost of capital. Therefore, we will adopt Edison's 1989 requested capital structure of 48.00% long-term debt, 6.00% preferred stock, and 46.00% common equity.

## C. Cost of Long-Term Debt and Preferred Stock

Edison's 9.35% cost of long-term debt is comparable to DRA's 9.27% and FEA's 9.31%. The difference in estimating the cost of long-term debt is attributable to DRA updating estimates with actual cost and using more recent interest forecasts than Edison. However, Edison, DRA, and FEA concur that the November 1988 DRI "control" interest rate forecast should be used to determine the cost of Edison's long-term debt. Late-Filed Exhibit 30, filed November 10, 1988, shows that the parties agree that Edison's cost of long-term debt for the 1989 attrition year should be 9.30%. Therefore, we will adopt a 9.30% long-term debt cost for Edison's 1989 attrition year, which reflects the November 1988 DRI control interest forecast.

Edison's 7.84% cost of preferred stock was not disputed by DRA or FEA, therefore, we will adopt Edison's 7.84% cost of preferred stock for its 1989 attrition year.

## D. Return on Common Equity

The major issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| Edison | 13.75% |
| DRA | 12.50%* |
| FEA | 12.50% |

* Recommends Mid of Range 12.25% to 12.75%

Edison, DRA, and FEA submitted testimony on the results of various financial models which they used as the starting point to determine their recommended return on equity. Edison and DRA use the DCF (Discounted Cash Flow Analysis), RPM (Risk Premium Analysis), and CAPM (Capital Asset Pricing Model). FEA uses the DCF and RPM model.

Detailed descriptions of each financial model is contained in the record and are not repeated here. These models are used only to establish a range from which the parties use individual judgement to determine a fair return on common equity. Although the parties agree that the models are objective, the results are dependent on the subjective inputs. From these subjective inputs the parties advance arguments in support of their respective analysis and in criticism on the input assumptions used by other parties. These arguments will not be addressed extensively in this opinion, since they do not alter the model results. As Miller testified, in the final analysis, it is the application of judgement, not the precision of these models, which is the key to selecting a specific return on common equity estimate within the range predicted by analysis.

The following table summarizes the results of the models presented by witnesses Miller, Quan, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | Edison | 12.70% - 14.00% |
| | DRA | 12.26 - 12.80 |
| | FEA | 11.40 - 12.60 |
| RPM | Edison | 13.10 - 14.60 |
| | DRA | 13.04 - 15.13 |
| | FEA (5-yr. premiums) | 13.00% |
| CAPM | Edison | 13.40 - 14.70 |
| | DRA | 12.29 - 15.80 |

Edison asserts that to arrive at a fair return on common equity, it is necessary to apply informed judgement to the regulatory, competitive, and financial risk which Edison faces.

Edison also asserts that regulatory risk is one of the significant factors that affects the total level of risk perceived by investors. Fohrer believes that investor risk "may" increase because the elimination of ERAM (Energy Regulatory Adjustment Mechanism) and ARA (Attrition Rate Adjustment) for the large industrial and commercial customers because full cost recovery will be dependent on accurate forecast. Edison also believes that the seasonal variation in earnings will impact investors' expectations.

The AER (Annual Energy Rate) reasonableness review, a percentage of fuel and purchased power costs recoverable on a fixed, forecast basis is another regulatory risk that must be considered because of the flux of this recovery mechanism. Although Edison was authorized to implement this mechanism in 1981, it was temporarily suspended in 1986, reinstated in 1987, and again suspended in 1988 until Edison's 1989 Energy Cost Adjustment Clause proceeding. Fohrer believes that additional risk exists because of the uncertainty of whether Edison will be able to recover volatile fuel and purchased power costs.

Fohrer cites the reasonableness review procedure, which allows Edison to recover 75% of the revenue requirement associated with certain plant additions costing over $50 million pending a reasonableness review, as another regulatory risk factor. According to Fohrer, this procedure compounds an investor's fear that recovery of plant investments will be made more difficult because the procedure requires a separate proceeding and delays full rate base treatment of the plant investment.

Alternative forms of capital recovery such as the proposed Diablo Canyon settlement are identified by Fohrer as a new regulatory risk because such proposed settlement departs from the traditional ratemaking treatment of plant investment. Although the proposal involves recovery of a controversial nuclear plant investment, Fohrer believes that it affects investors' perception and if adopted will signal to the investors that shareholders in California utilities may bear greater risks.

Edison cites several Federal Energy Regulatory Commission (FERC) proposed rulemakings which may affect how prices are to be set in contracts with Qualifying Facilities (QFs) and which may streamline regulation for independent power producers. Edison supports many of the QF proposals but has concerns about proposals which favor the non traditional suppliers.

DRA's Quan concurs that the Commission has created new forms of regulation and provided regulatory flexibility to meet the needs of both the utilities and ratepayers to respond to the competitive marketplace. Quan acknowledges that utilities such as Edison faces different risk to operate in the new competitive marketplace and that such risk should be recognized in setting the appropriate return on common equity. However, he believes that only the incremental change in risks over the level already recognized in the last rate of return authorization should be considered.

Legler's analysis of regulatory risk was based on a national perspective. It was not based on a California specific regulatory risk. According to Legler the financial community looks at an overall perspective of regulatory risk, not a checklist approach. Legler concludes that the California regulatory climate is good and that the financial community considers the California regulatory climate to be above average compared to other states. Salomon Brothers, Inc.'s March 31, 1988 stock research publication (Exhibit 12) substantiates Legler's conclusion of the California regulatory climate.

Fohrer asserts that a significant risk exists in the competitive marketplace from third-party producers and self producers within Edison's service territory. He testified that Edison could be required to obtain new sources of power on short notice and at higher prices because third party electric producers have no obligation to serve, may abandon unprofitable projects, and may discontinue supply because of unrelated business failures.

Also, the bypass of large industrial and commercial customers is a continual threat recognized by Salomon Brothers, Inc. and other members of the financial community as the major investment consideration for Edison during the next several years.

DRA concurs with Edison that competitive risk should be considered. However, Quan believes that Edison and the other utilities have mitigated and reduced risk from the competitive marketplace challenges by direct competition with the independent power producers through separate subsidiaries. In Edison's case, Edison obtains approximately 10% of its energy from third party producers, half of which is provided by Mission Energy Company, Edison's non-utility subsidiary.

Edison's financial measurement of risk is based on its prospective bond rating and increase in interest rates. Edison's present debt ratio exceeds Standard & Poor's double-A bench mark of 46% debt. However, Edison has maintained its bond rating because of positive action in other areas. Fohrer states that if Edison is authorized a 13.75% return on common equity, its interest coverage, which has steadily declined, is projected to decrease to 3.3 by 1990. This decline in interest coverage equates to a decline in Edison's financial strength and increase risk because the projected interest coverage is below Standard & Poor's 3.5 minimum coverage for a double-A rating. This, coupled with the projected inflation forecasts of up to 6.1% in 1989 will impact Edison's ability to attract funds and to maintain its financial strength in 1989.

Quan considered Edison's financial risk and concludes that Edison's risk has remained approximately the same since the 1988 attrition proceeding. Specifically, internally generated funds have remained at substantially higher levels the past few years from 52% of total construction funds in 1983 to 79% in 1987, and AFUDC (Allowance for Funds Used During Construction) earnings have significantly dropped from 59% in 1983 to 16% in 1987. Also, Edison's stock continues to trade in excess of book value which indicates that the investors' perception of the current value of Edison relative to the value of its assets is high. Although Quan acknowledges that the stock traded is Edison's holding company, SCE Corp., Quan views Edison and SCE Corp. as virtually the same entity.

Quan disputes Edison's argument that rising interest rates and the uncertainty of the future levels of inflation require the return on common equity to be set at a level higher than that currently authorized. Table 7 to Quan's Exhibit 4 compares the overall trends in long-term interest rates with the authorized returns on common equity for the last eleven years. This table shows that the authorized returns on common equity does move in the same direction as interest rates, but not in direct proportion.

Although long-term interest rates have moved moderately upward during the year, the August 1988 long-term interest rate is similar to the level of interest rates in December 1987 when the current return on common equity was set. Further, Jenkins-Stark of PG&E testified that actual long-term interest rates continued to decrease in September 1988.

We do not place sole reliance on DRI's interest rate forecasts. Forecasts are estimates based on subjective analysis. This is confirmed by San Diego's Krumvieda who compared DRI's quarterly AA utility bond forecast with actual results from the first quarter of 1982 through the first quarter of 1988 and concludes that DRI's forecast varies an average of +/- 1.81%.

SoCalGas' Sanladerer testified that returns on common equity are historically based on an implicit spread between DRI's AA bond interest rate forecast and the authorized return on common equity. According to Sanladerer, SoCalGas' implicit spread is from 275 basis points to 307 basis points. Sanladerer's assertion is not correct. Although the end result may have fallen within this range, we consider and balance a multitude of risk to arrive at a reasonable return on common equity, only one of which is the interest rate forecast.

If we assume for argument sake that Sanladerer's 275 to 307 basis point spread is correct and adjust for DRI's margin of error rate presented by Krumvieda, then the 1989 authorized return on equity should be within the range of 11.38% to 15.32%.[1] A common equity range of this magnitude provides little guidance to the Commission in arriving at a reasonable return on common equity and greatly exceeds the range of common equity returns recommended by the parties in this consolidated proceeding. As pointed out above, the interest rate forecast is only one component of risk which we consider to arrive at a reasonable return on common equity.

Absent from Edison's risk analysis is a discounting of benefits investors stand to gain from the regulatory policies and the discounting of risk associated with prior years risk. For example, investors have been aware of the potential for elimination of the ERAM and ARA mechanisms since late 1986 in I.86-10-001 and should have already adjusted for the expected risk. California regulatory policy recognized by the financial community as above average is also a positive factor to consider.

We concur that the competitive risk is present. However, Edison has reduced the risk of reliability and availability of third party power by purchasing half of its third party producer power from its subsidiary, Mission Energy Company. Financial risk is also present; however, Edison has not demonstrated that such

---

1 The range is calculated as follows:

| | Low | High |
|---|---|---|
| November DRI Forecast | 10.44% | 10.44% |
| Basis Point Range | 2.75 | 3.07 |
| DRI Error Rate | +/-1.81 | +/-1.81 |
| Calculated Range | 11.38% to 15.00% | 11.70% to 15.32% |

risk has substantially increased during 1988 or that such risk warrants a 100 basis point increase in its authorized return on equity.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that a 13.00% return on equity is just and reasonable for Edison's 1989 attrition year.

E. Adopted Cost of Capital

The 13.00% adopted return on common equity produces an overall rate of return of 10.91% for the 1989 attrition year, an increase of 0.16% from its 10.75% overall rate of return for 1988. The following table shows Edison's adopted cost of capital for its 1989 attrition year:

Edison's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.30% | 4.46% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 13.00 | 5.98 |
| TOTAL | 100.00% | | 10.91% |

## V. PG&E's Application

A. Background

On July 20, 1988, PG&E filed an application for authority to increase its authorized return on common equity from 13.10% to 14.50%. The requested change in common equity will result in approximately an $87 million gross revenue requirement increase for PG&E's Electric Department and a $22 million revenue requirement increase for its gas department. Subsequently, on September 16, 1988, PG&E revised its requested return on common equity to 13.75% to reflect the provisions of PG&E's proposed Diablo Canyon Settlement Agreement and Implementing Agreement of June 24, 1988.

PG&E's presently authorized rate of return and requested rate of return is depicted in the following tables:

PG&E's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.34% | 4.25% |
| Preferred Stock | 8.50 | 8.80 | 0.75 |
| Common Equity | 46.00 | 13.10 | 6.03 |
| TOTAL | 100.00% | | 11.03% |

PG&E's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.40% | 4.35% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 13.75 | 6.43 |
| TOTAL | 100.00% | | 11.40% |

PG&E presented two witnesses, John F. Jenkins-Stark, Treasurer, and Laura Paratte, Senior Financial Analyst. Jenkins-Stark testified on PG&E's financial policy and Paratte testified on PG&E's cost of capital methodology. DRA presented the testimony of Edwin Quan. FEA presented the testimony of John B. Legler. Roger Poynts, of Utility Design, Inc. also presented testimony.

B. Capital Structure

PG&E's requested preferred stock ratio decreased 1.50% from its presently authorized preferred stock ratio, from 8.50% to 7.00%. This reduction resulted from the refunding of high coupon preferred stock issues. PG&E asserts that its capital structure, which excludes the impacts of Diablo Canyon operations, is consistent with the terms of the proposed Diablo Canyon settlement agreement pending before the Commission in A.84-06-014.

There is no dispute over PG&E's proposed capital structure. DRA concludes that PG&E's requested capital structure is reasonable, based on DRA's review of PG&E's 1989 capital requirements and financing plans. Poynts did not recommend any capital structure. We will adopt PG&E's 1989 requested capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity for its 1989 attrition year.

### C. Cost of Long-Term Debt and Preferred Stock

PG&E's requested cost of long-term debt and preferred stock is not in dispute. Consistent with the updating of Edison's long-term cost of debt, PG&E concurs that its long-term debt cost should be updated with the November 1988 DRI "control" interest rate forecast. We will adopt a 9.39% cost of debt factor for PG&E's 1989 attrition year, as shown in Late-Filed Exhibit 30 which reflects DRI's November 1988 control interest forecast. PG&E's 8.79% cost of preferred stock, which is not disputed, should be adopted for the 1989 attrition year.

### D. Return on Common Equity

At issue is the appropriate return on common equity for PG&E's 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| PG&E | 13.75%* |
| DRA | 12.50%** |
| FEA | 12.75% - 13.25% |
| Poynts | No Recommendation |

* Revised from 14.50% to exclude Diablo Canyon impacts.

** Recommends Mid Range of 12.25% to 12.75%

PG&E excluded its projected Diablo Canyon risk to arrive at its requested 13.75% return on common equity, pursuant to its Diablo Canyon settlement agreement with all parties to the Diablo Canyon proceeding. In response to the ALJ's concern that this agreement has not yet been approved by the Commission, Jenkins-Stark testified that PG&E's sole recommendation for a return on common equity in this proceeding is 13.75%. Therefore, the return on common equity adopted in this opinion for PG&E should be effective for the entire 1989 attrition year.

Poynts did not recommend a specific return on common equity; however, he did recommend that the return on common equity not be increased. This recommendation is based on Poynts' review of the increase in interest rates, the modest increase in the consumer price index from 4.4% in 1987 to 4.6% in 1988 and his belief that PG&E has no increased regulatory or competitive risk because PG&E is a monopoly utility which is allowed to increase its rates to offset anticipated inflation.

PG&E, DRA, and FEA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Paratte, Quan, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | PG&E | 10.42% - 16.73% |
| | DRA | 12.12 - 12.66 |
| | FEA | 13.20 - 14.70 |
| RPM | PG&E | 14.16 - 14.42 |
| | DRA | 13.04 - 15.13 |
| | FEA (5-yr. premiums) | 14.40 - 14.50 |
| CAPM | PG&E | 14.92% |
| | DRA | 11.95 - 15.53 |

Legler's financial model results, as summarized above, are based on PG&E's initial showing which include impacts associated with Diablo Canyon. Legler was unable to discount the impacts of Diablo Canyon because PG&E submitted its revised testimony after Legler's direct testimony was submitted. However, Legler did address PG&E's revised testimony on direct examination and did reduce his recommended return on common equity from the

13.00% - 14.00% range to the 12.75% - 13.25% range. His financial model results were not adjusted to exclude Diablo Canyon impacts and, therefore, will not be addressed.

DRA's financial models are based on market data related to a comparable group of electric utilities. PG&E specific data was not used because Quan believes that it is impossible to isolate any perceived investor risk associated with Diablo Canyon.

Although PG&E excludes its estimated risk associated with Diablo Canyon, it believes that its return on common equity should be increased 65 basis points, from 13.10% to 13.75% because of increased business risk from ongoing regulatory changes and restructure of the California gas and electric industry, and a significant increase in the 1989 attrition year interest rate forecast over the 1987 interest rate forecast.

Jenkins-Stark testified that regulatory developments have increased investor risk and reduced regulatory protection thereby moving PG&E closer toward the risk levels of unregulated sectors of the economy. He cites the gas rate restructure which began in December 1986, the Electric rate restructure, FERC regulatory changes, self generators and cogenerators, and customers' use of alternative fuels as the basis for increased risk.

Except for the gas rate restructure, PG&E's risk factors are similar to Edison's risk factors. To the extent that these risk factors are already discussed, they will not be repeated.

Although Quan acknowledges that the electric industry is in a continual state of transition, he testified that as different areas of risk are created, there are other circumstances, such as Commission policies, which mitigate some of the risk. Change in the electric industry is not new. In the 1988 attrition proceeding, we agreed with PG&E that investors will consider to some extent increased risks associated with regulatory changes, specifically the electric industry restructure. However, it is apparent from Salomon Brothers, Inc. above average rating given to the Commission that the investment community has mitigated increased risk associated with the California electric industry.

Similar to the electric industry changes, the natural gas regulatory framework was considered in the 1988 attrition proceedings. The question to address in this proceeding is whether such risk has increased. Although Jenkins-Stark asserts that the elimination of the Supply Adjustment Mechanism (SAM) effective May 1, 1988 increases utility risk in 1989, he acknowledges that this risk is partially mitigated by the Negotiated Revenue Stability Account (NRSA) which limits the maximum variation of after tax earnings from the noncore sector for two years after implementation of the new regulatory structure. PG&E did not provide an assessment of other risk which have been mitigated.

The investment community has been aware of risk associated with the new gas regulatory structure since 1986 and we have provided for that increased risk in Commission policy and in the attrition proceedings, most recently in the 1988 attrition proceeding. Similar to the electric industry restructure, the gas industry is in a continual state of transition. Quan recognizes that as new risks develop, other risks are mitigated.

Of all the energy utilities, PG&E was authorized the highest return on common equity in 1988 primarily because of increased risk associated with the uncertainty of the Diablo Canyon reasonableness review. However, with the proposed settlement in A.84-06-014 and PG&E's exclusion of risk associated with Diablo Canyon, PG&E's risks are now comparable to the other California energy utilities.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that a 13.00% return on common equity is just and reasonable for PG&E's 1989 attrition year.

## E. Adopted Cost of Capital

The 13.00% adopted return on common equity produces an overall rate of return of 11.04% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

**PG&E's Adopted Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.39% | 4.34% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 13.00 | 6.08 |
| TOTAL | 100.00% | | 11.04% |

# VI. San Diego's Application

## A. Background

On December 1, 1987, San Diego filed an application for a general rate increase. San Diego requested, among other things, a 13.75% return on equity. Subsequently, by an ALJ ruling, San Diego's cost of capital issue was bifurcated from the general rate proceeding for consideration in this generic attrition proceeding.

On July 15, 1988 San Diego revised its cost of capital testimony and reduced its requested return on common equity to 13.25%.

San Diego's presently authorized rate of return is depicted in the following table:

**San Diego's Present Authorization**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 40.50% | 9.24% | 3.74% |
| Preferred Stock | 8.50 | 7.28 | 0.62 |
| Common Equity | 51.00 | 12.75 | 6.50 |
| TOTAL | 100.00% | | 10.86% |

Although the present authorized structure, except for the return on common equity, is consistent with San Diego's recommendation for the 1989 attrition year, it is in contrast to DRA's recommendation. The following tables show the active parties recommendations for the 1989 attrition year:

San Diego's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 42.75% | 9.22% | 3.94% |
| Preferred Stock | 6.25 | 7.21 | 0.45 |
| Common Equity | 51.00 | 13.25 | 6.76 |
| TOTAL | 100.00% | | 11.15% |

DRA's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.22% | 4.20% |
| Preferred Stock | 6.00 | 6.97 | 0.42 |
| Common Equity | 48.50 | 12.50* | 6.06 |
| TOTAL | 100.00% | | 10.68% |

* Recommends Mid Range of 12.25% to 12.75%

FEA's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 42.75% | 9.12% | 3.90% |
| Preferred Stock | 6.25 | 7.21 | 0.45 |
| Common Equity | 51.00 | 12.75 | 6.50 |
| TOTAL | 100.00% | | 10.85% |

City of San Diego's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.22% | 4.20% |
| Preferred Stock | 6.00 | 6.97 | 0.42 |
| Common Equity | 48.50 | 12.50 | 6.06 |
| TOTAL | 100.00% | | 10.68% |

San Diego presented two witnesses, Margo A. Kyd, Treasurer, and Richard A. Krumvieda, Manager of Financial Analysis and Forecasting. Kyd testified on San Diego's financial policy and Krumvieda testified on San Diego's cost of capital methodology. DRA presented the testimony of Phyllis White. FEA presented the testimony of John B. Legler. William Shaffran, appearing for the City of San Diego, actively participated in the examination of witnesses. Duncan also examined the witnesses.

B. Capital Structure

San Diego believes that a "ratemaking" capital structure with a 51% common equity ratio authorized for its 1988 attrition year will be sufficient to provide an adequate level of financial flexibility. Although San Diego projects that its actual common equity will exceed 51%, San Diego recommends that its ratemaking common equity be held at the 51% level.

DRA's White recommends a capital structure with a 48.50% common equity ratio, which more closely resembles San Diego's reported and target financial capital structure. White's common equity ratio is lower than San Diego's primary because White included the $123 million Encina 5 Power Plant non-nuclear capitalized lease as a component of long-term debt. White believes her proposal should be adopted because:

a. Capital leases are a part of long-term debt.

b. The Financial Accounting Standards Board Statement No. 71 (FASB 71) requires capital leases to be recorded as long-term debt on the utility's balance sheet to show a clear and explicit reflection of a utility's leverage and accompanying financial risk.

c. San Diego's investors and financial analysts consider non-capitalized lease information when assigning expected risk adjusted returns on investment.

d. There is no deleterious effect on the market's view of San Diego or San Diego's ability to attract capital.

However, if San Diego's common equity ratio of 51% is adopted, White recommends that San Diego's return on common equity be reduced to 12.00% to recognize San Diego's lower financial risk.

DRA's basis for including such capitalized leases is flawed. We have not adopted FASB 71 an accounting pronouncement for the energy utilities. If we adjust San Diego's capital structure because of FASB 71 then we should consistently adjust for other components of FASB 71, and other accounting pronouncements for ratemaking purposes. We are not prepared to do so.

Even if we assume that non-nuclear capitalized leases should be a component of long-term debt, DRA's proposal is still flawed. Capitalized assets are assumed to be financed by a combination of long-term debt, preferred stock, and common equity even though individual assets may have been financed by a particular debt or equity issuance. The costs of these capitalized assets historically are recoverable through rate base. However, DRA does not propose rate base treatment for these capitalized leases. Rather, DRA proposes that these leases should be recovered through operating expenses as they are currently being recovered.

We share DRA's concern about the high level of common equity which San Diego requests, especially when Edison is requesting a 46% common equity capital structure, PG&E a 46.75%, Sierra Pacific a 41.93%, and SoCalGas a 45.20%. This is not a new concern. In D.85-12-108 we observed that San Diego's increasing equity might well present a serious problem in the future and directed San Diego and DRA to address, thoroughly, San Diego's increasing equity in the next appropriate rate proceeding. Although San Diego is requesting that its common equity be held at 51.00%, San Diego acknowledges that its common equity is projected to exceed this level.

San Diego's current common equity ratio goal is 45.00% to 48.00% for financial reporting purposes. Kyd testified that San Diego's 1989 expected equity ratio is 46.10% for financial reporting purposes, well within its current goal.

San Diego periodically publishes its financial goals which investors assess for performance and goals. As shown in San Diego's quarterly financial report, it is the financial common equity ratio, not the rate making common equity ratio that is shown in San Diego's quarterly report and is used for financial analysis for its investors review.

An imputed adjustment to San Diego's requested 51.00% common equity ratio is warranted because it is substantially out of line with other California energy utilities' common equity ratio and because San Diego has not justified the need for such a high equity ratio. We will adopt a 48.00% common equity ratio for San Diego's 1989 attrition year to bring it in line with what investors use to assess San Diego's performance and to bring it in line with other California energy utilities' common equity ratio. This common equity ratio is derived from the top range of San Diego's common equity goal of 45.00% - 48.00% for its financial structure. Any common equity ratio higher than 48.00% would warrant a proportional reduction in its return on equity. We will adopt San Diego's requested 6.25% preferred stock ratio and impute a 45.75% long-term debt ratio for a balanced capital ratio.

We will expect San Diego, Edison, PG&E, Sierra Pacific, SoCalGas, and DRA to address in the next cost of capital proceeding the optimum capital structure for California energy utilities.

### C. Cost of Long-Term Debt and Preferred Stock

San Diego's 9.22% cost of long-term debt is consistent with DRA's and the City of San Diego's estimate, and comparable to FEA's 9.212%. Although FEA used a cost factor which did not reflect San Diego's update for actual costs, Legler accepts

San Diego's cost estimate. Consistent with the other utilities, San Diego concurs that its cost of long-term debt should be updated to reflect the impact of DRI's November 1988 control interest forecast.

We will adopt a 9.23% long-term debt cost for San Diego's 1989 attrition year as shown in Late-Filed Exhibit 30, which reflects DRI's November 1988 control interest forecast.

The only dispute regarding San Diego's estimated cost of preferred stock is how the unamortized issuance costs associated with refunded perpetual preferred stock should be treated. San Diego reduces its net proceeds by the issuance cost for perpetual series preferred stock, which were refunded in 1986 and 1987, and amortized the issuance cost over a 20-year period. The amortized costs are included in San Diego's 7.21% 1989 effective preferred stock dividend rate. San Diego's witness rationalizes this amortization by citing D.87-12-066, an Edison proceeding, which considered and approved the recovery of preferred stock issuance costs by increasing the embedded cost of preferred stock.

DRA's White excluded the issuance costs in her recommended 6.97% effective preferred stock dividend rate for San Diego's 1989 attrition year because the Uniform System of Accounts for Account No. 214-B, Capital Stock Expense requires the issuance expense of perpetual capital stock to be expensed in the year that such stock is retired.

DRA points out in its brief that D.87-12-066, which San Diego relies on, authorized such issuance costs to be included in the preferred stock embedded costs because Edison demonstrated that San Diego was previously authorized to recover similar costs and because the cost impact on preferred stock was minimal, only 8 basis points. There was not a sufficient record to address the merits of the issue.

However, in this proceeding DRA's witness established that the proper method to account for such costs is to expense the issuance costs in the year incurred. San Diego's own witness testified that preferred stock is a form of long-term equity capital stock, and acknowledged that capital stock issuance costs are not recovered. Since preferred stock is similar to common stock and because common stock issuance costs are not recovered from ratepayers, we will adopt DRA's 6.97% cost of preferred stock for San Diego's 1989 attrition year.

D. Return on Common Equity

The following table summarizes the parties return on common equity recommendation:

| Party | Recommended Return |
|---|---|
| San Diego | 13.25% |
| DRA | 12.50%* |
| FEA | 12.75% |
| City of San Diego | 12.50% |

* Recommends Mid Range of 12.25% to 12.75%

San Diego, DRA, and FEA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Krumvieda, White, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | San Diego | 12.40% - 14.00% |
| | DRA | 11.36 - 12.65 |
| | FEA | 11.80 - 13.00 |
| RPM | San Diego | 14.40 - 16.00 |
| | DRA | 13.22 - 15.25 |
| | FEA (5-yr. premiums) | 12.00 - 12.26 |
| CAPM | DRA | 11.73 - 15.42 |

In the final analysis, it is the application of judgement, not the the precision of test models, which is the key to selecting a specific return on common equity.

Kyd asserts that the Commission should recognize specific business risks to set a fair return on common equity. According to Kyd, these business risks consist of: a substantial uncertainty of purchased power costs associated with the Southwest Powerlink (SWPL), the re-examination of utility ratemaking mechanisms, such as the potential elimination of the ERAM, and ongoing business risk associated with nuclear operations and third party producers.

According to Kyd, the SWPL balancing account, which accounts for the difference between the cost of SWPL energy received and avoided costs, poses substantial new risk because investors view it as a procedure to defer timely cost recovery of prudently incurred costs. Further, Kyd is concerned that the deferred recovery of SWPL and purchased power costs may preclude San Diego from achieving reasonable levels of short-term debt and result in a downgrading of its commercial paper rating.

The City of San Diego points out that the SWPL risk is not a new risk. Not only was it addressed in San Diego's 1988 attrition proceeding, it has existed for the past three years. The City of San Diego also points out that the Commission granted limited rehearing on the SWPL balancing account issue by D.86-06-026. It believes that the only reasonable assumption that can be made regarding a pending decision on the balancing account is that the Commission will reduce San Diego's risk further.

San Diego believes that the uncertainty regarding future Commission action on matters such as the elimination of the SAM, investigation to review the elimination of attrition adjustments and the ERAM, and decisions, in general, which show a tendency to make adjustments to established rate mechanisms only when such adjustments are in the ratepayers' favor results in higher investor risk.

Further, the City of San Diego reminds us that the elimination of these rate mechanisms can result in a benefit, not a risk, to the shareholders and investors. The City points out that since the AER mechanism was adopted and 8.0% of fuel costs were fixed, San Diego has consistently been benefited as follows:

| Period | Amount |
|---|---|
| May 1985-April 1986 | $ 821,765 |
| May 1986-April 1987 | 7,100,000 |
| May 1987-April 1988 | 4,300,000 |

We think San Diego's view of the risk associated with industry restructuring is misplaced. We must not lose sight of the intent of decisions related to the gas and electric industry restructure, that is, to provide the regulated utilities a means to respond to marketplace changes which are keyed to competition and bypass.

San Diego takes a very pessimistic approach to nuclear risk. San Diego asserts that ongoing business risks exist because the Nuclear Regulatory Commission (NRC) may require costly plant modifications to SONGS as a result of a problem, presently unidentified, at any other nuclear plant. Further, San Diego could be impacted by an accident at any other nuclear plant in the United States because NRC requires loss sharing among all the utilities that own nuclear reactors.

The other business risks identified by San Diego, third party producers and increased interest rates have already been discussed and will not be repeated here. However, it is worth noting that in regards to third party producer risk, San Diego's 1987 shareholders annual report shows that as a result of lowered costs and restructured sales, San Diego has been able to preserve most of its sales and retain most of its market share.

After considering all the evidence of the market conditions, trends, quantitative models presented by the parties, and San Diego's higher equity ratio, we conclude that a 13.00% return on equity is just and reasonable for San Diego's 1989 attrition year.

## E. Adopted Cost of Capital

The 13.00% adopted return on common equity produces an overall rate of return of 10.90% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

San Diego's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.75% | 9.23% | 4.22% |
| Preferred Stock | 6.25 | 6.97 | 0.44 |
| Common Equity | 48.00 | 13.00 | 6.24 |
| TOTAL | 100.00% | | 10.90% |

# VII. Sierra Pacific's Application

## A. Background

On July 28, 1988, Sierra Pacific filed an application for authority to increase its authorized return on common equity from 12.90% to 14.00% for the 1989 attrition year. The proposed increase in return on common equity will result in approximately a $1,136,000 revenue requirement.

Sierra Pacific's presently authorized rate of return and requested rate of return is depicted in the following tables:

Sierra Pacific's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 49.09% | 8.71% | 4.28% |
| Preferred Stock | 7.46 | 7.35 | 0.55 |
| Common Equity | 43.45 | 12.90 | 5.60 |
| TOTAL | 100.00% | | 10.43% |

Sierra Pacific's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.71% | 4.48% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 14.00 | 5.87 |
| TOTAL | 100.00% | | 10.87% |

Charles E. Olson, an economist and President of H. Zinder & Associates testified for Sierra Pacific, and Quan testified for DRA.

## B. Capital Structure

There is no dispute on Sierra Pacific's requested capital structure. DRA concludes that Sierra Pacific's capital structure is reasonable, based on its review of Sierra Pacific's capital requirements and financing plans through 1989. We will adopt Sierra Pacific's 1989 requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity.

## C. Cost of Long-Term Debt and Preferred Stock

Sierra Pacific's estimated 8.71% cost of long-term debt is 0.16% higher than DRA's 8.55% estimate. This difference in cost is the result of DRA using more recent DRI forecast. Sierra Pacific concurs with the other applicants and interested parties to this consolidated proceeding that the cost of long-term debt should be based on the November 1988 DRI control forecast. Late-Filed Exhibit 30 shows that the parties agree that Sierra's cost of long-term debt for the 1989 attrition year, which reflects DRI's November 1988 control interest forecast, should be 8.65%. Therefore, we will adopt 8.65% as the cost of Sierra Pacific's long-term debt for the 1989 attrition year.

We will adopt Sierra Pacific's requested 7.74% cost of preferred stock for the 1989 attrition year, which was not disputed.

## D. Return on Common Equity

The only issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| Sierra Pacific | 14.00% |
| DRA | 12.65% |

Sierra Pacific and DRA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity. These models are used only to establish a range from which parties use individual judgement to determine a fair return on common equity. However, there is a significant difference between Olson's 5.0% - 6.0% expected dividend growth rate and Quan's 3.50% - 4.00% expected dividend growth rate.

Quan's expected dividend growth rate is based on historical trends and forecasted dividend and earnings growth rates reported by various security analysts. Olson acknowledges that his estimate is above historical growth rates and above the Institutional Brokers Estimate System (IBES) 4% projected growth rate, which Olson believes is one of the best sources of information on expected future growth. However, Olson relied on judgement because historical data and IBES do not reflect the long-term growth potential from diversification and he believes that investors expect a substantial improvement in earnings from past levels.

We conclude that Sierra Pacific's projected dividend growth rate is an optimistic estimate and that DRA's expected dividend growth rate is a more realistic estimate, which is consistent with IBES's projected growth rate.

The following table summarizes the results of the models presented by witnesses Olson and Quan:

| Model | Party | Range |
|---|---|---|
| DCF | Sierra Pacific | 13.00% - 14.00% |
| | Sierra Pacific (9 Electrics) | 13.24 - 13.74 |
| | DRA | 11.69 - 12.23 |
| RPM | Sierra Pacific | 12.80% |
| | DRA | 13.04 - 15.13 |
| CAPM | DRA | 11.46 - 15.12 |

Sierra Pacific faces risk similar to the other California utilities. However, Sierra Pacific's risk is higher than Edison, PG&E, and other large utilities in relation to revenue and common equity ratios. Sierra Pacific's revenue is approximately $400 million as compared to Edison's $6 billion and PG&E's $7 billion revenue. Its 41.93% common equity ratio is low compared to Edison's 46.00% and PG&E's 46.75%. This lower revenue stream and lower common equity ratio indicates Sierra Pacific's need for a slightly higher return on common equity than the large California utilities.

After considering all the evidence of the market conditions, trends, and the quantitive models presented by the parties, we conclude that a 13.15% return on equity is just and reasonable for Sierra Pacific's 1989 attrition year.

E. Adopted Cost of Capital

The 13.15% adopted return on common equity produces an overall rate of return of 10.48% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

Sierra Pacific's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.65% | 4.45% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 13.15 | 5.51 |
| TOTAL | 100.00% | | 10.48% |

## VIII. SoCalGas' Application

A. Background

On August 1, 1988, SoCalGas filed an application for authority to increase its authorized return on common equity from 12.75% to 13.75%, and an operational attrition allowance. The request for an operational attrition allowance was filed in conformance with D.87-05-027, which approved the settlement of

SoCalGas' Test Year 1988 general rate case and authorized SoCalGas to file an application for attrition for 1989. The requested return on common equity and operational attrition will result in a $38 million revenue requirement.

SoCalGas' presently authorized rate of return and requested rate of return is shown in the following tables:

SoCalGas' Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.90% | 9.90% | 4.54% |
| Preferred Stock | 8.80 | 6.93 | 0.61 |
| Common Equity | 45.30 | 12.75 | 5.78 |
| TOTAL | 100.00% | | 10.93% |

SoCalGas' Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.84% | 4.48% |
| Preferred Stock | 9.30 | 7.31 | 0.68 |
| Common Equity | 45.20 | 13.75 | 6.22 |
| TOTAL | 100.00% | | 11.38% |

SoCalGas' Treasurer, Loren K. Sanladerer, testified on SoCalGas' requested cost of capital. DRA presented the testimony of Quan. FEA presented the testimony of Legler, and the City of LA presented the testimony of Manual Kroman. Duncan participated in the examination of the witnesses.

B. Capital Structure

There is no dispute on SoCalGas' requested capital structure. DRA concludes that SoCalGas' requested capital structure is reasonable, based on DRA's review of SoCalGas' capital requirements and financial plans through 1989. FEA and the City of LA also concur that SoCalGas' requested capital structure is reasonable for the 1989 attrition year.

We will adopt SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity for the 1989 attrition year.

## C. Cost of Long-Term Debt and Preferred Stock

SoCalGas' 9.84% cost of long-term debt for its 1989 attrition year is comparable to DRA's 9.92% and the City of LA's 9.832%. The difference in estimating the cost of long-term debt is attributable to DRA and the City of LA using a more recent interest forecast than SoCalGas. However, SoCalGas, consistent with other parties to this proceeding, has agreed to use the November DRI control interest rate forecast to determine its embedded debt cost. We will adopt a 9.66% cost of long-term debt for SoCalGas' 1989 attrition year long-term debt, as shown in Late-Filed Exhibit 30 which reflects the November 1988 DRI control interest forecast.

SoCalGas' 7.31% cost of preferred stock consists of the average of preferred stock previously issued and outstanding, weighted to the projected cost of a new 1989 preferred stock issue. The cost of the new preferred stock issue was derived from the comparison of "A" rated utility preferred stock yields for 1986, 1987, and the first five months of 1988 with DRI's "A" utility rated long-term debt yields during the same period.

DRA concurs with the method SoCalGas used to calculate its cost of preferred stock. DRA's estimate is 7.39%, or 0.08% higher because of the availability and use of more recent data. However, because the parties agreed to use an updated DRI forecast SoCalGas' cost of preferred stock was changed to 7.32%, as shown in Late-Filed Exhibit 30. We will adopt the 7.32% SoCalGas' 1989 attrition year cost of preferred stock.

## D. Return on Common Equity

The major issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| SoCalGas | 13.75% |
| DRA | 12.65%* |
| FEA | 13.00 |
| City of LA | 13.00% (maximum) |

* Recommended Range was 12.25% to 12.75%.

SoCalGas, DRA, FEA, and the City of LA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Sanladerer, Quan, Legler, and Kroman:

| Model | Party | Range |
|---|---|---|
| DCF | SoCalGas | 14.82% - 15.79% |
| | DRA | 12.33 - 12.87 |
| | FEA | 11.80 - 13.20 |
| RPM | SoCalGas | 13.53 - 13.93 |
| | DRA | 12.71 - 15.10 |
| | FEA (5-yr. premiums) | 13.20 - 13.30 |
| CAPM | DRA | 11.70 - 15.32 |

Sanladerer testified that SoCalGas' business risk is the same as those business risks which SoCalGas described in its 1988 attrition proceeding. However, two of these risks, the earnings risk resulting from the SAM, and the market risk brought on by intense competition warrant additional consideration because of their expected full year impact in 1989. Although Sanladerer presented DCF an RPM model results, he did not rely on these models to develop his recommended 13.75% return on common equity.

The initial SAM adjustment provides for partial protection from sales losses for two years. However, Sanladerer contends that SoCalGas' exposure to potential pre-tax annual losses from variations in non-core gas margin for the first $27.5 million

and one-third of the losses thereafter up to another $27.5 million, increases SoCalGas' risk.

SoCalGas also states that it faces substantial market risk because of the competitive conditions. According to Sanladerer, this increased risk is reflected in the lower alternate energy prices which have resulted in lower gas rates to low-priority customers as well as lower margin contributions from these customers. Further, the FERC issued a Declaratory Order, on July 1, 1988, stating the FERC's intent to allow an out-of-state transmission company to build a bypass pipeline to serve customers presently served by SoCalGas. SoCalGas also expects two other transmission companies to obtain bypass pipeline certificates by year end 1988.

The City of LA and DRA dispute SoCalGas' claim of increased risk. DRA asserts that while there may be some incremental effect on SoCalGas' risk in 1989, such risk is ongoing and familar to the investors. The City of LA concurs with DRA and suggests that SoCalGas has substantially exaggerated its business and financial risk for its 1989 attrition year.

SoCalGas' SAM argument has been already addressed in this opinion. There is no dispute that risk exists; however, it was considered in arriving at SoCalGas' 1988 attrition proceeding. As the City of LA cites from SoCalGas' 1988 attrition decision (D.87-12-064), we acknowledge that SoCalGas 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.

SoCalGas' competitive risk arguments are no different than the electric and telecommunications utilities' competitive risk arguments. SoCalGas presents a bleak picture about competitive risks; however, the City of LA points out that SoCalGas' 1987 shareholders annual report shows the opposite. SoCalGas has achieved its authorized return on rate base for the fifth year in a row. Customers increased an additional 119,000, the largest number added in a single year since 1955. Even gas volumes delivered increased 22.00% over 1986's gas volumes. As to risk associated to non-core customers, SoCalGas states that the rates charged to these customers will allow it to collect most of the costs allocated to the non-core market in an up-front charge. SoCalGas expects approximately three-fourths of its margin to continue to be protected from earnings fluctuations by the Consolidated Adjustment Mechanism procedure.

After considering all the evidence of the market conditions, trends, quantitative models presented by the parties, we conclude that a 13.00% return on common equity is just and reasonable for SoCalGas' 1989 attrition year.

E. Adopted Cost of Capital

The 13.00% adopted return on common equity produces an overall rate of return of 10.96% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

SoCalGas' Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.66% | 4.40% |
| Preferred Stock | 9.30 | 7.32 | 0.68 |
| Common Equity | 45.20 | 13.00 | 5.88 |
| TOTAL | 100.00% | | 10.96% |

F. Operational Attrition

SoCalGas also requests an operational attrition allowance pursuant to D.87-05-027. Its attrition request is calculated in accordance with the guidelines set forth in D.85-12-076, with the following modifications:

1. Rate base estimates used to calculate the 1988 and 1989 attrition allowance is based

on $325 million of additional gross capital expenditures during the 1988 and 1989 calendar years. The revenue requirement overcollection attributable to any shortfall in such authorized investment is to be refunded to SoCalGas' customers.

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

3. The cost of gas inventory stored underground is removed from ratebase effective for attrition year 1988.

4. 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.

No party objected to SoCalGas' operational attrition filing. However, Toward Utility Rate Normalization (TURN) objected to SoCalGas' proposed rate design and filed a motion to strike SoCalGas' testimony regarding rate design. TURN objected to SoCalGas' proposal to recover over one half of gas supply project expenses from retail noncore and wholesale customers as demand related transmission costs and commodity related cost because one quarter of the system fixed costs are allocated to the retail noncore and wholesale market segments.

Subsequent to the filing of its motion, TURN continued to discuss the rate design issue with SoCalGas. On October 5, 1988 TURN, DRA, and SoCalGas submitted a joint proposal on a revised rate design as shown in Appendix B. The filing of this joint proposal resolves all disputes with SoCalGas' operational attrition and rate design filing.

This joint proposal provides that the operational and financial attrition allowance will be allocated to core and noncore customers in the same proportion that existing gas margin, net of the costs associated with the abandoned gas supply projects, is allocated to such customers. It further provides that the reduced revenue requirement, which results from the termination of the abandoned gas supply projects, will be allocated to core and noncore customers in the same proportion that such costs were previously allocated to such customer classes under the terms of D.87-12-039.

SoCalGas requests that we approve the joint proposal. SoCalGas and TURN requests that such approval not be considered a precedent in any future proceeding.

We will adopt SoCalGas' operational attrition and the joint rate design proposal, updated to reflect the November DRI forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity authorized in this opinion. SoCalGas is authorized to file an Advice Letter pursuant to General Order 96-A to implement its operational attrition allowance effective January 1, 1989.

## IX. Section 311 Comments

The ALJ's proposed decision on this matter was filed with the Docket Office and mailed to all parties of record on November 18, 1988, pursuant to Rule 77 of the Commission's Rules of Practice and Procedure.

DRA, PG&E, and Edison filed comments and served copies of their comments timely to parties of record on December 8, 1988. SoCalGas and San Diego filed their comments with the Docket Office timely. SoCalGas and San Diego did not timely serve copies of their comments to the ALJ or to the parties of record; however, we will accept SoCalGas' and San Diego's comments for this proceeding only because there was no protest and because there was no request for an extension of time to file reply comments.

Rule 77.3 of the Commission's Rules of Practice and Procedure provides that comments to the ALJ's proposed decision shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record.

Filed comments that did not comply with Rule 77.3 were not considered. Comments that identified technical errors have been adopted and corrected in the appropriate place of the decision. Clarification of specific matters were included in the appropriate place of the decision, to the extent adopted. Reply comments were timely filed and received from Edison and DRA.

Findings of Fact

1. Each of the utilities filed its financial attrition request using a calendar-year basis and a 15-month period basis.

2. The utilities' respective applications show that there is no material difference between a calendar-year attrition and a 15-month attrition period.

3. The energy utilities exercised a prudent management decision to retire, prematurely, bonds issued in the early 1980's when interest rates were at all time highs even though they are required to pay premiums to the existing bond holders in connection with these retirements.

4. DRA objects to the utilities using inconsistent methods to pass to ratepayers the tax benefits generated from the premiums paid to retire high cost debt prematurely.

5. The utilities do not object to DRA's proposal to develop, through workshops, a consistent method for passing the high cost debt tax benefits to the ratepayers.

6. San Diego opposes DRA's recommendation that the energy utilities should be required to record the high cost debt tax benefits in a memorandum account, pending adjustment to reflect the impact of the final method decided in the workshops.

7. DRA finds no fault with San Diego's method of passing the high cost debt tax benefits to its ratepayers.

8. The premature retirement of high cost debt is equally applicable to the telephone and the water industry.

9. There is no dispute on Edison's proposed 1989 capital structure of 48.00% long-term debt, 6.00% preferred stock, and 46.00% common stock equity.

10. All parties concur that the cost of long-term debt should be updated to reflect DRI's November 1988 control interest rate forecast.

11. Late-Filed Exhibit 30 shows that the parties concur that Edison's cost of long-term debt for the 1989 attrition year is 9.30%.

12. No party disputes Edison's 7.84% cost of preferred stock for its 1989 attrition year.

13. The DCF, RPM, and CAPM are financial models which are used to establish a range from which the parties use individual judgement to determine a fair return on common equity.

14. The new regulatory structure in the gas and electric industry has created new risk; however, such risk was recognized in the 1988 attrition proceeding.

15. The new regulatory structure has provided the energy utilities flexibility to meet both their needs and ratepayers' needs to respond to the competitive marketplace.

16. The financial community considers the California regulatory climate to be above average.

17. Edison and the other utilities have mitigated and reduced risk from the competitive marketplace challenges by direct competition with the independent power producers according to DRA.

18. Edison's present debt ratio exceeds Standard & Poor's double-A bench mark of 46% debt; however, it has maintained its bond rating because of positive action in other areas.

19. Edison's level of internally generated funds has remained at substantially higher levels the past few years (from 52% of total construction funds in 1983 to 79% in 1987), and AFUDC earnings have significantly dropped from 59% in 1983 to 16% in 1987.

20. Edison's stock continues to trade in excess of book value which indicates that investor perception of the current value of Edison relative to the value of its assets is high.

21. The authorized return on common equity moves in the same direction as interest rates, but not in direct proportion.

22. Although long-term interest rates have moved moderately upward during the year, August 1988 long-term interest rate levels are similar to the level of interest rates at December 1987, when the current returns on common equity were set.

23. DRI's interest rate forecast is based on a subjective analysis and has varied an average of +/- 1.81% from the first quarter of 1982 through the first quarter of 1988.

24. Investors have been aware of the elimination of ERAM and ARA mechanisms since late 1986.

25. Edison has reduced the risk of reliability and availability of third party power producers by purchasing half of its third party producer power from its own subsidiary.

26. There is no dispute on PG&E's proposed capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity.

27. Parties agree that PG&E's cost of long-term debt should be 9.39% for its 1989 attrition year.

28. There is no dispute on PG&E's 8.79% cost of preferred stock.

29. PG&E requests that its authorized return on equity exclude any risk associated with its Diablo Canyon investment, pursuant to its proposed Diablo Canyon settlement agreement.

30. PG&E's risks, except for risks associated with the gas rate restructure, are similar to those of Edison.

31. Increased risk associated with regulatory changes in the electric and gas industry were considered in the 1988 attrition year proceeding.

32. PG&E concurs that risk associated with the elimination of SAM is partially mitigated by the NRSA.

33. The investment community has been aware of increased risk associated with the new gas regulatory structure since 1986.

34. PG&E was authorized the highest return on common equity in the 1988 attrition proceeding primarily because of increased risk associated with the uncertainty of Diablo Canyon.

35. D.85-12-108 observed that San Diego's increasing equity ratio may well present a serious problem in the future and directed San Diego and DRA to address thoroughly San Diego's increasing equity in the next appropriate rate proceeding.

36. San Diego's current common equity goal for financial reporting purposes is 45.00% to 48.00%.

37. San Diego's 1989 expected equity ratio for financial statement purposes is 46.10%.

38. Parties agree that San Diego's cost of long-term debt should be 9.23% for its 1989 attrition year.

39. The Uniform System of Accounts requires that the issuance expense of perpetual capital stock be expensed in the year such stock is retired.

40. Preferred stock is a form of capital stock.

41. Common stock issuance costs are not recovered from ratepayers.

42. San Diego's risk associated with SWPL was addressed in the 1988 attrition proceeding.

43. The elimination of SAM and ERAM can result in a benefit to the shareholders.

44. San Diego has consistently benefited from the AER mechanism and the setting of an 8.0% fixed fuel cost.

45. The intent of decisions related to the gas and electric industry restructure is to provide the regulated utilities a means of responding to marketplace changes, keyed to competition and bypass.

46. San Diego, as a result of lowered costs and restructured sales, has been able to preserve most of its sales and retain most of its market share.

47. There is no dispute on Sierra Pacific's requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity.

48. Parties agree that Sierra Pacific's cost of long-term debt should be 8.65% for Sierra Pacific's 1989 attrition year.

49. Sierra Pacific's requested 7.74% cost of preferred stock was not disputed.

50. Sierra Pacific's expected dividend growth rate is above its historical growth rate and above IBES projected growth rate.

51. Sierra Pacific's revenues are substantially lower than Edison's and PG&E's revenues.

52. There is no dispute on SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity for its 1989 attrition year.

53. Parties agree that SoCalGas' cost of long-term debt should be 9.66% for SoCalGas' 1989 attrition year.

54. DRA agrees with the method SoCalGas used to calculate its cost of preferred stock.

55. SoCalGas' business risk is the same as those business risks which SoCalGas described in its 1988 attrition proceeding.

56. SoCalGas did not rely on the DCF or RPM.

57. SoCalGas has achieved its authorized return on rate base for the last five years.

58. SoCalGas has collected most of its costs allocated to the non-core market in an up-front charge.

59. SoCalGas expects approximately three-fourths of its margin to continue to be protected from earning fluctuations by the Consolidated Adjustment Mechanism.

60. SoCalGas' operational attrition filing is not disputed.

61. SoCalGas, DRA, and TURN concur with the Appendix B rate design proposal.

## Conclusions of Law

1. This opinion should authorize applicants a 1989 cost of capital attrition on a calendar-year basis because there is no material difference between a calendar-year and a 15-month attrition period.

2. The 1989 cost of capital attrition should be continued three additional months, through March 31, 1990, only if a 15-month cost of capital period for the 1989 attrition period is adopted in R.87-11-011.

3. The five energy utilities in this proceeding should not be required to establish memoranda accounts to record tax savings associated with the premiums paid to retire high cost debt.

4. CACD should schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost debt, and with DRA, to establish one consistent method to account for the associated tax savings.

5. Edison's proposed 1989 capital structure should be adopted.

6. Edison should be authorized a 9.30% cost of long-term debt and 7.84% cost of preferred stock for its 1989 attrition year.

7. A 13.00% return on common equity, which results in an overall 10.91% return on rate base, should be adopted as just and reasonable for Edison's 1989 attrition year, based upon all of the evidence considered in this proceeding.

8. PG&E's requested capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity should be adopted for its 1989 attrition year.

9. PG&E should be authorized a 9.39% cost of long-term debt and a 8.79% cost of preferred stock for its 1989 attrition year.

10. A 13.00% return on common equity, which results in an overall 11.04% return on rate base, should be adopted as just and reasonable for PG&E's 1989 attrition year, based upon all of the evidence considered in this proceeding.

11. DRA's recommended 48.50% common equity ratio for San Diego's 1989 attrition year should not be adopted.

12. San Diego did not justify its 51.00% requested common equity ratio.

13. San Diego should be authorized a capital structure of 45.75% long-term debt, 6.25% preferred stock, and 48.00% common equity for its 1989 attrition year.

14. San Diego, Edison, PG&E, Sierra Pacific, SoCalGas, and DRA should address what an optimum capital structure for the California energy utilities should be in their next cost of capital attrition proceeding.

15. San Diego should be authorized a 9.23% cost of long-term debt for its 1989 attrition year.

16. San Diego's unamortized issuance costs associated with refunded perpetual preferred stock should not be included as a component of its preferred stock embedded cost.

17. DRA's recommended 6.97% cost of preferred stock for San Diego's 1989 attrition year should be adopted.

18. A 13.00% return on common equity, which results in an overall 10.90% return on rate base, should be adopted as just and reasonable for San Diego's 1989 attrition year, based upon all of the evidence considered in this proceeding.

19. Sierra Pacific's requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity should be adopted for its 1989 attrition year.

20. Sierra Pacific should be authorized a 8.65% cost of long-term debt and a 7.74% cost of preferred stock for its 1989 attrition year.

21. A 13.15% return on common equity, which results in an overall 10.48% return on rate base, should be adopted as just and reasonable for Sierra Pacific's 1989 attrition year, based upon all of the evidence considered in this proceeding.

22. SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity should be adopted for its 1989 attrition year.

23. SoCalGas should be authorized a 9.66% cost of long-term debt and a 7.32% cost of preferred stock for its 1989 attrition year.

24. A 13.00% return on common equity, which results in an overall 10.96% return on rate base, should be adopted as just and reasonable for SoCalGas' 1989 attrition year, based upon all of the evidence considered in this proceeding.

25. SoCalGas' operational attrition and the joint rate design proposal shown in Appendix B, as revised to reflect the November DRI forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity authorized in this opinion, should be adopted.

# O R D E R

IT IS ORDERED that:

1. Southern California Edison Company's (Edison) adopted cost of capital for its 1989 attrition year is as follows:

Edison's Adopted 1989 Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.30% | 4.46% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 13.00 | 5.98 |
| TOTAL | 100.00% | | 10.91% |

2. Edison's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 1, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. Edison's advice letter shall be filed on or before December 28, 1988.

3. Pacific Gas & Electric Company's (PG&E) adopted cost of capital for its 1989 attrition year is as follows:

PG&E's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.39% | 4.34% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 13.00 | 6.08 |
| TOTAL | 100.00% | | 11.04% |

4. PG&E's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 3, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. PG&E's advice letter shall be filed on or before December 28, 1988.

5. San Diego Gas & Electric Company's (San Diego) adopted cost of capital for its 1989 test year is as follows:

San Diego's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.75% | 9.23% | 4.22% |
| Preferred Stock | 6.25 | 6.97 | 0.44 |
| Common Equity | 48.00 | 13.00 | 6.24 |
| TOTAL | 100.00% | | 10.90% |

6. San Diego's adopted 1989 test year rate of return, as shown in Ordering Paragraph 5, shall be used in conjunction with its pending 1989 general rate case proceeding decision for the purpose of calculating revised rates for the 1989 test year. San Diego's advice letter shall be filed on or before December 28, 1988.

7. Sierra Pacific Power Company's (Sierra Pacific) adopted cost of capital for its 1989 attrition year is as follows:

Sierra Pacific's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.65% | 4.45% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 13.15 | 5.51 |
| TOTAL | 100.00% | | 10.48% |

8. Sierra Pacific's adopted 1989 rate of return, as shown in Ordering Paragraph 7, may be used to revise its authorized base rate revenue requirement to be recovered through its ERAM (Energy Regulatory Adjustment Mechanism) balancing account, to become effective no earlier than four days after an advice letter filing by Sierra Pacific, but no earlier than January 1, 1989.

9. Southern California Gas Company's (SoCalGas) adopted cost of capital for its 1989 attrition year is as follows:

SoCalGas' Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.66% | 4.40% |
| Preferred Stock | 9.30 | 7.32 | 0.68 |
| Common Equity | 45.20 | 13.00 | 5.88 |
| TOTAL | 100.00% | | 10.96% |

10. SoCalGas' operational attrition and rate design proposal as shown in Appendix C, updated to reflect the November Data Resources, Inc.'s November 1989 forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity adopted in Ordering Paragraph 9, shall be adopted. SoCalGas is authorized to file an Advice Letter pursuant to General Order 96-A to implement its operational and financial attrition allowance effective January 1, 1989. SoCalGas' advice letter shall be filed on or before December 28, 1988.

11. The Commission Advisory and Compliance Division (CACD) shall schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost bonds for the purpose of establishing a consistent method to pass the resultant tax benefits back to the ratepayers. If an Order Instituting Investigation (OII) is opened to address this tax issue, then the applicants to this consolidated proceeding shall participate in the OII and CACD shall cancel any scheduled workshops. A copy of this opinion shall be served on the CACD Director.

12. Edison, PG&E, San Diego, Sierra Pacific, SoCalGas, and Division of Ratepayer Advocates shall address the results of the workshops identified in Ordering Paragraph 11, in their next financial attrition proceeding.

13. Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas shall address the optimum balanced capital structure in their

respective electric and gas regulated industry in their next financial attrition proceeding.

This order is effective today.

Dated DEC 19 1988, at San Francisco, California.

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

I will file a written concurring opinion.

/s/ FREDERICK R. DUDA
Commissioner

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

Victor Weisser, Executive Director

## APPENDIX A

## LIST OF APPEARANCES

**Applicants:** Richard K. Durant, Carol B. Henningson, James M. Lehrer, and Frank Mc Nulty, Attorneys at Law, for Southern California Edison Company; Roger J. Peters, Michelle L. Wilson and Kermit R. Kubitz, Attorneys at Law, for Pacific Gas and Electric Company; Barton Myerson and Tom Hankley, Attorneys at Law, and Bruce Williams, for San Diego Gas and Electric Company; James D. Salo, Attorney at Law, for Sierra Pacific Power Company; and Peter N. Osborn and Roy M. Rawlings, Attorneys at Law, for Southern California Gas Company.

**Interested Parties:** William S. Shaffran, Attorney at Law, for the City of San Diego; Shelley Ilene Smith, Attorney at Law, for the City of Los Angeles; Norman J. Furuta, Attorney at Law, for Consumer Interest of the Federal Executive Agencies; Manuel Kroman, for himself; Michael P. Alcantar and Frederick Dorey, Attorneys at Law, for Lindsay, Hart, Neil & Weigler; David J. Byers, Attorney at Law, of McCracken, Byers & Martin, for California City County Street Light Association; Edward Duncan, for himself; Reed V. Schmidt, of Chester and Schmidt Consultants, for City of Fresno, City of Irvine and County of Marin; Reed Sato and Phillip A. Stohr, Attorneys at Law, of Downey, Brand, Seymore & Rohwer, for Industrial Users Group; Donald W. Schoenbeck and Frederick Dorey, for RCS, Inc.; Richard Wolf, for C. P. National Corporation; Michel Peter Florio, Attorney at Law, for Toward Utility Rate Normalization (TURN); Joseph D. Milanowski, for Southwest Gas; and Roger Poynts, for Utility Design, Inc.

**Division of Ratepayer Advocates:** Timothy E. Treacy, Attorney at Law, and Terry Mowrey.

(END OF APPENDIX A)

**Southern California Gas Company**
**1989 Attrition - TURN Proposal**

Prorate requested 1989 Attrition over 1988 Margin in rates at May 1, 1988 net of LNG and Gas Supply Project Amortization costs. Credit back LNG/Gas Supply Project cost reductions on the same bases used to allocate these costs in the May 1, 1988 rates.

**Margin Reflected in Rates at May 1, 1988 (A.L. 1767-A, 3rd Suppl)**

| | | Noncore | | |
|---|---|---|---|---|
| | Core | Retail | Whos'l | Total |
| Common Distribution | 290573 | 38276 | 0 | 328849 |
| Demand Related Transmission | 45666 | 42395 | 15362 | 103422 |
| Demand Related Storage | 66341 | 37491 | 17458 | 121289 |
| Customer Related | 555987 | 5618 | 2237 | 563842 |
| Commodity Related | 5005 | 5028 | 1690 | 11723 |
| 50% A&G | 51884 | 52129 | 2469 | 106482 |
| (A) Totals | 1015454 | 180937 | 39215 | 1235607 |

**LNG & Gas Supply Project Amortization Costs Included in Above Margin Components**

| | Core | Retail | Whos'l | Total |
|---|---|---|---|---|
| Demand Rel Trans - LNG Proj Amortization* | 6795 | 6309 | 2286 | 15390 |
| Commod Rel - Gas Supply Proj Amortization* | 4828 | 4850 | 1630 | 11308 |
| Subtotal Amortization | 11623 | 11159 | 3916 | 26698 |

**Margin at May 1, 1988 Excluding LNG and Gas Supply Project Amortization Costs**

| | | Noncore | | |
|---|---|---|---|---|
| | Core | Retail | Whos'l | Total |
| Common Distribution | 290573 | 38276 | 0 | 328849 |
| Demand Related Transmission | 38870 | 36086 | 13076 | 88032 |
| Demand Related Storage | 66341 | 37491 | 17458 | 121289 |
| Customer Related | 555987 | 5618 | 2237 | 563842 |
| Commodity Related | 177 | 178 | 60 | 415 |
| 50% A&G | 51884 | 52129 | 2469 | 106482 |
| (B) Adjusted May 1, 1988 Margin Allocation | 1003832 | 169778 | 35299 | 1208909 |

| | Core | Retail | Whos'l | Total |
|---|---|---|---|---|
| * Calculation Bases (Mth) | | | | |
| Demand Related Transmission base | | | | |
| Cold Year Throughput | 4152976 | 3855540 | 1397031 | 9405547 |
| Commodity Related base | | | | |
| Average Year Throughput | 3837422 | 3855540 | 1295714 | 8988676 |

APPENDIX B
Page 2

**Southern California Gas Company**
**1989 Attrition - TURN Proposal**

| | | | | |
|---|---|---|---|---|
| (B) Adjusted May 1, 1988 Margin Allocation (from page 1) | 1003832 | 169778 | 35299 | 1208909 |
| Ratios of above (B) totals | 83.036% | 14.044% | 2.920% | 100.000 |
| Requested 1989 Attrition (total before adj) Prorated per above ratios | 57366 | 9702 | 2017 | 69085 |
| Adjustment for Current LNG and Gas Supply Project Amortization Costs** | | | | |
| LNG Project Amortization* | -9058 | -8409 | -3047 | -20514 |
| Gas Supply Project Amortization | -4635 | -4657 | -1565 | -10857 |
| Subtotal Amortization | -13693 | -13066 | -4612 | -31371 |
| (C) Net Total - 1989 Attrition | 43673 | -3364 | -2595 | 37714 |
| Margin Allocation in May 1, 1988 Rates (A) | 1015454 | 180937 | 39215 | 1235607 |
| Subtotal - 1989 Margin (A) + (C) | 1059127 | 177574 | 36621 | 1273321 |
| Pipeline Demand Charge in May 1, 1988 Rates | 145680 | 135246 | 48824 | 329750 |
| EOR Credit in May 1, 1988 Rates | -15742 | -4287 | -1194 | -21222 |
| Net - Allocated Totals per TURN Proposal | 1189065 | 308533 | 84251 | 1581849 |
| Totals per Attrition Filing: A.88-08-001 | 1189677 | 308187 | 83986 | 1581849 |
| Difference from A.88-08-001 Filing | -612 | 346 | 265 | 0 |

** The difference in the adjustment to margin for the LNG and gas supply projects cost ($26,698,000) underlying May 1, 1988 rates as compared to the amount credited back to ratepayers in the attrition filing ($31,371,000) is attributable to differences in the treatment of income taxes, franchise fees, and uncollectibles which result from the termination of these costs in the attrition filing as compared to treatment of these related costs when the base costs (LNG and gas supply projects) are ongoing in nature.

(END OF APPENDIX B)

(APPENDIX C TO BE PROVIDED LATER)

A.88-07-023 et al.
D.88-12-094

FREDERICK R. DUDA, Commissioner, concurring.

I concur in order to praise, rather than criticize, this decision.

I am especially pleased with Ordering Paragraph 13, which requires Edison, PG&E, San Diego, Sierra Pacific and SoCalGas to address the optimum balanced capital structure in their respective electric and gas regulated industry in their next financial attrition proceeding. This requirement will help make sure that ratepayer interests, not just debt credit rating criteria, guide our capital structure decisions.

Frederick R Duda

Frederick R. Duda, Commissioner

December 19, 1988
San Francisco, California

ALJ/MJG/tcg

Decision ___________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

| | |
|---|---|
| In the Matter of the Application of Southern California Edison Company (U-338-E) for authority to (i) increase its authorized rate of return on common equity, (ii) adjust its authorized capital structure, (iii) adjust cost factors for imbedded debt and preferred stock, and (iv) related substantive and procedural relief. | Application 88-07-023 (Filed July 25, 1988) |
| Application of Pacific Gas and Electric Company for adoption of authorized rate of return for 1989 pursuant to attrition rate adjustment mechanism. (U-39-M) | Application 88-07-037 (Filed July 20, 1988) |
| In the Matter of the Application of San Diego Gas & Electric Company for authority to decrease its rates and charges for Electric, and to increase its rates and charges for gas and steam service. (Cost of Capital Phase) (U-902-M) | Application 87-12-003 (Filed December 1, 1987) |
| Order Instituting Investigation into the rates, charges and practices of San Diego Gas and Electric Company. | I.88-01-006 (Filed January 13, 1988) |
| In the Matter of the Application of Sierra Pacific Power Company to authorize a return on equity for calendar year 1989 pursuant to attrition rate adjustment mechanism. (U-903-E) | Application 88-07-052 (Filed July 28, 1988) |
| In the Matter of the Application of Southern California Gas Company (U-904-G) to implement its attrition allowance and to establish a return on equity for 1989. | Application 88-08-001 (Filed August 1, 1988) |

(See Appendix A for appearances.)

# INDEX

# INDEX

# OPINION

## I. Summary

These proceedings were consolidated to address Southern California Edison Company's (Edison), Pacific Gas & Electric Company's (PG&E), San Diego Gas & Electric Company's (San Diego), Sierra Pacific Power Company's (Sierra Pacific), and Southern California Gas Company's (SoCalGas) 1989 rate of return attrition filings. This opinion also authorizes SoCalGas an 1989 operational attrition allowance.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that the utilities should be authorized a return on common equity and an overall return on rate base as follows:

| Utility | Common Equity | Rate Base |
|---|---|---|
| Edison | 12.75% | 10.98% |
| PG&E | 12.75 | 10.92 |
| San Diego | 12.75 | 10.78 |
| Sierra Pacific | 12.90 | 10.38 |
| SoCalGas | 12.75 | 10.84 |

## II. Background

Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas filed their respective applications pursuant to Decision (D.) 85-12-076, which requires the energy utilities to address return on equity issues for their respective attrition years. Order Instituting Rulemaking (OIR) 87-11-012's assigned administrative law judge (ALJ) issued a proposed schedule for future annual cost of capital reviews to be moved from a calendar year basis to a fiscal year basis. Accordingly, the ALJ in OIR 87-11-012 requested the energy utilities to file their 1989 cost of capital reviews on a calendar year basis and on a 15-month basis. Subsequently, the ALJ issued his proposed decision recommending that the cost of capital reviews continue on a calendar year basis.

This opinion addresses and authorizes a calendar year basis cost of capital because the utilities' respective filings show that there are no significant differences between a calendar year basis and a 15-month basis. However, if an OIR 87-11-012 opinion adopts the 15-month period, then the cost of capital authorized for the respective utilities in this opinion should continue for the three additional months, through March 31, 1990.

On August 10, 1988, a prehearing conference on the energy utilities' cost of capital applications was held before ALJ Galvin in Los Angeles. At the prehearing conference, the ALJ consolidated the applications into one proceeding, pursuant to Rule 55 of the Commission's Rules of Practice and Procedure which allows such consolidation of proceedings with related questions of law or fact.

Hearings were held from October 3 to October 7 in Los Angeles. Concurrent briefs were filed on October 17, 1988, and the consolidated proceeding was submitted on November 10, 1988 upon the receipt of Late-Filed Exhibit 30 which updates the embedded cost of long-term debt estimates with a cost factor equivalent to Data Resources, Inc.'s (DRI) November 1988 "control" interest rate forecast.

Letters of protest to the applications concerning the objection to any increase in rates because of ratepayers' limited income and the idea that shareholders should share risk with the utilities were received from approximately 500 ratepayers. Received as Item 1 is a petition signed by approximately 40 of Edison's ratepayers opposing any increase in Edison's rates because they believe that any additional increase in rates to the average residential user could make basic comforts more difficult to acquire. The following table summarizes the number of protest letters placed in the respective utility's formal file:

| Utility | Letters |
|---|---|
| Edison | 159 |
| PG&E | 61 |
| San Diego | 185 |
| Sierra Pacific | 0 |
| SoCalGas | 95 |

This opinion addresses the issues raised in Edison's, PG&E's, San Diego's, Sierra Pacific's, and SoCalGas' application on an individual utility basis. However, an issue pertaining to the uniform recovery of the tax savings from deducting premiums paid to retire high cost debt is addressed as a generic issue.

## III. Recovery of Premiums Paid to Retire High Cost Debt

The Commission Division of Ratepayer Advocates (DRA) witness, Quan, testified that the utilities have exercised a prudent management decision to retire, prematurely, bonds issued in the early 1980's when interest rates were at all time highs even though the utilities are required to pay premiums to the existing bond holders of the high cost debt. However, DRA takes issue with the method that the utilities use to pass the tax savings generated from deducting these premiums in the year the high cost bonds are retired to their ratepayers. DRA estimates that SoCalGas' premium for high cost bonds prematurely retired, alone, is projected to be approximately $1.5 million in 1990.

DRA raises this tax issue because the utilities use different methods to pass these tax savings back to the ratepayers. Some utilities include the entire premium in the embedded debt cost calculation with an offset for the tax savings in the deferred tax reserve account as a reduction to rate base. Other utilities include the entire premium in the embedded debt cost, however, with no offset for tax savings reflected in the deferred tax reserve.

These are only two of the many methods used by the utilities. The result is an inconsistent flow of tax benefits to the ratepayers.

DRA recommends that the utilities should use one consistent method for treating premiums associated with the retirement of high cost debt and pass back the associated tax savings to the ratepayers. DRA did not recommend any specific method. Instead, DRA recommends that workshops be held with DRA and the utilities to establish a consistent method for all utilities.

DRA, citing D.88-08-061, where General Telephone Company of California was ordered to establish a balancing account to record the potential tax savings associated with the premiums paid to retire high cost debt pending resolution of the issue, recommends that the energy utilities establish a memorandum account effective January 1, 1989 to track the amounts currently recovered in rates related to these retirements. DRA recommends that this memorandum account be adjusted to reflect the impact of the final method decided in the workshops.

The utilities do not oppose DRA's workshop proposal. However, San Diego opposes the establishment of a memorandum account because it believes it is unnecessary and will create a new business risk. San Diego argues that its method of accounting for such tax benefits was previously approved by the Commission, and that DRA's witness acknowledged that he found no fault with San Diego's method.

The premature retirement of high cost bonds is not restricted to the energy utilities. As DRA points out, it is also happening in the telephone industry, and is probably happening in the water industry. This issue is generic to all California utilities. DRA's proposal has merit. However, we can not expect or require DRA and the five energy utilities in this consolidated proceeding to set policy for all electric, gas, telephone, and water utilities. Nor would it be fair to require the five energy utilities in this proceeding to establish memorandum accounts subject to adjustment without establishing the fact that the energy utilities are improperly accounting for the tax benefits, particularly since their respective methods have previously been used to set rates. For the above reasons, we will not require the utilities to establish a memorandum account to track the tax benefits earned from the premature retirement of high cost bonds.

We will consider issuing a generic utility OII (Order Instituting Investigation) on this issue. However, in the interim, the Commission Advisory and Compliance Division (CACD) should schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost bonds. CACD should notify DRA and other parties CACD believes may be interested in participating in the workshops. Although we will not keep this proceeding open to address the workshop results, we will expect the energy utilities and DRA to present testimony on the method and/or alternative method established at the workshops in the respective utility's first rate or attrition proceeding following the final workshop. If we issue a generic utility OII on this issue prior to the workshops, the workshops should be cancelled and the energy utilities should actively participate in the OII.

## IV. Edison's Application

### A. Background

On July 15, 1988, Edison filed an application for authority to increase its authorized return on common equity from 12.75% to 13.75%, to adjust its authorized capital structure, to adjust its cost factors for embedded debt and preferred stock, and to reflect the impact of such changes (approximately $80 million) in its 1989 operational attrition Advice Letter filing.

Edison's presently authorized rate of return and requested rate of return is depicted in the following tables:

### Edison's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 47.00% | 9.22% | 4.33% |
| Preferred Stock | 7.00 | 7.88 | 0.55 |
| Common Equity | 46.00 | 12.75 | 5.87 |
| TOTAL | 100.00% | | 10.75% |

### Edison's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.35%* | 4.49% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 13.75 | 6.33 |
| TOTAL | 100.00% | | 11.29% |

* Revised from the 9.31% cost factor in Edison's application to reflect DRI's October 1988 interest forecast.

Edison presented two witnesses, Alan J. Fohrer, Assistant Treasurer and Manager of Cost Control, and Alex C. Miller, Manager of Financial Planning. Fohrer testified on Edison's financial policy and Miller testified on Edison's cost of capital methodology. DRA presented the testimony of Edwin Quan. Federal Executive Agencies (FEA) presented the testimony of John B. Legler. Edward Duncan, representing himself, participated in examination of the witnesses.

B. Capital Structure

The difference between Edison's authorized and requested capital structure is a nominal decline (1%) in the amount of preferred stock as a percentage of total capitalization.

There is no dispute on Edison's capital structure. DRA concludes that Edison's requested capital structure is reasonable, based on DRA's review of Edison's capital requirements and financing plans through 1989. FEA also accepts Edison's proposed capital structure for the purpose of estimating the weighted average cost of capital. Therefore, we will adopt Edison's 1989 requested capital structure of 48.00% long-term debt, 6.00% preferred stock, and 46.00% common equity.

## C. Cost of Long-Term Debt and Preferred Stock

Edison's 9.35% cost of long-term debt is comparable to DRA's 9.27% and FEA's 9.31%. The difference in estimating the cost of long-term debt is attributable to DRA updating estimates with actual cost and using more recent interest forecasts than Edison. However, Edison, DRA, and FEA concur that the November 1988 DRI "control" interest rate forecast should be used to determine the cost of Edison's long-term debt. Late-Filed Exhibit 30, filed November 10, 1988, shows that the parties agree that Edison's cost of long-term debt for the 1989 attrition year should be 9.30%. Therefore, we will adopt a 9.30% long-term debt cost for Edison's 1989 attrition year, which reflects the November 1988 DRI control interest forecast.

Edison's 7.84% cost of preferred stock was not disputed by DRA or FEA, therefore, we will adopt Edison's 7.84% cost of preferred stock for its 1989 attrition year.

## D. Return on Common Equity

The major issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| Edison | 13.75% |
| DRA | 12.50%* |
| FEA | 12.50% |

* Recommends Mid of Range 12.25% to 12.75%

Edison, DRA, and FEA submitted testimony on the results of various financial models which they used as the starting point to determine their recommended return on equity. Edison and DRA use the DCF (Discounted Cash Flow Analysis), RPM (Risk Premium Analysis), and CAPM (Capital Asset Pricing Model). FEA uses the DCF and RPM model.

Detailed descriptions of each financial model is contained in the record and are not repeated here. These models are used only to establish a range from which the parties use individual judgement to determine a fair return on common equity. Although the parties agree that the models are objective, the results are dependent on the subjective inputs. From these subjective inputs the parties advance arguments in support of their respective analysis and in criticism on the input assumptions used by other parties. These arguments will not be addressed extensively in this opinion, since they do not alter the model results. As Miller testified, in the final analysis, it is the application of judgement, not the precision of these models, which is the key to selecting a specific return on common equity estimate within the range predicted by analysis.

The following table summarizes the results of the models presented by witnesses Miller, Quan, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | Edison | 12.70% - 14.00% |
| | DRA | 12.26 - 12.80 |
| | FEA | 11.40 - 12.60 |
| RPM | Edison | 13.10 - 14.60 |
| | DRA | 13.04 - 15.13 |
| | FEA (5-yr. premiums) | 13.00% |
| CAPM | Edison | 13.40 - 14.70 |
| | DRA | 12.29 - 15.80 |

Edison asserts that to arrive at a fair return on common equity, it is necessary to apply informed judgement to the regulatory, competitive, and financial risk which Edison faces.

Edison also asserts that regulatory risk is one of the significant factors that affects the total level of risk perceived by investors. Fohrer believes that investor risk "may" increase because the elimination of ERAM (Energy Regulatory Adjustment Mechanism) and ARA (Attrition Rate Adjustment) for the large industrial and commercial customers because full cost recovery will be dependent on accurate forecast. Edison also believes that the seasonal variation in earnings will impact investors' expectations.

The AER (Annual Energy Rate) reasonableness review, a percentage of fuel and purchased power costs recoverable on a fixed, forecast basis is another regulatory risk that must be considered because of the flux of this recovery mechanism. Although Edison was authorized to implement this mechanism in 1981, it was temporarily suspended in 1986, reinstated in 1987, and again suspended in 1988 until Edison's 1989 Energy Cost Adjustment Clause proceeding. Fohrer believes that additional risk exists because of the uncertainty of whether Edison will be able to recover volatile fuel and purchased power costs.

Fohrer cites the reasonableness review procedure, which allows Edison to recover 75% of the revenue requirement associated with certain plant additions costing over $50 million pending a reasonableness review, as another regulatory risk factor. According to Fohrer, this procedure compounds an investor's fear that recovery of plant investments will be made more difficult because the procedure requires a separate proceeding and delays full rate base treatment of the plant investment.

Alternative forms of capital recovery such as the proposed Diablo Canyon settlement are identified by Fohrer as a new regulatory risk because such proposed settlement departs from the traditional ratemaking treatment of plant investment. Although the proposal involves recovery of a controversial nuclear plant investment, Fohrer believes that it affects investors' perception and if adopted will signal to the investors that shareholders in California utilities may bear greater risks.

Edison cites several Federal Energy Regulatory Commission (FERC) proposed rulemakings which may affect how prices are to be set in contracts with Qualifying Facilities (QFs) and which may streamline regulation for independent power producers. Edison supports many of the QF proposals but has concerns about proposals which favor the non traditional suppliers.

DRA's Quan concurs that the Commission has created new forms of regulation and provided regulatory flexibility to meet the needs of both the utilities and ratepayers to respond to the competitive marketplace. Quan acknowledges that utilities such as Edison faces different risk to operate in the new competitive marketplace and that such risk should be recognized in setting the appropriate return on common equity. However, he believes that only the incremental change in risks over the level already recognized in the last rate of return authorization should be considered.

Legler's analysis of regulatory risk was based on a national perspective. It was not based on a California specific regulatory risk. According to Legler the financial community looks at an overall perspective of regulatory risk, not a checklist approach. Legler concludes that the California regulatory climate is good and that the financial community considers the California regulatory climate to be above average compared to other states. Salomon Brothers, Inc.'s March 31, 1988 stock research publication (Exhibit 12) substantiates Legler's conclusion of the California regulatory climate.

Fohrer asserts that a significant risk exists in the competitive marketplace from third-party producers and self producers within Edison's service territory. He testified that Edison could be required to obtain new sources of power on short notice and at higher prices because third party electric producers have no obligation to serve, may abandon unprofitable projects, and may discontinue supply because of unrelated business failures.

Also, the bypass of large industrial and commercial customers is a continual threat recognized by Salomon Brothers, Inc. and other members of the financial community as the major investment consideration for Edison during the next several years.

DRA concurs with Edison that competitive risk should be considered. However, Quan believes that Edison and the other utilities have mitigated and reduced risk from the competitive marketplace challenges by direct competition with the independent power producers through separate subsidiaries. In Edison's case, Edison obtains approximately 10% of its energy from third party producers, half of which is provided by Mission Energy Company, Edison's non-utility subsidiary.

Edison's financial measurement of risk is based on its prospective bond rating and increase in interest rates. Edison's present debt ratio exceeds Standard & Poor's double-A bench mark of 46% debt. However, Edison has maintained its bond rating because of positive action in other areas. Fohrer states that if Edison is authorized a 13.75% return on common equity, its interest coverage, which has steadily declined, is projected to decrease to 3.3 by 1990. This decline in interest coverage equates to a decline in Edison's financial strength and increase risk because the projected interest coverage is below Standard & Poor's 3.5 minimum coverage for a double-A rating. This, coupled with the projected inflation forecasts of up to 6.1% in 1989 will impact Edison's ability to attract funds and to maintain its financial strength in 1989.

Quan considered Edison's financial risk and concludes that Edison's risk has remained approximately the same since the 1988 attrition proceeding. Specifically, internally generated funds have remained at substantially higher levels the past few years from 52% of total construction funds in 1983 to 79% in 1987, and AFUDC (Allowance for Funds Used During Construction) earnings have significantly dropped from 59% in 1983 to 16% in 1987. Also, Edison's stock continues to trade in excess of book value which indicates that the investors' perception of the current value of Edison relative to the value of its assets is high.

Quan disputes Edison's argument that rising interest rates and the uncertainty of the future levels of inflation require the return on common equity to be set at a level higher than that currently authorized. Table 7 to Quan's Exhibit 4 compares the overall trends in long-term interest rates with the authorized returns on common equity for the last eleven years. This table shows that the authorized returns on common equity does move in the same direction as interest rates, but not in direct proportion.

Although long-term interest rates have moved moderately upward during the year, the August 1988 long-term interest rate is similar to the level of interest rates in December 1987 when the current return on common equity was set. Further, Jenkins-Stark of PG&E testified that long-term interest rates continued to decrease in September 1988.

We do not place sole reliance on DRI's interest rate forecasts. Forecasts are estimates based on subjective analysis. This is confirmed by San Diego's Krumvieda who compared DRI's quarterly AA utility bond forecast with actual results from the first quarter of 1982 through the first quarter of 1988 and concludes that DRI's forecast varies an average of +/- 1.81%.

Absent from Edison's risk analysis is a discounting of benefits investors stand to gain from the regulatory policies and the discounting of risk associated with prior years risk. For example, investors have been aware of the potential for elimination of the ERAM and ARA mechanisms since late 1986 in I.86-10-001 and should have already adjusted for the expected risk. California regulatory policy recognized by the financial community as above average is also a positive factor to consider.

We concur that the competitive risk is present. However, Edison has reduced the risk of reliability and availability of third party power by purchasing half of its third party producer power from its subsidiary, Mission Energy Company. Financial risk is also present; however, Edison has not demonstrated that such risk has substantially increased during 1988 or that such risk warrants a 100 basis point increase in its authorized return on equity.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that a 12.75% return on equity is just and reasonable for Edison's 1989 attrition year.

E. Adopted Cost of Capital

The 12.75% adopted return on common equity produces an overall rate of return of 10.98% for the 1989 attrition year, an increase of 0.23% from its 10.75% overall rate of return for 1988. The following table shows Edison's adopted cost of capital for its 1989 attrition year:

Edison's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.30% | 4.64% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 12.75 | 5.87 |
| TOTAL | 100.00% | | 10.98% |

## V. PG&E's Application

A. Background

On July 20, 1988, PG&E filed an application for authority to increase its authorized return on common equity from 13.10% to 14.50%. The requested change in common equity will result in approximately an $87 million gross revenue requirement increase for PG&E's Electric Department and a $22 million revenue requirement increase for its gas department. Subsequently, on September 16, 1988, PG&E revised its requested return on common equity to 13.75% to reflect the provisions of PG&E's proposed reasonable return on common equity, only one of which is the interest rate forecast.

If we assume for argument sake that Sanladerer's 275 to 307 basis point spread is correct and adjust for DRI's margin of error rate presented by Krumvieda, then the 1989 authorized return on equity should be within the range of 11.38% to 15.32%.[1] A common equity range of this magnitude provides little guidance to the Commission in arriving at a reasonable return on common equity and greatly exceeds the range of common equity returns recommended by the parties in this consolidated proceeding. As pointed out above, the interest rate forecast is only component of risk which we consider to arrive at a reasonable return on common equity.

Absent from Edison's risk analysis is a discounting of benefits investors stand to gain from the regulatory policies and the discounting of risk associated with prior years risk. For example, investors have been aware of the potential for elimination of the ERAM and ARA mechanisms since late 1986 in I.86-10-001 and should have already adjusted for the expected risk. California regulatory policy recognized by the financial community as above average is also a positive factor to consider.

We concur that the competitive risk is present. However, Edison has reduced the risk of reliability and availability of third party power by purchasing half of its third party producer power from its subsidiary, Mission Energy Company. Financial risk is also present; however, Edison has not demonstrated that such

1 The range is calculated as follows:

| | Low | High |
|---|---|---|
| November DRI Forecast | 10.44% | 10.44% |
| Basis Point Range | 2.75 | 3.07 |
| DRI Error Rate | +/-1.81 | +/-1.81 |
| Calculated Range | 11.38% to 15.00% | 11.70% to 15.32% |

Diablo Canyon Settlement Agreement and Implementing Agreement of June 24, 1988.

PG&E's presently authorized rate of return and requested rate of return is depicted in the following tables:

PG&E's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.34% | 4.25% |
| Preferred Stock | 8.50 | 8.80 | 0.75 |
| Common Equity | 46.00 | 13.10 | 6.03 |
| TOTAL | 100.00% | | 11.03% |

PG&E's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.40% | 4.35% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 13.75 | 6.43 |
| TOTAL | 100.00% | | 11.40% |

PG&E presented two witnesses, John F. Jenkins-Stark, Treasurer, and Laura Paratte, Senior Financial Analyst. Jenkins-Stark testified on PG&E's financial policy and Paratte testified on PG&E's cost of capital methodology. DRA presented the testimony of Edwin Quan. FEA presented the testimony of John B. Legler. Roger Poynts, of Utility Design, Inc. also presented testimony.

B. Capital Structure

PG&E's requested preferred stock ratio decreased 1.50% from its presently authorized preferred stock ratio, from 8.50% to 7.00%. This reduction resulted from the refunding of high coupon preferred stock issues. PG&E asserts that its capital structure, which excludes the impacts of Diablo Canyon operations, is consistent with the terms of the proposed Diablo Canyon settlement agreement pending before the Commission in A.84-06-014.

There is no dispute over PG&E's proposed capital structure. DRA concludes that PG&E's requested capital structure is reasonable, based on DRA's review of PG&E's 1989 capital requirements and financing plans. Poynts did not recommend any capital structure. We will adopt PG&E's 1989 requested capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity for its 1989 attrition year.

C. Cost of Long-Term Debt and Preferred Stock

PG&E's requested cost of long-term debt and preferred stock is not in dispute. Consistent with the updating of Edison's long-term cost of debt, PG&E concurs that its long-term debt cost should be updated with the November 1988 DRI "control" interest rate forecast. We will adopt a 9.39% cost of debt factor for PG&E's 1989 attrition year, as shown in Late-Filed Exhibit 30 which reflects DRI's November 1988 control interest forecast. PG&E's 8.79% cost of preferred stock, which is not disputed, should be adopted for the 1989 attrition year.

D. Return on Common Equity

At issue is the appropriate return on common equity for PG&E's 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| PG&E | 13.75%* |
| DRA | 12.50%** |
| FEA | 12.75% - 13.25% |
| Poynts | No Recommendation |

* Revised from 14.50% to exclude Diablo Canyon impacts.

** Recommends Mid Range of 12.25% to 12.75%

PG&E excluded its projected Diablo Canyon risk to arrive at its requested 13.75% return on common equity, pursuant to its Diablo Canyon settlement agreement with all parties to the Diablo

Canyon proceeding. In response to the ALJ's concern that this agreement has not yet been approved by the Commission, Jenkins-Stark testified that PG&E's sole recommendation for a return on common equity in this proceeding is 13.75%. Therefore, the return on common equity adopted in this opinion for PG&E should be effective for the entire 1989 attrition year.

Poynts did not recommend a specific return on common equity; however, he did recommend that the return on common equity not be increased. This recommendation is based on Poynts' review of the increase in interest rates, the modest increase in the consumer price index from 4.4% in 1987 to 4.6% in 1988 and his belief that PG&E has no increased regulatory or competitive risk because PG&E is a monopoly utility which is allowed to increase its rates to offset anticipated inflation.

PG&E, DRA, and FEA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Jenkins-Stark, Quan, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | PG&E | 10.42% - 16.73% |
| | DRA | 12.12 - 12.66 |
| | FEA | 13.20 - 14.70 |
| RPM | PG&E | 14.16 - 14.42 |
| | DRA | 13.04 - 15.13 |
| | FEA (5-yr. premiums) | 14.40 - 14.50 |
| CAPM | PG&E | 14.92% |
| | DRA | 11.95 - 15.53 |

Legler's financial model results, as summarized above, are based on PG&E's initial showing which include impacts associated with Diablo Canyon. Legler was unable to discount the impacts of Diablo Canyon because PG&E submitted its revised testimony after Legler's direct testimony was submitted. However, Legler did address PG&E's revised testimony on direct examination and did reduce his recommended return on common equity from the 13.00% - 14.00% range to the 12.75% - 13.25% range. His financial model results were not adjusted to exclude Diablo Canyon impacts and, therefore, will not be addressed.

DRA's financial models are based on market data related to a comparable group of electric utilities. PG&E specific data was not used because Quan believes that it is impossible to isolate any perceived investor risk associated with Diablo Canyon.

Although PG&E excludes its estimated risk associated with Diablo Canyon, it believes that its return on common equity should be increased 65 basis points, from 13.10% to 13.75% because of increased business risk from ongoing regulatory changes and restructure of the California gas and electric industry, and a significant increase in the 1989 attrition year interest rate forecast over the 1987 interest rate forecast.

Jenkins-Stark testified that regulatory developments have increased investor risk and reduced regulatory protection thereby moving PG&E closer toward the risk levels of unregulated sectors of the economy. He cites the gas rate restructure which began in December 1986, the Electric rate restructure, FERC regulatory changes, self generators and cogenerators, and customers' use of alternative fuels as the basis for increased risk.

Except for the gas rate restructure, PG&E's risk factors are similar to Edison's risk factors. To the extent that these risk factors are already discussed, they will not be repeated.

Although Quan acknowledges that the electric industry is in a continual state of transition, he testified that as different areas of risk are created, there are other circumstances, such as Commission policies, which mitigate some of the risk. Change in the electric industry is not new. In the 1988 attrition proceeding, we agreed with PG&E that investors will consider to some extent increased risks associated with regulatory changes, specifically the electric industry restructure. However, it is apparent from Salomon Brothers, Inc. above average rating given to the Commission that the investment community has mitigated increased risk associated with the California electric industry.

Similar to the electric industry changes, the natural gas regulatory framework was considered in the 1988 attrition proceedings. The question to address in this proceeding is whether such risk has increased. Although Jenkins-Stark asserts that the elimination of the Supply Adjustment Mechanism (SAM) effective May 1, 1988 increases utility risk in 1989, he acknowledges that this risk is partially mitigated by the Negotiated Revenue Stability Account (NRSA) which limits the maximum variation of after tax earnings from the noncore sector for two years after implementation of the new regulatory structure. PG&E did not provide an assessment of other risk which have been mitigated.

The investment community has been aware of risk associated with the new gas regulatory structure since 1986 and we have provided for that increased risk in Commission policy and in the attrition proceedings, most recently in the 1988 attrition proceeding. Similar to the electric industry restructure, the gas industry is in a continual state of transition. Quan recognizes that as new risks develop, other risks are mitigated.

Of all the energy utilities, PG&E was authorized the highest return on common equity in 1988 primarily because of increased risk associated with the uncertainty of the Diablo Canyon reasonableness review. However, with settlement in A.84-06-014 and the exclusion of any settlement risk associated with Diablo Canyon, PG&E's risks are now comparable to the other California energy utilities.

After considering all the evidence of the market conditions, trends, and the quantitative models presented by the parties, we conclude that a 12.75% return on common equity is just and reasonable for PG&E's 1989 attrition year.

### E. Adopted Cost of Capital

The 12.75% adopted return on common equity produces an overall rate of return of 10.92% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

PG&E's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.39% | 4.34% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 12.75 | 5.96 |
| TOTAL | 100.00% | | 10.92% |

## VI. San Diego's Application

### A. Background

On December 1, 1987, San Diego filed an application for a general rate increase. San Diego requested, among other things, a 13.75% return on equity. Subsequently, by an ALJ ruling, San Diego's cost of capital issue was bifurcated from the general rate proceeding for consideration in this generic attrition proceeding.

On July 15, 1988 San Diego revised its cost of capital testimony and reduced its requested return on common equity to 13.25%.

San Diego's presently authorized rate of return is depicted in the following table:

San Diego's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 40.50% | 9.24% | 3.74% |
| Preferred Stock | 8.50 | 7.28 | 0.62 |
| Common Equity | 51.00 | 12.75 | 6.50 |
| TOTAL | 100.00% | | 10.86% |

Although the present authorized structure, except for the return on common equity, is consistent with San Diego's recommendation for the 1989 attrition year, it is in contrast to DRA's recommendation. The following tables show the active parties recommendations for the 1989 attrition year:

San Diego's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 42.75% | 9.22% | 3.94% |
| Preferred Stock | 6.25 | 7.21 | 0.45 |
| Common Equity | 51.00 | 13.25 | 6.76 |
| TOTAL | 100.00% | | 11.15% |

DRA's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.22% | 4.20% |
| Preferred Stock | 6.00 | 6.97 | 0.42 |
| Common Equity | 48.50 | 12.50* | 6.06 |
| TOTAL | 100.00% | | 10.68% |

* Recommends Mid Range of 12.25% to 12.75%

FEA's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 42.75% | 9.12% | 3.90% |
| Preferred Stock | 6.25 | 7.21 | 0.45 |
| Common Equity | 51.00 | 12.75 | 6.50 |
| TOTAL | 100.00% | | 10.85% |

City of San Diego's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.22% | 4.20% |
| Preferred Stock | 6.00 | 6.97 | 0.42 |
| Common Equity | 48.50 | 12.50 | 6.06 |
| TOTAL | 100.00% | | 10.68% |

San Diego presented two witnesses, Margo A. Kyd, Treasurer, and Richard A. Krumvieda, Manager of Financial Analysis and Forecasting. Kyd testified on San Diego's financial policy and Krumvieda testified on San Diego's cost of capital methodology. DRA presented the testimony of Phyllis White. FEA presented the testimony of John B. Legler. William Shaffran, appearing for the City of San Diego, actively participated in the examination of witnesses. Duncan also examined the witnesses.

B. Capital Structure

San Diego believes that a "ratemaking" capital structure with a 51% common equity ratio authorized for its 1988 attrition year will be sufficient to provide an adequate level of financial flexibility. Although San Diego projects that its actual common equity will exceed 51%, San Diego recommends that its ratemaking common equity be held at the 51% level.

DRA's White recommends a capital structure with a 48.50% common equity ratio, which more closely resembles San Diego's reported and target financial capital structure. White's common equity ratio is lower than San Diego's primary because White included the $123 million Encina 5 Power Plant non-nuclear capitalized lease as a component of long-term debt. White believes her proposal should be adopted because:

a. Capital leases are a part of long-term debt.

b. The Financial Accounting Standards Board Statement No. 71 (FASB 71) requires capital leases to be recorded as long-term debt on the utility's balance sheet to show a clear and explicit reflection of a utility's leverage and accompanying financial risk.

c. San Diego's investors and financial analysts consider non-capitalized lease information when assigning expected risk adjusted returns on investment.

d. There is no deleterious effect on the market's view of San Diego or San Diego's ability to attract capital.

However, if San Diego's common equity ratio of 51% is adopted, White recommends that San Diego's return on common equity be reduced to 12.00% to recognize San Diego's lower financial risk.

DRA's basis for including such capitalized leases is flawed. We have not adopted FASB 71 an accounting pronouncement for the energy utilities. If we adjust San Diego's capital structure because of FASB 71 then we should consistently adjust for other components of FASB 71, and other accounting pronouncements for ratemaking purposes. We are not prepared to do so.

Even if we assume that non-nuclear capitalized leases should be a component of long-term debt, DRA's proposal is still flawed. Capitalized assets are assumed to be financed by a combination of long-term debt, preferred stock, and common equity even though individual assets may have been financed by a particular debt or equity issuance. The costs of these capitalized assets historically are recoverable through rate base. However, DRA does not propose rate base treatment for these capitalized leases. Rather, DRA proposes that these leases should be recovered through operating expenses as they are currently being recovered.

We share DRA's concern about the high level of common equity which San Diego requests, especially when Edison is requesting a 46% common equity capital structure, PG&E a 46.75%, Sierra Pacific a 41.93%, and SoCalGas a 45.20%. This is not a new concern. In D.85-12-108 we observed that San Diego's increasing equity might well present a serious problem in the future and directed San Diego and DRA to address, thoroughly, San Diego's increasing equity in the next appropriate rate proceeding. Although San Diego is requesting that its common equity be held at 51.00%, San Diego acknowledges that its common equity is projected to exceed this level.

San Diego's current common equity ratio goal is 45.00% to 48.00% for financial reporting purposes, which falls within Standard & Poor's range of 46.00% - 52.00% for a single A utility bond rating. Kyd testified that San Diego's 1989 expected equity ratio is 46.10% for financial reporting purposes, well within its current goal.

San Diego periodically publishes its financial goals which investors assess for performance and goals. As shown in San Diego's quarterly financial report, it is the financial return on equity, not the rate making return on equity that is shown in San Diego's quarterly report and is used for financial analysis for its investors review.

An adjustment to San Diego's requested 51.00% common equity ratio is warranted because it is substantially out of line with other California energy utilities' common equity ratio and because San Diego has not justified the need for such a high equity ratio. We will adopt a 48.00% common equity ratio for San Diego's 1989 attrition year to bring it in line with what investors use to assess San Diego's performance. This common equity ratio is derived from the top range of San Diego's common equity goal of 45.00% - 48.00% for its financial structure. We will adopt San Diego's requested 6.25% preferred stock ratio and impute a 45.75% long-term debt ratio for a balanced capital ratio.

We will expect San Diego, Edison, PG&E, Sierra Pacific, SoCalGas, and DRA to address in the next cost of capital proceeding the optimum capital structure for California energy utilities.

### C. Cost of Long-Term Debt and Preferred Stock

San Diego's 9.22% cost of long-term debt is consistent with DRA's and the City of San Diego's estimate, and comparable to FEA's 9.212%. Although FEA used a cost factor which did not reflect San Diego's update for actual costs, Legler accepts San Diego's cost estimate. Consistent with the other utilities, San Diego concurs that its cost of long-term debt should be updated to reflect the impact of DRI's November 1988 control interest forecast.

We will adopt a 9.23% long-term debt cost for San Diego's 1989 attrition year as shown in Late-Filed Exhibit 30, which reflects DRI's November 1988 control interest forecast.

The only dispute regarding San Diego's estimated cost of preferred stock is how the unamortized issuance costs associated with refunded perpetual preferred stock should be treated. San Diego reduces its net proceeds by the issuance cost for perpetual series preferred stock, which were refunded in 1986 and 1987, and amortized the issuance cost over a 20-year period. The amortized costs are included in San Diego's 7.21% 1989 effective preferred stock dividend rate. San Diego's witness rationalizes this amortization by citing D.87-12-066, an Edison proceeding, which considered and approved the recovery of preferred stock issuance costs by increasing the embedded cost of preferred stock.

DRA's White excluded the issuance costs in her recommended 6.97% effective preferred stock dividend rate for San Diego's 1989 attrition year because the Uniform System of Accounts for Account No. 214-B, Capital Stock Expense requires the issuance expense of perpetual capital stock to be expensed in the year that such stock is retired.

DRA points out in its brief that D.87-12-066, which San Diego relies on, authorized such issuance costs to be included in the preferred stock embedded costs because Edison demonstrated that San Diego was previously authorized to recover similar costs and because the cost impact on preferred stock was minimal, only 8 basis points. There was not a sufficient record to address the merits of the issue.

However, in this proceeding DRA's witness established that the proper method to account for such costs is to expense the issuance costs in the year incurred. San Diego's own witness

San Diego's current common equity ratio goal is 45.00% to 48.00% for financial reporting purposes. Kyd testified that San Diego's 1989 expected equity ratio is 46.10% for financial reporting purposes, well within its current goal.

San Diego periodically publishes its financial goals which investors assess for performance and goals. As shown in San Diego's quarterly financial report, it is the financial common equity ratio, not the rate making common equity ratio that is shown in San Diego's quarterly report and is used for financial analysis for its investors review.

An imputed adjustment to San Diego's requested 51.00% common equity ratio is warranted because it is substantially out of line with other California energy utilities' common equity ratio and because San Diego has not justified the need for such a high equity ratio. We will adopt a 48.00% common equity ratio for San Diego's 1989 attrition year to bring it in line with what investors use to assess San Diego's performance and to bring it in line with other California energy utilities' common equity ratio. This common equity ratio is derived from the top range of San Diego's common equity goal of 45.00% - 48.00% for its financial structure and common equity ratio higher than 48.00% would warrant a proportional reduction in its return on equity. We will adopt San Diego's requested 6.25% preferred stock ratio and impute a 45.75% long-term debt ratio for a balanced capital ratio.

We will expect San Diego, Edison, PG&E, Sierra Pacific, SoCalGas, and DRA to address in the next cost of capital proceeding the optimum capital structure for California energy utilities.

## C. Cost of Long-Term Debt and Preferred Stock

San Diego's 9.22% cost of long-term debt is consistent with DRA's and the City of San Diego's estimate, and comparable to FEA's 9.212%. Although FEA used a cost factor which did not reflect San Diego's update for actual costs, Legler accepts testified that preferred stock is a form of long-term equity capital stock, and acknowledged that capital stock issuance costs are not recovered. Since preferred stock is similar to common stock and because common stock issuance costs are not recovered from ratepayers, we will adopt DRA's 6.97% cost of preferred stock for San Diego's 1989 attrition year.

D. Return on Common Equity

The following table summarizes the parties return on common equity recommendation:

| Party | Recommended Return |
|---|---|
| San Diego | 13.25% |
| DRA | 12.50%* |
| FEA | 12.75% |
| City of San Diego | 12.50% |

* Recommends Mid Range of 12.25% to 12.75%

San Diego, DRA, and FEA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Kyd, Quan, and Legler:

| Model | Party | Range |
|---|---|---|
| DCF | San Diego | 12.40% - 14.00% |
| | DRA | 11.36 - 12.65 |
| | FEA | 11.80 - 13.00 |
| RPM | San Diego | 14.40 - 16.00 |
| | DRA | 13.22 - 15.25 |
| | FEA (5-yr. premiums) | 12.00 - 12.26 |
| CAPM | DRA | 11.73 - 15.42 |

In the final analysis, it is the application of judgement, not the the precision of test models, which is the key to selecting a specific return on common equity.

Kyd asserts that the Commission should recognize specific business risks to set a fair return on common equity. According to

Kyd, these business risks consist of: a substantial uncertainty of purchased power costs associated with the Southwest Powerlink (SWPL), the re-examination of utility ratemaking mechanisms, such as the potential elimination of the ERAM, and ongoing business risk associated with nuclear operations and third party producers.

According to Kyd, the SWPL balancing account, which accounts for the difference between the cost of SWPL energy received and avoided costs, poses substantial new risk because investors view it as a procedure to defer timely cost recovery of prudently incurred costs. Further, Kyd is concerned that the deferred recovery of SWPL and purchased power costs may preclude San Diego from achieving reasonable levels of short-term debt and result in a downgrading of its commercial paper rating.

The City of San Diego points out that the SWPL risk is not a new risk. Not only was it addressed in San Diego's 1988 attrition proceeding, it has existed for the past three years. The City of San Diego also points out that the Commission granted limited rehearing on the SWPL balancing account issue by D.86-06-026. It believes that the only reasonable assumption that can be made regarding a pending decision on the balancing account is that the Commission will reduce San Diego's risk further.

San Diego believes that the uncertainty regarding future Commission action on matters such as the elimination of the SAM, investigation to review the elimination of attrition adjustments and the ERAM, and decisions, in general, which show a tendency to make adjustments to established rate mechanisms only when such adjustments are in the ratepayers' favor results in higher investor risk.

Further, the City of San Diego reminds us that the elimination of these rate mechanisms can result in a benefit, not a risk, to the shareholders and investors. The City points out that since the AER mechanism was adopted and 8.0% of fuel costs were fixed, San Diego has consistently been benefited as follows:

| Period | Amount |
|---|---|
| May 1985-April 1986 | $ 821,765 |
| May 1986-April 1987 | 7,100,000 |
| May 1987-April 1988 | 4,300,000 |

We think San Diego's view of the risk associated with industry restructuring is misplaced. We must not lose sight of the intent of decisions related to the gas and electric industry restructure, that is, to provide the regulated utilities a means to respond to marketplace changes which are keyed to competition and bypass.

San Diego takes a very pessimistic approach to nuclear risk. San Diego asserts that ongoing business risks exist because the Nuclear Regulatory Commission (NRC) may require costly plant modifications to SONGS as a result of a problem, presently unidentified, at any other nuclear plant. Further, San Diego could be impacted by an accident at any other nuclear plant in the United States because NRC requires loss sharing among all the utilities that own nuclear reactors.

The other business risks identified by San Diego, third party produces and increased interest rates have already been discussed and will not be repeated here. However, it is worth noting that in regards to third party producer risk, San Diego's 1987 shareholders annual report shows that as a result of lowered costs and restructured sales, San Diego has been able to preserve most of its sales and retain most of its market share.

After considering all the evidence of the market conditions, trends, quantitative models presented by the parties, and San Diego's higher equity ratio, we conclude that a 12.75% return on equity is just and reasonable for San Diego's 1989 attrition year.

## E. Adopted Cost of Capital

The 12.75% adopted return on common equity produces an overall rate of return of 10.78% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

San Diego's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.75% | 9.23% | 4.22% |
| Preferred Stock | 6.25 | 6.97 | 0.44 |
| Common Equity | 48.00 | 12.75 | 6.12 |
| TOTAL | 100.00% | | 10.78% |

# VII. Sierra Pacific's Application

## A. Background

On July 28, 1988, Sierra Pacific filed an application for authority to increase its authorized return on common equity from 12.90% to 14.00% for the 1989 attrition year. The proposed increase in return on common equity will result in approximately a $1,136,000 revenue requirement.

Sierra Pacific's presently authorized rate of return and requested rate of return is depicted in the following tables:

Sierra Pacific's Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 49.09% | 8.71% | 4.28% |
| Preferred Stock | 7.46 | 7.35 | 0.55 |
| Common Equity | 43.45 | 12.90 | 5.60 |
| TOTAL | 100.00% | | 10.43% |

Sierra Pacific's Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.71% | 4.48% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 14.00 | 5.87 |
| TOTAL | 100.00% | | 10.87% |

Charles E. Olson, an economist and President of H. Zinder & Associates testified for Sierra Pacific, and Quan testified for DRA.

B. Capital Structure

There is no dispute on Sierra Pacific's requested capital structure. DRA concludes that Sierra Pacific's capital structure is reasonable, based on its review of Sierra Pacific's capital requirements and financing plans through 1989. We will adopt Sierra Pacific's 1989 requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity.

C. Cost of Long-Term Debt and Preferred Stock

Sierra Pacific's estimated 8.71% cost of long-term debt is 0.16% higher than DRA's 8.55% estimate. This difference in cost is the result of DRA using more recent DRI forecast. Sierra Pacific concurs with the other applicants and interested parties to this consolidated proceeding that the cost of long-term debt should be based on the November 1988 DRI control forecast. Late-Filed Exhibit 30 shows that the parties agree that Sierra's cost of long-term debt for the 1989 attrition year, which reflects DRI's November 1988 control interest forecast, should be 8.65%. Therefore, we will adopt 8.65% as the cost of Sierra Pacific's long-term debt for the 1989 attrition year.

We will adopt Sierra Pacific's requested 7.74% cost of preferred stock for the 1989 attrition year, which was not disputed.

D. Return on Common Equity

The only issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| Sierra Pacific | 14.00% |
| DRA | 12.65% |

Sierra Pacific and DRA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity. These models are used only to establish a range from which parties use individual judgement to determine a fair return on common equity. However, there is a significant difference between Olson's 5.0% - 6.0% expected dividend growth rate and Quan's 3.50% - 4.00% expected dividend growth rate.

Quan's expected dividend growth rate is based on historical trends and forecasted dividend and earnings growth rates reported by various security analysts. Olson acknowledges that his estimate is above historical growth rates and above the Institutional Brokers Estimate System (IBES) 4% projected growth rate, which Olson believes is one of the best sources of information on expected future growth. However, Olson relied on judgement because historical data and IBES do not reflect the long-term growth potential from diversification and he believes that investors expect a substantial improvement in earnings from past levels.

We conclude that Sierra Pacific's projected dividend growth rate is an optimistic estimate and that DRA's expected dividend growth rate is a more realistic estimate, which is consistent with IBES's projected growth rate.

The following table summarizes the results of the models presented by witnesses Olson and Quan:

| Model | Party | Range |
|---|---|---|
| DCF | Sierra Pacific | 13.00% - 14.00% |
| | Sierra Pacific (9 Electrics) | 13.24 - 13.74 |
| | DRA | 11.69 - 12.23 |
| RPM | Sierra Pacific | 12.80% |
| | DRA | 13.04 - 15.13 |
| CAPM | DRA | 11.46 - 15.12 |

Sierra Pacific faces risk similar to the other California utilities. However, Sierra Pacific's risk is higher than Edison, PG&E, and other large utilities in relation to revenue and common equity ratios. Sierra Pacific's revenue is approximately $400 million as compared to Edison's $6 billion and PG&E's $7 billion revenue. Its 41.93% common equity ratio is low compared to Edison's 46.00% and PG&E's 46.75%. This lower revenue stream and lower common equity ratio indicates Sierra Pacific's need for a slightly higher return on common equity than the large California utilities.

After considering all the evidence of the market conditions, trends, and the quantitive models presented by the parties, we conclude that a 12.90% return on equity is just and reasonable for Sierra Pacific's 1989 attrition year.

### E. Adopted Cost of Capital

The 12.90% adopted return on common equity produces an overall rate of return of 10.38% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

**Sierra Pacific's Adopted Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.65% | 4.45% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 12.90 | 5.41 |
| TOTAL | 100.00% | | 10.38% |

## VIII. SoCalGas' Application

### A. Background

On August 1, 1988, SoCalGas filed an application for authority to increase its authorized return on common equity from 12.75% to 13.75%, and an operational attrition allowance. The request for an operational attrition allowance was filed in conformance with D.87-05-027, which approved the settlement of

SoCalGas' Test Year 1988 general rate case and authorized SoCalGas to file an application for attrition for 1989. The requested return on common equity and operational attrition will result in a $38 million revenue requirement.

SoCalGas' presently authorized rate of return and requested rate of return is shown in the following tables:

SoCalGas' Present Authorization

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.90% | 9.90% | 4.54% |
| Preferred Stock | 8.80 | 6.93 | 0.61 |
| Common Equity | 45.30 | 12.75 | 5.78 |
| TOTAL | 100.00% | | 10.93% |

SoCalGas' Recommendation

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.84% | 4.48% |
| Preferred Stock | 9.30 | 7.31 | 0.68 |
| Common Equity | 45.20 | 13.75 | 6.22 |
| TOTAL | 100.00% | | 11.38% |

SoCalGas' Treasurer, Loren K. Sanladerer, testified on SoCalGas' requested cost of capital. DRA presented the testimony of Quan. FEA presented the testimony of Legler, and the City of LA presented the testimony of Manual Kroman. Duncan participated in the examination of the witnesses.

## B. Capital Structure

There is no dispute on SoCalGas' requested capital structure. DRA concludes that SoCalGas' requested capital structure is reasonable, based on DRA's review of SoCalGas' capital requirements and financial plans through 1989. FEA and the City of LA also concur that SoCalGas' requested capital structure is reasonable for the 1989 attrition year.

We will adopt SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity for the 1989 attrition year.

C. Cost of Long-Term Debt and Preferred Stock

SoCalGas' 9.84% cost of long-term debt for its 1989 attrition year is comparable to DRA's 9.92% and the City of LA's 9.832%. The difference in estimating the cost of long-term debt is attributable to DRA and the City of LA using a more recent interest forecast than SoCalGas. However, SoCalGas, consistent with other parties to this proceeding, has agreed to use the November DRI control interest rate forecast to determine its embedded debt cost. We will adopt a 9.66% cost of long-term debt for SoCalGas' 1989 attrition year long-term debt, as shown in Late-Filed Exhibit 30 which reflects the November 1988 DRI control interest forecast.

SoCalGas' 7.31% cost of preferred stock consists of the average of preferred stock previously issued and outstanding, weighted to the projected cost of a new 1989 preferred stock issue. The cost of the new preferred stock issue was derived from the comparison of "A" rated utility preferred stock yields for 1986, 1987, and the first five months of 1988 with DRI's "A" utility rated long-term debt yields during the same period.

DRA concurs with the method SoCalGas used to calculate its cost of preferred stock. DRA's estimate is 7.39%, or 0.08% higher because of the availability and use of more recent data. However, because the parties agreed to use an updated DRI forecast SoCalGas' cost of preferred stock was changed to 7.32%, as shown in Late-Filed Exhibit 30. We will adopt the 7.32% SoCalGas' 1989 attrition year cost of preferred stock.

D. Return on Common Equity

The major issue is the appropriate return on common equity for the 1989 attrition year. The following table summarizes the position of each party:

| Party | Recommended Return |
|---|---|
| SoCalGas | 13.75% |
| DRA | 12.50%* |
| FEA | 12.65 |
| City of LA | 13.00% (maximum) |

* Recommends Mid Range of 12.25% to 12.75%

SoCalGas, DRA, FEA, and the City of LA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Sanladerer, Quan, Legler, and Kroman:

| Model | Party | Range |
|---|---|---|
| DCF | SoCalGas | 14.82% - 15.79% |
| | DRA | 12.33 - 12.87 |
| | FEA | 11.80 - 13.20 |
| RPM | SoCalGas | 13.53 - 13.93 |
| | DRA | 12.71 - 15.10 |
| | FEA (5-yr. premiums) | 13.20 - 13.30 |
| CAPM | DRA | 11.70 - 15.32 |

Sanladerer testified that SoCalGas' business risk is the same as those business risks which SoCalGas described in its 1988 attrition proceeding. However, two of these risks, the earnings risk resulting from the SAM, and the market risk brought on by intense competition warrant additional consideration because of their expected full year impact in 1989. Although Sanladerer presented DCF an RPM model results, he did not rely on these models to develop his recommended 13.75% return on common equity.

The initial SAM adjustment provides for partial protection from sales losses for two years. However, Sanladerer contends that SoCalGas' exposure to potential pre-tax annual losses from variations in non-core gas margin for the first $27.5 million

and one-third of the losses thereafter up to another $27.5 million, increases SoCalGas' risk.

SoCalGas also states that it faces substantial market risk because of the competitive conditions. According to Sanladerer, this increased risk is reflected in the lower alternate energy prices which have resulted in lower gas rates to low-priority customers as well as lower margin contributions from these customers. Further, the FERC issued a Declaratory Order, on July 1, 1988, stating the FERC's intent to allow an out-of-state transmission company to build a bypass pipeline to serve customers presently served by SoCalGas. SoCalGas also expects two other transmission companies to obtain bypass pipeline certificates by year end 1988.

The City of LA and DRA dispute SoCalGas' claim of increased risk. DRA asserts that while there may be some incremental effect on SoCalGas' risk in 1989, such risk is ongoing and familar to the investors. The City of LA concurs with DRA and suggests that SoCalGas has substantially exaggerated its business and financial risk for its 1989 attrition year.

SoCalGas' SAM argument has been already addressed in this opinion. There is no dispute that risk exists; however, it was considered in arriving at SoCalGas' 1988 attrition proceeding. As the City of LA cites from SoCalGas' 1988 attrition decision (D.87-12-064), we acknowledge that SoCalGas 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.

SoCalGas' competitive risk arguments are no different than the electric and telecommunications utilities' competitive risk arguments. SoCalGas presents a bleak picture about

| Party | Recommended Return |
|---|---|
| SoCalGas | 13.75% |
| DRA | 12.65%* |
| FEA | 13.00 |
| City of LA | 13.00% (maximum) |

* Recommended Range was 12.25%.

SoCalGas, DRA, FEA, and the City of LA submitted testimony on the results of various financial models which they used as a starting point to determine their recommended return on common equity.

The following table summarizes the results of the models presented by witnesses Sanladerer, Quan, Legler, and Kroman:

| Model | Party | Range |
|---|---|---|
| DCF | SoCalGas | 14.82% - 15.79% |
| | DRA | 12.33 - 12.87 |
| | FEA | 11.80 - 13.20 |
| RPM | SoCalGas | 13.53 - 13.93 |
| | DRA | 12.71 - 15.10 |
| | FEA (5-yr. premiums) | 13.20 - 13.30 |
| CAPM | DRA | 11.70 - 15.32 |

Sanladerer testified that SoCalGas' business risk is the same as those business risks which SoCalGas described in its 1988 attrition proceeding. However, two of these risks, the earnings risk resulting from the SAM, and the market risk brought on by intense competition warrant additional consideration because of their expected full year impact in 1989. Although Sanladerer presented DCF an RPM model results, he did not rely on these models to develop his recommended 13.75% return on common equity.

The initial SAM adjustment provides for partial protection from sales losses for two years. However, Sanladerer contends that SoCalGas' exposure to potential pre-tax annual losses from variations in non-core gas margin for the first $27.5 million

competitive risks; however, the City of LA points out that SoCalGas' 1987 shareholders annual report shows the opposite. SoCalGas has achieved its authorized return on rate base for the fifth year in a row. Customers increased an additional 119,000, the largest number added in a single year since 1955. Even gas volumes delivered increased 22.00% over 1986's gas volumes. As to risk associated to non-core customers, SoCalGas states that the rates charged to these customers will allow it to collect most of the costs allocated to the non-core market in an up-front charge. SoCalGas expects approximately three-fourths of its margin to continue to be protected from earnings fluctuations by the Consolidated Adjustment Mechanism procedure.

After considering all the evidence of the market conditions, trends, quantitative models presented by the parties, we conclude that a 12.75% return on common equity is just and reasonable for SoCalGas' 1989 attrition year.

## E. Adopted Cost of Capital

The 12.75% adopted return on common equity produces an overall rate of return of 10.84% for the 1989 attrition year, as shown in the following table depicting the adopted cost of capital:

SoCalGas' Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.66% | 4.40% |
| Preferred Stock | 9.30 | 7.32 | 0.68 |
| Common Equity | 45.20 | 12.75 | 5.76 |
| TOTAL | 100.00% | | 10.84% |

## F. Operational Attrition

SoCalGas also requests an operational attrition allowance pursuant to D.87-05-027. Its attrition request is calculated in accordance with the guidelines set forth in D.85-12-076, with the following modifications:

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

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

3. The cost of gas inventory stored underground is removed from ratebase effective for attrition year 1988.

4. 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.

No party objected to SoCalGas' operational attrition filing. However, Toward Utility Rate Normalization (TURN) objected to SoCalGas' proposed rate design and filed a motion to strike SoCalGas' testimony regarding rate design. TURN objected to SoCalGas' proposal to recover over one half of gas supply project expenses from retail noncore and wholesale customers as demand related transmission costs and commodity related cost because one quarter of the system fixed costs are allocated to the retail noncore and wholesale market segments.

Subsequent to the filing of its motion, TURN continued to discuss the rate design issue with SoCalGas. On October 5, 1988 TURN, DRA, and SoCalGas submitted a joint proposal on a revised rate design as shown in Appendix B. The filing of this joint proposal resolves all disputes with SoCalGas' operational attrition and rate design filing.

This joint proposal provides that the operational and financial attrition allowance will be allocated to core and noncore customers in the same proportion that existing gas margin, net of the costs associated with the abandoned gas supply projects, is allocated to such customers. It further provides that the reduced revenue requirement, which results from the termination of the abandoned gas supply projects, will be allocated to core and noncore customers in the same proportion that such costs were previously allocated to such customer classes under the terms of D.87-12-039.

SoCalGas requests that we approve the joint proposal. SoCalGas and TURN requests that such approval not be considered a precedent in any future proceeding.

We will adopt SoCalGas' operational attrition and the joint rate design proposal, updated to reflect the November DRI forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity authorized in this opinion. SoCalGas is authorized to file an Advice Letter pursuant to General Order 96-A to implement its operational attrition allowance effective January 1, 1989.

Findings of Fact

1. Each of the utilities filed its financial attrition request using a calendar-year basis and a 15-month period basis.

2. The utilities' respective applications show that there is no material difference between a calendar-year attrition and a 15-month attrition period.

3. The energy utilities exercised a prudent management decision to retire, prematurely, bonds issued in the early 1980's when interest rates were at all time highs even though they are required to pay premiums to the existing bond holders in connection with these retirements.

4. DRA objects to the utilities using inconsistent methods to pass to ratepayers the tax benefits generated from the premiums paid to retire high cost debt prematurely.

5. The utilities do not object to DRA's proposal to develop, through workshops, a consistent method for passing the high cost debt tax benefits to the ratepayers.

6. San Diego opposes DRA's recommendation that the energy utilities should be required to record the high cost debt tax benefits in a memorandum account, pending adjustment to reflect the impact of the final method decided in the workshops.

7. DRA finds no fault with San Diego's method of passing the high cost debt tax benefits to its ratepayers.

8. The premature retirement of high cost debt is equally applicable to the telephone and the water industry.

9. There is no dispute on Edison's proposed 1989 capital structure of 48.00% long-term debt, 6.00% preferred stock, and 46.00% common stock equity.

10. All parties concur that the cost of long-term debt should be updated to reflect DRI's November 1988 control interest rate forecast.

11. Late-Filed Exhibit 30 shows that the parties concur that Edison's cost of long-term debt for the 1989 attrition year is 9.30%.

12. No party disputes Edison's 7.84% cost of preferred stock for its 1989 attrition year.

13. The DCF, RPM, and CAPM are financial models which are used to establish a range from which the parties use individual judgement to determine a fair return on common equity.

14. The new regulatory structure in the gas and electric industry has created new risk; however, such risk was recognized in the 1988 attrition proceeding.

15. The new regulatory structure has provided the energy utilities flexibility to meet both their needs and ratepayers' needs to respond to the competitive marketplace.

16. The financial community considers the California regulatory climate to be above average.

17. Edison and the other utilities have mitigated and reduced risk from the competitive marketplace challenges by direct competition with the independent power producers according to DRA.

18. Edison's present debt ratio exceeds Standard & Poor's double-A bench mark of 46% debt; however, it has maintained its bond rating because of positive action in other areas.

19. Edison's level of internally generated funds has remained at substantially higher levels the past few years (from 52% of total construction funds in 1983 to 79% in 1987), and AFUDC earnings have significantly dropped from 59% in 1983 to 16% in 1987.

20. Edison's stock continues to trade in excess of book value which indicates that investor perception of the current value of Edison relative to the value of its assets is high.

21. The authorized return on common equity moves in the same direction as interest rates, but not in direct proportion.

22. Although long-term interest rates have moved moderately upward during the year, August 1988 long-term interest rate levels are similar to the level of interest rates at December 1987, when the current returns on common equity were set.

23. DRI's interest rate forecast is based on a subjective analysis and has varied an average of +/- 1.81% from the first quarter of 1982 through the first quarter of 1988.

24. Investors have been aware of the elimination of ERAM and ARA mechanisms since late 1986.

25. Edison has reduced the risk of reliability and availability of third party power producers by purchasing half of its third party producer power from its own subsidiary.

26. There is no dispute on PG&E's proposed capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity.

27. Parties agree that PG&E's cost of long-term debt should be 9.39% for its 1989 attrition year.

28. There is no dispute on PG&E's 8.79% cost of preferred stock.

29. PG&E requests that its authorized return on equity exclude any risk associated with its Diablo Canyon investment, pursuant to its proposed Diablo Canyon settlement agreement.

30. PG&E's risks, except for risks associated with the gas rate restructure, are similar to those of Edison.

31. Increased risk associated with regulatory changes in the electric and gas industry were considered in the 1988 attrition year proceeding.

32. PG&E concurs that risk associated with the elimination of SAM is partially mitigated by the NRSA.

33. The investment community has been aware of increased risk associated with the new gas regulatory structure since 1986.

34. PG&E was authorized the highest return on common equity in the 1988 attrition proceeding primarily because of increased risk associated with the uncertainty of Diablo Canyon.

35. D.85-12-108 observed that San Diego's increasing equity ratio may well present a serious problem in the future.

36. San Diego's current goal of 45.00% to 48.00% common equity for financial reporting purposes falls within Standard & Poor's range of 46.00% to 52.00% for a single A utility bond rating.

37. San Diego's 1989 expected equity ratio for financial statement purposes is 46.10%.

38. Parties agree that San Diego's cost of long-term debt should be 9.23% for its 1989 attrition year.

39. The Uniform System of Accounts requires that the issuance expense of perpetual capital stock be expensed in the year such stock is retired.

40. Preferred stock is a form of capital stock.

41. Common stock issuance costs are not recovered from ratepayers.

42. San Diego's risk associated with SWPL was addressed in the 1988 attrition proceeding.

43. The elimination of SAM and ERAM can result in a benefit to the shareholders.

44. San Diego has consistently benefited from the AER mechanism and the setting of an 8.0% fixed fuel cost.

45. The intent of decisions related to the gas and electric industry restructure is to provide the regulated utilities a means of responding to marketplace changes, keyed to competition and bypass.

46. San Diego, as a result of lowered costs and restructured sales, has been able to preserve most of its sales and retain most of its market share.

47. There is no dispute on Sierra Pacific's requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity.

48. Parties agree that Sierra Pacific's cost of long-term debt should be 8.65% for Sierra Pacific's 1989 attrition year.

49. Sierra Pacific's requested 7.74% cost of preferred stock was not disputed.

50. Sierra Pacific's expected dividend growth rate is above its historical growth rate and above IBES projected growth rate.

51. Sierra Pacific's revenues are substantially lower than Edison's and PG&E's revenues.

52. There is no dispute on SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity for its 1989 attrition year.

53. Parties agree that SoCalGas' cost of long-term debt should be 9.66% for SoCalGas' 1989 attrition year.

54. DRA agrees with the method SoCalGas used to calculate its cost of preferred stock.

55. SoCalGas' business risk is the same as those business risks which SoCalGas described in its 1988 attrition proceeding.

56. SoCalGas did not rely on the DCF or RPM.

57. SoCalGas has achieved its authorized return on rate base for the last five years.

58. SoCalGas has collected most of its costs allocated to the non-core market in an up-front charge.

59. SoCalGas expects approximately three-fourths of its margin to continue to be protected from earning fluctuations by the Consolidated Adjustment Mechanism.

60. SoCalGas' operational attrition filing is not disputed.

61. SoCalGas, DRA, and TURN concur with the Appendix B rate design proposal.

## Conclusions of Law

1. This opinion should authorize applicants a 1989 cost of capital attrition on a calendar-year basis because there is no material difference between a calendar-year and a 15-month attrition period.

2. The 1989 cost of capital attrition should be continued three additional months, through March 31, 1990, only if a 15-month cost of capital period for the 1989 attrition period is adopted in R.87-11-011.

3. The five energy utilities in this proceeding should not be required to establish memoranda accounts to record tax savings associated with the premiums paid to retire high cost debt.

4. CACD should schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost debt, and with DRA, to establish one consistent method to account for the associated tax savings.

5. Edison's proposed 1989 capital structure should be adopted.

6. Edison should be authorized a 9.30% cost of long-term debt and 7.84% cost of preferred stock for its 1989 attrition year.

7. A 12.75% return on common equity, which results in an overall 10.98% return on rate base, should be adopted as just and reasonable for Edison's 1989 attrition year, based upon all of the evidence considered in this proceeding.

8. PG&E's requested capital structure of 46.25% long-term debt, 7.00% preferred stock, and 46.75% common equity should be adopted for its 1989 attrition year.

9. PG&E should be authorized a 9.39% cost of long-term debt and a 8.79% cost of preferred stock for its 1989 attrition year.

10. A 12.75% return on common equity, which results in an overall 10.92% return on rate base, should be adopted as just and reasonable for PG&E's 1989 attrition year, based upon all of the evidence considered in this proceeding.

11. DRA's recommended 48.50% common equity ratio for San Diego's 1989 attrition year should not be adopted.

12. San Diego should be authorized a capital structure of 45.75% long-term debt, 6.25% preferred stock, and 48.00 common equity for its 1989 attrition year.

13. San Diego, Edison, PG&E, Sierra Pacific, and SoCalGas should address what an optimum capital structure for the California energy utilities should be in their next cost of capital attrition proceeding.

14. San Diego should be authorized a 9.23% cost of long-term debt for its 1989 attrition year.

15. San Diego's unamortized issuance costs associated with refunded perpetual preferred stock should not be included as a component of its preferred stock embedded cost.

16. DRA's recommended 6.97% cost of preferred stock for San Diego's 1989 attrition year should be adopted.

17. A 12.75% return on common equity, which results in an overall 10.78% return on rate base, should be adopted as just and reasonable for San Diego's 1989 attrition year, based upon all of the evidence considered in this proceeding.

18. Sierra Pacific's requested capital structure of 51.39% long-term debt, 6.68% preferred stock, and 41.93% common equity should be adopted for its 1989 attrition year.

19. Sierra Pacific should be authorized a 8.65% cost of long-term debt and a 7.74% cost of preferred stock for its 1989 attrition year.

20. A 12.90% return on common equity, which results in an overall 10.38% return on rate base, should be adopted as just and reasonable for Sierra Pacific's 1989 attrition year, based upon all of the evidence considered in this proceeding.

21. SoCalGas' requested capital structure of 45.50% long-term debt, 9.30% preferred stock, and 45.20% common equity should be adopted for its 1989 attrition year.

22. SoCalGas should be authorized a 9.66% cost of long-term debt and a 7.32% cost of preferred stock for its 1989 attrition year.

23. A 12.75% return on common equity, which results in an overall 10.84% return on rate base, should be adopted as just and reasonable for SoCalGas' 1989 attrition year, based upon all of the evidence considered in this proceeding.

24. SoCalGas' operational attrition and the joint rate design proposal shown in Appendix B, as revised to reflect the November DRI forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity authorized in this opinion, should be adopted.

# ORDER

IT IS ORDERED that:

1. Southern California Edison Company's (Edison) adopted cost of capital for its 1989 attrition year is as follows:

**Edison's Adopted 1989 Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.30% | 4.64% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 12.75 | 5.87 |
| TOTAL | 100.00% | | 10.98% |

2. Edison's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 1, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. Edison's advice letter shall be filed on or before December 29, 1988.

3. Pacific Gas & Electric Company's (PG&E) adopted cost of capital for its 1989 attrition year is as follows:

**PG&E's Adopted Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.39% | 4.34% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 12.75 | 5.96 |
| TOTAL | 100.00% | | 10.92% |

4. PG&E's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 3, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. PG&E's advice letter shall be filed on or before December 29, 1988.

5. San Diego Gas & Electric Company's (San Diego) adopted cost of capital for its 1989 attrition year is as follows:

San Diego's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.75% | 9.23% | 4.22% |
| Preferred Stock | 6.25 | 6.97 | 0.44 |
| Common Equity | 48.00 | 12.75 | 6.12 |
| TOTAL | 100.00% | | 10.78% |

6. San Diego's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 5, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. San Diego's advice letter shall be filed on or before December 29, 1988.

7. Sierra Pacific Power Company's (Sierra Pacific) adopted cost of capital for its 1989 attrition year is as follows:

Sierra Pacific's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.65% | 4.45% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 12.90 | 5.41 |
| TOTAL | 100.00% | | 10.38% |

8. Sierra Pacific's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 7, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. Sierra Pacific's advice letter shall be filed on or before December 29, 1988.

9. Southern California Gas Company's (SoCalGas) adopted cost of capital for its 1989 attrition year is as follows:

SoCalGas' Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.66% | 4.40% |
| Preferred Stock | 9.30 | 7.32 | 0.68 |
| Common Equity | 45.20 | 12.75 | 5.76 |
| TOTAL | 100.00% | | 10.84% |

10. SoCalGas' operational attrition and rate design proposal as shown in Appendix B, updated to reflect the November Data Resources, Inc.'s November 1989 forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity adopted in Ordering Paragraph 9, shall be adopted. SoCalGas is authorized to file an Advice Letter pursuant to General Order 96-A to implement its operational and financial attrition allowance effective January 1, 1989. SoCalGas' advice letter shall be filed on or before December 29, 1988.

11. The Commission Advisory and Compliance Division (CACD) shall schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost bonds for the purpose of establishing a consistent method to pass the resultant tax benefits back to the ratepayers. If an Order Instituting Investigation (OII) is opened to address this tax issue, then the applicants to this consolidated proceeding shall participate in the OII and CACD shall cancel any scheduled workshops. A copy of this opinion shall be served on the CACD Director.

12. Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas shall address the results of the workshops identified in Ordering Paragraph 11, in their next financial attrition proceeding.

# O R D E R

IT IS ORDERED that:

1. Southern California Edison Company's (Edison) adopted cost of capital for its 1989 attrition year is as follows:

**Edison's Adopted 1989 Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 48.00% | 9.30% | 4.46% |
| Preferred Stock | 6.00 | 7.84 | 0.47 |
| Common Equity | 46.00 | 13.00 | 5.98 |
| TOTAL | 100.00% | | 10.91% |

2. Edison's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 1, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. Edison's advice letter shall be filed on or before December 8, 1988.

3. Pacific Gas & Electric Company's (PG&E) adopted cost of capital for its 1989 attrition year is as follows:

**PG&E's Adopted Cost of Capital**

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 46.25% | 9.39% | 4.34% |
| Preferred Stock | 7.00 | 8.79 | 0.62 |
| Common Equity | 46.75 | 13.00 | 6.08 |
| TOTAL | 100.00% | | 11.04% |

4. PG&E's adopted 1989 attrition year rate of return, as shown in Ordering Paragraph 3, shall be used in conjunction with its pending 1989 attrition year advice letter filing for the purpose of calculating revised rates for the 1989 attrition year. PG&E's advice letter shall be filed on or before December 8, 1988.

5. San Diego Gas & Electric Company's (San Diego) adopted cost of capital for its 1989 test year is as follows:

San Diego's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.75% | 9.23% | 4.22% |
| Preferred Stock | 6.25 | 6.97 | 0.44 |
| Common Equity | 48.00 | 13.00 | 6.24 |
| TOTAL | 100.00% | | 10.90% |

6. San Diego's adopted 1989 test year rate of return, as shown in Ordering Paragraph 5, shall be used in conjunction with its pending 1989 general rate case proceeding decision for the purpose of calculating revised rates for the 1989 test year. San Diego's advice letter shall be filed on or before December 8, 1988.

7. Sierra Pacific Power Company's (Sierra Pacific) adopted cost of capital for its 1989 attrition year is as follows:

Sierra Pacific's Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 51.39% | 8.65% | 4.45% |
| Preferred Stock | 6.68 | 7.74 | 0.52 |
| Common Equity | 41.93 | 13.15 | 5.51 |
| TOTAL | 100.00% | | 10.48% |

8. Sierra Pacific's adopted 1989 rate of return, as shown in Ordering Paragraph 7, may be used to revise its authorized base rate revenue requirement to be recovered through its ERAM (Energy Regulatory Adjustment Mechanism) balancing account, to become effective no earlier than four days after an advice letter filing by Sierra Pacific, but no earlier than January 1, 1989.

9. Southern California Gas Company's (SoCalGas) adopted cost of capital for its 1989 attrition year is as follows:

13. Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas shall address the optimum balanced capital structure in their respective electric and gas regulated industry in their next financial attrition proceeding.

This order is effective today.

Dated ____________________, at San Francisco, California.

SoCalGas' Adopted Cost of Capital

| Component | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 45.50% | 9.66% | 4.40% |
| Preferred Stock | 9.30 | 7.32 | 0.68 |
| Common Equity | 45.20 | 13.00 | 5.88 |
| TOTAL | 100.00% | | 10.96% |

10. SoCalGas' operational attrition and rate design proposal as shown in Appendix C, updated to reflect the November Data Resources, Inc.'s November 1989 forecasts with the relevant price indices and relevant impacts from the capital structure and return on common equity adopted in Ordering Paragraph 9, shall be adopted. SoCalGas is authorized to file an Advice Letter pursuant to General Order 96-A to implement its operational and financial attrition allowance effective January 1, 1989. SoCalGas' advice letter shall be filed on or before December 8, 1988.

11. The Commission Advisory and Compliance Division (CACD) shall schedule and chair workshops with the energy utilities impacted by the premature retirement of high cost bonds for the purpose of establishing a consistent method to pass the resultant tax benefits back to the ratepayers. If an Order Instituting Investigation (OII) is opened to address this tax issue, then the applicants to this consolidated proceeding shall participate in the OII and CACD shall cancel any scheduled workshops. A copy of this opinion shall be served on the CACD Director.

12. Edison, PG&E, San Diego, Sierra Pacific, SoCalGas, and Division of Ratepayer Advocates shall address the results of the workshops identified in Ordering Paragraph 11, in their next financial attrition proceeding.

13. Edison, PG&E, San Diego, Sierra Pacific, and SoCalGas shall address the optimum balanced capital structure in their

## APPENDIX A

## LIST OF APPEARANCES

**Applicants:** Richard K. Durant, Carol B. Henningson, James M. Lehrer, and Frank Mc Nulty, Attorneys at Law, for Southern California Edison Company; Roger J. Peters, Michelle L. Wilson and Kermit R. Kubitz, Attorneys at Law, for Pacific Gas and Electric Company; Barton Myerson and Tom Hankley, Attorneys at Law, and Bruce Williams, for San Diego Gas and Electric Company; James D. Salo, Attorney at Law, for Sierra Pacific Power Company; and Peter N. Osborn and Roy M. Rawlings, Attorneys at Law, for Southern California Gas Company.

**Interested Parties:** William S. Shaffran, Attorney at Law, for the City of San Diego; Shelley Ilene Smith, Attorney at Law, for the City of Los Angeles; Norman J. Furuta, Attorney at Law, for Consumer Interest of the Federal Executive Agencies; Manuel Kroman, for himself; Michael P. Alcantar and Frederick Dorey, Attorneys at Law, for Lindsay, Hart, Neil & Weigler; David J. Byers, Attorney at Law, of McCracken, Byers & Martin, for California City County Street Light Association; Edward Duncan, for himself; Reed V. Schmidt, of Chester and Schmidt Consultants, for City of Fresno, City of Irvine and County of Marin; Reed Sato and Phillip A. Stohr, Attorneys at Law, of Downey, Brand, Seymore & Rohwer, for Industrial Users Group; Donald W. Schoenbeck and Frederick Dorey, for RCS, Inc.; Richard Wolf, for C. P. National Corporation; Michel Peter Florio, Attorney at Law, for Toward Utility Rate Normalization (TURN); Joseph D. Milanowski, for Southwest Gas; and Roger Poynts, for Utility Design, Inc.

**Division of Ratepayer Advocates:** Timothy E. Treacy, Attorney at Law, and Terry Mowrey.

(END OF APPENDIX A)

APPENDIX B
Page 1

Southern California Gas Company
1989 Attrition - TURN Proposal

Prorate requested 1989 Attrition over 1988 Margin in rates at May 1, 1988 net of LNG and Gas Supply Project Amortization costs. Credit back LNG/Gas Supply Project cost reductions on the same bases used to allocate these costs in the May 1, 1988 rates.

Margin Reflected in Rates at May 1, 1988 (A.L. 1767-A, 3rd Suppl)

| | | Noncore | | |
|---|---|---|---|---|
| | Core | Retail | Whos'l | Total |
| Common Distribution | 290573 | 38276 | 0 | 328849 |
| Demand Related Transmission | 45666 | 42395 | 15362 | 103422 |
| Demand Related Storage | 66341 | 37491 | 17458 | 121289 |
| Customer Related | 555987 | 5618 | 2237 | 563842 |
| Commodity Related | 5005 | 5028 | 1690 | 11723 |
| 50% A&G | 51884 | 52129 | 2469 | 106482 |
| (A) Totals | 1015454 | 180937 | 39215 | 1235607 |

LNG & Gas Supply Project Amortization Costs Included in Above Margin Components

| | | | | |
|---|---|---|---|---|
| Demand Rel Trans - LNG Proj Amortization* | 6795 | 6309 | 2286 | 15390 |
| Commod Rel - Gas Supply Proj Amortization* | 4828 | 4850 | 1630 | 11308 |
| Subtotal Amortization | 11623 | 11159 | 3916 | 26698 |

Margin at May 1, 1988 Excluding LNG and Gas Supply Project Amortization Costs

| | | Noncore | | |
|---|---|---|---|---|
| | Core | Retail | Whos'l | Total |
| Common Distribution | 290573 | 38276 | 0 | 328849 |
| Demand Related Transmission | 38870 | 36086 | 13076 | 88032 |
| Demand Related Storage | 66341 | 37491 | 17458 | 121289 |
| Customer Related | 555987 | 5618 | 2237 | 563842 |
| Commodity Related | 177 | 178 | 60 | 415 |
| 50% A&G | 51884 | 52129 | 2469 | 106482 |
| (B) Adjusted May 1, 1988 Margin Allocation | 1003832 | 169778 | 35299 | 1208909 |

| | | | | |
|---|---|---|---|---|
| * Calculation Bases (Mth) | | | | |
| Demand Related Transmission base | | | | |
| Cold Year Throughput | 4152976 | 3855540 | 1397031 | 9405547 |
| Commodity Related base | | | | |
| Average Year Throughput | 3837422 | 3855540 | 1295714 | 8988676 |

APPENDIX B
Page 2

**Southern California Gas Company**
**1989 Attrition - TURN Proposal**

| | | | | |
|---|---|---|---|---|
| (B) Adjusted May 1, 1988 Margin Allocation (from page 1) | 1003832 | 169778 | 35299 | 1208909 |
| Ratios of above (B) totals | 83.036% | 14.044% | 2.920% | 100.000 |
| Requested 1989 Attrition (total before adj) Prorated per above ratios | 57366 | 9702 | 2017 | 69085 |
| Adjustment for Current LNG and Gas Supply Project Amortization Costs** | | | | |
| LNG Project Amortization* | -9058 | -8409 | -3047 | -20514 |
| Gas Supply Project Amortization | -4635 | -4657 | -1565 | -10857 |
| Subtotal Amortization | -13693 | -13066 | -4612 | -31371 |
| (C) Net Total - 1989 Attrition | 43673 | -3364 | -2595 | 37714 |
| Margin Allocation in May 1, 1988 Rates (A) | 1015454 | 180937 | 39215 | 1235607 |
| Subtotal - 1989 Margin (A) + (C) | 1059127 | 177574 | 36621 | 1273321 |
| Pipeline Demand Charge in May 1, 1988 Rates | 145680 | 135246 | 48824 | 329750 |
| EOR Credit in May 1, 1988 Rates | -15742 | -4287 | -1194 | -21222 |
| Net - Allocated Totals per TURN Proposal | 1189065 | 308533 | 84251 | 1581849 |
| Totals per Attrition Filing: A.88-08-001 | 1189677 | 308187 | 83986 | 1581849 |
| Difference from A.88-08-001 Filing | -612 | 346 | 265 | 0 |

** The difference in the adjustment to margin for the LNG and gas supply projects cost ($26,698,000) underlying May 1, 1988 rates as compared to the amount credited back to ratepayers in the attrition filing ($31,371,000) is attributable to differences in the treatment of income taxes, franchise fees, and uncollectibles which result from the termination of these costs in the attrition filing as compared to treatment of these related costs when the base costs (LNG and gas supply projects) are ongoing in nature.

(END OF APPENDIX B)