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Decision 92-06-061 June 17, 1992

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company (U 902-M) for an Ex Parte Order Granting Authority to Increase Expenditures to Support Demand Side Management Programs; to Implement Balancing Account Treatment for New DSM Program Expenditures; to Recover Increased Expenditures in Future Rates; and to Implement Incentive Mechanisms.

ORIGINAL

Application 90-04-034
(Filed April 19, 1990)

In the Matter of the Application of Southern California Edison Company (U 338-E) for an Ex Parte Order Authorizing Expenses, Implementation of Incentive and Performance Mechanisms, and Revision of Rates.

Application 90-04-036
(Filed April 24, 1990)

In the Matter of the Application of Southern California Gas Company for authority to expand Demand Side Management Programs. (U 904 G)

Application 90-04-037
(Filed April 25, 1990)

Application of Pacific Gas and Electric Company for Authority to Adjust its Electric and Gas Rates Effective January 1, 1991 to Implement an Expanded Customer Energy Efficiency Program Resulting From the Statewide Collaborative Process. (U 39 M)

Application 90-04-041
(Filed April 25, 1990)

O P I N I O N

By this order we approve Southern California Gas Company's (SoCal) request to extend through 1993 the expanded demand-side management (DSM) programs approved in Decision (D.) 90-08-068. We also find that SoCal's current incentive mechanism is consistent with the "comparable earnings" directive we adopted in D.92-02-075 in our DSM Rulemaking/Investigation (R.91-08-003/I.91-08-002).

Petition for Modification

On January 24, 1992, SoCal filed a petition for modification of D.90-08-068. In its petition, SoCal requests to extend through 1993 the expanded DSM programs approved in D.90-08-068. D.90-08-068 authorized SoCal to implement the expanded DSM programs through 1992. In D.91-07-057, the Commission delayed the test year for SoCal's next general rate case from 1993 to 1994. Because of this delay in the general rate case, SoCal explains that it will be without authority to carry out the expanded DSM programs unless the requested modification is made.

On February 20, 1992, the Commission issued D.92-02-075 in the DSM Rulemaking/Investigation. In that order, the Commission adopted the following directive on "comparable earnings," as it applies to SoCal's current DSM incentive mechanism:

"For incentive mechanisms based on program expenditures, such as SoCalGas' current variable rate of return mechanism, the earnings rate on program costs should not exceed (and could be lower than) the authorized rate of return on utility constructed plants."
(D.92-02-075, mimeo. page 48.)

Recognizing that SoCal's current shareholder incentive mechanism would expire at the end of 1992, and that SoCal's next general rate case was delayed until 1994, the Commission invited

interested parties to develop procedural proposals for incorporating this directive into SoCal's incentive mechanism. On March 25, 1992, SoCal filed comments on this issue. In its comments, SoCal refers to its January 24, 1992 petition for modification of D.90-08-068. SoCal argues that the continuation of its currently adopted shareholder incentive mechanism, as proposed in its petition, would be consistent with D.92-02-075. Therefore, SoCal recommends that the Commission address the issue of comparable earnings by acting on its request to extend current DSM authorization by one year.

No party protested SoCal's January 24, 1992 petition. However, by Administrative Law Judge Ruling dated March 30, 1992, parties in this proceeding and the DSM Rulemaking/Investigation were given additional opportunity to respond to SoCal's comments on the comparable earnings issue. Pacific Gas and Electric Company (PG&E) and the Division of Ratepayer Advocates (DRA) filed reply comments, and SoCal responded to DRA's comments on May 8, 1992.

Position Of The Parties

Comparable Earnings Decision

To clarify the positions of the parties, it is useful to briefly review certain financial terms and definitions used in their discussion of comparable earnings. First, the utility's authorized rate of return is the after-tax rate adopted in the Commission's generic cost-of-capital proceedings. This rate reflects the cost of long-term debt and preferred and common stocks (or "equity"), and reflects the capital structure (i.e., proportion of debt and equity) approved in the cost of capital proceeding. Another way of expressing an after-tax return to investors is by calculating after-tax operating income. The only difference between after-tax operating income and the authorized rate of return is the assumed capital structure. Unlike the authorized rate of return, an earnings rate based on operating income assumes that the project is financed with 100% equity (i.e., no long-term

debt in its capital structure). Before-tax returns represent earnings to investors before the payment of taxes.

In its March 25, 1992 filing, SoCal calculates the after-tax operating income per dollar of investment in either supply- or demand-side resources, based on its current authorized rate of return and its DSM shareholder incentive rate. SoCal starts its calculations by "grossing up" its 10.49% authorized rate of return to yield a 15.71% before-tax return. In other words, in order to earn its authorized overall rate of return of 10.49%, SoCal must collect a before-tax amount equivalent to 15.71% of its rate base. The 15.71% translates to an after-tax operating income rate of 8.71%. On the demand side, SoCal starts with its current shareholder incentive rate of 14.00%, which is a before-tax earnings rate. The 14.00% translates into an after-tax operating income rate of 7.76%.¹ Based on these comparisons, SoCal concludes that its current DSM incentive rate is in compliance with the directive on comparable earnings adopted in the DSM Rulemaking/Investigation. PG&E concurs with SoCal's conclusions.

DRA, on the other hand, argues that SoCal's current shareholder incentive rate is not in compliance with Commission orders. In DRA's view, the relevant comparison is between the before-tax shareholder incentive rate of 14.00% and the after-tax

1 As discussed above, an earnings rate based on operating income assumes that the project is financed with 100% equity (i.e., no long-term debt). If one assumes the same capital structure as authorized in the general rate case (which includes long-term debt), then the after-tax rate of return on supply-side investments is identical to SoCal's authorized rate of return of 10.49%. The comparable after-tax rate of return on DSM, based on a before-tax incentive rate of 14%, would then be 9.35%. As long as one is consistent in imputing the same capital structure on both sides, the comparative results do not change. In discussing "after-tax" rates in this order, we do not distinguish between after-tax operating income (where 100% equity financing is assumed) and calculations of after-tax rates assuming other capital structures.

supply-side earnings rate of 8.71%. DRA bases this interpretation on D.91-12-076, which addressed Southern California Edison Company's (SCE's) shareholder incentive mechanism. In that order, the Commission adopted SCE's authorized rate of return of 10.59% for the DSM target incentive rate, but also made those incentives subject to taxes.² In effect, the Commission established SCE's before-tax shareholder incentive rate at the level of SCE's after-tax authorized rate of return. Therefore, DRA argues that SoCal's before-tax shareholder incentive rate of 14.00% should be reduced to 8.71%, and SoCal should be expected to pay taxes on those earnings.³

In response to DRA's position, SoCal and PG&E argue that, for earnings comparability to have any meaning, tax effects must be considered on both the supply and demand sides. SoCal points out that DRA's interpretation would lower SoCal's effective after-tax DSM rate of return to about 5.1%, which is about half of the after-tax return on supply-side investments. In SoCal's view, this is contrary to the concept of comparable earnings.

² See D.91-12-076, mimeo., pp. 160, Appendix G, and Finding of Fact 328.

³ DRA appears to be mixing capital structures in developing its specific recommendations. On the one hand, DRA refers to SCE's authorized rate of return (which is an after-tax rate that assumes a specific capital structure including long-term debt) in recommending that an after-tax rate of return be the basis for comparing SoCal's pre-tax DSM incentive rate. However, instead of referencing SoCal's 10.49% authorized rate of return, DRA specifically refers to the 8.71% rate calculated by SoCal, which is based on a different capital structure. (See footnote 1 above.) It is not clear if DRA is also recommending that after-tax operating income, as opposed to the authorized rate of return, should serve as the basis for its recommended comparable earnings comparison.

Discussion

In D.92-02-075 in the DSM Rulemaking/Investigation, we established interim guidance on the issue of earnings comparability. As we stated in that order, this issue will be revisited in greater depth during our comprehensive review of DSM shareholder incentives, which is scheduled to begin in 1993. The guidance established in D.92-02-075 says only that shareholders' rate of return on DSM programs should be no greater (and could be less) than shareholders' rate of return on utility-constructed plants facing traditional ratemaking. D.92-02-075 does not specify the appropriate level of shareholder earnings or earnings rates on DSM for each utility. Rather, the order essentially establishes a broad interim policy that shareholders should not earn more on DSM than on utility investments in supply-side resources, and that shareholders could earn less. It leaves the specifics of each incentive mechanism to be addressed in upcoming utility-specific proceedings. Such specifics include whether the return on DSM should be lower than the utility's rate of return on supply-side investments, and if so, by how much. In the case of SCE, which had just completed its general rate case, the order briefly confirms that the incentive rate mechanism established in D.91-12-076 was consistent with this interim policy; i.e., that the rate of return established for DSM was no higher than the authorized rate of return on utility constructed plants. (See D.92-02-075, mimeo., pp. 48-50.)

As DRA acknowledges, D.92-02-075 did not explicitly state whether or how the comparison between supply- and demand-side returns should take tax effects into account. We agree with PG&E and SoCal that the most logical, common sense interpretation of D.92-02-075 would be to consider tax effects when comparing shareholders' rate of return on supply-side investments with their rate of return on DSM activities. To do otherwise would result in a comparison of, as PG&E puts it, "apples and oranges." While DRA

is correct in noting that SCE's before-tax DSM incentive rate was based on an after-tax supply-side rate, it does not follow that such a comparison is the starting point for establishing comparable earnings potential. In our view, the starting point should be a comparison between "apples and apples," i.e., before-tax rates on DSM compared with before-tax rates on supply-side investments or after-tax rates for both sides of the comparison.⁴ Once this starting point is established, the debate should focus on whether or not the return on DSM should be lower than the utility's rate of return on supply-side investments, and if so, by how much.

We conclude that SoCal's current incentive mechanism, as adopted in D.90-08-068, is consistent with the interim comparable earnings policy articulated D.92-02-075, and we reaffirm the conclusion in D.92-02-075 that SCE's shareholder incentive mechanism is also consistent with that policy. When we take tax effects into account consistently for both DSM and supply-side earnings, both mechanisms result in a shareholder return on DSM that is no greater (and is actually lower) than the authorized return on supply-side investments. The fact that SCE's after-tax rate of return on DSM is comparatively lower than SoCal's does not alter the conclusion that SoCal's incentive mechanism is consistent with our interim guidelines on comparable earnings. As we

4 The difference between after-tax rates of return on DSM and supply-side investments and before-tax rates of return is a common factor (i.e., a net-to-gross multiplier). Therefore, a comparison between before-tax rates should yield the same conclusions on whether a DSM incentive rate complies with D.92-02-075 as a comparison between after-tax rates. SoCal's calculations raise the issue of what capital structure to impute in calculating after-tax earnings for the purpose of comparing earnings on DSM and supply-side investments. The resolution of this issue is not critical to today's decision. We will explore this and other specific implementation issues related to earnings comparability during our comprehensive review of DSM shareholder incentives, beginning in 1993.

acknowledged in D.92-02-075, there is diversity in the interim shareholder incentive mechanisms we have adopted for SCE, PG&E, SoCal and San Diego Gas & Electric Company. There are variations in the form of the incentive mechanism itself (e.g., SCE's shared-savings S-curve versus SoCal's return on program expenditures), the definition of net benefits in the calculation of earnings, performance minimums and goals, among others. We intend to fully explore the pros and cons of these differences in our 1993 review of DSM shareholder incentives.

The interim guidelines established in D.92-02-075 are intended to help focus the debate on utility-specific shareholder incentive mechanisms on an interim basis until we can fully resolve the issues in a later phase of our DSM Rulemaking/Investigation. For SDG&E and PG&E, that debate will take place in their test year 1993 general rate cases, which are currently underway. Interim shareholder incentive mechanisms that comply with the policy directive of D.92-02-075 will be addressed in those cases. For SoCal, if we have not completed our review of shareholder incentives by the end of 1993, the debate will take place in SoCal's test year 1994 general rate case proceeding. In the interim, we will grant SoCal's petition. The stipulation approved in D.90-08-068 authorized expenditures only through 1992 and contemplated that further DSM programs and expenditures, including shareholder earnings, would be reviewed in the next general rate case for SoCal, then scheduled for test year 1993. An extension of the DSM authorization one year fills a void created when we postponed the general rate case. As discussed above, we also find that this extension in authorization is consistent with our interim guidelines on comparable earnings.

In D.90-08-068, we authorized 1992 DSM expenditures of \$14.575 million in 1990 dollars. As a result of adjustments to SoCal's DSM programs required in D.90-08-068, the Commission in D.90-12-071 reduced shareholder incentives for 1991 by \$542,000,

and SoCal acknowledges that this reduction should also be reflected in 1992 DSM expenditures (although in D.90-12-071 continued to authorize 1992 DSM expenditures of \$14.575 million). The resulting corrected authorized 1992 DSM expenditures are \$14.079 million (in 1990 dollars). Therefore, SoCal should be authorized to expend \$14.079 million (in 1990 dollars) on DSM programs set forth in the settlement as approved and refined in D.90-08-068 and D.90-12-071. As SoCal proposes, the 1990 dollars should be escalated by the appropriate factors used in SoCal's attrition rate adjustment proceedings.

The ordering paragraphs of D.90-08-068 are conformed to the modifications made in this decision and in D.90-12-071 and are restated in Attachment A.

Closing A.90-04-034 et al.

In D.90-12-071, we granted the Commission Advisory and Compliance Division (CACD) the discretion to hold workshops to address implementation of the details of the decision. CACD was to hold these workshops within six months, and Application (A.) 90-04-034, A.90-04-036, A.90-04-037, and A.90-04-041 were held open to receive CACD's report from any workshops that were held.

The six-month period has passed, and CACD has informed us that no workshops were held. With today's resolution of SoCal's petition for modification, nothing remains to be done in this proceeding, and the four applications should be closed.

Findings of Fact

1. On January 24, 1992, SoCal filed a petition to modify D.90-08-068 to extend authorized DSM expenditures through 1993.
2. D.91-07-057 delayed the test year for SoCal's next general rate case by one year, from 1993 to 1994.
3. The stipulation approved by D.90-08-068 and D.90-12-071 authorized DSM expenditures through 1992 and contemplated that DSM programs and expenditures would be reviewed in the next general rate case for SoCal, then scheduled for test year 1993.

4. D.92-02-075 adopted interim guidelines on comparable earnings, which apply to the utilities' DSM shareholder incentive mechanisms.

5. D.92-02-075 states that the rate of return on DSM programs should be no greater (and could be less) than shareholders' rate of return on utility-constructed plants facing traditional ratemaking.

6. The incentive mechanism established for SCE in D.91-12-076 resulted in a before-tax incentive rate for DSM that is equal to the authorized rate of return on supply-side investments, which is an after-tax rate.

7. In D.92-02-075, we found that SCE's incentive mechanism, as established in D.91-12-076, is consistent with our interim guidelines on comparable earnings.

8. D.92-02-075 did not explicitly state whether or how the comparison between supply-and demand-side returns should take tax effects into account.

9. Comparing a before-tax rate of return with an after-tax rate of return as the starting point for establishing comparable earnings potential would result in a comparison of "apples and oranges."

10. When tax effects are taken into account consistently for both DSM and supply-side earnings, SoCal's current incentive mechanism results in a shareholder return on DSM that is lower than SoCal's authorized return on supply investments.

11. There is currently wide diversity in the interim shareholder incentive mechanisms we have adopted for SCE, PG&E, SoCal, and SDG&E, including the earnings rates on DSM activities. We intend to fully explore the pros and cons of these differences in our review of shareholder incentives, beginning in 1993.

12. SoCal should be authorized to expend \$14.079 million (in 1990 dollars) in 1993. The 1990 dollars should be escalated by the appropriate factors adopted in SoCal's attrition rate adjustment proceedings.

13. CACD did not hold workshops to address implementation of D.90-12-071.

Conclusions of Law

1. The starting point for establishing comparable earnings should be a comparison of returns from supply- and demand-side activities, taking tax effects into account consistently for both DSM and supply-side earnings.

2. SoCal's current incentive mechanism is consistent with the interim guidelines on comparable earnings we adopted in D.92-02-075.

3. SoCal's petition should be granted.

4. D.90-08-068 should be modified to authorize SoCal to expend \$14.079 million (in 1990 dollars) on DSM programs approved in D.90-08-068 and D.90-12-071.

5. The four applications, A.90-04-034, A.90-04-036, A.90-04-037, and A.90-04-041 should be closed.

O R D E R

IT IS ORDERED that:

1. The "Petition of Southern California Gas Company for Modification of Decision No. 90-08-068," filed January 24, 1992, is granted.

2. A new subparagraph is added to Ordering Paragraph 1 of Decision 90-08-068, to read as follows:

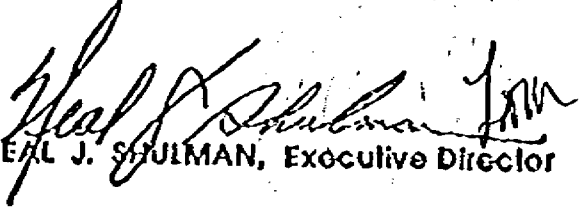
"j. The expenditures authorized for 1992 in the Settlement Agreement in SoCal's A.90-04-037 will be continued and authorized for calendar year 1993."

3. Application (A.): 90-04-034, A.90-04-036, A.90-04-037, and A.90-04-041 are hereby closed.

4. The Executive Director shall serve copies of this order on all parties to Rulemaking 91-08-003 and Investigation 91-08-002. This order becomes effective 30 days from today. Dated June 17, 1992, at San Francisco, California.

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

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


NEAL J. SHULMAN, Executive Director

Attachment A
Page 1

ORDERING PARAGRAPHS OF D.90-08-068
AS MODIFIED BY D.90-12-071 AND THIS ORDER

INTERIM ORDER

IT IS ORDERED that:

1. The Settlement Agreement in SDG&E's A.90-04-034, filed June 27, 1990, the Settlement Agreement in SCE's A.90-04-036, filed July 2, 1990, the Settlement Agreement in SoCal's A.90-04-037, filed June 27, 1990, and the Settlement Agreement in PG&E's A.90-04-041 are adopted, with the following clarifications and modifications:

- a. SoCal's incentive for resource programs shall be changed from 16.6% to 14%, and its incentive for new construction programs shall be changed from 12% to 10%.
- b. SoCal's 10% environmental adder shall be eliminated.
- c. PG&E shall be eligible to receive incentive/penalty payments for expenditures incurred between the establishment of their tracking accounts pursuant to Resolution E-3194 (effective June 27, 1990) and the date of this decision.
- d. Interest on incentive/penalty payments shall accrue in the same manner for SDG&E, SoCal, and PG&E and shall begin to accrue on July 1 following the filing of the annual DSM report explaining the basis for the claimed incentive/penalty and shall continue to accrue until the payments are reflected in rates.
- e. SDG&E, SCE, SoCal, and PG&E shall file any requests for rate recovery under these expanded DSM programs in the ECAC proceeding for electric rate recovery and the ACAP proceeding for gas rate recovery.

Attachment A
Page 2

- f. SDG&E may reflect these rate changes in its 1991 ACAP and ECAC applications, as the settling parties recommended, and SDG&E may request rate recovery of its already-approved 1990 and 1991 DSM expenditures in alternate 1991 proceedings, such as the biennial cost adjustment proceeding, gas reasonableness review, of 1991 year-end attrition proceeding.
- g. We will rely on the litigation process in the rate recovery proceedings to evaluate the March 31 utility filings.
- h. The Commission Advisory and Compliance Division shall submit by December 31, 1992 a report on the effectiveness of the procedures we adopt today, together with recommendations for improvements.
- i. The method of funding and accounting for conservation payments made under electric rate special contracts established by D.89-05-067 and affirmed in D.90-05-030 shall be modified to exclude the use of DSM funds authorized in the utilities' most recent GRC and these expanded DSM program applications to fund the conservation payments and to require that such conservation payments be accounted for separately.
- j. The expenditures authorized for 1992 in the Settlement Agreement in SoCal's A.90-04-037 will be continued and authorized for calendar year 1993.

2. The motion of Reaction Thermal Systems, Inc. for leave to intervene is granted.

3. Parties shall have 20 days to file comments and 5 days to file reply comments on the modifications and clarifications to the settlements set forth in Ordering Paragraph 1.

Attachment A
Page 3

4. SoCal and SCE shall file within 15 days any modifications to DSM program goals and expenditures or similar changes due to the date of this decision, to the extent that the settlements provide for such changes and specify no time period for filing the changes.

5. PG&E, SCE, SoCal, and SDG&E shall file within 120 days a report outlining any problems, either operational, financial or regulatory, they now face when evaluating and considering investments to improve the efficiency on their side of customer meters, as well as steps they plan on taking to improve their performance in this area.

(END OF ATTACHMENT A)