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Decision 90-08-037 August 8, 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY (U 904 G) for authorization to establish its cost of capital for 1990.	Application 89-05-011 (Filed May 8, 1989)
	Application 89-05-019 (Filed May 8, 1989)
	Application 89-05-021 (Filed May 8, 1989)
And Related Matters.	Application 89-05-023 (Filed May 8, 1989)
	Application 89-05-037 (Filed May 17, 1989)
	Application 89-06-015 (Filed June 15, 1989)

OPINION ON PETITION FOR MODIFICATION OF DECISION 89-11-068

On January 12, 1990, the Division of Ratepayer Advocates (DRA) filed a petition for modification of Decision (D.) 89-11-068. That decision established the 1990 ratemaking cost of capital for the major energy utilities, adopting for each utility a ratemaking capital structure, return on common equity (ROE), cost of long-term debt, cost of preferred stock, and overall rate of return on rate base.

DRA requests that the ratemaking capital structure established for San Diego Gas & Electric Company (SDG&E) be modified. D.89-11-068 adopted a capital structure for SDG&E consisting of 44.25% long-term debt, 6.25% preferred stock, and 49.50% common equity. DRA requests that the equity ratio be

lowered to 48.00% and that the debt ratio be raised to 45.75%. The preferred stock ratio would remain unchanged under DRA's request. DRA notes that the capital structure proposed in its petition is the same as had been proposed by the administrative law judge (ALJ) in the proposed decision (Public Utilities Code § 311(d)). The ALJ's opinion had, in turn, adopted the capital structure recommended by DRA in the proceeding. DRA estimates that the marginal revenue requirement resulting from the Commission's adoption of SDG&E's requested capital structure over the imputed capital structure it had proposed is approximately $5 million.

In support of the lower equity ratio it proposes for SDG&E, DRA refers to the history of the Commission's treatment of SDG&E's capital structure since 1985 (D.85-12-108, D.87-12-068, D.88-12-094, and D.89-04-051). DRA believes that the Commission's adoption of a 49.50% equity ratio for SDG&E in D.89-11-068 represents an abrupt departure from this line of decisions, in which the Commission expressed its concern over SDG&E's equity ratio, and imputed hypothetical equity ratios lower than those proposed by SDG&E.

DRA believes that the Commission incorrectly accepted SDG&E's argument concerning long-term capital leases. SDG&E had argued that DRA's imputed capital structure ignores the use of these leases, thereby penalizing it for having entered into these financing arrangements that have benefited ratepayers. DRA argues that based on the testimony described on page 63 of D.89-11-068, SDG&E's equity ratio is excessive compared to those of other California utilities. DRA argues further that the decision unduly enriches SDG&E's shareholders because not only are they already compensated for the cost of capital leases in operating expenses, they are also provided, by the decision, with additional revenue through the adoption of an equity ratio which is higher than those of the other utilities to reflect the existence of SDG&E's capital leases.

As an alternative proposal, if SDG&E's capital structure is not modified, DRA requests that SDG&E's ROE be reduced from the 12.90% authorized by D.89-11-068. DRA asserts that authorized returns should be lowered when a firm's ratemaking equity ratio is allowed to increase. DRA does not specify the extent to which it proposes the ROE be lowered.

Response of SDG&E

On February 8, 1990, SDG&E filed a response in opposition to DRA's petition. SDG&E disagrees with DRA's contention that D.89-11-068 represents a departure from earlier decisions. SDG&E states that the Commission recognized the impact of capital leases in setting SDG&E's cost of capital as early as 1979, in D.90405.

SDG&E contends that it was appropriate for the Commission to consider the impact of long-term lease obligations as long-term debt for the purpose of comparing its capital structure with those of other utilities, and that doing so did not result in double counting of costs which are recovered as operating expenses. SDG&E contends that when the effects of the leases are considered, the adopted equity ratio is reasonable in comparison to those of the other California utilities.

SDG&E also contends that DRA's petition is procedurally defective, noting that under Rule 43 of the Rules of Practice and Procedure (Rules), petitions for modification should only be filed to make minor changes in a Commission decision. According to SDG&E,

> "The only authorized procedure for requesting non-minor changes is by application for rehearing filed within 30 days of the date of issuance (i.e., mailing) of the decision (see Rule 85).
>
> "[T]he DRA petition seeks to reverse totally the Commission's decision on a critical issue which was extensively litigated. Such a change may not be sought by petition for modification. Accordingly, the Commission should dismiss DRA's petition with prejudice. Moreover, the

DRA has forfeited its opportunity to request the Commission's review of this issue by application for rehearing through its failure to file such an application within the designated time."

Discussion

While we were concerned about SDG&E's increasing proportion of equity in 1985, and while we adopted an equity ratio of 48.00% for 1989 based partly on exclusion of leases from debt, these facts do not negate our determination, from the evidence in this year's proceeding, that 49.50% is the appropriate equity ratio for SDG&E for 1990.[1] We do not agree that our determination represents an abrupt departure from earlier decisions.

Other arguments raised by DRA in support of the requests were already addressed by the Commission in D.89-11-068, and need not be addressed in detail here. The issue of whether the capital lease financing used by SDG&E (which all parties agreed has benefited its ratepayers) should be taken into account when evaluating SDG&E's capitalization in comparison with other utilities, and the comparisons themselves, were fully litigated by the parties and considered by the Commission.[2] We find nothing

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1 Nor should parties assume that our adoption of a 49.50% ratio for 1990 in any way signals a lessening of such concern on our part. As we stated in D.89-11-068, at page 35:

"It should be emphasized that we are not excusing [the energy] utilities from their burden of showing that their capital structures and their ratemaking capital structure proposals are reasonable and justified in cost of capital proceedings. We anticipate that capital structure issues will continue to be important parts of these proceedings, particularly the question whether equity-rich structure should be adopted."

2 While we agree that SDG&E's past use of long-term lease financing has yielded benefits for its ratepayers, we do not conclude that such financing is necessarily beneficial in all cases.

new in DRA's arguments, and we find no grounds to change our determination that it is appropriate to take SDG&E's overall capitalization into account when comparing it to other utilities, and that doing so does not result in overcompensation or double counting of costs. We conclude that the request to adjust SDG&E's 1990 authorized capital structure should be denied.

In requesting that we establish a lower ROE for SDG&E if the equity ratio is not reduced, DRA has apparently assumed that the Commission failed to take into account risk factors related to the theoretical tradeoff between equity ratios and returns required by investors (a tradeoff which we reaffirm in principle). Such an assumption is in error. In establishing the authorized ROE of 12.90%, the Commission gave specific recognition "to the overall level of business and financial risk facing SDG&E, including [the] adopted capital structure." (D.89-11-068, page 69; emphasis added.) There is no basis for adjusting the authorized ROE.

DRA requests significant changes in our order in D.89-11-068 as it pertains to the major issues affecting SDG&E's authorized cost of capital. However, we do not need to decide whether the request should have been filed as a petition for modification or as an application for rehearing since in either case it fails on its merits.

Findings of Fact

1. On January 12, 1990, the Division of Ratepayer Advocates (DRA) filed a petition for modification of D.89-11-068.

2. On February 8, 1990, SDG&E filed a response in opposition to DRA's petition.

3. The issue of whether capital leases should be taken into account when evaluating SDG&E's capitalization in comparison with other utilities, and the resulting comparisons themselves, were extensively litigated by the parties and considered by the Commission in D.89-11-068.

4. In establishing the authorized ROE of 12.90%, the Commission considered the capital structure adopted for SDG&E, including the 49.5% equity ratio.

Conclusion of Law

DRA's petition should be denied.

O R D E R

IT IS ORDERED that the petition for modification of D.89-11-068 filed by the Division of Ratepayer Advocates is denied.

This order is effective today.

Dated August 8, 1990, at San Francisco, California.

G. MITCHELL WILK
President
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

I will file a written dissent.

/s/ FREDERICK R. DUDA
Commissioner

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

NEAL J. SHULMAN, Executive Director

FREDERICK R. DUDA, Commissioner, dissenting:

I dissent from today's decision for the same reasons I dissented from the portion of D.89-11-068 which authorized the inclusion of capital leases in SDG&E's capital structure. Decision 89-11-068 allowed the utility to recover the cost of capital leases both through operating expense allowances and through returns on equity that are excessive in light of the 49.5% ratemaking equity ratio that resulted from the inclusion of capital leases in SDG&E's financial capital structure analysis.

SDG&E's 49.5% equity ratio is excessive when compared to the equity ratios of other energy utilities and should result in a return on equity that is lower than the returns on equity earned by such other utilities. After capital leases are taken into account and a "financial capital structure," as opposed to a ratemaking capital structure, is determined, the equity component of that financial capital structure is according to SDG&E's own testimony still 120 to 270 basis points higher than the equivalent equity ratios of Pacific Gas and Electric and Southern California Edison. Traditional ratemaking principles hold that higher equity ratios reduce utility risk and that utilities facing reduced risks should earn lower returns on equity since investors do not require as great a financial reward for their investments in such utilities.

The Commission has now erred twice in granting SDG&E an equity ratio that is excessive when compared to the equity ratios of comparable utilities. It has also twice erred in authorizing SDG&E to earn a return on equity that does not reflect the lower risk accompanying SDG&E's increased equity ratio.

The Commission is unable in its two decisions to explain why it now accepts SDG&E's argument in favor of a 49.5% equity ratio despite its rejection of this argument in several previous

decisions which excluded capital leases from capital structure analysis and imputed lower equity ratios than those sought by SDG&E. There were no new facts or changed circumstances to rely upon for this inconsistent result.

Nor is the Commission able to explain why it does not lower the return on equity it awards SDG&E to reflect the reduced financial risk it faces as a result of the increased equity ratio authorized by D.89-11-068.

The ALJ's original proposed decision adopting a 48% equity ratio was correct. The final version of D.89-11-068 is in error. The errors in D.89-11-068 are repeated in today's decision. The Commission can and should do better than this result.

Frederick R. Duda, Commissioner

August 8, 1990
San Francisco, California