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Decision 91-11-059 November 20, 1991

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Application of Pacific Gas and Electric Company for authority to (i) increase its authorized rate of return on common equity, (ii) adjust its authorized capital structure, (iii) adjust its cost factors for embedded debt and preferred stock, and (iv) increase its overall rate of return for calendar year 1992. (Electric and Gas) (U-39-M)	Application 91-05-016 (Filed May 8, 1991)
And Related Matters.	Application 91-05-018 (Filed May 8, 1991) Application 91-05-019 (Filed May 8, 1991) Application 91-05-022 (Filed May 8, 1991) Application 91-05-023 (Filed May 8, 1991) Application 91-05-024 (Filed May 8, 1991)

(See Appendix A for appearances.)

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OPINION

I. Summary of Decision

This order establishes the 1992 ratemaking cost of capital for Pacific Gas and Electric Company (PG&E), Southwest Gas Corporation (Southwest), Sierra Pacific Power Company (Sierra Pacific), Southern California Gas Company (SoCalGas), San Diego Gas & Electric Company (San Diego), and Southern California Edison Company (Edison).

Upon consideration of the market conditions, trends, quantitative models, and joint recommendation of the parties to this proceeding, we conclude that the 1992 authorized return on common equity and overall return on rate base for the energy utilities should be:

Utility	Common Equity	Return on Rate Base
PG&E	12.65%	10.76%
Southwest	12.75	11.26
Sierra Pacific	12.75	10.07
SoCalGas	12.65	10.49
San Diego	12.65	10.75
Edison	12.65	10.59

These rates of return on common equity and rate base are less than those requested by the utilities and less than currently authorized by the Commission. With the adoption of the above-mentioned returns, each utility's revenue requirement for the 1992 calendar year will be reduced, directly resulting in lower energy costs to the ratepayers. PG&E's revenue requirement will be reduced by approximately $33.3 million, Southwest's by $0.3 million, Sierra Pacific's by $0.3 million, SoCalGas' by $11.6 million, San Diego's by $6.8 million, and Edison's by $22.8 million.

II. Procedural Background

Pursuant to Decision (D.) 89-01-040, the rate case plan for PG&E, Southwest, Sierra Pacific, SoCalGas, San Diego, Edison, and Pacific Power & Light Company (PP&L) was modified by removing the cost of capital issue from these energy utilities' general rate case (GRC) proceedings and established a separate generic, annual cost of capital (ACC) proceeding.

Beginning with May 8, 1989 and continuing on the same date in subsequent years, each of the seven energy utilities is required to file an ACC application for rate adjustments which reflect its projected cost of capital for the following year. The ACC process provides for the new rates to be implemented on January 1 in conjunction with the utility's pending GRC or attrition rate adjustment filing, as applicable.

PG&E, Southwest, Sierra Pacific, SoCalGas, San Diego, and Edison filed ACC Applications (A.) 91-05-016, A.91-05-018, A.91-05-019, A.91-05-022, A.91-05-023, and A.91-05-024, respectively. Because PP&L's 1991 GRC decision (D.90-12-022) exempted PP&L from filing its May 8, 1991 ACC application, PP&L did not actively participate in this proceeding. Accordingly, this order addresses only six of the seven energy utilities under the ACC process.

The energy utilities' ACC applications were consolidated into one proceeding at the June 25, 1991 prehearing conference, pursuant to Rule 55 of the Commission's Rules of Practice and Procedure. Evidentiary hearings were held on September 3 and 5, 1991 in San Francisco. The proceeding was submitted upon the receipt of late-filed Exhibit 18, Data Resources, Inc.'s (DRI) October 1991 "control" interest rate forecast on October 9, 1991.

Testimony and evidence was submitted by each of the energy utilities, by the Federal Executive Agencies (FEA), by the

City of Los Angeles (LA), and by the Division of Ratepayer Advocates (DRA). Although the City of San Diego did not present testimony or evidence, it actively participated in the proceeding. Six other interested parties, including Toward Utility Rate Normalization, filed appearances but did not actively participate in this proceeding.

Briefs were filed by PG&E and the FEA on September 20, 1991. Reply briefs were filed by DRA and Edison on September 27, 1991.

Protest letters were received from more than 600 ratepayers. The concerns of the protesters included: objection to any increase in rates because of ratepayers' limited income, unemployment, recession, and the need for utilities' stockholders to share risk with the ratepayers. The following table summarizes the number of protest letters placed in the respective utility's formal file:

Utility	Letters
PG&E	151
Southwest	0
Sierra Pacific	0
SoCalGas	132
San Diego	17
Edison	344

III. Joint Exhibit

At the beginning of the evidentiary hearing on September 3 and prior to receipt of prefiled testimony, DRA informed the administrative law judge (ALJ) that DRA and the utilities wanted to introduce a joint exhibit presenting a proposed settlement agreement.

No party present at the evidentiary hearing objected to the introduction of a joint settlement exhibit. However, because five of the seventeen parties who filed an appearance of record at the prehearing conference were not present at the evidentiary hearing, the ALJ instructed DRA to inform the parties not present of DRA's intention to file a joint exhibit recommending settlement of this proceeding, and of DRA's requested waiver of the Commission's rules on stipulations and settlements.

DRA contacted each of the appearances of record that did not attend the first day of evidentiary hearing, none of which expressed an interest in contesting a proposed joint settlement agreement and none of which appeared at the subsequent hearing. No party objected to the waiver of the Commission's rules on stipulations and settlements.

Because no party objected to a waiver of the stipulation and settlement rules and because Rule 51.10 of the Commission's Rules of Practice and Procedure provide that two or more parties may sponsor joint testimony in a Commission hearing without application of the rules, the ALJ allowed the joint testimony to be introduced into the record on September 5, 1991.

The joint exhibit sponsored by DRA's Mowrey and signed by all active parties[1] of record was received into evidence as Exhibit No. 17. Mowrey was cross-examined by PG&E, Edison, and the ALJ. The joint exhibit recommended that:

a. SoCalGas, San Diego, PG&E, and Edison be authorized a 12.65% return of common equity for the 1992 calendar year.

b. Southwest and Sierra Pacific be authorized a 12.75% return on common equity for the 1992 calendar year.

c. The capital structure recommended by the individual utilities be adopted for the 1992 calendar year.

1 The active parties were DRA, Edison, SoCalGas, San Diego, PG&E, Southwest, Sierra Pacific, FEA and the Department of the Navy, the City of LA, and the City of San Diego.

d. The costs of long-term debt and preferred stock be based on data available from the October 1991 DRI control forecast.

All parties to the exhibit, except for FEA, agreed to extend their best efforts to assure adoption of these recommendations as the basis for the final authorized return on common equity for each utility. FEA supports the joint exhibit with the exception of Edison's return on common equity.

As part of the joint recommendation, the signatory parties concur that none of the filed recommendations, principles or methodologies in the testimony or exhibits of any of the agreeing parties underlying the joint recommendation shall be deemed as precedent in any proceeding or any litigation, except in order to implement the agreed upon recommendations in this proceeding. The signatory parties expressly reserve the right to advocate different principles or methodologies from those underlying the joint exhibit in other proceedings.

Similarly, if the joint exhibit is not adopted, the signatory parties expressly state that Rule 51.7 shall apply and that the signatory parties may withdraw their joint recommendation to advocate any position supported by their admitted testimony or exhibits in hearings, briefs, comments on a proposed decision, rehearing or judicial review.

The mere agreement among active parties, except for FEA regarding Edison's return on common equity, does not supersede or restrict our analysis of the record to determine the appropriate capital structure, cost of debt and preferred stock, and return on common equity for the utilities' 1992 calendar year. The ALJ made this position quite clear when he instructed the parties that the agreeing parties would need to have at least one witness available to testify on the joint agreement and that the witness would need to substantiate that the proposed agreement is in the public interest.

To assure ourselves that the proposed settlement agreement is in the public interest, it is necessary to review and analyze the parties' prefiled testimony entered into the record prior to addressing the merits of the joint exhibit. Section IV addresses the generic issues identified in the prefiled testimony and Section V addresses the merits of the joint exhibit.

IV. Generic Issues

We have established a generic annual proceeding to consider the cost of capital for major energy utilities. However, it does not necessarily follow that a uniform return on equity or rate of return on rate base should be applied to each of the seven energy utilities. This is because each of these utilities has unique factors and differences that need to be considered in arriving at a reasonable return. These unique factors and differences encompass four distinct areas: capital structure, cost of long-term debt, cost of preferred stock, and return on common equity. However, in this consolidated proceeding PG&E proposes to add incentive returns on common equity for renewable resources as an additional factor.

Capital Structure

Capital structure is comprised of long-term debt, preferred stock, and common equity. Because the level of financial risk that a utility faces is determined by the proportion of its debt to permanent capital, or its leverage, our overriding concern with the utilities' capital structures is to ensure that equity ratios we adopt in determining overall rates of return on rate base are no greater than required to maintain reasonable credit ratings and to provide the utilities the ability to attract capital.

We considered adopting an optimum capital structure for each energy utility in D.89-11-068. However, upon reviewing the evidence presented in that proceeding, we concluded that the utilities should be given some discretion to manage their capitalization with a view towards a balance between shareholders' interests, regulatory requirements, and ratepayers' interests. Therefore, instead of adopting an optimum financial or ratemaking capital structures for each of the energy utilities, we concluded that we should continue to evaluate capital structures on a case-by-case basis in proceedings such as in the ACC filings.

The utilities' requested capital structures for 1992, although distinctly different from each other, are very similar, if not identical, to their respective 1991 authorized capital structure. As testified by DRA's Quan in Exhibit 6, the capital structures requested by the utilities do not significantly deviate from the capital structures authorized by the Commission over the past five years. DRA concluded that the utilities' requested capital structures for 1992 are reasonable and should be used to set the 1992 authorized rate of return.

FEA concurred with DRA that PG&E's, Southwest's, SoCalGas', San Diego's, and Edison's requested capital structures were reasonable. However, FEA's Legler recommended that the utilities' capital structures be updated for known and measurable changes at the time a decision is rendered. FEA presented no testimony on Sierra Pacific's requested capital structure.

The City of LA's testimony, restricted to SoCalGas only, shows that it concurs with DRA's and FEA's opinion that SoCalGas' requested capital structure for 1992 is reasonable.

The following tabulation shows the utilities' requested 1992 capital structures which are not disputed by any party to the proceeding:

Utility	Long-term Debt	Preferred Stock	Common Equity	Total Structure
PG&E	47.50%	5.75%	46.75%	100.00%
Southwest	50.00	5.00	45.00	100.00
Sierra Pacific	50.91	5.97	43.12	100.00
SoCalGas	43.80	10.10	46.10	100.00
San Diego	44.50	6.00	49.50	100.00
Edison	48.00	6.00	46.00	100.00

Cost of Long-Term Debt

The forecasted cost of long-term debt is based on the utility's actual, or embedded, cost of long-term debt. However, because we establish the cost of capital on a forecast basis each year, future interest rates must be anticipated to reflect projected changes in the utilities' debt costs caused by the issuance of new debt and by the retirement of old debt.

Prior cost of capital proceedings generated a considerable debate on the validity of various interest rate forecasts and on the appropriate methodology for equating forecast AA utility bond rates to other bond ratings. However, by D.90-11-057, we adopted the following recommendations of workshop held to settle the interest rate forecast issue.

a. To use the DRI Control AA utility bond forecast adjusted to the utility's specific bond rating for the cost of debt and preferred stock over the rate period.

b. To use the weighted average of the most recent 36-month of Moody's recorded Aa-A data ending with the first quarter of the filing year, rounded to the nearest five basis points for utilities which do not have an Aa bond rating. Utilities with split ratings would use half of the spread.

c. To use the latest DRI update (October) to finalize the embedded cost of debt.

d. To not adopt a standard forecast for use in the development of the cost of equity, but to use DRI with one scenario in models which use an interest rate forecast.

Although the above-mentioned procedure was adopted for the purpose of calculating the cost of long-term debt for ACC applications, the parties calculated different long-term debt estimates. This is because the utilities' testimony was based on data compiled prior to May 8, 1991 and all other parties' testimony was based on data compiled between May 8 and August 21, 1991, well before DRI's October control forecast was published.

Similar to the parties' position regarding the utilities' capital structures, the parties concurred that the adopted cost of debt should be the utilities' actual costs updated to reflect the October DRI control forecast. The following tabulation shows each party's projected cost of long-term debt prior to an October 1991 DRI update:

Utility	Utility	DRA	FEA	City of LA
PG&E	9.38%	9.20%	9.38%	NA %
Southwest	10.02	10.08	10.02	NA
Sierra Pacific	8.07	8.07	NA	NA
SoCalGas	9.53	9.49	9.48	9.44
San Diego	9.29	9.28	9.29	NA
Edison	9.07	9.03	9.06	NA

Cost of Preferred Stock

The cost of preferred stock is developed from the same process used to project long-term debt cost. Because PG&E, Southwest, and Sierra Pacific do not plan to issue new preferred stock in 1992, the embedded cost of preferred stock for these three utilities were used by all parties.

Differences between the parties in the projected costs of preferred stock of SoCalGas, San Diego, and Edison occurred because of the utilities' intent to issue new preferred stock in 1992 and because of the use of DRI forecasts from different time periods. However, each party concurs that the utilities' costs of preferred stock should be based on embedded costs updated to reflect the October 1991 DRI forecast for new issues. The following tabulation shows each party's recommended cost of preferred stock prior to being updated to reflect the October DRI forecast:

Utility	Utility	DRA	FEA	City of LA
PG&E	8.74%	8.74%	8.74%	NA %
Southwest	9.57	9.57	9.57	NA
Sierra Pacific	7.74	7.74	NA	NA
SoCalGas	6.04	5.88	6.04	6.04
San Diego	7.39	7.37	7.56	NA
Edison	7.66	7.66	7.66	NA

Return on Common Equity

We attempt to set return on common equity at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill the utility's public utility service obligation. To accomplish this objective we have consistently evaluated the following three considerations prior to arriving at a fair return on equity for the larger energy utilities:

a. The application and interpretation of financial models may not accurately reflect all of the intricacies of the financial market.

b. Market cost of equity capital reflects risk, such as the exposure of a utility's earnings to variability in fuel cost and sales levels.

c. Cost of capital varies in the same direction as changes in the general level of inflation and interest rates.

Historically, quantitative financial models have been used as a starting point to estimate a fair return on equity. The models commonly used in ACC proceedings are the Discounted Cash Flow Analysis (DCF), Risk Premium Analysis (RPM), and the Capital Asset Pricing Model (CAPM). Detailed descriptions of each financial model are contained in the record and are not repeated here.

The financial models are used only to establish a range from which the parties apply their individual judgment 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 analyses and in criticism of 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. In the final analysis, it is the application of judgment, 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 DCF, CAPM, and RPM models were used by a majority of the parties to the proceeding. Consistent with prior ACC proceedings, the FEA did not use the CAPM model, and the City of LA did not rely on any of the financial models. Rather, the City of LA relied on its observation that short-term interest rates and long-term bond yields are declining, the current rate of inflation is lower than the prior year, earnings on common equity of large energy utilities are on a downward trend and are now at 12% or less, adequate pretax interest coverage could be maintained at a 12% or lower return on common equity, and the current risk situation does not justify a higher return on common equity. The following table summarizes the broad range of results derived from the various financial models used by the utilities, DRA, and other interested parties:

PG&E	
PG&E	11.20%- 13.92%
DRA	11.77 - 13.54
FEA	11.40 - 13.80

Southwest	
Southwest	9.47%- 14.49%
DRA	11.93 - 13.54
FEA	10.80 - 12.60

Sierra	
Sierra	12.07%- 13.60%
DRA	11.45 - 13.03

SoCalGas	
SoCalGas	12.84%- 15.35%
DRA	12.19 - 15.09
FEA	10.50 - 13.40
City of LA	12.50

San Diego	
San Diego	11.60%- 14.00%
DRA	10.82 - 13.33
FEA	10.90 - 13.10

Edison	
Edison	10.54%- 15.63%
DRA	11.57 - 13.68
FEA	10.50 - 14.40

These broad ranges of return on common equity were fine-tuned by the parties to reflect their informed judgment with respect to increased financial, business, and regulatory risks expected to occur in 1992.

Financial Risks

Financial risk is tied to the utility's capital structure. As explained in our capital structure discussion, the level of financial risk that a utility faces is determined by the proportion of its debt to permanent capital. In general, the lower the proportion of a utility's total capitalization consisting of common equity, the higher the financial risk. Therefore, as a utility's debt ratio increases, a higher return on equity may be needed to compensate for that increased risk.

However, in this proceeding none of the utilities has proposed a major change in its 1992 capital structure from its 1991 authorized capital structure. Further, there is no dispute over the level of any utility's proposed capital structure. Absent a major shift in a utility's capital structure, there is no additional financial risk associated with debt/equity ratios to consider.

Business Risks

Business risks pertain to uncertainties resulting from competition and the economy. With respect to the increased business risk outlook for 1992, the utilities considered uncertainties concerning the timing and level of new generating capacity to meet growth demands and potential new environmental regulations. Components of environmental risks included future air pollution control standards and future requirements of the California State Water Resources Control Board's water quality plan.

The energy utilities' assessment of a fair return on common equity also reflected increased business risks from the deregulation of the gas industry and deregulation's effect on the utilities' ability to secure reliable sources of natural gas. The utilities adjusted their returns on common equity to reflect increased risks due to bypass, the Kern River/Mojave interstate gas transmission pipeline project, and their reliance on purchased power contracts.

On the other side, DRA's outlook for the energy utilities in 1992, as stated in its prefiled testimony, did not expect any significant change in the investors' perception of business risk as it relates to the California energy utilities.

Economic conditions were also a factor in the utilities' assessment of upward risks as related to return on common equity. The utilities' testimony reflected optimism that interest rates and the recession have reached the floor and that the economy is in recovery. As part of this recovery, they believe that upward pressures of risk will occur from perceived volatility and uncertainty of both inflation and interest rates. However, at the same time, the utilities recognize that recent data may provide a clearer picture of their business risks for 1992 as 1991 progresses.

Regulatory Risks

Several of the utilities adjusted their requested returns on common equity to reflect their belief that new risks for investors may result from future regulatory actions that we, and other regulatory agencies, might take. Among the myriad of pending proceedings that the utilities view as risk related are: Ratemaking (R.) 90-02-008 regarding the structure of gas utilities procurement practices, Investigation (I.) 90-08-006 regarding an incentive regulatory framework that could replace the traditional cost of service procedure for the energy utilities, and I.90-09-050 regarding the practices of transmission access and the wheeling of energy.

A second area of regulatory risk is the regulatory disallowance of operating expenses and rate base additions found by the Commission to be imprudent. An example of this type of risk cited by San Diego is a DRA recommendation, in a proceeding not specifically identified, that approximately $8.2 million of San Diego's future investment in San Onofre Nuclear Generating Station (SONGS) Unit 1 be disallowed, irrespective of the prudency of the expenditures.

DRA strongly disagrees with the utilities' negative view of regulatory risks that may occur from pending actions by the Commission. Quan's testimony showed that the California regulatory climate is perceived to be very good. This is substantiated by Merrill Lynch's rating of the regulatory environments in which energy utilities operate. In fact, on a scale of 1 to 5, with 5 as most favorable, Merrill Lynch recently raised its rating of California's regulatory environment from 4- to 4. Investors' assessment of perceived regulatory risk in California is not what the utilities would like us to believe, according to DRA.

Renewable Resources

Besides reflecting informed judgment into the determination of a reasonable return on common equity with respect to increased financial, business, and regulatory risk, PG&E believes that the development of alternative and renewable resources[2] should be an additional factor to consider in determining a fair return on common equity.

PG&E explained that it operates an extensive renewable resource system representing approximately a $1.5 billion investment, including the largest investor-owned hydroelectric system in the United States and the world's largest commercial geothermal production facility at the Geysers. It asserts that the additional consideration of its renewable resource system justifies granting a return on common equity at the higher end of PG&E's 11.20% to 13.92% range. PG&E believes that the additional consideration of its renewable resources is consistent with Public Utilities (PU) Code § 454.3.

PU Code § 454.3 provides in part that the Commission may approve an increase of from one-half of 1 percent to 1 percent in the rate of return otherwise allowed an electrical corporation on its electric plant for investment in facilities that are either:

a. Designed to generate electricity from a renewable resource subject to Resources Agency review of its environmental impacts,

b. Capable of meeting the then applicable environmental pollution standards, or

c. Experimental and reasonably designed to improve or perfect technology for the generation of electricity from renewable resources or to more efficiently utilize other resources which will decrease

2 Renewable resources include solar energy, geothermal steam, wind, and hydroelectric power at new or existing dams.

environmental pollution from and lower the costs of the electricity generated.

In order for a utility to receive a rate of return incentive under either of the first two alternatives, the utility must demonstrate that the facility's capital costs, when added to its costs of operation and maintenance, will result in a lower cost of electricity generated over the useful life of the facility than that of electricity generated by existing facilities utilizing nuclear power or fossil fuel.

DRA's Quan disagreed with PG&E's request for an incentive return on common equity to compensate PG&E for its renewable resources currently in place. According to Quan, when this code section was first chaptered into law in 1976, the intent was to encourage the use of alternative energy sources during a time of high fuel prices. The additional reward for meeting the requirements of the code section was intended to be authorized on a case-by-case basis for individual projects. Further, Quan reminds all parties that the ACC proceeding is for the sole purpose of setting an overall return of rate base on the utilities' entire rate base, not individual components of rate base.

Although PG&E believes that its renewable resources meet the PU Code requirements, it did not attempt to identify the specific facilities, to substantiate that the facilities meet current environmental and pollution standards, or to demonstrate that such facilities result in lower energy costs than electricity generated by existing facilities utilizing nuclear power or fossil fuel, as required by the code. PG&E merely stated that Section 454.3 applies to its renewable resources and, therefore, it is entitled to a return on common equity at the higher end of the range of reasonableness indicated by PG&E's witnesses.

PG&E's request does raise an interesting point, that is, whether the legislature intended the section to be applicable on a retroactive basis, as PG&E is apparently asserting. It is also interesting to note that PG&E has waited almost 16 years before seeking any incentive return on its renewable resources. However, we need not address these points because PG&E has not adequately justified its request.

We concur with Quan's assessment of Section 454.3 that an incentive return on rate base should be considered on a case-by-case basis for individual projects. This proceeding is restricted to determining the utilities' overall rate of return. To grant an incentive return on equity as requested by PG&E would erroneously burden its ratepayers by extending an incentive return to PG&E's entire rate base, contrary to the legislative intent of allowing an incentive return only on investment in facilities generating electricity from renewable resources. PG&E's request to include the development of its renewable energy system as a factor in determining its fair return on common equity in this proceeding should be denied.

PG&E should follow the lead of other utilities which have previously sought an incentive return on rate base, and not an incentive return on common equity, pursuant to the code section. One such utility is Edison, by A.88-05-012 (D.89-06-012) in which Edison sought authority to, among other matters, earn an incentive return on its investment in the Balsam Meadow hydroelectric project.

<u>Return on Common Equity Proposals</u>

Based upon the parties' analyses of the various financial models and informed judgment of upward pressure from financial, business, and regulatory risks, the recommended 1992 returns on common equity for the six energy utilities are as follows. For comparison purposes, the returns on common equity recommended in the joint exhibit are included in the tabulation.

Utility	Utility	DRA	FEA	City of LA	Joint Exhibit
PG&E	13.50%	12.20%	12.60%	NA %	12.65%
Southwest	13.05	12.30	12.65	NA	12.75
Sierra Pacific	13.50	12.30	NA	NA	12.75
SoCalGas	13.80	12.20	12.60	12.50	12.65
San Diego	13.60	12.20	12.50	NA	12.65
Edison	13.65	12.15	12.25	NA	12.65

V. Merits of the Joint Exhibit

The joint exhibit, consistent with the individual parties' prefiled testimony, recommended that the utilities' requested capital structure, cost of long-term debt, and cost of preferred stock adjusted to reflect the October 1991 DRI control forecast for new issues of long-term debt and preferred stock be adopted.

The recommended returns on common equity were the only change of position between the parties' prefiled testimony and the joint exhibit. The parties' joint exhibit recommended returns on common equity that average 27 basis points lower, excluding FEA's recommended return for Edison, than the utilities' 1991 authorized returns on common equity. FEA's recommended 12.25% return on equity for Edison is 60 basis points lower than Edison's 1991 authorized return and 40 basis points lower than the joint recommendation. The following tabulation compares the utilities' 1991 authorized returns on common equity with the joint exhibit proposed returns on common equity.

Utility	1991 Authorized	1992 Recommended
PG&E	12.90%	12.65%
Southwest	13.05	12.75
Sierra Pacific	13.00	12.75
SoCalGas	13.00	12.65
San Diego	12.90	12.65
Edison	12.85	12.65[3]

Historically, the Commission has not relied on one particular party's recommendation in authorizing a fair return on common equity. Accordingly, the parties, in arriving at their agreed upon returns on common equity, took into account DRA's, FEA's, City of LA's, and the individual utilities' prefiled testimony. The joint exhibit reflected the results of a compromise between the utilities, FEA, City of LA, and DRA which represented ratepayer interests.

The wide range of returns on common equity recommended by the various parties precludes us from relying on a particular party's analysis. This is attributed to the subjective inputs to the models to which informed judgment is applied. For example, in this proceeding the spread between the utilities' and interested parties' recommended returns averaged 129 basis points. We can only attribute this wide range to the utilities' pessimistic and the interested parties' optimistic view of risk. We would hope that all parties would support a more realistic position in future proceedings.

Mowrey acknowledged that the compromised recommendation is higher than DRA's initial recommendation. However, he explained that it is only slightly higher for most of the utilities than FEA's recommended return on common equity and substantially lower than what the utilities requested in their applications.

3 Except for FEA which recommended a 12.25% return on common equity for Edison.

DRA believes that the compromise returns on equity are reasonable and result in a balance between utility and ratepayer interests. Mowrey concluded that given the uncertainties, such as economic conditions, the reduction in rates of return for the first time in over three years resulting from the joint recommendation is in the public interest.

FEA agreed to the equity compromises identified in the joint exhibit, except for Edison, because the agreed upon returns were very close to its own recommendations. Although FEA acknowledged that judgment is involved in the setting of a return on common equity, it did not believe that the joint exhibit gave proper weight to the relative riskiness of Edison compared to the other utilities considered, such as PG&E.

In support of its riskiness position, FEA cited DRA testimony which stated that on a relative basis, Edison ranks favorably among the other electric utilities and that Edison's financial strength and safety characteristics, as defined by "Value Line," rank among the highest.

FEA concluded from its various studies that Edison should be authorized a return on common equity within a 11.9% to 13.1% range of reasonableness. However, based on the upper end of its DCF analysis, which produced a 10.5% to 11.9% range of reasonableness, and upper end of its comparable electric companies, which produced a 10.68% to 11.51% range, FEA recommended a 12.25% return on common equity for Edison. FEA placed less reliance on its RPM analysis which produced a 12.3% to 14.4% range of reasonableness. In effect, FEA's recommendation for Edison is between its DCF and RPM analysis, and at the lower end of its acceptable common equity range of reasonableness.

We do not believe that FEA's comparison of Edison to PG&E is appropriate. Each utility has unique factors and differences that need to be considered in arriving at a reasonable return on equity. This is substantiated by the parties' running of financial models for each utility, the results of which are used to establish a range from which individual judgment on business, financial, and regulatory risks is applied to determine a fair return on common equity.

Similarly, we do not concur with the high level of reliance that FEA places on its DCF analysis to arrive at its 12.25% recommendation for Edison, derived from the 11.9% to 13.1% range that it found reasonable. We have already discussed the merits of the DCF and other financial models in our return on common equity discussion and will not repeat them. However, a comparison of FEA's DCF analysis with DRA's and Edison's substantiate the subjective results of such an analysis. FEA's DCF analysis produced the lowest range of returns, DRA's was in the middle, and Edison's produced the highest which peaked at 15.63% for comparable companies.

Our analysis of the evidence shows that the compromised returns on common equity are well within the low 12% to the high 13% specific return on common equity recommended by individual parties, and are well within the broad range of results derived by individual parties from the various financial models.

This analysis of the evidence also leads us to conclude that, consistent with the joint recommendation, the utilities' authorized returns on common equity should be reduced from their 1991 level. Our decision to reduce the utilities' returns on common equity is based on the fact that the evidence does not show any substantial increase in business risks, the financial risk is leveling off, and the regulatory environment perceived by the business community has improved.

Further, the current outlook for inflation and interest rates for 1992 is more encouraging when compared to the 1990 timeframe, when current authorized returns on common equity were set. The July 10, 1991 Blue Chip Consensus Forecasts projected a 4.4% inflation rate during 1991 and a 3.8% inflation rate for 1992.

These rates are an improvement over the 5.4% rate of inflation for 1990. DRI's October 1991 control forecast projected a 9.10% rate for 1992 AA utility Bonds, a 66 basis point reduction from its October 1990 forecast of 9.76% for 1991.

In summary, we conclude from the evidence presented that the utility's requested capital structure, cost of long-term debt, and cost of preferred stock adjusted to reflect the DRI forecasts, as proposed by the parties' joint exhibit, is reasonable and should be adopted for the 1992 calendar year. We also conclude that the returns on common equity, including Edison's recommended 12.65%, recommended by the parties' joint exhibit should be adopted for the 1992 calendar year.

VI. 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 October 21, 1991, pursuant to Rule 77 of the Commission's Rules of Practice and Procedure. Comments to the ALJ's proposed decision were received from PG&E, the City of LA, and FEA.

Rule 77.3 requires comments to the proposed decision to focus on factual, legal, or technical errors in the proposed decision and in citing such errors requires the party to make specific references to the record. Rule 77.4 requires comments proposing specific changes to the proposed decision to include supporting findings of fact and conclusions of law.

We have carefully reviewed and considered all comments filed by the parties to this proceeding that focused on factual, legal, or technical errors in the proposed decision. To the extent that these comments required discussion, or changes to the proposed decision, the discussion or changes have been incorporated into the body of this order. Those comments that did not comply with Rule 77.3 and 77.4 were not considered.

Findings of Fact

1. The ACC process provides for the energy utilities' new rates to be implemented on January 1 in conjunction with the utilities' pending GRC or attrition rate adjustment filing.

2. ACC applications were timely filed by PG&E, Southwest, Sierra Pacific, SoCalGas, San Diego, and Edison.

3. The energy ACC applications were consolidated into one proceeding.

4. Protest letters were received from more than 600 ratepayers.

5. No party objected to the introduction of a joint settlement exhibit.

6. No party objected to the waiver of the Commission's rules on stipulations and settlements.

7. Rule 51.10 permits for two or more parties to sponsor joint testimony in a Commission hearing without application of the Commission's stipulation and settlement rules.

8. The joint exhibit recommended that:

   a. SoCalGas, San Diego, PG&E, and Edison be authorized a 12.65% return on common equity for the 1992 calendar year.

   b. Southwest and Sierra Pacific be authorized a 12.75% return on common equity for the 1992 calendar year.

   c. The capital structure recommended by the individual utilities be adopted for the 1992 calendar year.

   d. The cost of long-term debt and preferred stock be based on data available from the October 1991 DRI control forecast.

9. The joint exhibit was sponsored by DRA, Edison, SoCalGas, San Diego, PG&E, Southwest, Sierra Pacific, FEA and the Department of the Navy, the City of LA, and the City of San Diego.

10. FEA supported the joint exhibit except for Edison's return on common equity.

11. Each utility has unique factors and differences that need to be considered in arriving at a reasonable return.

12. The utilities' requested capital structure for 1992, although distinctly different from each other, are very similar, if not identical to their respective 1991 authorized capital structure.

13. All parties concurred that the utilities' requested capital structures are reasonable.

14. All parties concurred that the utilities' requested costs of long-term debt updated to reflect the October 1991 DRI control forecast are reasonable.

15. All parties concurred that the utilities' requested costs of preferred stock updated to reflect the October 1991 DRI control forecast are reasonable.

16. Quantitative financial models are used as a starting point to estimate a fair return on common equity.

17. Although the quantitative financial models are objective, the results are dependent on subjective inputs.

18. Individual judgment is applied to the range of results derived from the financial models to determine a fair return on common equity.

19. Absent a major shift in a utility's capital structure, there is no additional financial risk associated with debt/equity ratios to be considered.

20. The utilities recognize that recent data may provide a clearer picture of their business risks for 1992 as 1991 progresses.

21. Merrill Lynch perceives the California regulatory environment to be above average.

22. PU Code § 454.3 provided the Commission a means to approve an increase of from one-half of 1 percent to 1 percent in

the rate of return otherwise allowed an electrical corporation for investments in facilities operating electricity from renewable resources.

23. PU Code § 454.3 was intended to be applied to individual facilities.

24. The ACC proceeding is restricted to determining a utility's overall rate of return.

25. PG&E did not show that its facilities met the requirements of PU Code § 454.3.

26. The recommended returns on common equity were the only change of position between the parties' prefiled testimony and the joint exhibit.

27. Except for the FEA in regards to Edison's return on common equity, no party objected to the return on equity compromises identified in the joint exhibit.

28. FEA's common equity recommendation for Edison is between its DCF and RPM analysis, and at the lower end of FEA's acceptable common equity range of 11.9% to 13.1%.

29. The compromise returns on common equity are within the low 12% to the high 13% specific returns on common equity recommended by the individual parties.

30. The current outlook for inflation and interest rates for 1992 is more encouraging when compared to the 1990 timeframe, when current authorized returns on common equity were set.

<u>Conclusions of Law</u>

1. The cost of capital factors adopted by this decision should be implemented in conjunction with each utility's 1992 attrition year filing or 1992 test year general rate case filing, as applicable. Accordingly, this order should be effective on the date signed.

2. Claims for incentive returns on common equity for the development of renewable resource facilities should not be adjudicated in ACC proceedings.

3. Considering the current inflation and interest rate trends, improved regulatory climate perceived by Merrill Lynch, and the testimony of the parties of record, the energy utilities' 1992 returns on common equity should be reduced from their currently authorized rates to the returns proposed in Exhibit 17.

4. The individual utility's proposed 1992 capital structure should be adopted.

5. The individual utility's proposed long-term debt and preferred stock costs, adjusted to reflect the October 1991 DRI control forecast for new issues of long-term debt and preferred stocks should be adopted.

6. A 12.65% return on common equity, which results in an overall 10.76% return on rate base, should be adopted as just and reasonable for PG&E in 1992, based upon all of the evidence considered in this proceeding.

7. A 12.75% return on common equity, which results in an overall 11.26% return on rate base, should be adopted as just and reasonable for Southwest in 1992, based upon all of the evidence considered in this proceeding.

8. A 12.75% return on common equity, which results in an overall 10.07% return on rate base, should be adopted as just and reasonable for Sierra Pacific in 1992, based upon all of the evidence considered in this proceeding.

9. A 12.65% return on common equity, which results in an overall 10.49% return on rate base, should be adopted as just and reasonable for SoCalGas in 1992, based upon all of the evidence considered in this proceeding.

10. A 12.65% return on common equity, which results in an overall 10.75% return on rate base, should be adopted as just and reasonable for San Diego in 1992, based upon all of the evidence considered in this proceeding.

11. A 12.65% return on common equity, which results in an overall 10.59% return on rate base, should be adopted as just and

reasonable for Edison in 1992, based upon all of the evidence considered in this proceeding.

ORDER

IT IS ORDERED that:

1. Pacific Gas and Electric Company's (PG&E) adopted cost of capital for its 1992 attrition year is as follows:

PG&E's Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	47.50%	9.15%	4.35%
Preferred Stock	5.75	8.74	0.50
Common Equity	46.75	12.65	5.91
Total	100.00%		10.76%

2. PG&E's adopted 1992 rate of return, as shown in Ordering Paragraph 1, shall be used in conjunction with its 1992 attrition year advice letter filing and the most recently adopted cost allocation and rate design principles for the purpose of calculating revised rates for the 1992 attrition year.

3. Southwest Gas Corporation's (Southwest) adopted cost of capital for its 1992 test year is as follows:

Southwest's Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	50.00%	10.08%	5.04%
Preferred Stock	5.00	9.57	0.48
Common Equity	45.00	12.75	5.74
Total	100.00%		11.26%

4. Southwest's adopted 1992 test year rate of return, as shown in Ordering Paragraph 3, shall be used in conjunction with its pending 1992 general rate case proceeding for the purpose of calculating revised rates for the 1992 test year.

5. Sierra Pacific Power Company's (Sierra Pacific) adopted cost of capital for its 1992 attrition year is as follows:

Sierra Pacific's Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	50.91%	8.07%	4.11%
Preferred Stock	5.97	7.74	0.46
Common Equity	43.12	12.75	5.50
Total	100.00%		10.07%

6. Sierra Pacific's adopted 1992 rate of return, as shown in Ordering Paragraph 5, shall be used in conjunction with its 1992 attrition year advice letter filing and the most recent adopted cost allocation and rate design principles for the purpose of calculating revised rates for the 1992 attrition year.

7. Southern California Gas Company's (SoCalGas) adopted cost of capital for its 1992 test year is as follows:

SoCalGas' Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	43.80%	9.37%	4.10%
Preferred Stock	10.10	5.52	0.56
Common Equity	46.10	12.65	5.83
Total	100.00%		10.49%

8. SoCalGas' adopted 1992 rate of return, as shown in Ordering Paragraph 7, shall be used in conjunction with its 1992 attrition year advice letter filing and the most recent adopted cost allocation and rate design principles for the purpose of calculating revised rates for the 1992 attrition year.

9. San Diego Gas & Electric Company's (San Diego) adopted cost of capital for its 1992 test year is as follows:

San Diego's Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	44.50%	9.09%	4.05%
Preferred Stock	6.00	7.31	0.44
Common Equity	49.50	12.65	6.26
Total	100.00%		10.75%

10. San Diego's adopted 1992 rate of return, as shown in Ordering Paragraph 9, shall be used in conjunction with its 1992 modification attrition application and the most recent adopted cost allocation and rate design principles for the purpose of calculating revised rates for 1992.

11. Southern California Edison Company's (Edison) adopted cost of capital for its 1992 test year is as follows:

Edison's Adopted 1992 Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	48.00%	8.98%	4.31%
Preferred Stock	6.00	7.60	0.46
Common Equity	46.00	12.65	5.82
Total	100.00%		10.59%

12. Edison's adopted 1992 rate of return, as shown in Ordering Paragraph 11, shall be used in conjunction with its pending 1992 general rate case proceeding decision for the purpose of calculating revised rates for the 1992 test year.

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

NEAL J. SHULMAN, Executive Director

13. Application (A.) 91-05-016, A.91-05-018, A.91-05-019, A.91-05-022, A.91-05-023, and A.91-05-024 are hereby closed.

This order is effective today.

Dated November 20, 1991, at San Francisco, California.

PATRICIA M. ECKERT
President
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

Commissioner John B. Ohanian, being necessarily absent, did not participate.

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

Neal J. Shulman

NEAL J. SHULMAN, Executive Director

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APPENDIX A

Applicants: David R. Clark, Vincent Bartolomucci, and Nancy Doyne, Attorneys at Law, for San Diego Gas & Electric Company; Robert M. Johnson, Attorney at Law, for Southwest Gas Corporation; Roger Peters, Harry W. Long, Jr. and Kermit R. Kubitz, Attorneys at Law, for Pacific Gas and Electric Company; Stephen E. Pickett, Frank J. Cooley and Frank A. Mc Nulty, Attorneys at Law for Southern California Edison Company; David Norris, Attorney at Law, for Sierra Pacific Power Company; and Steven Patrick, Attorney at Law, and Robert Ballew, for Southern California Gas Company.

Interested Parties: C. Hayden Ames, Attorney at Law, for Chickering & Gregory; Sam De Frawi, Attorney at Law for Department of the Navy; Michel Florio and Joel Singer, Attorneys at Law, for Toward Utility Rate Normalization; Norman J. Furuta, Attorney at Law, for Federal Executive Agencies; Phyllis Huckabee and Randolph L. Wu, Attorneys at Law, for El Paso Natural Gas Company; John B. Legler, for himself; Melissa Metzler, for Barakat & Chamberlin; James K. Hann and Ed Perez, Attorneys at Law, for City of Los Angeles; Bartle Wells Associates, by Reed V. Schmidt, for California Street Light Association; William Stow and J. Paine, Attorneys at Law, for PacifiCorp dba Pacific Power and Light Company; John W. Wilt, William Shaffran, and Deborah Berger, Attorneys at Law, for City of San Diego; and Manuel Kroman, for himself.

Division of Ratepayer Advocates: Patrick S. Berdge, Attorney at Law, and Edwin Quan.

(END OF APPENDIX A)