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Decision 97-07-054 July 16, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Review the Time Schedules for the Rate Case Plan and Fuel Offset Proceedings.	R.87-11-012 (Filed November 13, 1987)
In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY to Adopt Performance Based Regulation ("PBR") for Base Rates to be Effective January 1, 1997.	Application 95-06-002 (Filed June 1, 1995)

ORIGINAL

(See Appendix C for appearances.)

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OPINION

I. Summary of Decision

In this decision we consider a proposal by Southern California Gas Company (SoCal or applicant) for adoption of performance-based ratemaking (PBR) for the portion of SoCal 's rates that recovers the costs of providing gas utility service that the Commission has reviewed in the past through the General Rate Case (GRC) process.[1]

Our decision today adopts a PBR system for SoCal which differs in several respects from the proposal advanced by SoCal. Most significantly, we adopt a system which requires SoCal to share with ratepayers the savings produced by the indexing method. We also adopt an indexing method, adjustments and exclusions, provisions to insure that high standards of service quality and safety are maintained, and a base margin to which the indexing will be applied.

Our decision is effective immediately. The rates based upon our adopted base margin revisions shall become effective August 1, 1997. The PBR mechanism shall become effective January 1, 1998, unless SoCal elects to operate under the mechanism effective as of January 1, 1997.

II. Background of Application

A. *Description of Applicant*

SoCal is an investor-owned utility subject to the jurisdiction of this Commission. It is engaged in the transmission, storage, and distribution of natural gas. SoCal is the principal subsidiary of Pacific Enterprises.

B. *Procedural History*

SoCal filed its application on June 1, 1995. Filing of the formal application was preceded by a series of workshops held by SoCal in December 1994 and January

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[1] SoCal uses the term "regulation" rather than "ratemaking" to characterize its proposal, but the rubric refers to a method for adjusting rates annually without prior Commission approval of the adjustment. The Commission has used the term "performance-based ratemaking" in similar proceedings previously, and does so here for the sake of consistency.

1995, in which SoCal met with interested parties to present the contemplated proposal. SoCal's application includes some changes from its original proposed concept, which were made after the workshops.[2]

Before filing the application SoCal also requested a suspension of the requirement to file a test year (TY) 1997 GRC. SoCal's last GRC had been for TY 1994, and its TY 1997 GRC was due to be filed under the Commission's rate case plan. The reason given by SoCal for its request was that it was actively pursuing a PBR system to become effective February 1, 1997, eliminating the requirement for a TY 1997 GRC. In Decision (D.) 95-04-072 in Rulemaking (R.) 87-11-012, the Commission granted the suspension, subject to conditions designed to protect ratepayers from the risks created by that suspension. The order also directed the Commission's staff to conduct an audit, as required at least every three years under Public Utilities (PU) Code 314.5, in connection with the PBR proceeding. The Commission later extended the order, suspending the requirement to file a TY 1998 GRC because the PBR application was being processed in a timely manner.

The assigned administrative law judge (ALJ) held prehearing conferences (PHCs) on September 25, 1995, and January 29, 1996. In response to a joint motion filed January 4, 1996 to request a specified procedural schedule, the ALJ ruled that SoCal must serve its recorded data for 1995 on February 14, 1996, and make a supplemental showing with respect to 1996 estimated expenses on June 6, 1996. This is the showing used by the parties, by agreement, to develop the base margin figures and other features of the PBR program considered here.

On October 14, 1996, Pacific Enterprises and Enova Corporation, the parent company of San Diego Gas & Electric Company (SDG&E), announced that they proposed to merge, and filed an application for approval by the Commission (Application (A.) 96-10-038). The Southern California Utility Power Pool and the

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[2] Conceptually, the most significant of these was a change from the Consumer Price Index (CPI) to an industry-specific index in the indexing formula.

Imperial Irrigation District (SCUPP/IID) and Southern California Edison Company (SCE) moved to suspend the procedural schedule in this proceeding in contemplation of these merger plans, but the ALJ denied that request by ruling dated October 23, 1996. The assigned commissioner denied reconsideration of that request on November 14, 1996.

The formal evidentiary hearing commenced December 2, 1996, and concluded December 19, 1996. Two rounds of briefs were filed, and the proceeding was submitted on February 14, 1997.

C. *Proposed Decision*

The Proposed Decision of ALJ Ryerson (PD) was filed on April 21, 1997, pursuant to § 311(d) of the Public Utilities (PU) Code and Rule 77.1 of the Commission's Rules of Practice and Procedure (Rules).[3]

D. *Comments on Proposed Decision*

Comments on the PD were filed by SoCal, ORA, SCE, SDG&E, SCUPP/IID, CEC, Enron, and Insulation Contractors Association. The Commission also received a letter from TURN indicating that it would not file comments, but would reserve the option to file replies to the comments of other parties.

SoCal's comments are critical of several aspects of the PD's treatment of both policy issues (i.e., the PBR mechanism) and the base margin. Specifically, SoCal criticizes the TURN/DGS formula adopted by the decision as being company-specific in nature, contrary to our policy of using external industry yardsticks; the stretch factor as being too rigorous in light of SoCal's recent history of productivity gains; the absence of pricing flexibility; the adoption of revenue indexing rather than rate indexing; and the absence of "tools" (particularly pricing flexibility) to enable it to attain greater

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[3] The PD was issued before the expiration of the 90-day statutory time limit following submission at the request of the applicant and the Commission, in order to facilitate coordination with A.96-10-038.

CORRECTION !!

THE PREVIOUS DOCUMENT(S) MAY HAVE BEEN FILMED INCORRECTLY .....

RESHOOT FOLLOWS

productivity through sales. On the base margin side, SoCal criticizes the resolution of a number of individual items on the grounds of legal or factual error.

ORA generally supports the PD as a whole, but in its comments offers a series of recommendations which would make the decision clearer and conceptually tighter, consistent with the adopted resolution of major issues. ORA also suggests corrections to a number of figures based on inadvertent factual errors.

SCE also generally supports the PD, but suggests certain clarifications and corrections.

SDG&E's comments are critical of the adopted indexing methodology and the PD's description of other PBR decisions, and of two of the items in the base margin section, the treatment of the Torrance and Mountain View facilities and the removal of Line 6900 from rate base.

SCUPP/IID reiterates concerns expressed by other parties about an ambiguity in the effective date of the decision, and about the discussion of exclusion of costs for Lines 6900 and 6902 from rate base.

CEC's brief comments are generally supportive of the PD, but suggests two changes: that energy efficiency funds be transferred to the Energy Efficiency Board, and that $5 million of SoCal's energy efficiency budget be allocated for market transformation efforts.

Enron and the Insulation Contractors Association filed comments that are directed specifically at the issue of unregulated new products and services, but are fully supportive of the PD. Certain of the other comments contain discussions of the new products and services issue.

Reply comments were filed by SoCal, ORA, SCE, DGS, NRDC, TURN, Enron, and the Plumbing-Heating-Cooling Contractors.

Revisions to the PD made in response to the comments and replies are reflected in this final decision. Additional revisions were made to correct or clarify the text. All areas changed are indicated on the margin.

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E. Description of SoCal's Proposal

The application proposes a new method for revising SoCal's rates annually by applying an index, based upon a measure of recorded input price inflation less a productivity factor, to its rates. The productivity factor would be fixed at this time, and would not be revised during the minimum five-year term that the new ratemaking system is proposed to be in effect, but adjustments to certain aspects of the rates would be made by annual rate revision filed by SoCal. In this section we describe the specific features of the PBR methodology SoCal has proposed.[4]

1. Rate Indexing

SoCal proposes to index core and noncore base rates and certain miscellaneous charges, as opposed to indexing total authorized margin or authorized margin per customer, i.e., revenue requirement. This means that rates would be indexed directly to inflation less the pre-set productivity factor. SoCal claims that its proposal for rate indexing "fixes the throughput forecast used to set rates over the PBR period and puts utility shareholders at risk/reward for any differences between forecast and actual throughput and customer count." (SoCal Opening Brief, p. 44.) SoCal asserts that its ratepayers will benefit, because the level of rates, in real terms, is guaranteed to decline over the period that this mechanism is in effect, by reason of enforced productivity gains over the period. SoCal supports this contention with a ten-year backcast analysis demonstrating that PBR would have resulted in rates 13% lower than under traditional "cost-plus" ratemaking.

a) Core Demand Forecast

The methodology chosen by SoCal is rate indexing, which depends upon fixing a specific throughput forecast for calculating the rate level at the

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[4] The details of SoCal's proposal are contained in prepared testimony and exhibits that were initially filed as part of the application. A number of modifications were made since the initial proposal, and the details of the current proposal, along with the supporting testimony, are contained in SoCal's direct testimony (Exh. 1-Exh. 33) and the jointly sponsored testimony (Exh. 200-Exh. 210) received at the evidentiary hearing.

outset. For core rates SoCal proposes that we adopt its recorded 1996 customer count and core throughput, normalized to average temperature conditions, in establishing the starting point for indexing. Also, because the current core rates are based upon throughput which uses a "normal" temperature measure that is set too low in relation to updated temperature averages, SoCal proposes to change this measure in establishing this starting point.

Under current ratemaking, a balancing account called the Core Fixed Cost Account (CFCA) operates to insure that SoCal over time will recover in rates exactly the amount of Commission-authorized margin, regardless of the actual level of customer demand (i.e., core throughput). However, if throughput is foreordained as part of the base margin, this balancing account cannot function. Core demand (throughput) will in fact vary because of variations in average temperatures from year to year, but rates cannot be adjusted because the throughput figure is set beforehand. As part of its proposal, SoCal therefore would eliminate the CFCA and substitute two other devices, the Weather Normalization Mechanism (WNM) and the Energy Efficiency Adjustment Factor (EEAF), to adjust rates in its place.

The WNM would adjust core rates to reflect differences in throughput due to differences between recorded and normal temperature conditions. The WNM would be used to adjust the bill of each customer at the time the bill is issued for variations from normal temperature conditions in the period for which the bill is rendered.[5] SoCal contends that this is appropriate because temperature conditions are wholly beyond the control of its management, and temperature variations could create large variations in core revenues relative to its authorized return on equity.

The EEAF would adjust rates for the effect on revenues from core throughput lost each year due to gas conservation and energy efficiency measures actually implemented by SoCal's customers. Under SoCal's proposal, the first 0.3% of

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[5] The WNM would apply only to core customers, and would exclude core gas engine and air-conditioning customers, because their load is basically not sensitive to heating requirements.

rate impact would not be adjusted for, on the presumption that the PBR index already reflects that impact. SoCal also proposes to cap the amount of EEAF adjustment at 1.0% annually. SoCal argues that implementing the EEAF as part of its proposal would be justified, because it eliminates SoCal's incentive to discourage conservation, as the PBR mechanism rewards the utility for selling more gas. SoCal also argues that the EEAF would eliminate the reduction in its earnings that would be caused by government-mandated or subsidized conservation measures.

b) *Noncore Demand Forecast and Rates*

The methodology proposed for fixing noncore rates for PBR indexing is entirely different, principally because of the effect of an agreement, the Global Settlement, that has been adopted by the Commission. The Global Settlement provides that, from August 1, 1994 through July 31, 1999, SoCal will calculate noncore rates based upon 1991 actual throughput. SoCal therefore proposes to use two sets of noncore rates for PBR indexing. The first is based upon 1996 adjusted base margin and allocation, but uses 1991 throughput. The second is based upon 1996 base margin and 1996 throughput, calculated in the same manner as the first set, but not effective until August 1, 1999. In its proposal, SoCal refers to these as "shadow rates." Both sets of rates rely, however, upon the use of a fixed throughput figure for establishing the base rate for PBR indexing.

2. Index to be Applied

a) *Inflation Measure*

The inflation measure proposed by SoCal is a weighted average of recorded indices of prices for labor operating and maintenance (O&M) costs, nonlabor O&M costs, and capital-related costs.[6] In the price index, the measure for labor O&M is the index of average hourly earnings of workers in gas production and distribution as reported by the U.S. Bureau of Labor Statistics. The measure for

[6] SoCal refers to this measure as the gas utility input price index, or GUPI.

nonlabor O&M is the Data Resources, Inc. (DRI)/McGraw Hill nonlabor O&M index for gas utilities. The inflation measure for capital-related costs is based upon the DRI/McGraw Hill indices for capital service prices and for the price of gas distribution capital goods. These measures would be weighted according to the average of expenditures in each category by SoCal for the past five years. Although a forecast of inflation would be used, the forecast would be trued up to recorded inflation at the next annual PBR rate adjustment. Rates for a year would be set using the latest available forecast for the price index elements for that forthcoming year, and the following year's rate filing would include an adjustment to true up any difference the forecast and actual price index.

b) Productivity Factor

SoCal proposes to employ a constant productivity factor of 1.0% per year as the second element of the PBR adjustment mechanism. SoCal's selection of this figure is based upon two components: historical gas distribution average productivity of 0.5%, plus a factor of 0.5% as an incentive to improve productivity over past performance.[7] SoCal asserts that this 1% total productivity factor, which would be applied for the entire period that PBR rates are in effect, affords an adequate incentive for the company to strive for greater efficiency.

In support of the component percentages, SoCal offers a study of 49 gas utilities nationwide as evidence that the 0.5% productivity increase is close to the national average.[8] The additional 0.5% "stretch factor" is essentially based upon the company's judgment of productivity gains that can reasonably be anticipated. SoCal asserts that this figure is consistent with Commission precedent and policy, and argues that a higher percentage would be unreasonable or unattainable in light of the

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[7] SoCal refers to this element of the productivity factor as a "stretch factor" or "consumer dividend."

[8] This was a multifactor productivity study of the gas local distribution service delivery industry conducted by Christensen Associates, which found the historic range to be 0.4% to 0.5%. (Exh. 5.)

cost forecasts and cost relationships upon which higher factors proposed by other parties rely.

c) *Starting Rate Level*

SoCal proposes that its level of base rates for 1997 would be determined by applying the PBR index to a starting level of rates and to the existing level of miscellaneous charges.[9] Establishment of the starting level is based upon a "test year" showing and analysis resembling that for a GRC. The basis selected for analysis is SoCal's calendar year 1996 internal operating budget. The approach to setting base margin in 1997 under PBR is to take the figure representing the reasonable level of expense and rate base for SoCal in 1996, and to adjust that revenue requirement for one year with the PBR index adopted by the Commission in this proceeding. This will produce rates to be in effect when a PBR decision goes into effect in 1997.

d) *Exclusions*

Certain costs would not be recovered through the portion of rates that would be subject to the PBR index. These would remain subject to recovery through other existing ratemaking mechanisms. In general, the principle behind these exclusions from PBR is that the costs are already subject to incentive-type mechanisms, that they are beyond SoCal's control, or that the level of expenditure is specifically authorized by this Commission or by the Federal Energy Regulatory Commission (FERC) in separate proceedings. The specific costs proposed to be excluded are discussed later in this decision.

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[9] The "base rate" is the part of rates reflecting gas margin, and excluding gas costs, pipeline demand charges, and other specifically identified items; it is only the base rate that is guaranteed to be reduced under PBR. Final rates measured in constant dollars will decline unless increases in gas costs and excluded items more than offset the reduction in the indexed portion of the rate. (Exh. 1, p. 13.)

e) "Z" Factor Adjustments

A "Z" factor, as recognized by this Commission, is an exogenous and unforeseen event largely beyond the utility's control that has a material impact upon the utility's costs. Examples of Z factors include accounting rule changes adopted by governing boards and agencies, state and federal tax law changes, and new government mandates.

SoCal proposes that its rates be adjusted, either upward or downward, by the amount of change in its costs exceeding a one-time $5 million "deductible" amount per qualifying Z factor. The amount of change in SoCal's costs subject to Z factor treatment would be reduced by the amount by which SoCal would already be compensated by the inflation factor in the PBR index formula. SoCal also proposes a specific procedure for handling each Z factor event.

f) Adjustments for Gain or Loss on Sale

SoCal proposes an adjustment in rates in addition to the PBR index if the company sells at a gain or loss land that was acquired and held in rate base before the implementation of PBR. SoCal proposes to credit its customers with one-half of the gain, but SoCal could request, on a case-by-case-basis, that the Commission authorize a smaller sharing of gain from the sale and replacement of a particular parcel of land, when the benefit from the sale and replacement to SoCal is less than the 50% of gain that it would otherwise have to refund in rates. Sales of all or a portion of a distribution system qualifying for allocation to shareholders under the holding of Decision (D.) 89-07-016 (City of Redding II), 32 CPUC2d 233 (1989), would not produce any reduction in rates under PBR. There would be no adjustment in rates for purchase or sale of land acquired after implementation of PBR.

g) Cost of Capital

SoCal does not propose to make any changes in PBR indexed rates in response to changes in costs of capital, except in the event that the 12-month trailing average yield on long-term Treasury Bonds increases or decreases radically, i.e, more than 250 basis points from the DRI average rate for the calendar year

1997 forecast, as adopted in SoCal's1997 cost of capital proceeding.[10] During at least the minimum five-year term of PBR, SoCal proposes not to file annual cost of capital applications, and rates would not be adjusted for changes in the cost of debt, preferred or common equity capital, or changes in capital structure, unless variation exceeded the 250 basis point "trigger."

In the event that the trigger is exceeded by an increase in interest rates, SoCal proposes to have the option to file a cost of capital application; in the event of a 250 basis point decrease, SoCal would be required to file a cost of capital application. In either event the Commission would determine whether any change in rates was appropriate in light of all factors affecting the cost of capital. Any rate change, whether an increase or decrease, would be prospective only from the effective date of a Commission decision.

h) Effective Date and Term of PBR Rates

SoCal initially proposed that its PBR mechanism would become effective on January 1, 1997, and would continue for a minimum term of five years, through year-end 2001. However, the time required to process the application has not permitted implementation of a PBR by the original target date, necessitating an adjustment of the proposed implementation schedule. Under the revised schedule SoCal continues to propose a five-year minimum term for PBR, and thus the original dates for all events would be extended to dates corresponding to the additional time involved in concluding the proceeding. Assuming the Commission issues a decision placing PBR rates in effect on July 1, 1997, the minimum term of the PBR would expire on June 30, 2002.

SoCal proposes that no change be made in PBR indexing during the five-year minimum term of the proposed mechanism, except to the extent such express features as Z factor adjustments and cost of capital revisions require. SoCal therefore asks that we forgo provision for any formal midterm review process,

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[10] See D.96-11-060.

continuous "forum" proceeding, or "off-ramp" that would permit or require suspension of the PBR during the initial five-year term.

SoCal proposes that the PBR continue automatically beyond the minimum period, unless changed at the behest of a party or the Commission. At any time after June 30, 2000, any party, or the Commission on its own motion, could institute a proceeding to change or replace the PBR mechanism effective on or after the expiration date.

i) Maintenance of Service Quality

In order to insure that SoCal's focus on increased productivity through cost reductions does not have a deleterious effect upon the quality of service, SoCal proposes a mechanism to ensure the maintenance of service quality during the period when the PBR rates are in effect. Originally, SoCal proposed a service quality guarantee for core customers based upon random customer telephone survey responses to questions concerning customer satisfaction with SoCal's call center response time; call center employee performance; field service employee response time; and field service employee performance. SoCal proposed the adoption of a benchmark for its performance, namely, the average recorded level of customer satisfaction for July 1993 through June 1996 in random surveys on these four service dimensions. A "deadband" below this benchmark would allow for some sampling error, but below the deadband the company would be required to reduce rates in increments of $1 million per year up to a maximum of $4 million per year for failure to meet the criterion. No incentive was proposed for exceeding the benchmark for customer satisfaction. SoCal proposed to retain its existing Service Interruption Credit (SIC) mechanism for service to noncore customers, but did not propose any other service guarantees for noncore customers in recognition that competition provides an incentive for SoCal to assure adequate, efficient, just, and reasonable service to noncore customer.

Subsequent negotiations among the parties produced a proposal for a somewhat different customer satisfaction measure. The concept of this proposal is essentially the same as that of the one it replaces in the original application.

j) *Employee Safety*

Originally, SoCal did not propose any specific safety performance measures for public, customer, or employee safety, on the assumption that existing federal and state safety laws and regulations mandate standards with which SoCal must comply. However, SoCal, TURN, and ORA have agreed to propose an annual employee safety standard which would be used to adjust rates if SoCal's performance fell below or above the standard by a material margin.

The proposed standard is 9.3 incidents per 200,000 hours worked, with a deadband of 1.0 incidents in each direction, measured annually from the Occupational Safety and Health Administration (OSHA) Recordable Injury and Illness Rate. Should the annual rate exceed 10.3 incidents, customers would receive a rate reduction through the annual rate adjustment filing process. Conversely, SoCal would receive a reward through the annual rate adjustment filing process if its performance were better than an annual rate of 8.3 incidents. The customer rate adjustment would be based upon $20,000 for each 0.1 point above or below the deadband.

k) *New Products and Services*

In its application SoCal seeks authorization to offer on a competitive and unregulated basis products and services that it has not previously offered. SoCal also seeks the authorization to provide support to its non-regulated affiliates in connection with their offering of new products and services. SoCal states that these new products and services would be provided entirely at shareholder risk, and would not be funded by the rates charged for utility services.

l) *Rate Design Changes*

SoCal proposes to include several changes in rate design in its program for PBR. These include changes in residential rate design, and a proposal for flexibility to negotiate rate discount agreements and offer optional rate schedules for certain core customers.

Currently, the company's monthly residential customer charge, which went into effect in 1996, is $5.00. Effective with PBR implementation, SoCal proposes to charge single-family and master meter residential customers a monthly customer charge of $7.11, and multifamily customers $5.47 per month. By January 1, 2001, SoCal proposes to charge a single-family and master meter residential customers a monthly customer charge of $13.57 and multifamily customers $10.35 per month (stated in 1996 dollars). Customer charges upon PBR implementation, and on each January 1 thereafter through 2001, would be increased by 1/5 of the difference between the 1996 customer charge of $5 and the aforementioned 2001 charges.[11] Corresponding reductions would be made in residential volumetric rates.

Upon implementation of PBR, SoCal also proposes to reduce the differential between residential volumetric Tier I and Tier II rates from the current 35% to 10%, and to maintain this relationship at least through the end of the minimum PBR period. SoCal claims that these proposed residential design changes are necessary to bring rates more into line with costs, as fixed residential customer-related costs are currently understated, and that the increased customer charges and decreased volumetric rates will reflect the true long-run marginal cost of gas service.[12]

SoCal proposes to be granted authority to negotiate rate discount agreements with individual core customers, and to offer core rate schedules that customers meeting the applicability requirements would have the option to select. The proposed discounting flexibility would apply only to the "base rate" element of core bundled rates. Under SoCal's proposal, negotiated agreements of less than five years' duration would not require Commission approval prior to becoming effective.

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[11] SoCal recommends that these customer charge rate level adjustments be made on January 1 of each year in order to coincide with the other annual rate changes under the PBR index formula.

[12] SoCal proposes certain other changes in rate design in addition to these basic changes. SoCal proposes to update the submetering credit for master meter customers, and to index that credit; to reduce baseline allowances in climate zone 1 from the current 50 therms to 46 therms in winter and from the current 15 therms to 14 therms in summer, with similar reductions in climate zones 2 and 3; and to modify non-residential core rate design.

Optional core rate schedules would become effective upon filing with the Commission without the requirement of prior Commission approval, and could be withdrawn by SoCal upon 30 days' notice to the Commission, unless otherwise specified by the terms of the schedule. SoCal's authorized rates would be the default rates for qualified customers who do not want to avail themselves of the optional schedules.

m) Storage Costs

SoCal proposes to apply the PBR rate index to the base rate elements that recover the cost of storage which is currently bundled in core and noncore rates. This request was not in the original application, but was later included in its request in response to a proposal by ORA to eliminate the Noncore Storage Balancing Account (NSBA) and put SoCal wholly at risk for market demand for the costs allocated to unbundled noncore storage service when the PBR rates become effective. SoCal asserts that its request is consistent with the overall concept that PBR substitutes for a general rate case, in which the revenue requirement for bundled storage costs would otherwise have been adopted by the Commission. SoCal states that because it is proposing to be at risk for throughput under PBR, it would also be at risk for the recovery of the portion of storage costs that is bundled in transmission rates.

n) Monitoring and Evaluation

SoCal states that it recognizes the need for the Commission to monitor the functioning of the PBR mechanism and to be prepared to evaluate the program at the conclusion of the minimum term. Nevertheless, SoCal urges the elimination of a significant number of existing reporting and recordkeeping requirements, and advocates the avoidance of new reporting requirements insofar as possible, in the interest of simplifying and streamlining regulation.

o) Base Margin

SoCal initially proposed a starting base margin which represented a $61.2 million reduction as compared to its 1995 authorized level. Following several revisions in response to discussions with ORA, SoCal's final position is a $110 million reduction in margin compared to the 1995 authorized level. SoCal and ORA have agreed upon a variety of base margin items, and the individual items are described, along with our resolution, in the discussion below.

III. Discussion

A. *Introduction: Performance-based Ratemaking*

In general, performance-based ratemaking refers to any of a variety of ratemaking mechanisms designed to improve utility performance and also return financial benefits to the utility's ratepayers. Its purpose is to break the direct link between costs and rates by inserting "an independent and explicit incentive [for the utility] to increase efficiency through lowering costs," so that ratepayers will not have to bear the risk of inefficient utility operation. (D.96-09-092, mimeo., p. 14, September 20, 1996.) The mechanism itself is intended to emulate an unregulated market.

The basic PBR concept involves two basic steps:

> "First, the PBR regulator sets an initial price based on the utility's observed and projected costs. Next, the regulator provides the utility with incentives to reduce these costs and pass some of the resulting savings onto the consumer. To assure that the utility does not achieve costs savings simply by cutting safety, reliability or quality, the PBR system must also include a quality-control mechanism." Navarro, *"The Simple Analytics of Performance-based Ratemaking: A Guide for the PBR Regulator"* (Yale Journal on Regulation 13:1 (Winter 1996), p. 107.)

The hallmarks of the PBR system under the previous practice of this Commission are an incentive device to encourage cost reduction and revenue enhancement, and a device to ensure sharing of the savings produced thereby with customers.

We first replaced traditional rate case regulation with PBR in D.89-10-031, which placed the two major California local exchange telecommunications companies under an incentive form of regulation. The mechanism we adopted is often called "CPI-X" regulation. As we explained in our most recent PBR decision, D.96-09-092, which adopted PBR regulation for SCE:

"This form of PBR regulation adopts starting rates based on an analysis of utility costs with these rates then updated in each subsequent year by a rule which includes expected changes in input prices, CPI, and productivity, X. . . . [W]e refer to this price less productivity adjustment, or CPI-X, as the update rule.

"To make this update of utility rates independent of the utility's costs, the price and productivity values should come from national or industry measures and not from the utility itself. The independence of the update rule from the utility's own costs allows PBR regulation to resemble the unregulated market where the firm faces market prices which develop independently of its own cost and productivity. In contrast, traditional regulation often updates rates through a review of the utility's own costs and productivity. The form of this PBR update rule of "price less productivity" or CPI-X arises from the unregulated market where, independent of demand response, a firm's output price will change to reflect changes in its input prices less its change in productivity, where productivity is simply the change in the firm's outputs less its change in inputs, both value weighted.

"Finding a measure for the price term in the update rule requires a choice between a general price index such as the well-known CPI or an industry specific index. The former choice involves less controversy but uses a general approximation to industry specific prices, and this approximation can work reasonably well during periods of generally low inflation. While the latter choice clearly tracks industry costs more closely, it does engender more controversy because often it requires construction of a new industry specific price index to track industry price changes closely. Complexity readily arises in the construction of price indices; for example, an accurate current price index for labor requires a weighted average wage for...many different classifications of workers from clerks to system engineers.

"The productivity measure should come from a forecast of industry-specific productivity. However, such studies are not common and most published econometric studies not only assume efficient operation but also use historical data. In D.89-10-031, we relied on a study of AT&T's historical productivity and expert judgment in setting the productivity value for the local exchange utilities. Realizing that technological change in telecommunications offered the opportunity for substantial productivity and wanting to encourage increased efficiency in utility operations, we added a "stretch" factor to set the productivity value or X.

"We note that improved efficiency can arise from three sources: adopting more efficient technology in meeting current demand, realizing economies of scale when expanding the operation, or reducing existing inefficiencies in the current operation. ... [P]articularly in the distribution business, the first source of productivity may contribute only selectively toward greater efficiency and lower rates. The incentives of this PBR should discover the opportunities to increase the efficiency of the current operation and thereby lower rates.

"In D.89-10-031, we also adopted a net revenue sharing rule which allows the utility to keep some of the increased net revenue which occurs if the utility can reduce its costs. Adoption of this rule should increase the utility's incentive to reduce costs. Allowing the utility to retain some of the net revenue from cost reduction efforts also resembles the competitive market where a firm can increase its profits by lowering its costs. Combined with the use of independent prices, the use of a net revenue sharing rule emulates the outcome of a competitive market.

"Thus, we see PBR as emulating the competitive process to encourage utility management to make decisions which resemble an efficient or competitive outcome. An efficient utility will control rates which benefits ratepayers. However, we want to ensure fairness to ratepayers, employees, and shareholders in the PBR process. This requires balancing potentially conflicting interests. The utility can increase short run profits through reducing variable costs, but without revenue sharing such cost reductions will not lower rates. Moreover, such reductions not only can affect staff immediately but the service quality impact may only appear much later." (D.96-09-092, mimeo., pp. 14-16.)

We have already expressed our preference for replacing traditional cost-of-service regulation with performance-based regulation in those areas of the electric services industry which exhibit natural monopoly attributes. See Order Instituting Rulemaking and Order Instituting Investigation in R. 94-04-031 and I.94-04-032 ("Blue Book"). Our policy favoring that deployment of PBR reflects our successful experience with it in the field of telecommunications. Certainly, we are favorably disposed to using PBR wherever it would further our regulatory goals and policies.

At the commencement of I.94-04-003, the SCE proceeding, supra, we stated our goals for undertaking the development of PBR. These included:

- Improving the efficiency and performance of the utility;
- Improving incentives and removing disincentives for utility cost reductions;
- Simplifying and streamlining the regulatory process;
- Moving rates for all customer classes, in real dollars, steadily down the national average for investor-owned utilities;
- Maintaining a reasonable opportunity for the utility to earn a fair rate of return; and
- Maintaining and improving quality of service.

We still regard these as our general goals in evaluating any PBR proposal, and as the policy yardstick for measuring SoCal's proposal in the present instance.

We have embraced PBR in concept with the clear recognition of our "fundamental and enduring duty to protect California's consumers of [energy]," a duty which we have pledged not to change during the transition to a streamlined and more efficient regulatory approach. (Blue Book, p. 34.) This means that, despite our preference for PBR, we will not approve any PBR proposal just because it encourages efficiency on the part of the utility. The other part of the equation, protection of ratepayer interests, must also be satisfied.

B. The SoCal PBR Proposal Must be Modified to be Acceptable, but Much of SoCal's PBR Proposal Is Consistent with our Stated Goals for PBRs

We have examined SoCal's proposal on the threshold question of whether elements of the proposed mechanism conflict with existing Commission decisions and orders, or with the policies we have articulated above. Consistent with the parties testimony, we conclude that in several respects it does. We must therefore modify SoCal's PBR to conform to these overriding principles.

1. The SoCal PBR Proposal Violates the Terms of the Global Settlement

Both the Commission's Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN) criticize SoCal's proposal as being inconsistent with the Global Settlement. That agreement was adopted in final form by the Commission in D.94-07-064, 55 CPUC2d 452 (1994), and governs a number of aspects of ratemaking for SoCal's gas utility operations for the period from August 1, 1994, through July 31, 1999, when it expires.

TURN asserts that there are five inconsistencies between SoCal's PBR proposal and the Global Settlement which preclude adoption of SoCal's proposal in its present form. First, TURN states that SoCal's proposal to base rates upon 1996 adjusted throughput violates a provision of the Global Settlement that requires rates instead to be based upon 1991 throughput. Second, TURN argues that SoCal's proposal to extend the cost allocations adopted by the Global Settlement beyond the term of that agreement would violate a provision requiring cost allocations to be determined in the 1998 Biennial Cost Allocation Proceeding (BCAP). Third, TURN alleges that the proposal to use one definition of a "normal" temperature year for setting rates, and another for allocating costs between classes, to the detriment of the core class, also violates the Global Settlement. Fourth, TURN claims that SoCal's proposal to index rates, thus doing away with the authorized revenue requirement allocated by the Global Settlement, violates the settlement. Fifth, TURN argues that the proposal to eliminate the CFCA violates the Global Settlement, because the continued operation of that account was a basic assumption underpinning the settlement. We conclude that SoCal's PBR proposal conflicts with the Global Settlement at least in some of these respects, and that the proposal will have to be modified to avoid these conflicts.

Section II, paragraph 1, of the Global Settlement states:

> "SoCal shall calculate rates based on 1991 actual throughput, with [specified adjustments] for the five-year period

> commencing upon the date that this [settlement] becomes effective." (55 CPUC2d 458.)

Notwithstanding this language, SoCal proposes to use 1996 customer count and core throughput, normalized for average temperature conditions, to set throughput because it would be "fair and reasonable" to do so. This would vary the express language of the Global Settlement. Moreover, it would not be consistent with the table of specified average year volumes and customer counts for basing cost allocation and calculating rates during the period covered by the Global Settlement. See Global Settlement Implementation Appendix, Section C.1, paragraph 2 (55 CPUC2d at 469).

As justification for this variance, SoCal argues that its proposal would also eliminate the CFCA, and that use of the Global Settlement throughputs would impose upon it a $39 million annual revenue penalty because of the resultant undercollection. We do not find SoCal's position to be persuasive. The Commission has a strong policy favoring settlements as a means of resolving issues in its proceedings, and we will not undermine that policy by changing the terms of a settlement after it becomes a Commission order.

In addition to expressly providing that cost allocation and rates during the five-year term of the Global Settlement would utilize specific throughput volumes based upon adjusted 1991 data, the Global Settlement also reflects the parties' intent that the cost allocation be terminated by the 1998 BCAP. Under the PBR, by contrast, the cost allocation would continue for the entire PBR period, some two and one half years beyond the term of the Global Settlement. The significance, as explained by TURN witness Florio, is that SoCal's approach would harm core customers because of the underlying temperature assumption used to develop the throughput for the purposes of calculating core rates. The company now uses 1506 annual heating degree days (HDDs) to define an average temperature year under the Global Settlement. SoCal's suggested reduction would reduce the average year forecast of throughput by 5%. The lower measure of HDDs suggested by SoCal for use in designing core rates would deny ratepayers the benefit of the lower throughput forecast for purposes of cost allocation.[13]

The Global Settlement contemplates that there will be a specific allocation of costs to customer classes during its five-year term. Section II, paragraph 3, sets up a memorandum account to track the variance between costs allocated to noncore and wholesale markets and SoCal's actual noncore and wholesale revenues. By contrast, the PBR would not have explicit costs allocated to noncore and wholesale markets, or an annual cost used to develop the effective rates for noncore transportation service. As explained by witness Florio, the Global Settlement,

> "plainly contemplated that there would be an authorized revenue requirement that was allocated between the core and noncore markets during the entire term of the settlement. The fact that SoCal would now like to shift to a program of rate indexing cannot overcome the deal that the company made." (Ex. 55, p. 20, l. 11-16.)

Consequently, we cannot accept this feature of the PBR proposal.

TURN argues that the Global Settlement mechanism implies that revenue variations are to be passed onto core ratepayers through the CFCA, and that elimination of the CFCA would therefore violate the intent of the Global Settlement. We agree. The Global Settlement would be unworkable without the CFCA, and SoCal's proposal would therefore violate the terms of that agreement.

2. The Absence of a Sharing Mechanism is Inconsistent with Commission Policy

In most respects, SoCal's proposal fits our model of PBR. However, the proposal omits any mechanism for sharing the savings between shareholders and ratepayers. Instead, SoCal argues that the productivity factor (or "X" factor) utilized in adjusting rates annually, and particularly the "stretch" component incorporated into that productivity factor, should be considered an "upfront" device that will adequately

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[13] SoCal is now willing to accept the figure of 1330 HDDs in place of the 1316 HDDs it originally proposed, but the result is essentially the same.

compensate for lack of an after-the-fact mechanism to allocate savings, because it creates a downward pressure on costs and, therefore, rates. We disagree.

In previous PBR proceedings we have rejected substitution of a productivity factor for a sharing mechanism for SDG&E and for SCE. There are several reasons for this. First, PU Code § 728 imposes upon us a duty to insure that utility rates are maintained at a level that is just and reasonable. This can only be assured if the overall level of profits is effectively controlled by placing a practical limit on how far the utility is willing to go to earn a share of the marginal profit. The consequence is that profits, and therefore rates, are maintained at reasonable levels.

A sharing mechanism is the ultimate "safety net" for ratepayers, as it corrects for the possible adoption of a productivity factor that turns out to be overly conservative, understating the productivity increases which the utility is actually able to achieve. With a sharing mechanism, if the utility attains productivity increases that exceed the adopted productivity factor, the resultant profits must be shared with the ratepayers rather than going solely to the utility. SoCal argues that this would "dilute" its incentives to achieve greater productivity goals, but we see no reason why we should fix a productivity index based upon imperfect forecasting techniques, and permit it to remain undisturbed for a five-year period, based upon speculation that this mechanism will adequately benefit the ratepayers. If the utility is actually able to reap benefits above the level reflected by the adopted productivity factor, it would not be "just and reasonable" to require ratepayers to be satisfied with only the share of savings based upon attaining the productivity estimate made at the outset of the program.

SoCal admits that the reduction in its rate base alone will result in an increase in its rate of return of 87 basis points. This is simply a consequence of depreciation of its rate base rather than cost-cutting. A sharing mechanism would insure that the ratepayers will receive their fair share of the rewards of improved productivity, however those rewards are achieved. Because a PBR with a sharing mechanism simultaneously allows higher profits than at present, and lower rates due to increased productivity, a sharing mechanism creates the potential for a "win-win" situation.

3. The SoCal PBR Must be Modified Because It Does not Simplify Regulation

Certain features of SoCal's PBR proposal would also be contrary to the Commission's goal of simplifying regulation under performance-based ratemaking. Rather than eliminating balancing accounts and reducing the degree of Commission oversight, SoCal's proposal introduces altogether new concepts, the WNM and the EEAF, to reduce its level of risk. Monitoring the operation of these new devices will add to, rather than lessen, the Commission's regulatory tasks, representing a movement away from the Commission's goal of lessening the regulatory burden that is ultimately borne by ratepayers.

4. Certain Features of the Proposal are not Related to Performance-based Ratemaking, and Should not be Adopted by the Commission as an Aspect of SoCal's PBR Proposal

SoCal's proposal includes some features that are extraneous to a scheme which encourages efficiency on the part of the utility through a system of incentives. Instead, these additional features appear to have been included by SoCal as a "wish list" of items which, if authorized, would enhance the potential profitability of SoCal without rewarding ratepayers in kind. Specific examples include the proposals for major changes in residential rate design, and gain on sale exceptions, which appear to be designed only to enhance SoCal's profitability without any relation to ratepayers' interests. Residential rate design issues were addressed by the decision in SoCal's BCAP, adopted on April 23, 1997.

We are also mindful that we should not make any major changes in general industry policy in a proceeding which involves a single utility, such as this one. Questions of new products and services and gain on sale are broad ones which potentially apply to an entire class of utilities, and any major changes should be adopted in a generic proceeding to insure that they will apply evenhandedly to all utilities in the class. We must therefore refrain from addressing such proposals in this proceeding.

5. Conclusion: The SoCal PBR Methodology must be Modified for Adoption by the Commission

In recognition of these conceptual problems, we cannot adopt the PBR proposal advanced by SoCal. Doing so would contradict important Commission policies and orders, and would represent an abdication of our responsibility to ratepayers. Although we favor performance-based ratemaking as a tool for regulating utilities in the current regulatory environment, we must in some respects replace SoCal's proposal with a program which more accurately advances our regulatory goals.

C. The Commission's Adopted PBR

In this section we enumerate the essential features of our adopted PBR for SoCal. This PBR will become effective immediately. Insofar as possible it retains the elements of the SoCal proposal, but it includes changes that bring it into conformance with other decisions, goals, and policies of the Commission.

The features we adopt are: (1) the productivity index (inflation less productivity); (2) the quantity indexed; (3) exclusions and adjustments; (4) offramps and termination provisions; (5) service quality, customer satisfaction, and safety incentives; and (6) monitoring and evaluation provisions. We also establish the amount of the base margin for indexing.

1. Indexing Method

As earlier explained, we must first select the overall index (price index minus "X") to be applied to the indexed quantity in order to obtain the subsequent years' base rates.

a) Inflation Measure

SoCal is proposing an inflation measure (the GUPI) based upon a weighted average of the recorded indices of labor O&M, nonlabor O&M, and capital-related costs. In the GUPI, the measure for labor O&M is the index of average hourly earnings of workers in gas production and distribution as reported by the U.S. Bureau of Labor Statistics. The measure for nonlabor O&M is the DRI/McGraw Hill nonlabor O&M index for gas utilities. The inflation measure for capital-related costs would be based on the DRI/McGraw Hill indices for capital service prices and for the price of gas distribution capital goods. These measures would be weighted according to the average of expenditures in each category for the past five years.

SoCal proposes that rates for a year would be set using the latest available forecasts for the GUPI elements for that forthcoming year at the time that SoCal makes its annual PBR rate formula rate filing, but that the next year's rate filing would include an adjustment to "true up" any difference between the forecast and actual GUPI.

SoCal originally proposed to use a weighting of input price inflation based on SoCal's own historical ratio of labor expense, nonlabor expense and capital inputs to total costs. ORA proposed using a weighting that was the average of gas operations for SoCal, Pacific Gas and Electric Company (PG&E), and SDG&E. The rationale for ORA's recommendation was that it would make it easier for the Commission to administer PBRs for the three major gas utilities it regulates. In any event, a broader-based price index is consistent with the Commission's disinclination to use company-specific indexes.[11] SoCal has accepted ORA's alternative.

We adopt the approach to price indexing proposed by ORA.

b) Productivity Factor

As explained earlier, the productivity or "X" factor consists of two parts. The first component is a historic measure of industry productivity. The second component represents an additional productivity target, or aspiration measure, which is based upon potential incremental productivity improvement that the utility can expect to achieve over and above the historical average. SoCal refers to this as the "stretch" factor, or "consumer dividend," because it creates downward pressure on costs and, by extension, on rates.

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[11] SCUPP/IID propose a weighting based on five to ten western U.S. gas utilities. This proposal is vague and undefined; the exact companies are not identified and there is no basis for comparing it to other parties' positions. It would not simplify the Commission's administration of PBR, and we will not adopt it.

(1) Industry Productivity Measure

SoCal proposes using a historical industry productivity measure of 0.5%. This figure was developed from the Christensen Associates study, and elicited little criticism from the parties. We adopt the 0.5% historical industry productivity figure.

(2) "Stretch" Factor

The second component, the "stretch" factor, is more problematic. SoCal proposes that this component also be fixed at 0.5%, and claims that this is a liberal figure in relation to the productivity gains it expects to be able to achieve beyond the historical average.

ORA advocates a 1% stretch factor, double that proposed by SoCal. This would produce a total productivity factor of 1.5%. TURN/Department of General Services (DGS) supports ORA's estimate as reasonable in the long run, but believes that the pendency of the Enova-Pacific Enterprises merger will cause an increase in productivity. This is based upon the experience of witness Marcus, who testified that during the period of the SCE-SDG&E merger proposal, (1) staff members sought jobs outside the company because of organizational uncertainty and were not all replaced because of the possibility of postmerger job consolidations, and (2) capital spending was curtailed. Thus, TURN/DGS recommends adoption of a 1.5% stretch factor while the merger application is pending.

Although the subject of merger savings is not a part of our consideration here, we believe that the pendency of the merger proceeding distinguishes this period of time from that which was examined in developing SoCal's productivity and stretch factors. Given the nature of management's motivation, it is indeed likely that capital spending will be curtailed and expenses otherwise forgone before the merger is consummated or disapproved. We therefore believe that the stretch factor proposed by SoCal is likely to be conservative.

SoCal's objection to the adoption of a stretch factor greater than 0.5% is based primarily on the number of multiples of historical productivity that each figure represents. Thus, SoCal states that ORA's suggestion of a 1.5% total productivity factor would be three times the historical average, and TURN/DGS's 2.5% figure would be five times the historical average. SoCal argues that this would not be reasonable.

We find that ORA's suggestion comes as close to the mark as any, particularly in view of the likelihood that disproportionately large productivity gains may be on the near-term horizon. It is appropriate to "set the bar high" in the expectation that SoCal will, indeed, stretch to maximize productivity. Were we to set too low a goal, SoCal's benefit could come at the expense of the ratepayers, even allowing for a sharing mechanism. There would be no advantage to adopting such a PBR over traditional ratemaking methodology. Nevertheless, we recognize that productivity improvements are not likely to occur all at once. Both cost reductions and revenue enhancements may take several years to come to fruition. We recognized this in D.9-09-092 in SCE's PBR when we adopted an "X" factor, including a stretch factor, which ramped up from 1.2% to 1.6% over the life of the PBR. We believe it is appropriate to take a similar approach here.

We will adopt a stretch factor that increases incrementally over the initial five-year PBR timetable resulting in an X factor of 1.1% in Year 1, 1.2% in Year 2, 1.3% in Year 3, 1.4% in Year 4, and 1.5% in Year 5.

c) Quantity Indexed

SoCal proposes to index rates directly, rather than indexing total authorized margin or authorized margin per customer, for several reasons. First, SoCal contends that this mechanism will put it at risk for the level of customer demand (throughput), and that this is the direction in which the Commission wants to move; SoCal points to the Commission's recent adoption of rate indexing for SCE to support this contention. SoCal also argues that this mechanism will best prepare it for the transition to a competitive marketplace, and will change its corporate culture. SoCal claims that rate indexing will allow the elimination of a major balancing account, the CFCA, and thus simplify regulation. Finally, SoCal argues that this approach is consistent with the direction the Commission has already taken by putting SoCal at risk for a specific throughput for most noncore customers under the Global Settlement.

We do not find SoCal's arguments persuasive in relation to its unique circumstances. First, the probability of risk to the shareholders is far lower than SoCal suggests, because realistic throughput forecasts indicate a growing core market.[15] In addition, SoCal's president, Mr. Mitchell, acknowledged on cross-examination that the company continues to seek new throughput opportunities, such as business ventures in Mexico. Under traditional regulation, a portion of the cost of these ventures would be allocated to the resultant new loads, reducing rates for existing customers. This would not be true under PBR. In light of these realities, we prefer not to give SoCal carte blanche to increase its throughput and apply what will almost surely be a positive index each year (reflecting inflation in excess of productivity) to actual throughput.

Preservation of the CFCA, at least through the period covered by the Global Settlement, is central to this indexing method. The Global Settlement establishes throughput based on the 1991 level. SoCal has agreed to this through the term of the agreement. Although the Global Settlement does not specifically refer to the CFCA, as SoCal says, once throughput is fixed in this fashion, the CFCA handles overcollection or undercollection from sales variations. Retention of CFCA is therefore implicit in the Global Settlement, as the mechanism will not work properly without it.

As we have already explained, retention of the CFCA in connection with throughput variations requires the use of revenue indexing. This is required by the Global Settlement. Other provisions of the Global Settlement also require the existence of a revenue requirement. These include "a memorandum account to track the variance between the costs allocated to the noncore and wholesale markets

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[15] <u>See</u>, for example, Exh. 62A, Attachment 7, p. 25: SoCal projects systemwide sales growth of 3.4% between the years 1996 and 2000, principally in the high-margin residential sector.

and [SoCal's] actual noncore and wholesale mechanisms," which is calculated using "a debit entry equal to one twelfth (1/12) of the authorized annual cost used to develop the effective rates for noncore transportation service including EOR [Enhanced Oil Recovery]." (TURN/DGS Opening Brief, p. 9, quoting Global Settlement, Section II, para. 3 and Implementation Appendix, p. 21.) These features preclude rate indexing, and must be retained until expiration of that agreement.

Another circumstance unique to SoCal compels us to adopt indexing of the revenue requirement, rather than rates. Specifically, the proposed Enova-Pacific Enterprises merger will create a need to track savings, which cannot be accomplished with rate indexing. Although the merger application is not directly relevant to the SoCal PBR proposal, we take notice that if we approve the merger, we will have to determine the amount of merger savings in that proceeding. Those savings are expressed in the same terms as the total revenue requirement. Indexing the total revenue requirement will enable that sum to be deducted from the pre-merger totals. On the other hand, if rates are indexed where throughput forecasts are no longer calculated, then savings cannot be passed back to customers. This means that if we were to adopt rate indexing now, we would have to revisit the subject in the merger proceeding and translate the PBR results in order to insure consistency after the merger takes place, if it is approved.

Finally, we conclude that revenue rather than rates must be indexed because SoCal's rate base is declining at the time the PBR is to go into effect. SoCal's proposal to index rates, which would fix SoCal's rate base at the 1996 level and index it for at least five years thereafter, fails to recognize this fact. Rate indexing would benefit SoCal's shareholder because its capital spending is declining. This is an important fact, as SoCal's earnings will consequently increase by 87 basis points more than its currently authorized rate of return as the sole result of depreciation.[14]

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[14] SCUPP/IID considers this fact sufficient to justify retention of traditional ratemaking for SoCal rather than moving to a PBR system at this time. That course would be contrary to our policy of favoring PBR, and we believe it is too extreme. Alternatively, SCUPP/IID proposes a

The operation of depreciation is best understood in relation to the level of a utility's capital expenditures. If a utility's plant additions increase more than its plant is depreciated, rate base and associated taxes will grow. On the other hand, if the utility's plant additions are lower than its depreciation expense, the level of depreciated plant, and hence rate base, will decline. SoCal's additional capital expenditures are less than depreciation, thus significantly reducing rate base as well as the amount of return and of associated taxes. This is because SoCal is experiencing low customer growth (Exh. 52, pp. 4-5). The low customer growth rate is reducing investment requirements to a level lower than its depreciation expense, and its rate base is declining.

As explained by SCUPP/IID witness Yap, SoCal's 1995-1999 Financial Plan sets out the Company's projection of the decline in its average rate base. The table and chart on page 8-5 of the Financial Plan shows a decline beginning in 1995, acknowledging the trend: "Depreciation exceeds capital expenditures in traditional markets beginning in 1995." See Exh. 52, p. 5 (SCUPP/IID - Yap). This projection is consistent with SoCal's 1995 10-K report to the Securities Exchange Commission (SEC), which reflects a 3.4% decrease in rate base for 1995. The 10-K report projects 1996 capital expenditures of $224 million, while SoCal's Summary of Earnings Table for 1996 filed in this proceeding projects $255 million in depreciation (Exh. 24, Table 12-A). When compared to the $231 million capital expenditure level and $237 million depreciation level that accompanied the 3.4% reported decline in rate base during 1995, it is clear that the decline in rate base is accelerating. (Exh. 52, p. 5 (SCUPP/IID - Yap.))

Under traditional ratemaking, declining rate base tends to reduce rates. Declining rate base results in lower depreciation expense, return, and

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methodology which would separately index the O&M portion and the capital portion of the base margin rate. This would correct for the declining rate base, but would provide an incentive for SoCal's management to substitute capital for O&M expenses wherever possible, thus perpetuating one of the disadvantages of traditional ratemaking.

associated taxes, which are reflected in lower rates. But if rate base is "frozen" and rates are indexed, they will rise despite the fact that rate base is declining.

d) Adopted Indexing Formula

For the reasons we have described, it is necessary to index SoCal's *revenues*, rather than rates. SoCal's rate indexing proposal, however, is easily adapted into an equivalent revenue-indexing mechanism. SoCal's rate indexing proposal is

PBR rates (year 2) = PBR rates (year 1) *x* (1 + inflation - productivity)

This is a standard price cap formula, in its basic form identical to the ones we have adopted for Pacific Bell and GTEC, and for Southern California Edison.[17] Recognizing that by definition SoCal's revenues are the product of rates and the quantity of gas sold or transported (throughput), this formula can be translated into an equivalent revenue setting mechanism:

PBR revenue requirement (year 2) = PBR revenue requirement (year 1) *x* (1 + inflation - productivity + growth in throughput)

Since throughput by definition is average throughput per customer times the number of customers, the last term—growth in throughput—can be decomposed further into the sum of customer growth and growth in throughput per customer. Making this substitution in the revenue indexing formula results in SoCal's proposal for rates translated into its equivalent for indexing revenues:

PBR rev. req. (year 2) = PBR rev. req. (year 1) *x* [1 + inflation - productivity + customer growth + growth in throughput per customer]

[17] Typically such formulas include as well a term for so-called "Z factors." The Z-factor term is ignored in the above discussion just to keep things simple.

Finally, this formula can be converted into its equivalent for revenue requirement *per customer*[18] by deleting the customer growth term on the right hand side:

PBR rev. req. per customer (year 2) = PBR rev. req. per customer (year 1) x [1+inflation - productivity + growth in throughput per customer]

Like SoCal, ORA proposes to index rates using the same, standard inflation minus productivity format. Its proposal, translated into the equivalent revenue per customer indexing formula, therefore looks exactly the same as SoCal's depicted above. The only difference--as described earlier--is that ORA proposes a 1.5 percent productivity factor, while SoCal's is 1.0 percent.

Unlike SoCal and ORA, TURN/DGS proposes to index revenues directly. Like the two other parties' proposals, its indexing mechanism is driven by inflation, productivity and customer growth. However, because the proposal is not based on indexing rates, it does not reward the utility with additional revenues from increasing throughput per customer. Additionally, it includes a minus 1.41% constant term in the formula[19] that is missing from the other two. Perhaps most importantly, it does not give the same *weight* to the common factors it shares with the SoCal and ORA proposals—inflation, productivity and customer growth. TURN/DGS's indexing mechanism assigns less weight to inflation and the productivity offset, and more weight to customer growth, in determining the utility's revenue requirement. TURN/DGS's revenue indexing proposal for revenue per customer is:[20]

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[18] Actual customers are used to calculate customer growth and convert revenue per customer into total revenues.

[19] This number, because it is negative, could be interpreted as an additional productivity offset.

[20] TURN/DGS provide formulas both for indexing total revenues and revenues per customer. The differences in the parameters, however, are insignificant. TURN/DGS argues that a *long-run* PBR indexing mechanism should index revenues per customer. *See* Exh. 63, p. 20 (TURN/DGS - Marcus).

PBR rev. req. per cust. (year 2) = PBR rev. req. per cust. (year 1)
x [1 + 0.610 x inflation - 0.610 x productivity
+ 0.605 x cust. growth - 1.41%]

Although the TURN/DGS formula relies upon essentially the same set of factors as SoCal's and ORA's the difference in *results* is not insignificant. With the throughput per customer term dropped in the SoCal and ORA proposals for directness of comparison, the results for a 1.0 percent customer growth rate and inflation of 3 percent are:[21]

SoCal
PBR Rev. Req. per cust. (year 2) = (1 + .03 - .01) x PBR Rev. Req. per cust. (year 1)
= 102% of PBR year 1 Rev. Req. per customer

ORA
PBR Rev. Req. per cust. (year 2) = (1 + .03 - .015) x PBR Rev.Req. per cust. (year 1)
= 101.5% of PBR year 1 Rev. Req. per customer

TURN/DGS
PBR Rev. Req. per cust. (year 2)
= [1+ 0.610 x (.03 - .015) + 0.605 x .01 - .0141] x PBR Rev. Req. per cust. (year1)
= 100.11% of PBR year1 Rev. Req. per customer

A PBR mechanism provides an incentive to utilities to cut costs by disconnecting their rates from their *actual* costs. Traditional ratemaking sets rates and revenues on the basis of utilities' actual costs. The poor cost-cutting incentives provided by such ratemaking are too well known to repeat here. A PBR mechanism, on the other hand, sets a *limit* for revenues or rates—independent of the utilities subsequent actual cost performance—based on the general factors that drive costs: inflation, customer and output growth, with an offset for productivity gains.

This does not mean, however, that we cannot ignore special circumstances that may affect a specific utility's costs. We agree with TURN/DGS that

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[21] The omission of the average throughput per customer factor is not trivial. SoCal Gas' forecast of throughput growth is 2 percent per year; for customers, 1 percent growth. The

an indexing method should be chosen which, among other things, would leave ratepayers at least as well off under PBR as they would have been under traditional ratemaking. Without some assurance to that effect, there is no real "consumer dividend" for ratepayers from adopting PBR.

In this context, SoCal (and ORA's) approach fails to take into account its specific circumstances, and therefore omits an important consideration that needs to be taken into account in setting its indexing formula. As noted in the previous section, SoCal's projected plant expenditures are less than projected depreciation, thus significantly reducing future rate base and the associated amount of return and taxes. The low customer growth rate SoCal is experiencing is reducing investment requirements to a level lower than its depreciation expense, and its rate base is declining.

Two utilities could face the same inflation and have the same level of productivity (*X*), but could have very different trajectories in revenue requirements if one was growing more rapidly and had an increasing rate base and the other was growing more slowly and faced declining rate base. A simple inflation minus X indexing formula—for revenue per customer—would give the same revenue increase to both utilities, possibly yielding a windfall for one and a loss for the other.

Thus, if one is constructing a single "X" factor, it may not be sufficient to construct that factor from a historical factor productivity study plus a stretch, as SoCal and ORA have proposed. Neither SCE nor SDG&E claimed that they would face rate base declines, as SoCal forecasts that it will. TURN/DGS's methodology attempts to take into account SoCal's current investment plans over the next five years. However, while we agree with the basic logic of the TURN/DGS approach, we are unwilling to go so far as to adopt its proposed formula. The formula relies on a complex regression analysis, underlying which is a set of assumptions and variables. One important assumption is that the projected rate base decline will occur as

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implied growth in throughput per customer therefore is 1 percent. When this effect is included in the SoCal and ORA proposals, the respective escalation factors become 103% and 102.5%.

SoCal has projected in its 1996-2000 financial plan. SoCal's future investment plans may well vary due to a variety of factors, including the rate of customer growth and the incentives afforded by this PBR decision. The TURN/DGS approach assumes that SoCal's management will have no control over the extent of future capital investments. While we agree that the general trend is likely to be as presented in the 1996-2000 financial plan, we cannot rely on the exact numbers in that plan as the mathematical basis for the indexing formula.

As noted earlier, the indexing formula is intended to give utility management the incentive to improve productivity through reasonable management of costs and practices that are within its control. Thus, the productivity factor takes into account expected gains on an industry-wide level, and adds a stretch factor to provide a "consumer dividend" and account for the fact that implementation of the PBR necessarily will require increased productivity if the utility is to receive a fair benefit from the new system. We also adjust the base margin to ensure that the utility is starting from a reasonable starting point, just as we would under traditional ratemaking. TURN/DGS makes the case that the same concept should be applied to rate base. If rate base is falling due to factors extrinsic to the PBR, returns will increase unless an adjustment is made, and vice versa. While this issue was not introduced in other PBR cases, it is a legitimate consideration.

We would prefer to adopt a method to take rate base changes into account outside of the indexing formula. A methodology such as a direct revenue offset or adjustment of the benchmark rate of return could accomplish this. However, no party has proposed such a method, and we must rely upon the indexing methodology, in which rate base factors are effectively translated into productivity. SoCal estimates in its comments on the Proposed Decision (p. 4) that the impact of the TURN/DGS formula may result in an effective productivity factor as high as 2.9 percent, which is 1.4 percent above the 1.5 percent final stretch "X" factor. This suggests that it may be possible to translate directly the TURN/DGS formula into a straight productivity figure and thus roughly reconcile the TURN/DGS concept with the indexing methodologies adopted in other PBRs.

Since some of the capital spending decisions in the future are presumed to be under SoCal management's control, we find it reasonable to adopt a lower effective X factor than the 2.9 percent imputed from the TURN/DGS methodology. Accordingly, we will adopt a 1.0 percentage point increase to the ramped stretch productivity factor. Our final adopted productivity "X" factor will be 2.1 percent in year 1; 2.2 percent in year 2; 2.3 percent in year 3; 2.4 percent in year 4; and 2.5 percent in year 5.

The PBR indexing formula therefore that we adopt is:

PBR rev. req. per customer (year 2) = PBR rev. req. per customer (year 1) *x* [1+inflation - *X*],

with our adopted "X" factors described in the previous paragraph.

2. Sharing Mechanism

SoCal proposes that there be no adjustment in rates during the minimum five-year PBR period to share with ratepayers any difference between its recorded rate of return and a benchmark rate of return. We reject this aspect of SoCal's proposal, and require a sharing mechanism as part of the PBR for SoCal.

ORA, SCUPP/IID, SCE, and TURN/DGS advocate the inclusion of a sharing mechanism as an integral feature of SoCal's PBR, and two specific proposals have been advanced for our consideration. ORA's proposal would allow SoCal to retain all profits up to the level of 75 basis points above authorized rate of return (ROR), and 50% of any profits earned above that benchmark level. ORA states that earnings at the 75 basis point benchmark level will enable SoCal to keep $37.5 million of its revenues as a reward for its efforts, and above this level SoCal would net additional rewards, albeit at a proportionately lower rate. By contrast, TURN/DGS urges us to adopt a mechanism which shares cost savings with ratepayers on a progressive basis. This approach affords better insurance for ratepayers in the event that the productivity factor turns out to be unrealistically low, and profits therefore to be excessive.

TURN/DGS recommends as our basic model the PBR we adopted for SCE in D.96-09-092. That mechanism shares both profits and losses within "bands" above and below the benchmark return on equity (ROE). Under this approach, shareholders receive all of the gains and losses up to 50 basis points above and below the benchmark rate of return, which we termed the inner band. Our intent in so doing was to assign shareholders the responsibility for the gains and losses associated with routine operation. (Id., mimeo., p. 42.) Beyond the inner band, from 50 to 300 basis points, the shareholder share of gains rises continuously from 25 through 100%, while the ratepayer share correspondingly declines from 75 to 0%. This we defined as the middle band. The shareholders receive all gains 300 basis points above the benchmark and remain responsible for all losses more than 300 basis points below the benchmark.

TURN/DGS proposes one alteration to this mechanism. In recognition of the fact that SoCal will not be exposed to revenue fluctuations due to short-run temperature based sales fluctuations if we retain the CFCA, TURN/DGS recommends that the level of the inner band should be reduced to no more than 25 basis points, or be eliminated altogether. We agree. The allowance of the inner band for SCE was partially to account for weather-based sales fluctuations that were beyond the discretion of utility management. For SoCal we will retain the CFCA as part of the PBR and limit the inner band to 25 basis points to account for minor fluctuations in operations. Thus shareholders will receive 100% up to the level of 25 basis points above the benchmark ROR, and an increasing percentage in steps from 25 up to 300 basis points, above which level they will receive 100%. We refer to a mechanism of this type, where the utility share of net revenue increases as its earned return becomes greater than the benchmark return (and the ratepayer share correspondingly decreases), as progressive sharing.

Between 25 basis points above the benchmark ROR and 300 basis points above the benchmark, we will adopt 8 bands. The more bands that exist, the greater the potential to move into a new band and for shareholders to collect an increasing marginal share of the higher profits. The first band will be from 25 to 50 basis points above the benchmark. In this band, shareholders will receive 25% of the marginal revenues in the band and ratepayers 75%. Each successive band will see an increase of 10% in the incremental share allocated to shareholders and a decrease of 10% in the ratepayers share. The sixth band will fall between 150 and 200 basis points above the benchmark, with shareholders receiving 75% and ratepayers 25%. The seventh band will be between 200 and 250 basis points above the benchmark, and shareholders will receive 85% and ratepayers 15%. The eighth band will be between 250 and 300 basis points above the benchmark; shareholders will receive 95% and ratepayers 5%.

Under this system, shareholders may gain up to 68% of the increment up to 300 basis points above the benchmark. However, as shareholders may keep <u>all</u> of the increment above 300 basis points above the benchmark (subject to the offramp discussed below), it is possible for shareholders to gain significantly more than 68% of the increment. For example, if returns are 400 basis points above the benchmark, shareholders would retain 76% of the increment. This system gives an excellent and increasing incentive to shareholders, and is fair to ratepayers who receive both the "consumer dividend" in the productivity formula and a larger share of early (and presumably easier) productivity gains.

We do not perceive a need to impose any sharing below the ROR benchmark, except for the offramp provisions discussed below. Even under traditional cost-of-service ratemaking, we have never guaranteed the utility its authorized ROR. Our PBR mechanism is designed to allow SoCal to "stretch" for higher levels of revenue, and to keep a progressively greater amount of what it is able to earn. By setting the proper ROR benchmark, we will calibrate the mechanism so that it rewards improvements which exceed that baseline, and accomplishes the efficiency gains that we intend for the benefit of the ratepayers by providing for progressive sharing above the benchmark. We will set the ROR benchmark at the current ROR.

Shareholders	Ratepayers		Basis Points
100	0	* 2 years	300
95	5		250
85	15		200
75	25		150
65	35		125
55	45		100
45	55		75
35	65		50
25	75		25
100	0		
Benchmark Rate of Return			
100	0	* 2 years	-175

Sharing Mechanism

We have focused on the question of how cost changes are dealt with in a rate PBR versus revenue PBR. Our decision to adopt a revenue PBR has much to do with our view of the appropriate treatment of cost reductions. We now turn to the treatment of revenue increases (also called revenue enhancements) in this PBR. SoCal may be able to increase net revenues in several ways. As discussed elsewhere in this order, SoCal may be able to expand current service offerings unrelated to the provision of natural gas (such as meter repair), or offer new products or services. SoCal may increase revenues through pricing flexibility approved in this order. SoCal may also experience customer growth or increases in usage per customer.

With the exception of throughput increases, SoCal can benefit from each of the methods of revenue enhancement discussed above. Revenue enhancement increases productivity, and improved productivity is one of the primary goals of performance-based regulation. We believe the adoption of this PBR will encourage SoCal to seek out both cost reductions and revenue increases. If revenue increases occur, they will be factored along with associated costs into the total rate of return calculation that is a part of the revenue PBR. If any revenue increases push SoCal into the sharing range, or further into the sharing range (as discussed below), both SoCal shareholders and ratepayers will benefit from the productivity increases.

3. Exclusions

SoCal proposes that several cost categories handled by existing regulatory mechanisms be excluded from the PBR. These would be preserved, and would maintain their separate existence for adjudication by the Commission. The proposed exclusions are as follows:

- <u>Catastrophic Event Memorandum Account (CEMA).</u> The Commission authorized all utilities to establish this account under Resolution no. E-3238 (July 24, 1991) as a reaction to the 1989 Loma Prieta earthquake to record the costs of restoring utility service to customers; repairing, replacing, or restoring damaged utility facilities; and complying with government agency orders resulting from declared disasters. It was designed to expedite and facilitate prompt response by utilities in restoring services disrupted by declared disasters. SoCal proposed to exclude CEMA from PBR so that it will fulfill its intended purpose. ORA initially recommended that CEMA expenses be reviewed using Z-factor criteria to determine potential recovery (Exh. 107, p. 63), but subsequently stipulated that CEMA be treated as an exclusion.

- Hazardous Substance Cost Recovery Account (HSCRA). This mechanism is a long-term performance-based cost recovery mechanism for hazardous substance and insurance litigation costs related to hazardous substance sites identified by the utility for cost recovery from third parties, insurance carriers and ratepayers.

- Low Emission Vehicle (LEV) Program. In D.93-07-054, 50CPUC2d 452, the Commission ordered that all funding for utility LEV programs was to be established separate from the normal general rate case proceedings, and required all energy utilities to file separate applications for funding of six-year LEV programs under specified guidelines established in that decision. SoCal complied with that requirement. In D.95-11-035, -- CPUC2d -- (1995), the Commission allowed continued ratepayer funding of LEV fleet expenses subject to a one-way balancing account, and specified the treatment of the costs of customer-site stations. SoCal proposes that capital-related costs for utility LEV and customer-site stations remain in the PBR Base Margin showing, and that all expenses covered under the one-way balancing account be excluded from PBR and continue as a separate regulatory funding mechanism.

- Regulatory Transition Costs. SoCal proposes that all regulatory transition costs whose regulatory treatment is in the process of being determined at the federal and local levels to be excluded from the PBR to be separately resolved by the Commission. These matters are not subject to reasonable estimation, and SoCal describes them as both significant and potentially volatile. Transition costs identified by SoCal consist of Take-or-Pay (TOP) costs, Minimum Purchase Obligation (MPO) Transition costs, PITCO/POPCO[22] Transition costs, and the Interstate Transition Cost Surcharges (ITCS).

[22] These acronyms, respectively, refer to Pacific Interstate Transmission Company and Pacific Offshore Pipeline Company, both of which are SoCal affiliates.

- <u>Wheeler Ridge Interconnection Costs and Revenues.</u> D.95-04-078, -- CPUC2d -- (1995), in SoCal's 1994 BCAP, sets forth the adopted incremental ratemaking treatment for the Wheeler Ridge facilities. SoCal states that implementation requires that Wheeler Ridge interconnection costs and revenues be excluded from PBR.

- <u>Mandated Social Programs.</u> SoCal proposes that mandated social programs such as California Alternate Rates for Energy (CARE) and the low-income Direct Assistance Program (DAP) should be excluded from PBR because they are created by legislative or administrative mandate, and are not within SoCal's control.

- <u>Gas Costs and Pipeline Demand Charge.</u> Gas costs and pipeline demand charges for core sales customers are forecasted and recovered through rates adopted in BCAPs. SoCal proposes to exclude these charges from PBR to maintain the existing BCAP cost recovery system.

- <u>Costs Imposed by the Commission.</u> SoCal proposes that certain costs imposed by the Commission, such as intervenor compensation fees and costs related to Commission staff - supervised management of financial costs should be excluded from PBR because they are subject to separate cost recovery treatment.

There is no longer any serious dispute concerning exclusion of these items. All of them appear to be appropriate for exclusion from the PBR mechanism, because they are beyond the control of SoCal's management, or are subject to recovery through other existing ratemaking mechanisms. We will approve these proposed exclusions.

4. "Z" Factors

We agree with SoCal that events which qualify as Z factors should be handled outside of the PBR mechanism. We also agree that the adopted procedure must insure that there is no double-counting of Z factor events in the inflation index.

We will adopt the following procedure proposed by SoCal to handle Z factors under PBR.

When a potential Z factor event occurs, SoCal will promptly advise the Commission of its occurrence and establish a memorandum account for the event. The notification of the event will provide all relevant information about the event, such as a description, the amount involved, and the timing, and will advise of the establishment of the memorandum account. This notification will be followed by a supplement to the annual rate adjustment procedure for Commission review.

For each event, SoCal's shareholders will absorb the first $5 million per event of otherwise compensable Z factor adjustments. This will be accomplished through the operation of a "deductible." The deductible is cumulative for each Z factor event from year to year, and is exhausted when the cumulative Z factor costs exceed the deductible amount. The deductible is separately applicable to each Z factor event.

To implement the adjustment, we adopt SoCal's proposal for use of a formula based on the level of integration with the GUPI to avoid double-counting the Z factor event in the inflation index. This formula is based upon the extent to which the Z factor impact is captured in the GUPI, and excludes that amount. SoCal will have the burden of proof in a Z factor proceeding to demonstrate both the total cost of the Z factor event, and the percentage of such cost estimated to be captured within the GUPI.

ORA initially recommended that CEMA become a Z factor. However, ORA and SoCal have agreed to recommend that CEMA be treated a an exclusion rather than a Z factor. As part of the agreement SoCal will maintain commercial insurance for earthquake and other disaster coverage unless major adverse changes to premium levels occur in the future. We will adopt the agreement between ORA and SoCal.

5. Core Pricing Flexibility

SoCal has proposed that it be given the flexibility to offer optional tariffed rates and to negotiate discounted rates with core customers. Any discounts would be applied to the base rate portion of the default PBR rate (i.e., gas costs would not be discounted). With its proposed elimination of the CFCA, SoCal's shareholders would be at risk for any discounts provided to customers. SoCal proposes that optional tariffs and discounted rates be priced no lower than short-run marginal cost and go into effect on the date of filing.

ORA supports SoCal's request to be able to offer discounted rates provided that shareholders bear 100% of the risk associated with revenue shortfalls and that the price floor for contracts is long-run marginal cost. ORA also supports the concept of optional tariffs for the core but opposes authorizing them at this time, because SoCal has provided insufficient information. Therefore, ORA recommends that SoCal either submit an application that would allow for consideration of specific optional tariffs, as occurred for SCE, or to approve optional tariffs on a case by case basis.

Allowing for negotiated rates and optional tariffs will provide SoCal with opportunities to increase utilization of its system, which benefits ratepayers. Under our adopted sharing mechanism, incremental revenues translate into benefits for both ratepayers and shareholders, providing SoCal with the incentive to more efficiently operate the system. Therefore, allowing SoCal to enter into negotiated contracts and offer optional tariffs is consistent with our PBR goals.

We would prefer to authorize optional tariff offerings with more details than SoCal has provided in its application. However, because shareholders will be entirely at risk for the revenue shortfalls, we will allow SoCal to negotiate discounts and offer optional tariffs, provided that the price floor is above class average long-run marginal cost (LRMC) and allow the tariffs to be effective upon 20 days after filing unless protested on the basis that the price floor is below class average LRMC.[23] If protested, the optional tariff filing will proceed through the normal advice letter

[23] Nothing in this decision is intended to prevent parties from protesting such filings on any other basis, as well.

process. The optional tariffs must be available to all similarly situated customers that meet the eligibility criteria. If SoCal wishes to offer rates that are customer specific or targeted at some subset of a class and therefore below the class average LRMC, then additional information must be submitted, consistent with information required for long-term contracts under the Expedited Application Docket (EAD), and the contract or tariffs will be subject to Commission approval through the EAD process. Contracts with terms of five years or longer must be approved by the Commission. Consistent with allowing SoCal to offer core customers discounts, we will also allow SoCal to offer firm noncore customers negotiated discounts of less than five years' duration. Negotiated contracts must be filed with the Commission, but the confidentiality provisions in place for noncore contracts will also apply for core contracts.

Electric utilities who retain the Electric Revenue Adjustment Mechanism (ERAM) and offer discounted rates for which shareholders are at risk must currently include an adjustment to ERAM to ensure that ratepayers are not at risk for any revenue shortfall associated with discounted rates. Because we have retained the CFCA, we direct SoCal to develop an adjustment mechanism to the CFCA to ensure that ratepayers are isolated from any risk of revenue shortfall associated with discounted core rates or optional tariff offerings.

6. Implementation Date

The rates based upon our adopted base margin shall become effective July 1, 1997. We recognize that changing objectives as a result of implementing PBR mid-year may create implementation problems and therefore the PBR mechanism shall become effective as of January 1, 1998, unless SoCal elects to operate under the mechanism effective as of January 1, 1997.

7. "Offramp" Provisions

SoCal proposes that the Commission not terminate or modify the PBR mechanism before its minimum term, even if SoCal's recorded rate of return falls below or rises above any particular level during that period, and proposes to take full risk for the level of its earnings under PBR for at least the proposed minimum duration of the PBR mechanism. For the protection of both SoCal and its ratepayers, we conclude that this should not be the case.

a) *Cost of Capital Trigger*

Although SoCal proposes not to make any changes in PBR indexed rates for changes in cost of capital, it proposes an exception in the event that the 12-month trailing average yield on long-term Treasury Bond increases or decreases more than 250 basis points from the forecast average rate for calendar year 1997, as adopted in D.96-11-060 in SoCal's 1997 cost of capital application. Thus, SoCal acknowledges the need for an escape valve, or offramp of sorts, in the event of a dramatic change in the cost of capital.

Under the proposed mechanism, SoCal would have the option to file a cost of capital application in the event that the 250 basis point "trigger" were exceeded. In the event of a 250 basis point decrease, SoCal would be required to file a cost of capital application. In either event, the Commission would determine whether any change in rates was appropriate in light of all factors affecting the cost of capital. Any rate change, whether an increase or decrease, would be prospective from the effective date of a Commission decision.

ORA generally supports the trigger mechanism concept, but proposes a somewhat different approach to cost of capital. The principal differences between SoCal's proposal and ORA's proposal are that: (1) ORA's mechanism would not be triggered unless actual interest rates changed by more than 150 basis points <u>and</u> the then-current DRI forecast was for interest rates to continue to be at least 150 basis points different from the benchmark interest rate under PBR; and (2) if ORA's threshold were triggered, there would be an automatic adjustment of rates according to a pre-established formula. SCUPP/IID also supports the basic concept of using a triggering mechanism with a single-index PBR, and prefers ORA's proposal over SoCal's.

We prefer ORA's approach over that proposed by SoCal for two reasons. First, that approach is more sensitive to a realistic level of interest-rate savings. Secondly, it is a system which will not involve as great a level of regulatory burden on the Commission, because a cost of capital application would not have to be filed when the trigger level was reached.

We adopt for SoCal the ORA triggering mechanism for changes in cost of capital during the PBR period, coupled with the "MICAM" mechanism for rate adjustment that we recently adopted for SDG&E in D.96-06-055.

b) Rate of Return Offramp

SoCal opposes any offramp which would have the effect of allowing or requiring suspension or modification of the PBR mechanism before the expiration of the five-year minimum term in the event that SoCal earns a specified amount more or less than the benchmark rate of return. SoCal argues that this would result in dilution of the penalties for poor performance and rewards for superior performance, and tend to defeat or impair the incentive provided by the mechanism for the utility to operate efficiently.

As part of its proposal for a sharing mechanism, ORA advocates an offramp mechanism to protect both ratepayers and SoCal from significant deviations from anticipated earnings under this new and untested PBR system. For upside deviation, ORA proposes an offramp trigger set at 300 basis points above authorized earnings for two consecutive years. For downside deviation, ORA proposes an offramp at 175 basis points below authorized earnings for two consecutive years. This proposal conforms well to the sharing mechanism we adopt and is very similar to the approach we have taken with SDG&E. We also prefer an offramp "trigger" device to the adoption of an interim PBR with a shorter duration, which is the approach espoused by TURN.

We will adopt ORA's rate of return offramp proposal. The PBR mechanism will be subject to a motion for voluntary suspension if SoCal reports two consecutive years of net operating income that is at least 175 basis points below its authorized rate of return. Either SoCal or ORA may file this motion seeking suspension of the PBR mechanism. If the motion is granted, suspension of the PBR would be required. If SoCal reports return of 300 or more basis points above its authorized rate of return for two consecutive years, the PBR mechanism will automatically be suspended, and we will conduct a formal regulatory review to determine what, if any, changes in the ratemaking mechanism are required.

c) Mid-course Review

Although SoCal opposes any regulatory change to the PBR system prior to expiration of the 5-year minimum term (except for the cost of capital trigger), the experimental nature of the PBR and SoCal's own unique circumstances compel us to conclude that there is a need for reexamination of the program before five years elapse.

First, according to the Global Settlement, the expiration of that agreement on July 31, 1999, will alter SoCal's ratemaking environment and require the institution of a BCAP. As SoCal's witness Van Lierop acknowledges,

> "The Global Settlement requires that [SoCal] file a BCAP application in October of 1998 with rates to become effective on August 1, 1999. The key purpose of this BCAP filing is to terminate the provision in the Global Settlement that rates and cost allocation be based on 1991 throughput. . . . [SoCal] proposes that "shadow rates" - adopted in this proceeding - go into effect as actual base rates on August 1, 1999, which will terminate the 1991 throughput provision with respect to base rates. The 1998 BCAP filing is still required to replace 1991 throughput, with a forecasted throughput level for the purpose of determining exclusions surcharges. [SoCal] proposes that the 1998 BCAP be used to adopt surcharges and cost-of-gas rates for the remainder of the PBR period, i.e., from August 1, 1999 to December 31, 2001." (Exh. 11, pp. 69-70.)

This in itself establishes the need for a mid-course proceeding, currently anticipated to be in the form of the 1998 BCAP, to revisit certain of the issues in this PBR.

Notwithstanding explicit language to the contrary in the Global Settlement, SoCal's PBR proposal is premised upon retaining the inter-class cost allocation based on 1991 throughput for the entire PBR period, which extends well beyond the August 1, 1999, expiration of the Global Settlement. TURN's witness Florio testified that this would be particularly harmful to core customers, because the effect of the SoCal proposal would be to reduce the average year forecast of throughput by 5%, while at the same time denying core ratepayers the benefit of the lower throughput forecast for purposes of cost allocation. (Ex. 55, pp. 16-17.) Consistency must be assured through the 1998 BCAP or its equivalent.

TURN asserts that there is another reason why cost allocation issues must be resolved in the 1998 BCAP. In the current (1996) BCAP, ORA, and TURN have proposed certain refinements to the Commission's LRMC methodology which SoCal claims to exceed permissible cost allocation changes as defined by Section C.5 of the Global Settlement's Implementation Appendix. In the current BCAP we may conclude that these changes must await the expiration of the Global Settlement. However, SoCal's PBR proposal would preclude the allocation of base margin among customer classes from consideration in the 1998 BCAP, because the rates set in this proceeding (as indexed) will remain in force beyond the Global Settlement's expiration. Consequently, ORA and TURN would be foreclosed from proposing adjustments to the LRMC methodology well beyond the expiration of the Global Settlement unless there is a mid-course review.

The merger application of Enova Corporation and Pacific Enterprises, which is currently pending before us, also portends significant changes in SoCal's ratemaking environment. Approval of the merger application could result, for example, in alteration of the base margin, particularly if there are significant productivity gains due to what SoCal has characterized as "synergies" such as the consolidation of administrative and general office functions of the merged parent companies. Although we have declined to examine the financial implications of the pending merger application in this proceeding, we cannot turn a blind eye to the probability that the merger may have considerable impact on SoCal, requiring some adjustment of the PBR.

We have also identified a number of features of SoCal's PBR proposal which are simply not appropriate for inclusion. Among these features are changes in residential rate design, additional pricing flexibility, and gain on sale. To the extent that these items were not addressed in SoCal's current BCAP, they should be addressed in the next BCAP (or its successor proceeding).

Finally, SoCal, ORA, and TURN have agreed to recommend that a mid-course review be undertaken to examine the status of customer service quality indicators, including the penetration of the CARE program. The 1998 BCAP (or its successor) could be utilized as a vehicle for conducting this review.

In recognition of these circumstances, we conclude that there is a need for a mid-course evaluation of SoCal's PBR, and that SoCal's 1998 BCAP (or its successor) should serve as the forum for that effort. In that proceeding, we will address the issues of SoCal's throughput forecast, cost allocation, rate design, and other matters which may come to light from the interim results of SoCal's PBR experience.

d) Termination

Under SoCal's proposal, the PBR would remain in effect at least five years from its inception. Based upon this minimum term, SoCal proposes that any party, or the Commission on its own motion, could institute a proceeding to change or replace the PBR mechanism upon its expiration. ORA and SCUPP/IID object to the automatic continuation of SoCal's PBR. ORA proposes that the PBR be formally evaluated near the conclusion of the five-year PBR term to provide the Commission with a complete evaluation of the PBR mechanism.

ORA proposes that SoCal be required to notify the Commission and all parties of record of its intention to file either a general rate case application or a PBR application 24 months prior to the end of the PBR cycle. If SoCal indicates that it plans to file a general rate case application rather than a PBR application, ORA will submit its master data request to SoCal within one month after SoCal notifies the Commission. Thereafter, the procedural schedule would follow the rate case plan in accordance with R.87-11-012. Alternatively, ORA proposes that if SoCal notifies the Commission that it desires to continue with a PBR program, SoCal should be required to file a PBR application no less than 18 months prior to the end of the PBR cycle. In its filing, SoCal should provide both an evaluation of its existing PBR program and a recommendation as to what modifications should be made to the PBR mechanism for the future.

ORA witness Bower specifies the issues that, at a minimum, should be addressed in its filing requesting continuation of PBR. These are:

- Was SoCal successful in meeting or beating the adopted benchmarks?

- What happened to system average rates over the period of the PBR? How did this compare to the average national rate and to the overall rate of inflation?

- If SoCal was successful, how were the reductions accomplished? What types of expenses were reduced? Were there any side effects of the expense reduction?

- What was the operating environment of SoCal over the PBR period? Were there developments that either made it easier or more difficult to achieve the established goals? If so, what were those developments?

- Did the Commission and SoCal work together effectively in the process of monitoring and evaluating the PBR? If not, what parts of the monitoring and evaluation process did not work?

- Did the Commission and SoCal work together effectively in the event of any interim modifications to the PBR? If not, how could this process have been improved?

- Did the PBR demonstrate a more or less efficient method of regulation than the conventional general rate case method? What specific features of the PBR were either better or worse?

- Were the specific performance indicators in this PBR adequate to measure the effectiveness of the PBR? If not, how should the performance indicators be modified?

- Was SoCal successful in maintaining a stable credit rating over the term of the PBR? What other financial measures should be examined? What was SoCal's annual ROE and ROR performance over the PBR, and how did that compare to the company's authorized numbers? How did this performance compare to SoCal's historical record for periods prior to the PBR?

- What other consequences of the PBR were identified, if any? What was the impact of those consequences on the PBR? What was the impact of those consequences on SoCal, its ratepayers, the environment, and others? Were the consequences positive or negative?

- Considering the results of the PBR, what should be the next steps? Should the PBR be continued? If so, what "start up" conditions should prevail? Should those alternatives include a return to the general rate case or attrition process? (Exh. 107, pp. 16-18 - 16-19.)

ORA's proposal is well considered. Although we have no disinclination to continue SoCal's PBR beyond the five-year minimum, there is a need to insure that the system does not continue indefinitely without being subjected to one scrutiny, and to insure that it is meeting its intended goals and furthering our regulatory policy. The procedure for continuing the PBR outlined by ORA is far less onerous than the requirements for filing a GRC, and is appropriate for evaluation of a program that has been in force for five years, as contrasted with the three-year life of a GRC.

We will adopt ORA's proposal.

8. Service Quality, Customer Satisfaction, and Safety Incentives

By its nature, customer satisfaction is difficult to measure and to quantify. SoCal's original proposal to measure ongoing customer satisfaction by using an index figure generated considerable controversy, resulting in a great deal of discussion among the parties during the course of the hearing. The outcome of these negotiations was a joint position on behalf of SoCal, ORA, and TURN, which is set forth in Exh. 210. That exhibit provides a comprehensive joint recommendation for measures to ensure that customer satisfaction, service quality, and employee safety performance will be maintained in SoCal's PBR environment.

The four primary features of this comprehensive plan are:

- Individual targets would be established for each of the four key service attributes, with each service attribute carrying a potential rate reduction should the performance level for that attribute fall below its prescribed target and deadband. These four key service attributes are:

  (1) Customer satisfaction with the telephone customer service representative (CSR);

  (2) Customer satisfaction with the scheduling of an appointment for a field service call;

  (3) Satisfaction with the field Appliance Service Representative (ASR); and

  (4) Percentage of on-time arrival for the service call;

- An additional call center "prescriptive" performance standard would require 80% of all telephone calls to be answered within 60 seconds for regular calls, and 90% of all leak and emergency telephone calls to be answered within 20 seconds. SoCal would be subject to rate reduction for failure to meet these targets.

- In addition to rate incentives, SoCal would assume responsibility to provide reports to the Commission, on a quarterly basis, containing monthly data on several service quality indicators, as follows: level of telephone busy signals, percentage of estimated meter readings, leak response time, percentage of missed appointments, and percentage of customer problems resolved on the first service call.

- The Commission will undertake a mid-course review of the status of the customer service quality indicators.

The program specifies penalties for failure to attain goals below a deadband. Aggregate penalties of more than $4 million will trigger an investigation by the Commission.

SCE objects that the service program does not provide for rewards for attaining levels above the goals. This overlooks the purpose of our quality control efforts, which is to ensure that standards of service are upheld at least at current levels despite the adoption of PBR, and particularly that cost cutting will not result in the degradation of service and safety. We are concerned that if we provide rewards for the attainment of higher levels, we will encourage efforts to overdeliver service, thereby increasing the cost to provide service. The cost of the rewards would be passed along to customers through higher rates. This would be contrary to our purpose in adopting PBR. We have already described the terms to which SoCal, ORA, and TURN have agreed relative to attainment of the employee safety standard. As contrasted with the customer satisfaction provisions, this part of the agreement provides for both rewards and penalties.

The program agreed to by SoCal, ORA, and TURN is a rational and systematic approach to insuring the maintenance of service quality, customer satisfaction, and safety. We adopt that program as part of our order.[24] We also adopt the parties' recommendation to conduct a midterm review of the operation of these features. As stated above, we have selected the 1998 BCAP (or its successor) as the vehicle for conducting this review.

9. Additional Customer Service Issues

SoCal states that there are two additional unresolved issues which pertain to the customer satisfaction measure. First, in the event that SoCal is authorized to implement a late payment charge with respect to its core customers, TURN proposes additional service quality measures, with potential monetary penalties, pertaining to the mailing of customer bills and the posting of customer payments. Second, SCUPP/IID seeks to increase the amount of the SIC, which SoCal offered to its noncore customers as part of the Capacity Brokering Settlement in 1991. SoCal opposes both of these measures.

SoCal's proposal to impose a late payment charge on overdue balances for both core and noncore customers bears no immediate relationship to its

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[24] The portion of Exh. 210 which sets forth that program is included in our Order as Appendix A.

proposal to move to a PBR system of ratemaking. Accordingly, TURN's responsive proposal to impose standards on the date of bill mailing and payment posting, and penalties in the event that those standards are not met, is equally immaterial for this PBR. There is no logical nexus between the economic incentives under PBR, or the related provisions to insure service quality, and this controversy over administrative processing of bills. We therefore decline the request for additional service incentives relating to billing and payment, and defer the matter of instituting a late payment charge to a more appropriate Commission proceeding.

SCUPP/IID's request for an increase in the SIC is apparently intended to protect noncore customers from service interruptions caused by deferral of maintenance, replacements, and expansion of facilities. The SIC was originally negotiated as part of the 1991 Capacity Brokering Settlement, which was approved by the Commission in D.91-11-025, 41 CPUC2d 668 (1991). Specific provisions which apply to SoCal in that settlement allow SoCal to offer a performance guarantee in its tariffs by providing the customer with a credit equal to $2.50/dth of gas for curtailment episodes, with a maximum credit of $5 million in any calendar year. SCUPP/IID proposes that we make this penalty mandatory, adopt a higher $10 million initial penalty, and increase the penalty ceiling every time the maximum penalty is triggered.

We perceive no reason to adopt this measure as part of the quality assurance measures for SoCal's PBR. SoCal states that there have been no curtailments of intrastate transmission service since the SIC was implemented, and SCUPP/IID has not demonstrated any change in circumstances which would justify an increase in SoCal's penalty exposure. Moreover, for noncore business, SoCal faces significant competitive threats in the form of interstate pipeline bypass, alternate fuel consumption, and cheap imported electricity. Thus market forces, rather than penalties, will provide the impetus for service quality assurance for noncore customers.

10. Monitoring and Evaluation

Because PBR is intended as a means to reduce the need for periodic reexamination of a utility's financial results through the GRC process, its success depends upon an effective program of monitoring and evaluation. In order to discharge our responsibility, we must be in a position to understand and evaluate the performance of SoCal's PBR during interim periods between formal proceedings.

SoCal proposes to file a detailed annual advice letter to implement the annual PBR rate adjustment and report on the customer service performance measures, including any rate adjustment associated with customer service measures. This annual advice letter would be comprehensive in that it would include all elements of the PBR indexing and adjustment mechanisms, i.e., inflation, productivity, Z factors, and customer service refunds, if any. SoCal proposes to file this annual advice letter on October 1 to allow sufficient time for review and approval so that the rates can become effective January 1, and to furnish supporting documentation and workpapers to the appropriate staff divisions on October 1.

Apart from this advice letter filing, SoCal's proposal for monitoring and evaluation consists principally of recommendations for the discontinuation of many current reporting requirements in the interest of streamlining the regulatory process. SoCal proposes to eliminate or modify approximately ten reports. (See Exh. 107, Table 16-1.) Four of these reports are required by Commission General Orders and apply to all energy utilities.

ORA in its comments states that a procedural mechanism is needed so that SoCal can report its earnings annually. ORA does not object to the annual October 1 filing proposed by SoCal, but proposes that an additional annual filing be made to review the performance of the PBR during the previous calendar year. ORA notes that both telephone and energy utilities which currently operate under adopted PBR mechanisms are required to make annual filings to report on the performance of the PBR during the previous year. Telephone utilities are required to file sharable earnings advice letters evaluating the prior year's operating results no later than April 1 of each year. (D.89-10-031, Ordering Paragraph 16.) SDG&E must file a draft of its performance report by April 15, and a final version of the report by May 15. (D.94-08-023, p. 80.) SDG&E's filing includes a review not only of any sharable earnings, but also reviews the reliability, safety, customer satisfaction, and price performance components of the SDG&E PBR. SCE is required to file an annual performance report similar to the SDG&E report by March 31 of each year. (Advice Letter 1191-E, as adopted by Resolution E-3478.) ORA also requests an extended time period for the review of the performance report to allow parties more time than the usual amount for advice letter protests. ORA suggests the following schedule:

April 1 - SoCal provides a draft sharable earnings advice letter to appropriate Commission staff, which includes workpapers detailing operating results for SoCal's base rates.

July 1 - Commission staff can submit a report on its audit or analysis of SoCal's draft sharable earnings results.

July 10 - SoCal files its final performance advice letter, with supporting workpapers.

July 31 - Protests in accordance with General Order 96-A can be filed.

ORA, SCUPP/IID, and SCE object to the modification or elimination of existing reporting requirements. As ORA witness Bower states:

> "If the Commission is to successfully implement a monitoring and evaluation plan, it must continue to receive these reports. These reports will be essential tools in evaluating SoCal's performance under the PBR mechanism. The Commission will have the opportunity to evaluate the usefulness of these reports in a PBR environment and determine whether the reports should be modified, eliminated, or expanded. Some reports may prove to be essential while others may prove to be unnecessary. DRA [now ORA] recommends that SoCal continue to provide nine of the ten reports it proposes to eliminate." (Exh. 107, pp. 10-11.)

We acknowledge that reduction of regulatory paperwork in the interest of improving efficiency is certainly a worthy goal. It is not, however, an integral part of PBR. We would like to reduce the volume of reports for all utilities, not just SoCal. Particularly for those which are required by a Commission general order, a generic proceeding would be required in order to change the requirement. We cannot discriminate in favor of SoCal by eliminating reporting requirements in this proceeding merely because it would reduce SoCal's regulatory burden. The proposal to do so bears no direct relationship to the institution of a PBR system.

We will adopt SoCal's proposal for an annual PBR advice letter filing but deny its request to modify or eliminate any current reporting requirement in the interest of maintaining our ability to monitor and evaluate SoCal's performance under PBR for the present.[25] The existing reporting requirements, plus SoCal's annual PBR advice letter filing, will enable the Commission to monitor and evaluate SoCal's PBR program, and should remain in place until changed through mid-course review or other proceeding, as appropriate. We will also require an annual PBR performance report similar in scope to the SDG&E annual performance report, and will adopt ORA's suggested schedule for review of the filing. The filing should not only review the PBR performance including a report of any sharable earnings, but should also report on the service quality, customer satisfaction, and safety incentives which we have adopted. Finally, any party who wishes to receive a copy of the draft filing to be made on April 1 should make such a request to SoCal, and such requests should be honored by the Company.

D. New Products and Services

As we summarized earlier in this decision, SoCal seeks the ability to offer new products and services, either itself or through an affiliate, without prior Commission approval. It also asks us to agree that the Commission not regulate the prices, terms, and conditions for new products and services; that the profits or losses from new products and services flow entirely to shareholders; and that existing products and services that are offered on an unbundled basis in the future be treated in

[25] Other requirements, such as that which obligates SoCal to obtain our express permission before closing any branch offices, are also unaffected by this decision. (See D.92-08-038, 15 CPUC2d 301 (1992).)

the same manner as new utility-related products and services. SoCal's proposal is opposed by ORA, SCE, TURN, and others, on a number of grounds.

On December 9, 1996, Enron Capital and Trade Resources, New Energy Ventures, Inc., the School Project for Utility Rate Reduction, and the Regional Energy Management Coalition, TURN, UCAN, and XENERGY, Inc. (collectively, Petitioners) filed a petition which, for procedural reasons, was accepted as a motion in the electric restructuring docket. In their motion, the Petitioners requested the Commission to issue an order instituting a rulemaking to establish standards of conduct governing relationships between natural gas local distribution companies (like SoCal) and electric utilities and their affiliated, unregulated marketing entities. The Petitioners also requested that the utilities be required to have their nonregulated activities conducted by their affiliate companies, rather than the utility itself, subject to the affiliate standards. The Petitioners stated that the utility providing services within a monopoly structure should be required to limit its actions to those services, so that equal treatment among competitors can be ensured. It was pointed out in response to the motion that the Petitioners' motion was opposed to the proposal offered here by SoCal. In the rulemaking drafted for the Commission's consideration, staff recommended that this aspect of SoCal's proposal be consolidated with the rulemaking to assure that SoCal and its affiliates would not be placed at an unfair advantage *vis a vis* the other California energy utilities and their affiliates.

In the rulemaking and investigation docket (OIR) opened April 9, 1997, in response to the motion, we provided instead "...that our decision in the PBR docket on flexibility in introducing new products and services may be interim." (R.97-04-011, I.97-04-012.) We also stated that "[e]ntry by the energy utilities and their affiliates into the unregulated market for energy products and services should be on an equal footing with respect to regulatory posture." (Id.)

Although the OIR explicitly preserved the opportunity in this proceeding to adopt an interim order with respect to SoCal's proposal for flexibility in introducing new products and services, we decline to do so at this time. Now that we have carefully reviewed SoCal's proposal and the opposing pleadings, we believe it would be premature, at best, to allow SoCal to offer new products and services in competitive markets on an unregulated basis while requiring SoCal's competitors, the remaining energy utilities, to participate in the rulemaking and investigation before allowing them to offer the same services into the same markets on an unregulated, untariffed basis.

SoCal may choose to make the same proposal, or to modify it, in our affiliates rulemaking and investigation. A number of questions arise from this proposal that may need further consideration.

First, SoCal has not clearly specified the types of products or services which it seeks authority to offer on an unregulated basis. During the course of this proceeding, SCE and Enron each raised legitimate concerns about the types of services that SoCal would seek to offer on an unregulated basis, particularly concerning the unbundling of traditional services. In response, SoCal states that with respect to the service unbundling of concern to Enron and SCE, SoCal "expects" to file separate regulatory and ratemaking applications. This pledge leads to two further questions: (1) If SoCal will not be offering on an unregulated basis the services and products which are of concern to SCE and Enron, what products and services will it seek to offer? and (2) Is SoCal's "expectation" that it will seek further authority before unbundling any traditional services, a binding pledge not to do so, pending further regulatory approval?

Second, SoCal has not offered explicit criteria to define the relevant markets into which SoCal seeks entry on an unregulated basis. What criteria and process should the Commission utilize in determining the relevant market, the degree of competition or the extent of SoCal's market power? For example, SoCal has asked that it be able to unbundle existing elective after meter services (such as pilot lighting or appliance inspection) and offer these services on an unregulated basis "where there is no market power." (Exh. 144, p. 2.) However, SoCal has not explained how to determine, or who will determine, that SoCal has no market power with respect to a particular product or service.

One particular aspect of SoCal's proposal which is of concern to us is SoCal's assertion that it is considering offering new products and services in "either competitive markets which already exist...or are ripe for competition." (Exh. 7, p. 27.) As SCE observes, "Plainly, the fact that SoCalGas believes a market is 'ripe for competition' is a far cry from finding that a market is, in fact competitive...Under this proposal SoCalGas could conceivably unbundle a regulated monopoly bundled service into several unregulated monopoly unbundled services and then charge monopoly prices for them." (Exh. 50, pp. 17-18.) This issue needs further review.

We also note SoCal's argument that the Commission should presume that if SoCal does not currently offer a service, it cannot have market power with respect to it, and it is therefore a competitive service. By the very nature of SoCal's monopoly position in the energy and energy services market, its access to comprehensive customer records, its access to an established billing system, and its "name brand" recognition, it may be that SoCal enjoys significant market power with respect to any new product or service in the energy field.

Third, SoCal has not proposed what regulatory tools would be used to prevent cross-subsidization between the services SoCal would continue to provide on a monopoly basis and those it would provide as competitive services. In its rebuttal testimony to ORA, SoCal argues that the opportunity for a utility to cross-subsidize the launch of competitive services would be virtually eliminated. (Exh. 119, p. 11.) SoCal's argument seems to rest on the premise that because its PBR proposal contains no sharing mechanism, all profits would accrue to shareholders, and management is consequently free to distribute all revenues which it derives from the monopoly enterprise in any manner it sees fit. Elsewhere in this decision we expressly require SoCal's PBR to contain a sharing mechanism. But even if the absence of a sharing mechanism, cross-subsidization cannot be permitted.

SoCal may renew its request along with its competing utilities, properly defined and detailed, in the newly instituted OIR. The level of detail which we would expect of a proposal to offer new products and services is equivalent to that which we set forth when we adopted the three categories of services for telecommunication products and accompanying accounting safeguards. (See D.89-10-031.)

While we are deferring consideration of SoCal's proposal regarding new products and services, we are not changing anything in this decision with regard to SoCal's ability to provide services currently offered or to apply to offer new products or services. SoCal currently offers certain services beyond the provision of natural gas. For example, SoCal currently provides meter repair services for SDG&E at its shop. This service, and others like it, may continue (subject to our jurisdiction). SoCal may also use the appropriate application or advice letter process to seek our approval to offer new products or services. We will consider any such filing in the normal course of review, and we will coordinate any such decision with our conduct of the proceeding on affiliate transactions, R.97-04-011 and I.97-04-012.

If SoCal expands its current service offerings and/or gains approval for new products or services, SoCal may be able to increase net revenues. We see this as a type of productivity improvement that would be consistent with the goals of PBR. Under the PBR we adopt in this order, returns above the target arising from either cost decreases or revenue increases will be shared between ratepayers and shareholders.

E. Base Margin

1. Introduction

SoCal now proposes that the base rates for 1997 be developed by applying the PBR index to a starting level of rates based upon SoCal's 1996 operating budget. After SoCal filed its supplemental showing in May 1996, its proposed base margin was $1,451,981,000, which represented a $61.2 million reduction in gas margin as compared to the 1995 authorized level. ORA's Base Margin Report (Exh. 106), with errata filed December 2, 1996, proposed a starting margin of $1,235,376,000. ORA's proposal excluded Demand-Side Management (DSM), Research, Demonstration & Development (RD&D), and Direct Assistance Program (DAP) expense from base margin, but even allowing for this, the gap between ORA's and SoCal's position was $170 million as the proceeding entered the evidentiary hearing stage.

As the hearing neared its conclusion, several of the parties filed joint testimony which recommended the resolution of eight base margin and two policy issues (Exhs. 200-210). This reduced the difference between ORA's and SoCal's position to $71.7 million. We must now consider the recommended resolution of these issues and resolve those issues as to which there is still no agreement.

As is our practice with general rate case orders, we address these items on an exception basis. We do not address accounts or funding requests which were not at some point excepted to, or those which do not require our attention in order to ensure that they comply with the law or Commission policy. In such instances we implicitly find the utility's proposal to be reasonable.

2. Nonlabor Escalation Rate

In developing their estimates of reasonable base rates for the various cost categories, parties used a base year and escalated or deflated it to correspond to the test year, depending on the base year applied. ORA proposes a nonlabor escalation rate of 2.23% for such purposes. SoCal proposed a rate of 3.72% but did not oppose ORA's recommended rate. SoCal recommends, however, that the Commission use the same value to deflate 1996 dollars as it uses to inflate 1995 dollars in order to make consistent the showings of ORA and SoCal. We adopt ORA's proposed inflation rate as reasonable as well as ORA's recommendation to use the 1995 numbers in the record.

3. Customer Accounts (Accounts 901, 902, 903, 904, Sub-Account 184.103)

For customer accounts generally, ORA, TURN, and SoCal ultimately agreed to a level of expenses for customer accounts. They jointly recommend a level of $111.77 million for accounts 901, 902, and 903 and sub-account 184.103. They also recommend a reduction of $0.3 million for account 904 to recognize a reduction in industrial uncollectibles. The parties' joint recommendation recognizes $7 million in estimated benefits derived from SoCal's implementation of its Customer Information System (CIS). It also provides that costs for the administration of the CARE program would be appropriate until and unless a party other than SoCal administers the program. We adopt these recommendations.

4. Late Payment Charges

SoCal proposes a late payment charge to be assessed on customers who do not pay their bills on time. The parties recommend different approaches with regard to the implementation of a late payment charge and the appropriate late payment charge rate. As we have already stated, however, the institution of a late payment charge bears no direct relationship to the PBR proposal, and therefore should not be a part of this proceeding. We decline to adopt that part of SoCal's proposal here.

5. Gas Storage, Transmission, and Distribution Expenses

SoCal, TURN, and ORA agreed to total expenses of $20.37 million for gas storage and $25.017 million for gas transmission. SoCal observes that the amounts are in 1995 dollars and must be adjusted to account for inflation. We adopt the stipulated amounts and adjust them consistent with SoCal's recommendation.

SoCal and ORA do not dispute the estimated expenses for gas distribution. ORA's estimate is somewhat lower than SoCal's as a result of its estimated escalation factor, which SoCal does not dispute, and which we have adopted. We therefore adopt gas distribution expenses of approximately $176 million, which is a reduction in these accounts of about $35.3 million from levels recorded for 1994.

6. Marketing Expenses

ORA, TURN, and SoCal resolved any differences that initially existed for expenses associated with DSM, other marketing expenses not related to demand side management ("non-DSM marketing"), and the DAP, which is designed to provide conservation measures to low-income customers. The parties recommend DSM costs of about $27 million be included in a one-way balancing account rather than as part of base rates. TURN and DGS support this proposal.

The stipulation between ORA and SoCal also recommends that other marketing costs be reduced from the existing level of $29.14 million to $24.136 million and that capital costs for the Energy Resource Center would remain in base rates. Consistent with the parties' recommendations, we adopt total base rate marketing expenses of $24.136 million.

Funding and administration for DAP was not fully resolved in the stipulation. SoCal proposes a reduction in direct assistance funding from $18 million to $12 million. SoCal observes that the program is not cost-effective and that it is having difficulty finding new DAP customers because of program saturation.

Natural Resources Reference Council (NRDC) proposes retaining the $18 million funding level, arguing that the cost-effectiveness of the program has always been marginal and that SoCal has not justified changing funding on this basis. NRDC also observes that only 33% of income eligible households have received DAP help, contrary to SoCal's view that the market has been saturated.

We adopt SoCal's reduced funding levels in recognition that fewer customers are available to take advantage of the program as a result of the program's success. We also grant SoCal's request for increased program flexibility which would permit it to put the weatherization component of the program out to bid, among other things. We do not adopt any flexibility which would change SoCal's discretion to use the funds for other programs.

7. Administrative and General Accounts

a) Consultant Fees (Account 920)

Account 920 includes funds for outside consultants. ORA recommends disallowing $94,000 for a consultant hired for this proceeding because the consultant's work appears speculative after the test year. SoCal replies that it requires the funding for monitoring and evaluation of its PBR mechanism. We reject SoCal's argument, which appears to presume regulatory activity will increase as a result of PBR regulation. We adopt ORA's adjustment to this account.

b) Executive Compensation (Account 920 and 921)

TURN recommends adjusting labor costs by $0.606 million to reflect what it believes to be excessive compensation to executives. TURN observes that ORA's compensation study finds executive compensation to be almost 13% above market even though ORA does not recommend any reduction in SoCal's labor cost request. TURN's adjustment would amount to about 0.19% of SoCal's total request for employee compensation.

SoCal argues that its executive compensation rates are comparable to those offered to individuals working in markets from which SoCal recruits. It does not, however, present any evidence to support its argument. We therefore adopt TURN's adjustment to executive compensation.

c) Outside Expenses

(1) Stock Options Expenses (Account 923)

SoCal offers high level employees stock options as part of their compensation plans. ORA recommends that the Commission disallow expenses associated with stock options for executives, which ORA believes raises SoCal's long-term incentive levels to 21% above market levels. ORA observes that SCE's and PG&E's stock options programs are funded entirely by shareholders, and that the incentives are rewards for financial accomplishments which do not benefit ratepayers.

SoCal responds that ORA has improperly isolated a single element of SoCal's total compensation package. SoCal observes that ORA does not dispute that total compensation at SoCal is not above market levels. Isolating stock options expenses would therefore reduce the package of total compensation further.

We concur with SoCal that as long as its total compensation levels are appropriate we will not dictate how SoCal distributes compensation among various types of employment benefits.

(2) Lobbying Expenses

Following some initial disagreement regarding appropriate lobbying expenses, SoCal and ORA resolved their differences, proposing to reduce SoCal's request by $0.4 million. We adopt their agreement.

(3) Affiliate Transactions

SoCal pays its parent company for some services pursuant to direct billings which reflect specific services. ORA recommends a disallowance of $1.924 million of such affiliate costs sought by SoCal following an audit of related expenses. ORA proposes the disallowance on the basis that SoCal had failed to provide any meaningful documentation of $4.02 million worth of services provided to it by its parent, Pacific Enterprises. It is especially concerned with the lack of documentation for $3.32 million of law department charges.

SoCal replies that ORA and its auditors are not the "arbiters of how much documentation is 'enough.'" It argues that the law department of Pacific Enterprises could be expected to spend most of its resources on SoCal's needs because SoCal is the largest of the Pacific Enterprise companies. Finally, the SoCal level of funding for legal expenses is an estimate of 1996 expenses, not an accounting of actual expenses for 1995.

SoCal has the burden to demonstrate the reasonableness of its requests. In this instance, SoCal failed to provide sufficient documentation to support its request. However, SoCal submitted *some* documentation, which is adequate and to justify some payment by ratepayers for the services of SoCal's parent company. We therefore adopt ORA's recommendation of disallowing approximately 50% of SoCal's request, and allowing the rest.

(4) Multifactor Allocation Formula (Account 920)

SoCal pays its parent company for some services on the basis of indirect allocations to SoCal in cases where direct billings for specific services are not practical. ORA opposes elements of the formula SoCal uses to allocate such costs. Specifically, ORA would weigh operating expenses and payroll more heavily than assets. Applying ORA's methodology to the relevant costs, ORA recommends a disallowance of $2.939 million less than SoCal requests.

ORA believes SoCal's allocation to new lines of business – less than two tenths of a percent – is unrealistic. It would increase the amount to 20%.

SoCal responds with various arguments, among which are that its formula is used by other utilities and other jurisdictions, and that its other business units are designed to assist in new product development for sister units

and are not independent of SoCal. SoCal also argues that its affiliates are considerably smaller than SoCal in terms of employees and assets.

The record suggests that the purpose of SoCal's affiliates is to promote new product development which is not related directly to utility expenses that would be recoverable here. If that were not the case, there would be scant reason to create such entities, considering the potential inefficiencies of having utility operations in two separate units. We are not concerned with how other jurisdictions view SoCal's allocation methods so much as we are inclined to consider the method on its merits. We find that ORA's method is superior to the one proposed by SoCal, and we adopt that method.

(5) Law Department Rent (Account 923)

SoCal receives its legal services from its parent company, Pacific Enterprises, which bills SoCal for related costs. ORA recommends an adjustment of $889,669 to reflect billings by Pacific Enterprises for rental of property to house the Legal Department. The billings are in excess of the actual costs of the Gas Company Tower lease. SoCal responds that the adjustment would be unfair because the rate is nearly identical to that paid at the Gas Company Tower. SoCal believes ORA should not be able to penalize the company for a lease cost that was reasonable at the time SoCal entered into it, even if prevailing market rates are considerably lower.

We have made adjustments to the Gas Company Tower lease to reflect unused space, and by implication the effects of the Law Department's remaining at another location. ORA has not demonstrated that the Law Department's lease is unreasonable. We therefore adopt SoCal's request for the costs of the Law Department's lease.

d) Insurance Expenses (Account 924)

ORA believes corporate reorganization will cause eight facilities no longer to be useful. Elimination of these facilities and the costs to insure them, according to ORA, will offset increases in insuring remaining facilities. ORA recommends a $16,000 reduction over SoCal's estimate.

SoCal responds that it is not anticipating a reduction in these costs in the near future. Although they might decrease at some point as a result of corporate restructuring, SoCal argues that it has not asked for recovery of cost increases which might occur at some unspecified point and should therefore not be required to forgo uncertain decreases.

We reject ORA's adjustment in this account on the basis that ORA has not demonstrated that SoCal will stop using the facilities in question during the test year.

e) Injuries and Damages (Account 925)

Account 925 includes funds for compensating employees for injuries and damages sustained at the workplace. ORA recommends a $1.9 million reduction in SoCal's estimate for Account 925 to recognize employee reductions and associated reduced costs for this account. SoCal argues ORA inappropriately reached its estimate by applying year end accruals of employee settlements in lawsuits rather than looking to actual cash payments to estimate these revenues.

Consistent with existing policy, we adopt SoCal's recommended level of funding in this account using actual cash payments as the basis for estimating net costs.

f) Franchise Fees (Account 927)

ORA and SoCal resolved most issues concerning franchise fees, arguing that this proceeding should not be a forum for changing the franchise fee methodology, and that estimates adopted in this proceeding would include $23.31 million in revenues from miscellaneous services. SoCal and ORA did not agree on the appropriate rate for franchise fees. We adopt SoCal's number, because ORA's is based on an assumption that the methodology would be changed. ORA stipulated to retain the methodology in deriving a level of revenues; we therefore apply SoCal's rate for consistency.

and are not independent of SoCal. SoCal also argues that its affiliates are considerably smaller than SoCal in terms of employees and assets.

The record suggests that the purpose of SoCal's affiliates is to promote new product development which is not related directly to utility expenses that would be recoverable here. If that were not the case, there would be scant reason to create such entities, considering the potential inefficiencies of having utility operations in two separate units. We are not concerned with how other jurisdictions view SoCal's allocation methods so much as we are inclined to consider the method on its merits. We find that ORA's method is superior to the one proposed by SoCal, and we adopt that method.

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We have made adjustments to the Gas Company Tower lease to reflect unused space, and by implication the effects of the Law Department's remaining at another location. ORA has not demonstrated that the Law Department's lease is unreasonable. We therefore adopt SoCal's request for the costs of the Law Department's lease.

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g) Regulatory Commission Expenses (Account 928)

Account 928 includes funds for the costs of participating in regulatory commission activities. ORA recommends about $26,000 less in this account than SoCal. ORA uses the 1994 level and adds inflation for 1996. SoCal adds certain expenses and 1995 inflation to the 1994 level.

We adopt ORA's adjustment to recognize the likelihood that regulatory Commission expenses should not be increasing in the foreseeable future.

h) Rents (Account 931)

(1) Gas Company Tower

ORA recommends a disallowance of $5.384 million to reflect unused space at the Gas Company Tower, SoCal's corporate headquarters. ORA's recommended disallowance is based on ORA's assertion that 131,063 square feet of the site's 550,000 square feet is vacant.

ORA's recommendation is based on the analysis of its auditor, Overland. In its audit, Overland found that about 25% of the rentable space at Gas Company Tower was vacant, assuming that 375 employees would be moved to the Gas Company Tower. Based on SoCal's records, Overland concludes that SoCal has conducted "continuing review" of excess real estate rather than dispose of it or use it for company operations. ORA rejects company promises to move more employees to the Gas Company Tower, because such promises have not been fulfilled in the past. Specifically, ORA refers to SoCal's stated intent to move its Law Department to the Gas Company Tower during SoCal's last general rate case, which the Commission relied upon in granting associated funds for the Gas Company Tower.

SoCal responds that it has developed plan to occupy 97% of the Gas Company Tower in 1997. It presents a timeline which it developed shortly prior to hearing in this proceeding. Its witness asserts that at the time of the hearing the Gas Company Tower was 89% occupied. SoCal argues that it would not make sense for it to have sublet the unused space at the Gas Company Tower in the depressed Los Angeles rental market. SoCal states it attempted to sublease Gas

Company Tower space but, at a market rental value of $13 to $15 a square foot, the revenue would have barely covered SoCal's building operations costs.

SoCal claims that the fact that the Law Department did not relocate to Gas Company Tower is irrelevant. SoCal states that the relocation was deferred because of the need to house displaced employees at the Gas Company Tower, and because of the "extraordinary" cost of relocating the Law Department library.

ORA responds that the Commission should give no weight to the move plan, because the moves have been previously found to be uneconomic or are for personnel from CIS who are to be terminated. ORA argues that SoCal's analysis of future use of the Gas Company Tower assumes the company requires 120 workstations for equipment that is appropriately located on employee desks and 273 spaces for contractors, though only 140 contractors were expected to work for the company after December 1996. ORA also observes that Overland's report is generous because it does not account for 153 employees who have left the company since the audit was completed.

SoCal leased the space under a 20-year contract beginning in 1991. We originally reviewed the costs of the Gas Company Tower lease in D.92-11-017. In that order, we disallowed a portion of the excess space at Gas Company Tower on the basis that SoCal had not demonstrated the reasonableness of the costs. Subsequently, we reinstated much of the disallowance in D.93-12-043.

We begin by rejecting SoCal's argument that ORA is improperly relitigating this matter. As SoCal itself observes, D.93-12-043 permitted a reconsideration of the findings of that order with a showing of changed circumstances. ORA is seeking to demonstrate changed circumstances which would justify additional disallowances.

Indeed, circumstances have changed since 1994. Occupancy in the Gas Company Tower, assuming SoCal's analysis is correct, was 85% in 1995 and less than 80% in 1996. SoCal's assertion that the Gas Company Tower was 89% occupied at the time of hearing was refuted by ORA's auditors after a physical inspection of the building in November 1996. SoCal has not argued with Overland's findings of that physical inspection. Additionally, SoCal has presented no evidence to demonstrate that market prices would not permit it to recover operational costs.

SoCal has presented nothing but a promise that the occupancy rate at Gas Company Tower will increase to 97% in 1997. We have relied on promises with regard to Gas Company Tower occupancy in the past. The result is that ratepayers have paid at least $4 million annually in 1995 and 1996 for space at Gas Company Tower which is vacant and therefore not "used and useful."

SoCal must assume some portion of the risk for the long term lease it signed for its corporate headquarters, just as all businesses must assume such risks. Rather than make the best use of the Gas Company Tower under changing circumstances, SoCal appears to have deferred company consolidation and rejected opportunities to mitigate its losses by subletting portions of the Gas Company Tower.

ORA and its auditors have presented a reasonable analysis of the Gas Company Tower occupancy which, as SoCal observes, gives "partial credit" for the utility's plan to occupy the Gas Company Tower. We therefore adopt ORA's position to disallow recovery for 131,063 square feet of vacant space at Gas Company Tower at a cost of $41.08 per square foot, for a total disallowance of $5.384 million.

(2) Other Lease Savings

ORA proposes to exclude $1.02 million in costs related to leases for six facilities. ORA states SoCal will not be using these facilities beginning in 1997. SoCal replies that ORA has improperly violated test year ratemaking policy by applying 1997 savings to 1996 costs.

We concur with SoCal's position. The test year is 1996. We therefore will not adjust rates for 1997 cost savings.

(3) Other Net Savings

ORA recommends adjusting base rates by $0.74 million to account for ongoing savings associated with SoCal's restructuring efforts. SoCal replies that the amounts, which were referenced in an internal memo, are mainly for the six facilities which it will no longer use beginning in 1997.

Consistent with our determination above for the six facilities, we decline to make this ORA adjustment.

i) Maintenance of General Plant (Account 935)

SoCal seeks $6.723 million for plant maintenance in Account 935, the same amount it recorded in 1995. ORA recommends a reduction for Account 935 that is $1.296 million less than SoCal's request. ORA's adjustments result from its removal of nonrecurring costs. ORA argues that the Commission's policy does not permit such costs in rates. SoCal responds that it has already removed the nonrecurring costs to which ORA objects, that is, the costs associated with real estate moves. We are persuaded that SoCal has removed nonrecurring costs from its estimate of expenses, and we therefore reject ORA's adjustment.

j) Employee Pension and Benefits (Account 926)

ORA originally proposed disallowances in pension and benefits funding of $44.39 million for certain costs related to pension and pension benefits, certain medical benefits and miscellaneous benefits. SoCal and ORA settled their disagreements in these areas. As a result, the total amounts for these expenses would be reduced from SoCal's original estimate of $110.267 million to $82.124 million. The parties also agree that if the pension trust contributions must exceed $12 million annually, SoCal may enter the additional funding requirement to a memorandum account and obtain recovery of the amounts in its subsequent PBR filing. We adopt the provisions of SoCal and ORA's agreement in this account.

k) PBOPs Overcollections During 1992-1995 (Account 926)

Account 926 includes funds for post-retirement benefits other than pensions (PBOPs). D.93-12-043 required SoCal to return to ratepayers PBOPs revenues collected in excess of amounts required for the account. ORA recommends a refund of $3.5 million to recognize this requirement. SoCal opposes the adjustment on the basis that ORA in its view has improperly adopted an account-specific method for calculating the amounts. The approach results in the use of a 21% escalation factor, rather than an 11% escalation factor which is a composite rate.

ORA's method appears consistent with the one we adopted in D.93-12-043, and its results are consistent with those presented by SoCal's actuary. It is appropriate to calculate the overcollection using account-specific information because the Commission ordered an account-specific refund. We adopt ORA's adjustment. ORA states in its comments that the decision should specify a mechanism for accomplishing the refund associated with PBOPs. ORA suggests crediting the CFCA and NSBA. We require SoCal to adjust the appropriate entries to the CFCA and NSBA.

l) Capitalization of Administrative and General Expenses

ORA recommends removing $7.245 million from Account 922 for costs which it believes should have been capitalized rather than expensed. ORA's auditors believe SoCal's proposal to capitalize only 2.5% is contrary to industry norms which are to capitalize more than 8% of administrative and general expenses. ORA proposes that expensing such a large portion of overheads creates intertemporal inequities between today's ratepayers and tomorrow's. SoCal responds that the Commission has historically expensed most utility overhead costs on the basis that future ratepayers should not be saddled with past costs.

We decline ORA's proposal to modify our ratemaking practice in this area at this time. We adopt SoCal's proposal to expense administrative and general costs rather than include them in rate base.

8. Clearing Accounts

a) Call Center Communication Expenses (Sub-Account 184.003)

The Call Center handles incoming calls from customers needing assistance. ORA recommends a reduction of $1.8 million for call center expenses on the basis that the average call length is four minutes rather than eight minutes, as SoCal estimates. ORA, TURN, and SoCal subsequently reached an agreement to reduce the funding level for call center expense from $4.06 million to $3.46 million. We adopt the stipulated figure.

b) Communications (Account 184.7)

ORA recommends a reduction of $124,000 for nonrecurring costs associated with past improvements to SoCal's microwave network. Removing this cost from communications expenses, ORA stipulated to an increase for this account of 23%. This is a substantial increase and provides a cushion for future unanticipated expenses. We adopt the ORA adjustment.

c) Calculation Errors

ORA identified several calculation errors in Account 163.0 and Account 184.3 amounting to $15,000. SoCal does not dispute ORA's associated adjustments. We will therefore adopt them.

9. Rate Base

a) Beginning Plant

Beginning plant refers to plant which is to be included in rate base at the start of the test year. Disputed amount are usually related to plant for which construction was completed prior to the beginning of the test period. SoCal seeks $5.574 billion in rate based plant. ORA recommends $5.528 billion, a difference of about $46 million. SCUPP/IID and California Manufacturer's Association/California Industrial Group (CMA/CIG) generally concur with ORA's recommendations in this area. The difference between ORA's and SoCal's estimates is attributable to the parties' respective recommendations regarding allocation of costs of new gas lines, office space and noncore customer information systems, addressed below.

(1) Lines 6902, 325, and 6900

In recent years, SoCal has constructed or upgraded certain gas lines. Based on its independent audit, ORA recommends that $29.028 million be excluded from rate base for new construction associated with Lines 6902, 325, and 6900. ORA argues these projects were built to serve incremental noncore load. ORA observes that the Global Settlement permitted SoCal to retain the profits from noncore load and to assume the risk for fluctuations in throughput. ORA believes that consistency and fairness demand that SoCal assume the costs and risks associated with new plant which will serve noncore load. ORA does not recommend that the plant be excluded from rate base permanently, but only as long as the ratemaking treatment in the Global Settlement is in effect.

ORA states that SoCal planning documents refer to Line 325 as necessary to serve a new hydrogen plant which is a noncore customer and recommends that 50% of the costs of the plant be included in rate base to reflect the benefits of the upgrade to core customers. ORA contends that Line 6900 should not be included in rate base in this case in any event because it was not scheduled for completion until after the test period in late 1996.

SoCal responds that the Global Settlement specified only that noncore load building (or marketing), but not capital costs, were to be assumed by SoCal. It points out that Line 6900 is part of an integrated network designed to serve growth in the core market. It also argues that ORA's audit overlooks the benefits of Line 6902, which was designed to serve core and noncore growth in the Imperial Valley. With regard to Line 325, SoCal observes that the area in which the line was constructed had been previously subject to problems because of low pressure, and the new line eliminated these problems.

D.94-04-088 states simply and clearly that all capital costs and expenses related to increasing noncore load, and therefore earnings under the settlement, must be accounted for below the line. Construction of gas lines to serve noncore load permits SoCal to recover additional noncore revenues. Therefore, associated construction costs should not be included in rate base.

SoCal has not convinced us that Lines 6900, 6902, and 325 were constructed to serve core needs. In each instance, the line appears to have been constructed for the primary purpose of serving the needs of noncore customers, and any benefits they may provide to the core are incidental. ORA has reflected those benefits in its recommended disallowances. In any event, SoCal may not include Line 6900 in 1995 rate base, because the project was not scheduled for completion until 1996. We therefore adopt ORA's recommendation to exclude costs for construction of Lines 6900, 6902, and 325 from rate base. We make associated adjustments in the Construction Work in Progress account for Line 6900.

(2) GasSelect Restructure Project

ORA recommends excluding from rate base $2.8 million spent on upgrades to SoCal's GasSelect Project. The project is an electronic bulletin board and information system designed to help customers with competitive services make decisions regarding their gas purchase and transportation options. SoCal responds that the GasSelect upgrade will benefit all customers and that it is not, as ORA seems to assume, a noncore load-building project.

SoCal's description of the GasSelect upgrades clarifies that the project is designed to permit "customers to nominate transportation and storage...view daily balance statements...and create customized reports to meet their business requirements." Core customers do not use or require such services or information. The project is therefore designed to serve noncore customers. D.93-12-043 disallowed associated project expenses on the bases that the GasSelect program offers "services that are available or potentially available from competitors...customers who receive these services should therefore pay for them so that SoCal does not have a competitive advantage." SoCal has not distinguished the GasSelect upgrades from the GasSelect project funding which we declined to include in rate base. Consistent with our previous order, we exclude these costs from rate base.

(3) Gas Energy Management Systems (GEMS)

The GEMS project provides automated meter reading and related facilities to noncore customers. ORA proposes excluding $2.7 million from rate base for costs associated with the GEMS project on the basis that competitive services to noncore customers should not be included in rate base. SoCal opposes the adjustment to rate base on the basis that the GEMS project improves day-to-day operations which benefit core customers.

The GEMS project is designed to serve noncore customers who have competitive options. To the extent improved monitoring and metering may benefit core customers, it appears that the activity would not be required but for the activities of noncore customers. SoCal has not demonstrated that core customers benefit from the facilities, except to the extent noncore customer activity might otherwise impose planning problems. In SoCal's last GRC order we rejected SoCal's request to include these costs in rate base and thereby impose them on core customers. The Global Settlement provided that facilities which may improve service to noncore customers or increase throughput are the responsibility of SoCal, not its general body of ratepayers. We adopt ORA's recommended adjustment to rate base.

(4) Torrance and Mountain View Headquarters

ORA recommends that the costs of the Torrance and Mountain View Headquarters facilities, about $23.4 million, be removed from rate base. ORA argues that the facilities are to be sold or leased and are therefore not used and useful. ORA would defer the issue of gain on sale until and unless the property is sold.

SoCal replies that ratepayers are not entitled to the gross cost savings associated with the retirements, but only the net savings. Otherwise, SoCal would not be able to recover prudent costs associated with the restructuring of its operations. SoCal also states Commission policy is to adjust rate base for gains and losses only after they are accrued.

During the test period, SoCal had not sold the Torrance and Mountain View Headquarters. Therefore, consistent with our policy to include those investments made at the time of review in rate base, we will not adjust rate base to reflect a future sale.

(5) Pacer Project

ORA has recommended an increase of $2.762 million for capitalization of the Pacer project based on the Overland audit. SoCal is asking for an increase of $3.708 million. The difference between ORA and SoCal's amounts is in the inclusion of 1995 costs.

ORA's request takes into account the implementation schedule of the project, thus allowing 100% of 1994 and 50% of 1995 costs. SoCal indicates that errors were made regarding certain 1994 and 1995 costs for the Pacer project, which were against SoCal's capitalization policy. SoCal notes that certain costs should have been capitalized rather than expensed. Accordingly, SoCal requests 100% of 1994 and 100% instead of 50% of 1995 amounts.

We agree with ORA's position regarding the project implementation schedule and ORA's treatment of certain costs after the project was placed in operation. We therefore allow 100% of 1994 and 50% of 1995 amounts.

(6) Overhead Capitalization

ORA recommends an increase of $8.9 million to rate base, based upon the Overland audit. SoCal has indicated that it acquiesces in ORA's position and the recommended adjustment for distribution of clearing accounts costs between capital and expense. Although SoCal concurs with Overland's recommendation, it believes its existing procedures are adequate and reasonable.

We do not find ORA's recommendation of capitalization of the overhead costs appropriate. Moreover, we do not find SoCal's concurrence with ORA persuasive for adopting this recommendation. We therefore reject ORA's and SoCal's recommendation regarding this issue.

b) Ventura/Ojai Project

In 1993, SoCal customer appliances were damaged by nitrous oxides in gas received from certain of SoCal's producers. SoCal sued the producers, and the suit settled in 1996. ORA proposes to offset rate base and depreciation with the settlement proceeds of $3 million, on the basis that they were effectively contributions in aid of construction. ORA also recommends that the associated legal expenses of $0.8 million be disallowed on the basis that they are nonrecurring costs. ORA argues that SoCal has been compensated for related costs, because its rate of return has exceeded authorized amounts during the period in question.

SoCal responds that the costs associated with the project were never in rates, and any proceeds associated with it should accordingly accrue to shareholders.

ORA's ratemaking theory is contrary to our usual policy. If SoCal has assumed the risk of the project, it is entitled to associated gains. The fact that SoCal's previous rate of return exceeded our expectations is not germane to our disposition of cost recovery going forward. We decline to adopt ORA's proposed rate base adjustment. We will, however, reduce SoCal's legal expenses by $0.8 million for the sake of consistency. Since SoCal's revenues are below the line, its rates should not be increased to permit it to recover associated expenses.

c) CIS Costs

ORA recommends three adjustments to CIS costs, all of which would reduce recovery of expenses and increase capital funding. SoCal concedes ORA's recommendation to increase rate base to reflect $719,000 in "conversion" costs associated with computer software. SoCal opposes ORA's recommendation to capitalize $1.45 million in computer training and hardware maintenance costs. We adopt ORA's proposal for these costs.

Except for these disputed items, ORA and SoCal reached agreement on the appropriate level of rate base for CIS of $62.385 million, with a twenty-year depreciable life. SCUPP/IID oppose the inclusion of 100% of CIS costs in rates since only 40% of CIS investment is included in the 1996 rate base. SCUPP/IID observe that the inclusion of all costs in 1996 rates under these circumstances is contrary to Commission policy.

We adopt SCUPP/IID's proposal to include only 40% of CIS costs in rate base for the test period, consistent with our policy to include only those investments which have been made at the time of review. If we were to find otherwise, we would have to reconsider our decision in other parts of this order which apply this policy in SoCal's favor.

d) Working Cash

Working cash is funding for the cost of money required for day-to-day operations, upon which the utility earns a rate of return. SoCal seeks $35.996 million in working cash. ORA recommends a reduction in revenue requirement for working cash of $33.021 million. Their specific disagreements are discussed below.

(1) Deferred Credits

Like many businesses, SoCal sets aside funds in anticipation of litigation and regulatory losses. SoCal has set aside $58 million for this purpose. ORA would exclude this sum from working cash, and thereby reduce rate base by the corresponding amount, because SoCal has not demonstrated that the amount is not cost-free capital.

SoCal refused to provide information to ORA and its auditors about the source or purpose of the funds on the basis that the information is privileged. SoCal also argues that the amounts are not relevant to this proceeding because they are not requested as part of base rates. ORA responds that the company's access to the capital affects the working cash calculation.

SoCal has provided evidence which adequately refutes ORA's claim that its reserves are cost-free. Therefore, we do not adopt ORA's adjustment to the working cash reserve.

(2) Vacation Accrual

Like employees of other companies, SoCal's employees accrue vacation time rather than using it as they receive it. ORA recommends reducing working cash by $18 million to reflect vacation accrual on the company's books. ORA states the vacation accrual represents cost-free capital. SoCal responds that it has not been reimbursed in rates for vacation accruals and that therefore the amounts are consequently not cost-free.

SoCal receives in rates all of the costs of doing business, including the costs of offering vacation time to its employees. To the extent that employees accrue vacation time rather than use it as it becomes available, SoCal has access to cost-free capital. This finding is consistent with our treatment of the same issue for PG&E. We adopt ORA's recommended adjustment for this item.

(3) Workers' Compensation Accrual

SoCal accrues workers' compensation funds which it pays out as needed for workers' compensation claims. ORA recommends an adjustment to working cash of $21 million to reflect workers' compensation accruals. It does so for the same reasons it adjusted working cash for vacation accruals. SoCal responds by stating that workers' compensation is not cost-free capital, and the amounts have not been funded by ratepayers. ORA observes that SoCal has in fact requested over $1 million in this proceeding for workers' compensation accruals.

For the same reasons we adopted ORA's adjustments for vacation accruals, we adopt ORA's adjustments for workers' compensation accruals.

(4) Customer Advances for Construction

ORA proposes disallowing $11.6 million from working cash for unbilled customer advances. SoCal makes these advances to developers who are constructing new projects requiring gas service. ORA makes its recommendation on the basis that SoCal has in recent years delayed its presentation of bills for customer advances for construction. ORA states the average time for such billings is required to be no later than six months, but that SoCal's average billing period is now twenty months. The average collection time period is 33 months. These delays represent mismanagement which increase working cash requirements, according to ORA. DGS and TURN concur with ORA's proposal.

SoCal replies that the $11.6 million does not represent cost-free capital and must therefore be included in working cash. SoCal states the delays in billing and collections are in many cases outside of its control.

The periods between project completion and SoCal's billings and final collection of amounts owed are excessive. SoCal's ratepayers should not be required to subsidize either the mismanagement of SoCal's billing and collection system or the delays in remitting of amounts owed by developers. In this proceeding, SoCal urges the Commission to adopt a late payment charge for its gas customers. A similar charge for late paying developers would reduce SoCal's liability for these payments and promote timely payment. The encouragement of such efficiency is at the heart of our PBR philosophy, and consistency compels us to adopt ORA's recommended adjustment to working cash.

ORA recommends an additional $0.899 million reduction associated with customer advances for construction. SoCal does not oppose the adjustment. We will adopt ORA's recommendation.

(5) Customer Deposits

Some of SoCal's customers provide security deposits to SoCal as a condition of service. TURN and DGS recommend using customer deposits to reduce working cash. They observe that SoCal has $29 million in such funds as of the end of 1995, which constitute a permanent source of capital. SoCal pays the commercial paper rate on these funds, about 800 basis points below its authorized rate of return. The difference accrues to SoCal.

SoCal responds that the matter has already been litigated in cost of capital proceedings and in Commission workshops. It proposes that the Commission reject the proposal on this basis.

DGS and TURN have presented a strong argument that we should consider customer deposits as part of working cash. However, because this issue has been previously deferred by the Commission to a workshop, we will not consider the matter on the merits here. A staff workshop on these issues was held in May 1996 and a workshop report is pending. We will not prejudge the outcome of the workshop by ordering an adjustment to working cash at this time. We make this determination subject to refund; if the Commission ultimately finds that customer deposits should be considered part of working cash, we will order DGS and TURN's adjustment for the PBR period.

(6) Materials and Supplies

ORA proposes a reduction of materials and supplies costs in rate base of $202,000, reducing SoCal's request to $14.303 million. SoCal does not oppose this adjustment. We adopt ORA's recommendation.

e) 1996 Plant Additions and Retirements

SoCal and ORA's estimates of 1996 net plant additions differ by $94.1 million. ORA utilized separate five-year trend analysis of gross plant additions and retirements to develop its net plant additions estimate for 1996. SoCal's methodology averaged 3 years of net plant additions after retirements had been removed from rate base. We find ORA's methodology of incorporating the most recent recorded data in its estimating methodology appropriate. Therefore, we will adopt ORA's estimate for 1996 net plant additions.

10. Depreciation Expenses

Depreciation expenses are calculated according to amounts permitted in rate base and are designed to permit the utility to recover its capital investments over the period during which associated facilities are used and useful. SoCal seeks $254.79 million in annual depreciation expense. ORA estimates depreciation expense to be $17.097 million lower than SoCal, mostly on the basis of recommendations regarding plant which should appropriately be included in rate base, that we have addressed previously.

a) Plant Balances for 1995 Plant

ORA proposes to reduce 1995 plant balances amount by $1.755 million assuming that the system average depreciation rate equals 4.4%. SoCal estimates the average depreciation rate to be 4.41%. The difference between the SoCal and ORA results from disparities regarding items which should be appropriately included in rate base. We addressed these items in portions of this order addressing rate base and the depreciation expense should be modified to correspond to the rate base adjustments.

b) Estimated 1996 Net Plant Additions

SoCal and ORA's estimates of depreciation for 1996 net plant additions differ by $7.433 million. The controversy occurs mainly because of a difference of approach in how to apply the weighting factor used to calculate depreciation expense on plant additions. SoCal recommends a 100% weighting factor; ORA recommends a 40.29% weighting factor. ORA states that SoCal's use of 100% ignores the fact that 1996 plant additions are unlikely to reflect actual plant additions in the subsequent five years because it is not a weighted average plant additions occurring each year. More importantly, ORA claims that SoCal's method fails to recognize the fact that future year net plant additions will only have a weighted affect on that particular year's depreciation expense. Thus, additions made in 1997 will only have a partial year effect on depreciation expense for that year. SoCal's method assumes that all plant additions will occur on January 1 of each year.

SoCal responds that the timing of the adjustments in this PBR dictates a 100% weighting factor. Because the base rate adjustments will be made mid-year, a lower weighting factor will not recognize all of the depreciation expense. SoCal appears to propose that the net plant additions for every subsequent year be treated as if they occurred on the first day of each year, thereby giving the company credit for a full year's expense when in fact plant additions are made throughout the year. ORA's methodology might fail to reflect a small portion of the 1996 plant additions. ORA appears to have adjusted for that effect by recognizing that SoCal's plant additions may be higher in 1996 than they are likely to be in subsequent years. SoCal has not provided any reasonable alternative to ORA's proposal. We therefore adopt ORA's proposal, which is consistent with our usual practice for estimating net plant and fairly reflects anticipated practice.

c) CIS

SoCal observes that ORA failed to adjust depreciation in recognition of ORA's and SoCal's agreement to capitalize certain training costs. We adjust depreciation by $36,000 accordingly. SoCal and ORA agree that the rest of the annual depreciation expense associated with CIS is $3.119 million. We adjust this amount consistent with our earlier finding that 40% of CIS investment costs should be included in rate base, rather than the full amount to which SoCal and ORA have stipulated.

d) Torrance and Mountain View Facilities

ORA observes that if the Commission adopts ORA's proposal to retire the Torrance and Mountain View facilities, it should also adjust depreciation expenses by $0.46 million. SoCal argues that the amount must remain in rates until the facilities are sold.

We have not adopted ORA's recommendations regarding retirement of these facilities, so we will not adjust the associated depreciation accounts.

e) Capitalized Overheads

ORA's estimate for capitalized overheads is $66,000 lower than SoCal's due to its use of a 4.4% depreciation expense rate, compared to SoCal's rate of 4.41%. We adjust this item to make it consistent with the expense rate which derives from allowable plant balances for 1995.

f) Depreciation Reserve Account

ORA proposed a negative $50.939 million figure for the depreciation reserve account, equal to retirements less net salvage. SoCal opposes ORA's reductions to this account, which derive mainly from differences in 1995 plant balances discussed elsewhere. We incorporate the findings on these issues in setting the appropriate level for the reserve account.

11. Taxes

SoCal and ORA reached agreement regarding the appropriate tax rates. We adopt their recommendation to apply a California Corporate Franchise Tax rate of 8.84%.

SoCal and ORA do not agree to the estimate for ad valorem taxes associated with construction. ORA recommends reducing the SoCal request for tax expenses by $1.2 million and including the associated amounts in rate base. SoCal replies that the Commission has traditionally allowed utilities to recover ad valorem taxes as expenses rather than rate base.

We are not convinced that capitalizing ad valorem taxes offers any advantage to ratepayers or shareholders. We reject ORA's proposal to capitalize ad valorem taxes.

12. Research, Development and Demonstration (RD&D)

SoCal and ORA reached agreement with regard to RD&D funds. They recommend base margin funding of $7.8 million which would not be subject to prevailing Commission policy prohibiting SoCal from shifting RD&D funds between programs. They also propose $0.5 million for "public goods" RD&D which would be subject to "one-way" balancing account treatment. Royalties attributable to RD&D projects underway or completed prior to the implementation of PBR would accrue 100% to ratepayers. Royalties from subsequent work would be shared equally between ratepayers and shareholders.

NRDC opposes the proposal to eliminate the one-way balancing account for RD&D, believing that shareholders will retain part of the RD&D funding to accomplish short-term profit objectives at the expense of long-term benefits.

We adopt the recommendations of SoCal and ORA for RD&D programs and funding, with the exception that we will retain the one-way balancing account as NRDC proposes. SoCal did not make a compelling case that it would actually spend the RD&D funds on RD&D efforts.

Findings of Fact

1. On June 1, 1995, SoCal filed an application requesting adoption of PBR for the portion of its rates that recovers the costs of providing gas utility service that the Commission normally reviews through the GRC process.

2. SoCal filed its recorded data for 1995 results of operations on February 14, 1996, and a supplemental showing with respect to 1996 estimated results on June 6, 1996. The parties agreed that this would be used to develop the base margin in this proceeding.

3. On October 14, 1996, Pacific Enterprises, the parent of SoCal, and Enova Corporation, the parent of SDG&E, announced their intention to merge, and filed an application for authority to do so with the Commission (A.96-10-038).

4. SoCal's proposal for PBR is based upon a system of indexing its base rates annually, using an index of recorded input price inflation less than a productivity factor. The inflation factor would be trued up annually, but the productivity factor would remain constant throughout the minimum period that PBR remains in effect.

5. SoCal proposes a minimum period of five years for its PBR to be in effect.

6. SoCal's indexing proposal would put its shareholders, rather than its ratepayers, at risk or reward for any differences between forecast and actual throughput and customer count.

7. For its inflation measure, SoCal proposes a weighted average of recorded indices of prices for labor O&M costs, nonlabor O&M costs, and capital-related costs. SoCal refers to this as the gas utility input price index, or GUPI.

8. For its productivity factor, SoCal proposes to employ a constant factor of 1.0%, based upon a historical gas distribution productivity component of 0.5%, and a "stretch factor" or "consumer dividend" of 0.5%.

9. Under SoCal's proposal, only the base rate would be adjusted under PBR. The base rate is the part of rates reflecting gas margin, and excluding gas costs, pipeline demand charges, and other specifically identified items.

10. Under SoCal's proposal 1997 rates would be set by applying one year's PBR index to the reasonable level of expense and rate base for 1996.

11. Under SoCal's proposal, costs which are already subject to incentive-type mechanisms, are beyond SoCal's control, or are specifically authorized at a given level under separate governmental proceedings would be excluded from PBR indexes.

12. Under SoCal's proposal the cost of exogenous and unforeseen events largely beyond SoCal's control that have a material impact upon its costs (Z factors) would be subject to a special process of adjustment that would tend to exclude them from rates.

13. SoCal proposes an adjustment in rates in addition to the PBR index for land sold at a gain or loss.

14. Under SoCal's proposal the benchmark for cost of capital would be the DRI average rate for the calendar year 1997 forecast, as adopted in SoCal's 1997 cost of capital proceeding. No changes would be made in PBR indexed rates in response to changes in cost of capital, unless the 12-month trailing average yield on long-term Treasury Bonds increases or decreases more than 150 basis points from this benchmark during the minimum PBR term.

15. SoCal, ORA, and TURN have proposed a recommended plan to ensure the maintenance of standards of service quality, customer satisfaction and safety during the PBR period.

16. As part of its proposal, SoCal seeks authorization to offer on a competitive and unregulated basis products and services that it has not previously offered, and to provide support to its unregulated affiliates in connection with their offering of new products and services. SoCal proposes that these new products and services be provided entirely at the risk of shareholders, and not be funded by the rates charged for utility services.

17. As part of its proposal, SoCal proposes several changes in its rate design, including residential rate design changes, rate flexibility, and optional rate schedules for core customers.

18. The Commission's policy favors PBR for the utilities we regulate, wherever it would further our regulatory goals and policies.

19. The features of SoCal's proposed PBR that would base rates on 1996 adjusted throughput, extend cost allocations beyond July 30, 1999, alter the definition of a

"normal" temperature year, and eliminate the CFCA would violate the terms of the Global Settlement.

20. The Commission has a strong policy favoring settlements as a means of resolving issue in its proceedings, and will generally not change the terms of a settlement after it becomes a Commission order.

21. Certain features of SoCal's proposal are unrelated to the PBR system of incentives.

22. The pendency of the merger of Pacific Enterprises and Enova Corporation increases the likelihood that capital spending will be curtailed and expenses otherwise forgone before the merger is consummated or disapproved.

23. It is probable that SoCal will experience systemwide sales growth in the next five years.

24. Consideration of the pending Enova-Pacific Enterprises merger requires us to be able to track savings. Savings with respect to SoCal cannot be tracked if rates, rather than the revenue requirement, are indexed.

25. SoCal's rate base has been declining since 1995 as the result of depreciation.

26. SoCal's proposed indexing mechanism fails to recognize its unique circumstances, particularly its declining ratebase and the likelihood of increased throughput.

27. SoCal's proposed PBR does not include a mechanism for sharing net savings with ratepayers.

28. In R.97-04-011/I.97-04-012, the Commission preserved the opportunity to adopt an interim order with respect to SoCal's proposal for flexibility in introducing new products and services.

29. It would be unfair to allow one energy utility to operate on an unregulated and competitive basis while requiring the remaining energy utilities to participate in R.97-04-011 and I.97-04-012 before allowing them to offer the same services into the same market on a detariffed, competitive basis.

30. If the Commission considers SoCal's requests with respect to the introduction of new products and services, there are a number of questions that would need to be

answered for the Commission to fulfill its regulatory responsibilities under the proposal and to ratepayers generally.

31. SoCal and ORA reached agreement on several disputed issues during the course of the hearing. At the time of submittal, ORA and SoCal had disagreement over approximately $71.7 million in costs.

32. SoCal proposes that the same rate be used to escalate and deflate the estimates presented in this proceeding to make them comparable.

33. ORA, TURN and SoCal agreed to a level of expenses for customer accounts of $111.77 million. They also agreed that costs for administration of the CARE program should be included in SoCal's rates until and unless another party is responsible for the administration of the program.

34. SoCal's proposed late payment charge is not necessary for the establishment of base margin.

35. SoCal, TURN, and ORA agreed to total expenses of $20.37 million for gas storage and $25.017 million for gas transmission.

36. SoCal's request for gas distribution costs is somewhat lower than ORA's due to a difference in their respective escalation rates.

37. ORA, TURN, DGS, and SoCal agree to funding for DSM in the amount of $27 million, to be included in a one-way balancing account.

38. ORA, TURN, and SoCal agree to fund non-DSM marketing at a level of $24.136 million.

39. SoCal proposes a level of $12 million for funding direct assistance programs. NRDC proposes retaining the existing funding level of $18 million. SoCal's requested funding level recognizes that the direct assistance program market is becoming saturated.

40. SoCal did not demonstrate that its PBR will increase regulatory activity.

41. SoCal did not demonstrate with evidence that its executive compensation rates are comparable to those offered to individuals working in markets from which SoCal recruits.

42. SoCal's total compensation levels are reasonably close to market levels.

43. SoCal did not present adequate documentation to support the reasonableness of billings from Pacific Enterprises for the work of 50 attorneys.

44. SoCal's affiliates promote new lines of business that are not directly related to utility activities or that are not activities for which SoCal may seek funding from ratepayers.

45. SoCal and ORA reached agreement on issues regarding franchise fees with the exception of the appropriate rate.

46. SoCal did not occupy or lease to others 15% of the Gas Company Tower in 1995. It did not occupy or lease to others 20% of the Gas Company Tower in 1996. SoCal did not demonstrate that the Gas Company Tower will be 97% occupied in 1997.

47. ORA proposes a disallowance of Gas Company Tower lease costs which recognizes, in part, SoCal's plan to increase occupancy.

48. The Commission's policy in general rate cases is to base revenue requirement changes on a test year forecast.

49. SoCal appears to have removed non-recurring costs in its forecast of general plant maintenance costs.

50. ORA and SoCal agreed to an expense level of $82.124 million for various pension and benefits costs. The parties also agreed that, if annual pension trust contributions must exceed $12 million annually, SoCal may enter the additional funding requirement into a memorandum account and seek recovery of amounts in a subsequent PBR filing.

51. ORA's estimate of PBOP overcollections during 1992 through 1995 appears consistent with the one the Commission adopted in D.93-12-043 and the method's results are consistent with those presented by SoCal's actuary.

52. SoCal shall adjust the CFCA and NSBA with appropriate entries to reflect the $3.5 million refund for PBOP for 1992-1995.

53. SoCal's request for funding of non-recurring costs associated with its microwave network is excessive. Removing $0.124 million from the account results in an increase of 21% to Account 184.7.

54. ORA made several adjustments in Account 163.0 and Account 184.7 to reflect calculation errors, which SoCal does not dispute.

55. The Global Settlement states that all capital costs and expenses related to increasing noncore load and related earnings are the responsibility of SoCal.

56. SoCal did not demonstrate that Line 6900, Line 6902 or Line 325 construction would serve core needs except incidentally.

57. D.93-23-043 determined that the GasSelect project served noncore customers and should therefore not be included in rate base. SoCal has not distinguished the GasSelect upgrade in ways which would change this determination.

58. SoCal has not demonstrated that the GEMS project will benefit core customers except incidentally.

59. SoCal has not used half of the space available at the Torrance and Mountain View Headquarters and intends to sell or lease the facilities in the near future.

60. SoCal appears to have assumed the risk associated with litigation arising from nitrous oxides in gas received from certain of its producers. SoCal would include the costs of litigation in rates but not the settlement proceeds.

61. Only 40% of the CIS investment is included in 1996 rate base. For rate base calculations, Commission policy provides that rates include only those investments that are included in rate base during the review period.

62. SoCal provided adequate evidence to refute ORA's claims that SoCal's deferred credits for regulatory and litigation losses are cost-free for purposes of calculating working cash requirements.

63. Vacation accruals represent cost-free capital for purposes of calculating working cash requirements.

64. Workers' compensation accruals represent cost-free capital for purposes of calculating working cash requirements.

65. The average time SoCal takes for billing and collecting customer advances for construction is 33 months, an amount that is attributable either to mismanagement or tolerance of subsidies to developers who are late in remitting payments.

66. SoCal does not oppose ORA's proposed reduction of $0.899 million in estimates of customer advances for construction.

67. SoCal has access to about $29 million in capital attributable to customer deposits.

68. SoCal does not oppose ORA's proposed reduction of materials and supplies costs in rate base in the amount of $0.202 million.

69. SoCal and ORA's estimates of some depreciation expenses and plant balances for 1995 differ as a result of their differing estimates of rate base.

70. SoCal's methodology for calculating 1996 plant additions assumes that all plant additions occur on the first day of the year, giving the company credit for rate base investments that are not made until subsequent periods.

71. ORA's method for estimating 1996 plant additions is consistent with the Commission's usual practice and fairly reflects anticipated investments.

72. The Commission has traditionally allowed utilities to recover ad valorem taxes as expenses rather than as capital costs.

73. SoCal and ORA agreed to RD&D expense levels of $7.8 million. They also agree that 100% of royalties attributable to projects underway or completed prior to the implementation of PBR would accrue to ratepayers and that royalties from subsequent projects would be shared equally between ratepayers and shareholders.

74. SoCal did not demonstrate that it intended to spend all funds allocated to RD&D on RD&D projects.

Conclusions of Law

1. SoCal's proposed PBR conflicts with existing Commission decisions and orders, or with policies we have articulated previously. In order to ensure that SoCal's PBR conforms to these principles, we must modify the PBR program before we can adopt it.

2. SoCal's proposal would conflict in certain respects with the terms of the Global Settlement.

3. The absence of a sharing mechanism in SoCal's PBR proposal is contrary to Commission policy, and the adopted PBR program should therefore include a sharing mechanism.

4. The Weather Normalization Mechanism and the Energy Efficiency Adjustment Factor proposed by SoCal would increase, rather than simplify, regulation.

5. Features of SoCal's proposal which are unrelated to the PBR system of incentives should not be adopted as part of our order in this proceeding.

6. We should adopt ORA's proposal for price indexing, consisting of a weighting of labor expense, nonlabor expense, and capital inputs to total costs, that is the average of gas operations for SoCal, PG&E, and SDG&E.

7. We should adopt a Year 5 total productivity factor of 1.5%, consisting of 0.5% historical productivity and a 1.0% "stretch" factor (or "consumer dividend") for factors within the control of utility management. The productivity factor should be "ramped" up in each of the five years of the PBR, so that year 1 will be 1.1%, Year 2 will be 1.2%, year 3 will be 1.3%, year 4 will be 1.4%, and year 5 will be 1.5%. Recorded data should be used to determine the 1996 customer count.

8. The CFCA should be retained, at least until the expiration of the Global Settlement, in the PBR program we adopt.

9. The PBR program we adopt for SoCal should index the revenue requirement *per customer* rather than rates.

10. Establishment of the base margin for SoCal's PBR program should not place SoCal shareholders at risk/reward for variations in throughput at least until the expiration of the Global Settlement.

11. We should not adopt SoCal's proposed indexing mechanism.

12. The adopted indexing mechanism should recognize the special circumstances of SoCal's declining rate base. In order to conform the proposal to other adopted PBRs, while at the same time accounting for uncertainty in estimating the impact of this special circumstance, we should add 1.0 percent each year to the adopted productivity factor. The adopted "X" factor therefore should be 2.1 percent in year 1; 2.2 percent in year 2; 2.3 percent in year 3; 2.4 percent in year 4; and 2.5 percent in year 5.

13. SoCal's PBR program should include a mechanism for sharing net savings with ratepayers.

14. We should adopt a sharing mechanism as part of SoCal's PBR that will increase in eight steps SoCal's share of net revenue from 25% to 100% from 25 basis points above the benchmark rate of return up to 300 basis points above that benchmark, and should not share the deficit below that benchmark. The benchmark rate of return should be the current adopted rate of return.

15. We should adopt the cost categories suggested by SoCal for exclusion from PBR.

16. Z factors should be handled outside of the PBR mechanism and separately adjusted in the manner proposed by SoCal.

17. PBR rates under the adopted program should be implemented at the beginning of the next calendar year but could, at SoCal's discretion, be implemented as of the beginning of the current calendar year if this program is adopted before the end of the calendar year.

18. We should adopt ORA's proposal for a cost of capital triggering mechanism during the PBR period, coupled with the "MICAM" mechanism for rate adjustment that we recently adopted in D.96-06-055.

19. We should adopt ORA's proposal for a rate of return "offramp," which would suspend SoCal's PBR program before the five-year minimum term if rate of return deviates by 300 basis points above authorized earnings, or 175 basis points below authorized earnings, for two consecutive years.

20. We should conduct a midcourse review of SoCal's PBR program before the end of the five-year minimum term. SoCal's 1998 BCAP (or its successor proceeding) should serve as the forum for that review.

21. SoCal's PBR should remain in effect for a minimum five-year term, and should be terminable in the manner proposed by ORA.

22. We should adopt the program for ensuring maintenance of service quality, customer satisfaction, and safety that is proposed by SoCal, ORA, and TURN, and set forth in Exhibit 210.

23. We should adopt SoCal's proposal to implement the annual PBR rate adjustment and report on all aspects of the PBR program through the filing of a detailed annual advice letter and supporting workpapers on October 1.

24. We should deny SoCal's request to eliminate or modify existing reports required by the Commission at this time and require SoCal to file an annual PBR performance report, similar to that which is now filed by SDG&E.

25. SoCal should be allowed to offer negotiated rates and optional tariffs provided that the price floor is above class average long-run marginal cost and shareholders are entirely at risk for revenue shortfalls.

26. SoCal's request for flexibility in introducing new products and services should be considered in the affiliates rulemaking and investigation (R.97-04-011, I.97-04-012).

27. The Commission should calculate non-labor cost forecasts by deflating the 1996 dollars using a factor of 3.72%, and inflating them by using a factor of 2.23%.

28. The Commission should adopt all matters resolved by way of stipulation between SoCal and ORA except as provided herein.

29. The Commission should adopt ORA's adjustment to account 920 regarding consultant fees.

30. The Commission should adopt TURN's proposal to reduce Accounts 921 and 920 to reflect excessive executive compensation.

31. The Commission should disallow $1.924 million associated with affiliated transactions.

32. The Commission should disallow $2.939 million for costs estimated using SoCal's multi-factor allocation formula for calculating the cost of service provided to SoCal by its affiliates.

33. The Commission should reduce Account 928 by $0.026 million to reflect the lower costs of regulatory activity.

34. The Commission should disallow $5.384 million attributable to Gas Company Tower costs to recognize that substantial portions of the property is not used and useful.

35. The Commission should calculate the PBOPs overcollection for the period between 1992 and 1995 using a 21% escalation factor, consistent with D.93-12-043. SoCal should adjust the CFCA and NSBA with appropriate entries to reflect the $3.5 million refund for PBOPs for 1992-1995.

36. The Commission should reduce funding for Account 184.7 by $0.124 million to reflect SoCal's inclusion of nonrecurring costs for maintaining its microwave network.

37. The Commission should remove from rate base $29.028 million associated with construction on Lines 6900, 6902, and 325, and all costs associated with the GEMS upgrade and the GasSelect project, consistent with Commission determinations that the costs of serving noncore customers in competitive markets should not be allocated to the general body of ratepayers. In addition, the Commission should remove $6.18 million associated with Pacer and overheads capitalization.

38. The Commission should not remove $23.4 million from rate base related to the Torrance and Mountain View Headquarters.

39. The Commission should reduce Account 920 by $0.8 million to recognize the cost of litigating the Ventura/Ojai Project but permit SoCal to retain the proceeds of the settlement reached from associated lawsuits.

40. The Commission should recognize in rate base 40% of CIS costs, rather than 100% as ORA and SoCal propose.

41. The Commission should not adjust SoCal's estimate of working cash to reflect $58 million in deferred credits, and $29 million in customer deposits.

42. The Commission should adjust SoCal's estimate of working cash to reflect $18 million in vacation accruals, $21 million in workers compensation accruals, and $11.6 million in customer advances for construction.

43. The Commission should adopt depreciation expenses consistent with its findings regarding appropriate levels of rate base.

44. The Commission should adjust SoCal's estimate of 1996 plant additions by $7.433 million to reflect a 40.29% weighting factor rather than SoCal's 100% weighting factor, which assumes all plant additions are made on the first day of the year.

45. The Commission should retain a one-way balancing account for RD&D.

ORDER

IT IS ORDERED that:

1. The application of Southern California Gas Company (SoCal) for adoption of a system for performance-based ratemaking (PBR), for the portion of SoCal's rates that recovers the costs of providing gas utility service which are normally reviewed through the general rate case (GRC) process, is granted with the modifications set forth in the foregoing opinion, and in the findings of fact, conclusions of law, and appendices to the Order.

2. Not later than July 23, 1997, SoCal shall file a detailed advice letter which shall include:

a. A revised set of proposed tariffs, constructed in accordance with paragraph 1 of this Order for the portion of SoCal's rates that recovers the cost of providing gas utility service; and

b. An election of the effective date of the PBR mechanism adopted pursuant to this Order.

3. Within 30 days after the effective date of this order, SoCal shall file an advice letter to implement this PBR. This advice letter will be subject to approval by the Commission by means of a resolution.

4. The Commission staff shall monitor and evaluate the operation of the adopted PBR program throughout the period it remains in effect.

5. Midcourse review of all aspects of SoCal's PBR shall be conducted as part of SoCal's 1998 Biennial Cost Allocation Proceeding (BCAP), or the successor proceeding if the Commission no longer conducts the proceeding as a BCAP.

6. SoCal shall file an annual PBR performance report as set forth in the opinion, for processing on the following schedule:

a. April 1 - SoCal shall furnish a draft sharable earnings letter to the Commission's staff, including workpapers showing detailed operating results for its base rates.

b. July 1 - Commission staff shall submit its report on its audit analysis of SoCal's sharable earnings results.

c. July 10 - SoCal shall file its final performance advice letter, with supporting workpapers.

d. July 31 - Protests may be filed in accordance with General Order 96-A.

7. On October 1 of each year, SoCal shall file an advice letter which will implement the annual PBR rate adjustment for the following year.

8. During the period that SoCal's PBR program remains in effect, the requirement for SoCal to file a GRC is suspended, except as specifically provided under the terms of the adopted PBR program.

9. SoCal's request for flexibility in introducing new products and services, as described in Exhibit 7, section E, is denied.

10. The proceeding is closed.

This order is effective today.

Dated July 16, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners

We will file a joint dissent in part.

/s/ HENRY M. DUQUE
Commissioner

/s/ JOSIAH L. NEEPER
Commissioner

APPENDIX A

CUSTOMER SATISFACTION,
EMPLOYEE SAFETY,
AND
SERVICE QUALITY

Measuring Customer Satisfaction

Annual targets will be established for four service attributes: (1) customer satisfaction with the telephone Customer Service Representative (CSR), (2) customer satisfaction with the scheduling of the appointment for a field service call, (3) satisfaction with the field Appliance Service Representative (ASR), and (4) the percentage of on-time arrival for the service call. Customer satisfaction with these four service attributes is currently measured by way of question numbers 9, combined 19 and 28, 23, and 29, respectively, in the SoCalGas' customer satisfaction telephone survey.

The annual targets will be based upon the average performance for 1994 through 1996 for each of the four service attributes, measured as the percentage of customers "satisfied" with the service provided (i.e., responding with an 8, 9, or 10 on a 10 point scale) on the first three attributes, and the percentage of "yes" responses on the on-time arrival attribute.

Each service attribute carries a potential monetary penalty. For purposes of determining whether a performance penalty will be imposed upon SoCalGas, the target for each service attribute will have a one point deadband below the target.

As long as each performance level remains at or above the one point deadband, SoCalGas will not be penalized. Should performance decline below the deadband, SoCalGas will be penalized $10,000 per 0.1 point decline for the first point below the deadband. For any further performance decline, SoCalGas will be penalized $20,000 per 0.1 point decline.

Based upon the average customer satisfaction telephone survey results for 1994, 1995, and through November 1996, the current targets would be as follows:

	Target	Deadband
CSR Performance (Q9)	90.7	89.7
Appointment Scheduling (Q19 & 28)	79.1	78.1
ASR Performance (Q23)	94.3	93.3
On Time Arrival (Q29)	95.2	94.2

The ultimate target amounts will be based on averages including the entire year's results for 1996. Table 1 attached hereto contains the data that forms the basis for the target and deadband calculations.

Telephone Response Time

In addition to the foregoing customer satisfaction targets, an annual call center performance standard will require 80% of all telephone calls to be answered within 60 seconds for regular calls, and will require 90% of all leak and emergency telephone calls to be answered within 20 seconds. SoCalGas will be penalized $20,000 per 0.1 point decline below each standard (i.e., 80% and 90%), with no deadband.

Employee Safety Standard

Also, an annual employee safety standard will be established at 9.3 incidents per 200,000 hours worked, with a deadband of 1.0 point in each direction. The annual measure for this standard will be the OSHA Recordable Injury and Illness Rate (Rate). Penalties would be paid by SoCalGas if the annual Rate exceeds 10.3. Rewards would be paid to SoCalGas if the Rate falls below 8.3. Penalties and rewards will be assessed at $20,000 per 0.1 point outside the deadband.

Quarterly Reports

In addition to the foregoing incentive mechanisms, SoCalGas will provide reports to the Commission, on a quarterly basis, containing monthly data on the following customer service quality indicators:

- Level of busy signals in the call center (number of customers receiving a busy signal per each 100 calls)
- Estimated meter reads (percentage of total reads that were estimated)
- Leak response time (percentage of leak calls responded to within 30 minutes Monday through Saturday between 7:00 a.m. and 5:00 p.m., and within 45 minutes during other times)

- Missed appointments (percentage of appointments missed due to utility error)
- Customer problems resolved on the first service call (percentage of survey respondents indicating their problems were resolved on the first service call)

At this time, no penalties will be assessed with respect to these performance indicators.

The busy signals and leak response time report data would be available to the public. At the time of the initial filing of other reports, SoCalGas may elect to use Commission procedures to seek confidential treatment of the remaining report data, or part thereof. Any party may challenge SoCalGas' designation of materials as confidential.

Review of Customer Service Quality

These parties recommend that a review be undertaken to examine the status of customer service quality indicators, including the penetration of the CARE program. This review would be done either in a mid-course review proceeding or forum OII if the Commission adopts such proceedings, or alternatively, in another appropriate Commission proceeding.

Penalty/Reward Treatment

Penalties and/or rewards will be assessed as a part of the Annual Rate Adjustment Filing. The initial measurement period will begin on July 1, 1997, or the implementation date of PBR if it is later. It will end on June 30, 1998. Any rewards and/or penalties will be reflected as an increase or decrease in rates on January 1, 1999.

Table 2, attached hereto, illustrates the penalty amounts associated with various levels of performance on the four customer service attributes and the two telephone response time indicators. Table 3 illustrates the reward and penalty amounts associated with various levels of performance on the employee safety standard.

Should the aggregate total of penalties assessed pursuant to the forgoing mechanism in any one year reach or exceed $4 million, SoCalGas will refund $4 million to ratepayers and an investigation by the CPUC would be triggered to consider whether the penalty mechanism is working properly, and/or whether appropriate remedies are in place to address service deterioration. SoCalGas could argue that penalties beyond $4 million should not be assessed, and other parties could oppose that request. SoCalGas would be subject to whatever additional penalties the Commission determined to be appropriate at the conclusion of its investigation.

With the exception of the performance indicators recommended by TURN that relate to the late payment charge (i.e., mailing bills and posting payments), the recommendations made herein would be implemented in lieu of various satisfaction, service, and safety measures proposed in the prepared testimonies described above. The performance indicators that relate to the late payment charge are not a part of this joint settlement proposal, and will remain subject to a litigated outcome. Accordingly, the joint recommendation does not include an aggregate customer satisfaction index; mandatory customer monetary credits for missed appointments, delayed leak responses, disconnects by reason of utility error, or winter outages greater than 24 hours; a mandatory customer satisfaction mail survey requirement; or, quarterly reports upon any service quality indicators other than those identified herein.

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Table 1

Customer Service Attributes
1991-1996

YEAR	# of Customers Answering Question	Satisfaction CSR Q9 %8-10	Satisfaction Apt Arrangement Q19/Q28 %8-10	Satisfaction ASR Q23 %8-10	On Time Appointment Q29 %YES
1991	11887	88.6%		93.2%	
1992	24145	89.2%	93Q2	94.5%	93Q2
1993	25707	90.8%	81.7%	94.3%	95.7%
1994	26859	89.9%	78.3%	94.0%	94.7%
1995	29218	90.5%	79.1%	94.3%	95.4%
1996 YTD November	24913	91.6%	79.9%	94.6%	95.7%
94-96 average		90.7%	79.1%	94.3%	95.2%
Deadbands		89.7%	78.1%	93.3%	94.2%

Table 3
Example of Reward/Penalty Structure

Employee Safety Standard

	Reward*	OSHA Recordable Rate	Penalty*
		:	:
		10.8	$100,000
		10.7	$ 80,000
		10.6	$ 60,000
		10.5	$ 40,000
		10.4	$ 20,000
Deadband		10.3	$ 0
Target	$ 0	9.3	$ 0
Deadband	$ 0	8.3	
	$ 20,000	8.2	
	$ 40,000	8.1	
	$ 60,000	8.0	
	$ 80,000	7.9	
	$100,000	7.8	
	:	:	

*$20,000 penalty/reward per tenth of point decline in performance

(END OF APPENDIX A)

APPENDIX B

TABLES ESTABLISHING BASE MARGIN

SOUTHERN CALIFORNIA GAS COMPANY

TABLE OF CONTENTS

Table 1
SOUTHERN CALIFORNIA GAS COMPANY
SUMMARY OF EARNINGS
AT PRESENT AND ADOPTED RATES
Test Year 1996
(Thousands of Dollars)

Line No.	Description	PRESENT	ADOPTED	ADOPTED Exceeds Present Amount	ADOPTED Exceeds Present Percent
		(A)	(B)	(C=B-A)	(D=C/A)
	Operating Revenues				
1	Gas Base Margin	1,544,704	1,315,341	(229,363)	-14.8%
2	Other Revenues	53,387	53,387	0	0.0%
3	Total	1,598,091	1,368,728	(229,363)	-14.4%
4	Less: Cost of Gas	0	0	0	#N/A
5	Net Operating Revenues	1,598,091	1,368,728	(229,363)	-14.4%
6	Operating Expenses				
7	Reassignments	(39,429)	(39,429)	0	0.0%
8	Clearing Accounts	53,079	53,079	0	0.0%
9	Underground Storage	20,373	20,373	0	0.0%
10	Transmission	25,016	25,016	0	0.0%
11	Distribution	170,599	170,599	0	0.0%
12	Customer Accounts	105,367	105,367	0	0.0%
13	Uncollectibles	7,332	6,347	(985)	-13.4%
14	Marketing	23,408	23,408	0	0.0%
15	Administrative & General	277,468	277,468	0	0.0%
16	Franchise Requirements	23,142	19,755	(3,387)	-14.6%
17	Exec Comp Adjustment	(606)	(606)	0	0.0%
18	P & B Adjustment	0	0	0	#N/A
19	Subtotal (1995 Dollars)	665,749	661,377	($4,372)	-0.7%
20	Labor Escalation Amount	10,115	10,115	0	0.0%
21	Non-Labor Escalation Amount	7,116	7,116	0	0.0%
22	Subtotal (1996 Dollars)	682,980	678,608	($4,372)	-0.6%
23	Productivity Adjustment	0	0	0	#N/A
24	Depreciation	241,147	241,147	0	0.0%
25	Taxes Other Than On Income	61,011	61,011	0	0.0%
26	CA Corporation Franchise Tax	48,572	28,683	(19,889)	-40.9%
27	Federal Income Tax	187,384	108,637	(78,747)	-42.0%
28	Total Operating Expenses	1,221,095	1,118,087	($103,008)	-8.4%
29	Net Operating Revenues	$376,996	$250,641	($126,355)	-33.5%
30	Rate Base	2,660,734	2,660,734	0	0.0%
31	Rate of Return	14.17%	9.42%	-4.75%	-33.5%

Table 1-A
SOUTHERN CALIFORNIA GAS COMPANY
Comparison of
SUMMARY OF EARNINGS AT ADOPTED RATES
Test Year 1996
(Thousands of Dollars)

Line No.	Description	ADOPTED	SoCalGas
		(A)	(B)
	Operating Revenues		
1	Gas Base Margin	1,315,341	1,366,275
2	Other Revenues	53,387	53,387
3	Total	$1,368,728	$1,419,662
4	Less: Cost of Gas	0	0
5	Net Operating Revenues	$1,368,728	$1,419,662
6	Operating Expenses		
7	Reassignments	(39,429)	(39,984)
8	Clearing Accounts	53,079	53,291
9	Storage	20,373	20,373
10	Transmission	25,016	25,017
11	Distribution	170,599	170,599
12	Customer Accounts	105,367	105,760
13	Uncollectibles	6,347	6,566
14	Marketing	23,408	23,815
15	Administrative & General	277,468	290,384
16	Franchise Requirements	19,755	20,507
17	Exec Comp Adjustment	(606)	0
18	P & B Adjustment	0	0
19	Subtotal (1995 Dollars)	$661,377	$676,328
20	Labor Escalation Amount	10,115	10,216
21	Non-Labor Escalation Amount	7,116	7,300
22	Subtotal (1996 Dollars)	$678,608	$693,844
23	Productivity Adjustment	0	0
24	Depreciation	241,147	252,504
25	Taxes Other Than On Income	61,011	61,383
26	CCFT	28,683	31,312
27	Federal Income Tax	108,637	119,191
28	Total Operating Expenses	$1,118,087	$1,158,234
29	Net Operating Revenues	$250,641	$261,428
30	Rate Base	2,660,734	2,775,698
31	Rate of Return	9.42%	9.42%

Table 2

SOUTHERN CALIFORNIA GAS COMPANY

CLEARING ACCOUNTS SUMMARY

(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
		General Services	
1	163.0	Stores Expense	4,450
2	184.1	Shop Expense	8
3	184.2	Tool Expense	5,474
4	184.3	Auto & Const. Equipment	27,678
5	184.4	Miscellaneous Pipeline Material	626
6	184.5	Print Shop	4
7		Total General Services	$38,240
		Communications	
8	184.7	Communications Expense	14,836
9		Total Communications	$14,836
		Operations Support	
10	184.1	Other Shop Expense-Bldg Opn's	3
11	184.6	HQ Bldg Expense	0
12		Total Operations Support	$3
13		TOTAL CLEARING ACCOUNT (1995$)	$53,079
		Escalation Amounts, 1995 to 1996	
14		Labor	495
15		Non-Labor	826
16		Other	0
17		Total	$1,321
18		TOTAL CLEARING ACCOUNT (1996$)	$54,400
19		LABOR ADJUSTMENT (1996$)	$0

Table 3

SOUTHERN CALIFORNIA GAS COMPANY

UNDERGROUND GAS STORAGE EXPENSE
SUMMARY
(Thousands of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
		Operation	
1	814.0	Supervision and Engineering	2,639
2	815.0	Maps and Records	0
3	816.0	Wells expenses	1,753
4	817.0	Lines expenses	852
5	818.0	Compressor Station expenses	3,090
6	819.0	Compressor Sta. Fuel and Power	0
7	820.0	Measuring & Regulating Station Exp	150
8	821.0	Purification Expense	1,477
9	823.0	Gas Losses	0
10	824.0	Other Expenses	1,767
11	825.0	Storage Well Royalties	354
12	826.0	Rents	212
13		Total Operation expenses	$12,294
		Maintenance	
14	831.0	Structures and Improvements	76
15	832.0	Wells	2,660
16	833.0	Lines	649
17	834.0	Compressor Station Equipment	3,268
18	835.0	Measuring & Reg Station Equip.	173
19	836.0	Purification Equipment	1,032
20	837.0	Other Equipment	220
21		Total Maintenance expenses	$8,078
22		TOTAL UNDERGR. STORAGE (1995$)	$20,373
		Escalation Amounts, 1995 to 1996	
23		Labor	328
24		Non-Labor	218
25		Other	0
26		Total	$546
27		TOTAL UNDERGR. STORAGE (1996$)	$20,919
28		LABOR ADJUSTMENT (1996$)	$0

Table 4

SOUTHERN CALIFORNIA GAS COMPANY

GAS TRANSMISSION EXPENSE
SUMMARY
(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
		Operation	
1	850.0	Supervision and Engineering	7,571
2	851.0	System Con. & Load Dispatching	1,663
3	853.0	Compressor Station	1,638
4	854.0	Gas For Compressor Station Fuel	0
5	856.0	Mains Expenses	1,692
6	856.0	Removal of Condensate	0
7	857.0	Measuring & Reg. Station Exp.	1,327
8	858.0	Trans & Comp. of Gas by Others	0
9	859.0	Transmission Maps and Records	0
10	859.0	Other Expenses	2,713
11	859.0	Joint Expenses	0
12	860.0	Rents	3,208
13		Total Operation	$19,812
		Maintenance	
14	861.00	Supervision and Engineering	0
15	862.00	Structures and Improvements	108
16	863.00	Mains	2,205
17	864.00	Compressor Station Equipment	2,345
18	865.00	Measuring & Reg Station Equip.	417
19	867.00	Other Equipment	129
20		Total Maintenance	$5,204
21		TOTAL TRANSMISSION (1995$)	$25,016
		Escalation Amounts, 1995 to 1996	
22		Labor	467
23		Non-Labor	221
24		Other	0
25		Total	$688
26		TOTAL TRANSMISSION (1996$)	$25,704
27		LABOR ADJUSTMENT (1996$)	$0

Table 5

SOUTHERN CALIFORNIA GAS COMPANY
GAS DISTRIBUTION, MEASUREMENT, ENGINEERING & ENVIRONMENTAL EXPENSES SUMMARY
(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
		Operation	
1	870.0	Supervision and Engineering	31,163
2	874.0	Mains and Services Expenses	0
3	875.0	Meas & Reg Station Exp	361
4	878.0	Meter & house regulator expense	539
5	879.0	Customer Install. Exp.	68,383
6	880.0	Other expenses	34,371
7	881.0	Rents	11
8		Total Operation	$134,828
		Maintenance	
9	885.00	Supervision and Engineering	0
10	887.00	Mains	13,867
11	889.00	Meas & Reg Station Equip	713
12	892.00	Services	15,456
13	893.00	Meters & House Regulators	5,735
14	894.00	Other Equipment	0
15		Total Maintenance	$35,771
16		TOTAL EXPENSES (1995$)	$170,599
		Escalation Amounts, 1995 to 1996	
17		Labor	4,562
18		Non-Labor	513
19		Other	0
20		Total	$5,075
21		TOTAL EXPENSES (1996$)	$175,674

Table 6

SOUTHERN CALIFORNIA GAS COMPANY

CUSTOMER ACCOUNTS EXPENSE
SUMMARY
(Thousands of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
1	901.0	Supervision	7,151
2	902.0	Meter Reading Expenses	17,770
3	903.0	Cust.Rec.& Collec.Exp.(Co.7-B)	80,446
4	904.0	Uncollectible Accts (Pres.Rates)	7,332
5	905.0	Misc. Customer Accounts Exp.	0
6		TOTAL CUSTOMER ACCTS. (1995$)	$112,699
7		Total (Less Uncollectibles)	$105,367
		Escalation Amounts, 1995 to 1996	
8		Labor	2,544
9		Non-Labor	393
10		Other	0
11		Total	$2,937
12		TOTAL CUSTOMER ACCTS. (1996$)	$115,636
13		Total (Less Uncollectibles)	$108,304
14		LABOR ADJUSTMENT (1996$)	$0

Table 7

SOUTHERN CALIFORNIA GAS COMPANY

MARKETING EXPENSES
SUMMARY

(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
			(A)
		DIRECT EXPENSES	
		OPERATION	
1	907.0	Supervision	902
2	908.0	Customer Assistance Expenses	2,603
3	909.0	Informational Instrctl. Ads	3,733
4	910.0	Misc Customer Svc & Info Expenses	16,169
5	911.0	Supervision	0
6	916.0	Misc. Sales Expenses	0
5		TOTAL MARKETING EXPENSES(1995$)	$23,408
		Escalation Amounts, 1995 to 1996	
6		Labor	341
7		Non-Labor	387
8		Other	0
9		Total	$728
10		TOTAL MARKETING EXPENSES. (1996$)	$24,136
11		LABOR ADJUSTMENT (1996$)	$0

Tables 8

SOUTHERN CALIFORNIA GAS COMPANY

ADMINISTRATIVE AND GENERAL EXPENSE SUMMARY

(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	Account No.	Description	ADOPTED
---	---		---
			(A)
		Operation	
1	920.0	Administrative & Gen. Salaries	42,278
2	921.0	Office Supplies and Expenses	32,576
3	922.0	Admin. & Gen. Transfer Credit	0
4	923.0	Outside Services Employed	58,565
5	924.0	Property Insurance	2,796
6	925.0	Injuries and Damages	20,042
7	926.0	Employee Pensions and Benefits	80,332
8	927.0	Franchise Reqmnts (@Pres.Rates)	23,142
9	928.0	Regulatory Commission Expenses	269
10	930.2	Misc. General Expenses	12,661
11	931.0	Rents	21,440
12		Total Operation	$294,101
		Maintenance	
13	935.0	Maintenance of General Plant	6,509
14		Total Maintenance	6,509
15		TOTAL ADMIN. & GEN. (1995$)	$300,610
16		Total (Less Franchise Req.)	$277,468
		Escalation Amounts, 1995 to 1996	
17		Labor	1,398
18		Non-Labor	4,558
19		Other	0
20		Total	$5,956
21		TOTAL ADMIN. & GEN. (1996$)	$306,566
22		Total (Less Franchise Req.)	$283,424
23		LABOR ADJUSTMENT (1996$)	$0

Table 9

SOUTHERN CALIFORNIA GAS COMPANY

REASSIGNMENTS

(Thousands Of 1995 Dollars Unless Otherwise Indicated)
Test Year 1996

Line No.	ADOPTED TABLE No.	Description	ADOPTED
			(A)
1	4	Clearing Accounts	14,216
2	5	Underground Gas Storage	135
3	6	Gas Transmission	1,016
4		SUBTOTAL	$15,367
5	7-A	Gas Distribution-Operations Expenses	7,302
6	7-B	Gas Distribution-Measurement Expenses	0
7	7-C	Gas Distribution-Engineering Expenses	28
8	7-D	Environmental & Safety Expenses	0
9	8	Customer Accounts	0
10	9	Marketing Expenses	0
11	10	Administration & General	15,756
12		SUBTOTAL	$23,087
13		TOTAL REASSIGNMENTS (1995$)	$38,454
		Escalation Amounts, 1995 to 1996	
14		Labor	423
15		Non-Labor	552
16		Other	0
17		Total	$975
18		REASSIGNMENTS (1996$)	$39,429
19		ADJUSTMENT (1996$)	$0
20		TOTAL REASSIGNMENTS (1996$)	$39,429

Table 10

SOUTHERN CALIFORNIA GAS COMPANY

DEPRECIATION EXPENSE

Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
1	Underground Storage	18,907
2	Transmission Plant	20,934
3	Distribution Plant	164,617
4	General Plant	32,801
5	Subtotal	$237,259
6	Net Additions	2,211
7	Adjustment for Plant Issues	394
8	Adjustment for CIS dep'n accrual	1,284
9	Total Depreciation Expense	$241,147
10	1996 Depreciation Expense Estimate	$241,147

Table 11

SOUTHERN CALIFORNIA GAS COMPANY

DEPRECIATION RESERVE

Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
1	Reserve Balance @ 12/31/95	$2,586,090
2	Depreciation Accrual	241,147
3	Retirements & Net Salvage	(50,939)
4	Clearing Account	0
5	Reserve Balance @ 12/31/96	$2,776,298
6	Average Depreciation Accrual	120,574
7	Average Retirements & Net Salvage	(25,470)
8	Average Clearing Account	0
9	1996 Total Weighted Avg. Reserve (Line 1 + 6 + 7 + 8)	$2,681,194

Table 12

SOUTHERN CALIFORNIA GAS COMPANY

TAXES OTHER THAN ON INCOME

Test Year 1996
(Thousands of Dollars)

Line No.	Description	ADOPTED
		(A)
	Ad Valorem Taxes	
1	California	35,519
2	Total Ad Valorem Taxes	35,519
	Payroll Taxes	
3	Federal Insurance Contrib. Act	24,344
4	Federal Unemployment Insurance	398
5	State Unemployment Insurance	750
6	Exhibit 57 Payroll Tax Changes	0
7	Total Payroll Taxes	25,492
	Other Taxes	
8	Sales Tax Increase	0
9	Hazardous Substance Tax	0
10	Total Other Taxes	0
11	Total Taxes OTOI	$61,011

Table 13

SOUTHERN CALIFORNIA GAS COMPANY

INCOME TAX ADJUSTMENT

Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
	California Income Tax Adjustments	(A)
1	Tax Depreciation	204,431
2		0
3		0
4		0
5	Fixed Charges-Operating	91,536
6	Removal Costs	6,871
7	Repair Allowance	4,000
8		0
9		0
10	Miscellaneous-Net	(2,198)
11		0
12	Total CCFT Adjustments	$304,640
	Federal Income Tax Adjustments	
13	Tax Depreciation	182,573
14		0
15		0
16		0
17		0
18		0
19		0
20		0
21	Fixed Charges-Operating	91,536
22	Removal Costs	5,222
23		0
24		0
25	Miscellaneous-Net	17
26		0
27	Total FIT Adjustments	$279,348

Table 14
SOUTHERN CALIFORNIA GAS COMPANY

TAXES ON INCOME - PRESENT RATES

Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
	California Corporation Franchise Tax	
1	Operating Revenues	$1,598,091
2	Operating Exp (incl prod adjust)	682,980
3	Taxes Other Than On Income	61,011
4	Income Tax Adjustments	304,640
5	California Taxable Income	$549,459
6	CCFT Tax Rate	0.0884
7	CCFT	$48,572
8	State Tax Adjustment	0
9	Subtotal	$48,572
10	Defense Facilities Credit	0
11	Deferred Taxes	0
12	Total CCFT	$48,572
	Federal Income Tax	
13	Operating Revenues	$1,598,091
14	Operating Exp (incl prod adjust)	682,980
15	Taxes Other Than On Income	61,011
16	CCFT (Prior Year)	30,364
17	Income Tax Adjustments	279,348
18	Federal Taxable Income	$544,388
19	FIT Tax Rate	0.35
20	Federal Income Tax	$190,536
21	Investment Tax Credit	(2,867)
22		0
23		0
24		0
25	Average Rate Assumption	(285)
25	Total Federal Income Tax	$187,384

Table 15
SOUTHERN CALIFORNIA GAS COMPANY

TAXES ON INCOME - ADOPTED RATES

Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
	California Corporation Franchise Tax	
1	Operating Revenues	$1,368,728
2	Operating Exp (incl prod adjust)	678,608
3	Taxes Other Than On Income	61,011
4	Income Tax Adjustments	304,640
5	California Taxable Income	$324,468
6	CCFT Tax Rate	0.0884
7	Total CCFT	$28,683
8	State Tax Adjustment	0
9	Subtotal	$28,683
10	Defense Facilities Credit	0
11	Deferred Taxes	0
12	Total CCFT	$28,683
	Federal Income Tax	
13	Operating Revenues	$1,368,728
14	Operating Exp (incl prod adjust)	678,608
15	Taxes Other Than On Income	61,011
16	CCFT	30,364
17	Income Tax Adjustments	279,348
18	Federal Taxable Income	$319,397
19	FIT Tax Rate	0.35
20	Federal Income Tax	$111,789
21	Investment Tax Credit	(2,867)
22	Capitalized Int & Prop Txs	0
23	Superfund Tax (Line 18*0.0012)	0
24	Capitalized Employee Benefits	0
24	Average Rate Assumption	(285)
25	Total Federal Income Tax	$108,637

Table 16
SOUTHERN CALIFORNIA GAS COMPANY
GAS PLANT IN SERVICE
Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
1	1996 BOY GAS PLANT	$5,555,550
	1996 NET ADDITIONS:	
2	Gross Additions	163,196
3	Less Retirements	(38,454)
4	Net Additions	124,742
	1996 WEIGHTED AVG. ADDITIONS:	
5	Weighting Percentage	40.29%
6	Weighted Avg Net Additions	50,259
	1996 CUSTOMER INFO SYSTEM:	
7	Net Addition	24,954
8	Wtd. Avg. Addition	24,954
	SPECIAL RETIREMENTS:	
9	Plant No Longer Used & Useful	0
10	1996 EOY PLANT (1+4+7-9)	5,705,246
11	1996 WTD. AVG. PLANT (1+6+8-9)	5,630,762

Table 17

SOUTHERN CALIFORNIA GAS COMPANY

WEIGHTED AVERAGE DEPRECIATED RATE BASE
AT ADOPTED RATES
Test Year 1996
(Thousands of 1996 Dollars)

Line No.	Description	ADOPTED
		(A)
	Weighted Average Gas Plant:	
1	Gas Plant	5,630,762
2	Total Weighted Average Plant	5,630,762
	Working Capital:	
3	Materials and Supplies	14,303
4	Accum. Def. IT/Contrib.&Adv.	22,249
5	Work in Progress	12,388
6	Working Cash	26,485
7	Total Working Capital	$75,425
8	Total (Line 2+7)	5,706,187
	Less Adjustments:	
9	Customer Advances	53,299
10	Deferred Rev. Net Of FIT	9,624
11	Acc. Deferred FIT-Depreciation	293,237
12	Acc. Deferred Taxes	0
13	Acc. Deferred ITC	1,344
14	Aliso Gas Rights	210
15	Gain On Sales	6,545
16	Total Deductions	$364,259
17	Depreciation Reserve	2,681,194
18	Total Adjustments (Line 16+17)	3,045,453
19	Total Rate Base (Line 8-18)	$2,660,734

Table 18

SOUTHERN CALIFORNIA GAS COMPANY

DETERMINATION OF AVERAGE AMOUNTS OF WORKING CASH CAPITAL SUPPLIED BY INVESTORS

Test Year 1996
(Thousands of Dollars)

Line No.	Description	ADOPTED
		(A)
	Operational Cash Requirements	
1	Required Bank Balances/Cash	0
2	Special Deposits & Working Funds	160
3	Other Receivables	11,140
4	Other Prepayments	2,750
5	Deferred Debits	3,520
6	Total Operat'l Cash Requirement	$17,570
	Plus: Working Cash Rqmnt from lag in	
7	Collection of Revenues	68,122
	Less: Amounts Not Supplied By Investors	
8	Collection of state regulatory fees	370
9	Collection of utility users tax	690
10	Collection of transport tax before payment	(30)
11	Collect'n of municipal surchrg before paymnt	2,820
12	Employees withholding	1,280
13	Purchase of capitalized items	4,620
14	Purchase of materials and supplies	210
15	Current and accrued liabilities	28,234
16	Available Cash Balance Adjustment	0
17	Deferred Credit Adjustments-Overland	21,013
18	Total deductions	$59,207
19	Working Cash Capital (Line 6+7)	$85,692
	Plus: Average Amount Required	
20	Lead Lag @ ADOPTED Rates (Line 7)	68,122
	Working Cash Capital Supplied by Investors	
21	Calculated @ ADOPTED rate (Line 6 + 20 - 1	26,485
22	Use @ ADOPTED rate	$26,485

Table 19

SOUTHERN CALIFORNIA GAS COMPANY

DEVELOPMENT OF AVERAGE LAG IN PAYMENT OF EXPENSES

Test Year 1996
(Thousands of Dollars)

Line No.	Description	Expense
		(A)
1	Federal Income Tax	108,637
2	FIT: SIT Ded. Timing Adj. #1	0
3	FIT: SIT Ded. Timing Adj. #2	0
4	State Income Tax	28,683
5	Deferred Income Taxes	0
6	Franchise Requirements	37,963
7	Natural Gas Purchased	1,209,335
8	Company Labor	337,474
9	Pension Expense	0
10	Disability Plan	4,412
11	Retirement Saving Plan	6,829
12	Life Insurance	1,392
13	Medical & Dental	22,811
14	Health Maint. Organizations	4,246
15	Goods and Services	22,068
16	Materials From Storeroom	1,058
17	Depreciation	241,147
18	Ad Valorem Tax - CA	35,519
19	FICA Tax	24,344
20	Unemployment Tax - Federal	398
21	Unemployment Tax - California	750
22	Real Estate Rental Payments	24,239
23	Equipment Lease Payments	16,185
24	Amort. Of Insurance Premiums	6,887
25	Workers Comp.	12,986
26	Benefits Fees & Services	3,542
27	TOTAL	2,150,904
28	Expense Lag Days = (C)/(A) =	35.79
29	Revenue Lag Days	47.35
30	Working Cash From Lead Lag	68,122
31	Rate Base At ADOPTED Rates	2,660,734
32	Rate of Return	9.42%

Table 20
SOUTHERN CALIFORNIA GAS COMPANY

Development of the Net To Gross Multiplier

Test Year 1996

Line No.	Description	(A)	(B)	(C=AxB)
1	Gross Operating Revenues			1.000000
2	Less: Uncollectibles	0.004776	1.000000	0.004776
3				0.995224
4	Less: Franchise Requirements	0.014828	0.995224	0.014757
5				0.980467
6	Less: Superfund Tax	0.000000	0.980467	0.000000
7				0.980467
8	Less: State Income Tax	0.088400	0.980467	0.086673
9				0.893794
10	Less: Federal Income Tax	0.350000	0.980467	0.343163
11	Net Operating Revenues			0.550630
12	Net To Gross Multiplier (A/B)	1.000000	0.550630	1.816100

(END OF APPENDIX B)

APPENDIX C

LIST OF APPEARANCES

MASTER LIST R87-11-012/A95-06-002
CRTD :11/26/96 lil
Udated: 4/17/97 ica
Added : 4/17/97 ica
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(END OF APPENDIX C)

R.87-11-012/A.95-06-002
D.97-07-054

COMMISSIONER HENRY M. DUQUE, DISSENTING IN PART:

Throughout my deliberations on the proposed decision and the alternate pages, I have been supportive of simplifying the indexing formula. However, in examining ways to simplify the indexing formula, most proposed approaches focused on increasing the productivity factor to achieve a similar revenue requirement result as the TURN/DGS formula. This is the approach that President Conlon's alternate took and is the approach adopted in this decision. I reviewed President Conlon's alternate pages with great interest, given my preference for a simple formula. However, I ultimately concluded that if we believe that the results of the TURN/DGS methodology are sound, and by adjusting the productivity factor we were simply trying to emulate those results using a different formula, that we should adopt the TURN/DGS methodology. The complexity in the formula is in its development, not in its implementation, as it relies on the same inputs as the more simple formula. I believe that the proposed decision prepared by the ALJ accurately reflected productivity in the productivity factor, and accurately reflected the declining rate base in the indexing formula. In my opinion, the alternate approach adopted in this decision masks the declining rate base issue in the productivity factor and this is why the adopted productivity factor in the proposed decision was so different from that in the alternate pages.

For these reasons, I file this partial dissent regarding the indexing formula.

/s/ HENRY M. DUQUE
Henry M. Duque
Commissioner

I concur with Commissioner Duque's partial dissent.

/s/ JOSIAH L. NEEPER
Josiah L. Neeper
Commissioner

San Francisco, California
July 16, 1997

R.87-11-012/A.95-06-002
D.97-07-054

H-7

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For these reasons, I file this partial dissent regarding the indexing formula.

Henry M. Duque
Commissioner

I concur with Commissioner Duque's partial dissent.

Josiah L. Neeper
Commissioner

San Francisco, California
July 16, 1997

ALJ/VDR/tcg *

Mailed

Decision 97-07-054 July 16, 1997

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Review the Time Schedules for the Rate Case Plan and Fuel Offset Proceedings.	R.87-11-012 (Filed November 13, 1987)
In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY to Adopt Performance Based Regulation ("PBR") for Base Rates to be Effective January 1, 1997.	Application 95-06-002 (Filed June 1, 1995)

ORIGINAL

(See Appendix C for appearances.)

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OPINION

I. Summary of Decision

In this decision we consider a proposal by Southern California Gas Company (SoCal or applicant) for adoption of performance-based ratemaking (PBR) for the portion of SoCal 's rates that recovers the costs of providing gas utility service that the Commission has reviewed in the past through the General Rate Case (GRC) process.[1]

Our decision today adopts a PBR system for SoCal which differs in several respects from the proposal advanced by SoCal. Most significantly, we adopt a system which requires SoCal to share with ratepayers the savings produced by the indexing method. We also adopt an indexing method, adjustments and exclusions, provisions to insure that high standards of service quality and safety are maintained, and a base margin to which the indexing will be applied.

Our decision is effective immediately. The rates based upon our adopted base margin revisions shall become effective August 1, 1997. The PBR mechanism shall become effective January 1, 1998, unless SoCal elects to operate under the mechanism effective as of January 1, 1997.

II. Background of Application

A. *Description of Applicant*

SoCal is an investor-owned utility subject to the jurisdiction of this Commission. It is engaged in the transmission, storage, and distribution of natural gas. SoCal is the principal subsidiary of Pacific Enterprises.

B. *Procedural History*

SoCal filed its application on June 1, 1995. Filing of the formal application was preceded by a series of workshops held by SoCal in December 1994 and January

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[1] SoCal uses the term "regulation" rather than "ratemaking" to characterize its proposal, but the rubric refers to a method for adjusting rates annually without prior Commission approval of the adjustment. The Commission has used the term "performance-based ratemaking" in similar proceedings previously, and does so here for the sake of consistency.

1995, in which SoCal met with interested parties to present the contemplated proposal. SoCal's application includes some changes from its original proposed concept, which were made after the workshops.[2]

Before filing the application SoCal also requested a suspension of the requirement to file a test year (TY) 1997 GRC. SoCal's last GRC had been for TY 1994, and its TY 1997 GRC was due to be filed under the Commission's rate case plan. The reason given by SoCal for its request was that it was actively pursuing a PBR system to become effective February 1, 1997, eliminating the requirement for a TY 1997 GRC. In Decision (D.) 95-04-072 in Rulemaking (R.) 87-11-012, the Commission granted the suspension, subject to conditions designed to protect ratepayers from the risks created by that suspension. The order also directed the Commission's staff to conduct an audit, as required at least every three years under Public Utilities (PU) Code 314.5, in connection with the PBR proceeding. The Commission later extended the order, suspending the requirement to file a TY 1998 GRC because the PBR application was being processed in a timely manner.

The assigned administrative law judge (ALJ) held prehearing conferences (PHCs) on September 25, 1995, and January 29, 1996. In response to a joint motion filed January 4, 1996 to request a specified procedural schedule, the ALJ ruled that SoCal must serve its recorded data for 1995 on February 14, 1996, and make a supplemental showing with respect to 1996 estimated expenses on June 6, 1996. This is the showing used by the parties, by agreement, to develop the base margin figures and other features of the PBR program considered here.

On October 14, 1996, Pacific Enterprises and Enova Corporation, the parent company of San Diego Gas & Electric Company (SDG&E), announced that they proposed to merge, and filed an application for approval by the Commission (Application (A.) 96-10-038). The Southern California Utility Power Pool and the

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[2] Conceptually, the most significant of these was a change from the Consumer Price Index (CPI) to an industry-specific index in the indexing formula.

productivity through sales. On the base margin side, SoCal criticizes the resolution of a number of individual items on the grounds of legal or factual error.

ORA generally supports the PD as a whole, but in its comments offers a series of recommendations which would make the decision clearer and conceptually tighter, consistent with the adopted resolution of major issues. ORA also suggests corrections to a number of figures based on inadvertent factual errors.

SCE also generally supports the PD, but suggests certain clarifications and corrections.

SDG&E's comments are critical of the adopted indexing methodology and the PD's description of other PBR decisions, and of two of the items in the base margin section, the treatment of the Torrance and Mountain View facilities and the removal of Line 6900 from rate base.

SCUPP/IID reiterates concerns expressed by other parties about an ambiguity in the effective date of the decision, and about the discussion of exclusion of costs for Lines 6900 and 6902 from rate base.

CEC's brief comments are generally supportive of the PD, but suggests two changes: that energy efficiency funds be transferred to the Energy Efficiency Board, and that $5 million of SoCal's energy efficiency budget be allocated for market transformation efforts.

Enron and the Insulation Contractors Association filed comments that are directed specifically at the issue of unregulated new products and services, but are fully supportive of the PD. Certain of the other comments contain discussions of the new products and services issue.

Reply comments were filed by SoCal, ORA, SCE, DGS, NRDC, TURN, Enron, and the Plumbing-Heating-Cooling Contractors.

Revisions to the PD made in response to the comments and replies are reflected in this final decision. Additional revisions were made to correct or clarify the text. All areas changed are indicated on the margin.

Imperial Irrigation District (SCUPP/IID) and Southern California Edison Company (SCE) moved to suspend the procedural schedule in this proceeding in contemplation of these merger plans, but the ALJ denied that request by ruling dated October 23, 1996. The assigned commissioner denied reconsideration of that request on November 14, 1996.

The formal evidentiary hearing commenced December 2, 1996, and concluded December 19, 1996. Two rounds of briefs were filed, and the proceeding was submitted on February 14, 1997.

C. Proposed Decision

The Proposed Decision of ALJ Ryerson (PD) was filed on April 21, 1997, pursuant to § 311(d) of the Public Utilities (PU) Code and Rule 77.1 of the Commission's Rules of Practice and Procedure (Rules).[3]

D. Comments on Proposed Decision

Comments on the PD were filed by SoCal, ORA, SCE, SDG&E, SCUPP/IID, CEC, Enron, and Insulation Contractors Association. The Commission also received a letter from TURN indicating that it would not file comments, but would reserve the option to file replies to the comments of other parties.

SoCal's comments are critical of several aspects of the PD's treatment of both policy issues (i.e., the PBR mechanism) and the base margin. Specifically, SoCal criticizes the TURN/DGS formula adopted by the decision as being company-specific in nature, contrary to our policy of using external industry yardsticks; the stretch factor as being too rigorous in light of SoCal's recent history of productivity gains; the absence of pricing flexibility; the adoption of revenue indexing rather than rate indexing; and the absence of "tools" (particularly pricing flexibility) to enable it to attain greater

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[3] The PD was issued before the expiration of the 90-day statutory time limit following submission at the request of the applicant and the Commission, in order to facilitate coordination with A.96-10-038.

E. Description of SoCal's Proposal

The application proposes a new method for revising SoCal's rates annually by applying an index, based upon a measure of recorded input price inflation less a productivity factor, to its rates. The productivity factor would be fixed at this time, and would not be revised during the minimum five-year term that the new ratemaking system is proposed to be in effect, but adjustments to certain aspects of the rates would be made by annual rate revision filed by SoCal. In this section we describe the specific features of the PBR methodology SoCal has proposed.[4]

1. Rate Indexing

SoCal proposes to index core and noncore base rates and certain miscellaneous charges, as opposed to indexing total authorized margin or authorized margin per customer, i.e., revenue requirement. This means that rates would be indexed directly to inflation less the pre-set productivity factor. SoCal claims that its proposal for rate indexing "fixes the throughput forecast used to set rates over the PBR period and puts utility shareholders at risk/reward for any differences between forecast and actual throughput and customer count." (SoCal Opening Brief, p. 44.) SoCal asserts that its ratepayers will benefit, because the level of rates, in real terms, is guaranteed to decline over the period that this mechanism is in effect, by reason of enforced productivity gains over the period. SoCal supports this contention with a ten-year backcast analysis demonstrating that PBR would have resulted in rates 13% lower than under traditional "cost-plus" ratemaking.

a) Core Demand Forecast

The methodology chosen by SoCal is rate indexing, which depends upon fixing a specific throughput forecast for calculating the rate level at the

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[4] The details of SoCal's proposal are contained in prepared testimony and exhibits that were initially filed as part of the application. A number of modifications were made since the initial proposal, and the details of the current proposal, along with the supporting testimony, are contained in SoCal's direct testimony (Exh. 1-Exh. 33) and the jointly sponsored testimony (Exh. 200-Exh. 210) received at the evidentiary hearing.

outset. For core rates SoCal proposes that we adopt its recorded 1996 customer count and core throughput, normalized to average temperature conditions, in establishing the starting point for indexing. Also, because the current core rates are based upon throughput which uses a "normal" temperature measure that is set too low in relation to updated temperature averages, SoCal proposes to change this measure in establishing this starting point.

Under current ratemaking, a balancing account called the Core Fixed Cost Account (CFCA) operates to insure that SoCal over time will recover in rates exactly the amount of Commission-authorized margin, regardless of the actual level of customer demand (i.e., core throughput). However, if throughput is foreordained as part of the base margin, this balancing account cannot function. Core demand (throughput) will in fact vary because of variations in average temperatures from year to year, but rates cannot be adjusted because the throughput figure is set beforehand. As part of its proposal, SoCal therefore would eliminate the CFCA and substitute two other devices, the Weather Normalization Mechanism (WNM) and the Energy Efficiency Adjustment Factor (EEAF), to adjust rates in its place.

The WNM would adjust core rates to reflect differences in throughput due to differences between recorded and normal temperature conditions. The WNM would be used to adjust the bill of each customer at the time the bill is issued for variations from normal temperature conditions in the period for which the bill is rendered.[5] SoCal contends that this is appropriate because temperature conditions are wholly beyond the control of its management, and temperature variations could create large variations in core revenues relative to its authorized return on equity.

The EEAF would adjust rates for the effect on revenues from core throughput lost each year due to gas conservation and energy efficiency measures actually implemented by SoCal's customers. Under SoCal's proposal, the first 0.3% of

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[5] The WNM would apply only to core customers, and would exclude core gas engine and air-conditioning customers, because their load is basically not sensitive to heating requirements.

rate impact would not be adjusted for, on the presumption that the PBR index already reflects that impact. SoCal also proposes to cap the amount of EEAF adjustment at 1.0% annually. SoCal argues that implementing the EEAF as part of its proposal would be justified, because it eliminates SoCal's incentive to discourage conservation, as the PBR mechanism rewards the utility for selling more gas. SoCal also argues that the EEAF would eliminate the reduction in its earnings that would be caused by government-mandated or subsidized conservation measures.

b) Noncore Demand Forecast and Rates

The methodology proposed for fixing noncore rates for PBR indexing is entirely different, principally because of the effect of an agreement, the Global Settlement, that has been adopted by the Commission. The Global Settlement provides that, from August 1, 1994 through July 31, 1999, SoCal will calculate noncore rates based upon 1991 actual throughput. SoCal therefore proposes to use two sets of noncore rates for PBR indexing. The first is based upon 1996 adjusted base margin and allocation, but uses 1991 throughput. The second is based upon 1996 base margin and 1996 throughput, calculated in the same manner as the first set, but not effective until August 1, 1999. In its proposal, SoCal refers to these as "shadow rates." Both sets of rates rely, however, upon the use of a fixed throughput figure for establishing the base rate for PBR indexing.

2. Index to be Applied

a) Inflation Measure

The inflation measure proposed by SoCal is a weighted average of recorded indices of prices for labor operating and maintenance (O&M) costs, nonlabor O&M costs, and capital-related costs.[6] In the price index, the measure for labor O&M is the index of average hourly earnings of workers in gas production and distribution as reported by the U.S. Bureau of Labor Statistics. The measure for

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[6] SoCal refers to this measure as the gas utility input price index, or GUPI.

nonlabor O&M is the Data Resources, Inc. (DRI)/McGraw Hill nonlabor O&M index for gas utilities. The inflation measure for capital-related costs is based upon the DRI/McGraw Hill indices for capital service prices and for the price of gas distribution capital goods. These measures would be weighted according to the average of expenditures in each category by SoCal for the past five years. Although a forecast of inflation would be used, the forecast would be trued up to recorded inflation at the next annual PBR rate adjustment. Rates for a year would be set using the latest available forecast for the price index elements for that forthcoming year, and the following year's rate filing would include an adjustment to true up any difference the forecast and actual price index.

b) Productivity Factor

SoCal proposes to employ a constant productivity factor of 1.0% per year as the second element of the PBR adjustment mechanism. SoCal's selection of this figure is based upon two components: historical gas distribution average productivity of 0.5%, plus a factor of 0.5% as an incentive to improve productivity over past performance.[7] SoCal asserts that this 1% total productivity factor, which would be applied for the entire period that PBR rates are in effect, affords an adequate incentive for the company to strive for greater efficiency.

In support of the component percentages, SoCal offers a study of 49 gas utilities nationwide as evidence that the 0.5% productivity increase is close to the national average.[8] The additional 0.5% "stretch factor" is essentially based upon the company's judgment of productivity gains that can reasonably be anticipated. SoCal asserts that this figure is consistent with Commission precedent and policy, and argues that a higher percentage would be unreasonable or unattainable in light of the

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[7] SoCal refers to this element of the productivity factor as a "stretch factor" or "consumer dividend."

[8] This was a multifactor productivity study of the gas local distribution service delivery industry conducted by Christensen Associates, which found the historic range to be 0.4% to 0.5%. (Exh. 5.)

cost forecasts and cost relationships upon which higher factors proposed by other parties rely.

c) *Starting Rate Level*

SoCal proposes that its level of base rates for 1997 would be determined by applying the PBR index to a starting level of rates and to the existing level of miscellaneous charges.[9] Establishment of the starting level is based upon a "test year" showing and analysis resembling that for a GRC. The basis selected for analysis is SoCal's calendar year 1996 internal operating budget. The approach to setting base margin in 1997 under PBR is to take the figure representing the reasonable level of expense and rate base for SoCal in 1996, and to adjust that revenue requirement for one year with the PBR index adopted by the Commission in this proceeding. This will produce rates to be in effect when a PBR decision goes into effect in 1997.

d) *Exclusions*

Certain costs would not be recovered through the portion of rates that would be subject to the PBR index. These would remain subject to recovery through other existing ratemaking mechanisms. In general, the principle behind these exclusions from PBR is that the costs are already subject to incentive-type mechanisms, that they are beyond SoCal's control, or that the level of expenditure is specifically authorized by this Commission or by the Federal Energy Regulatory Commission (FERC) in separate proceedings. The specific costs proposed to be excluded are discussed later in this decision.

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[9] The "base rate" is the part of rates reflecting gas margin, and excluding gas costs, pipeline demand charges, and other specifically identified items; it is only the base rate that is guaranteed to be reduced under PBR. Final rates measured in constant dollars will decline unless increases in gas costs and excluded items more than offset the reduction in the indexed portion of the rate. (Exh. 1, p. 13.)

e) "Z" Factor Adjustments

A "Z" factor, as recognized by this Commission, is an exogenous and unforeseen event largely beyond the utility's control that has a material impact upon the utility's costs. Examples of Z factors include accounting rule changes adopted by governing boards and agencies, state and federal tax law changes, and new government mandates.

SoCal proposes that its rates be adjusted, either upward or downward, by the amount of change in its costs exceeding a one-time $5 million "deductible" amount per qualifying Z factor. The amount of change in SoCal's costs subject to Z factor treatment would be reduced by the amount by which SoCal would already be compensated by the inflation factor in the PBR index formula. SoCal also proposes a specific procedure for handling each Z factor event.

f) Adjustments for Gain or Loss on Sale

SoCal proposes an adjustment in rates in addition to the PBR index if the company sells at a gain or loss land that was acquired and held in rate base before the implementation of PBR. SoCal proposes to credit its customers with one-half of the gain, but SoCal could request, on a case-by-case-basis, that the Commission authorize a smaller sharing of gain from the sale and replacement of a particular parcel of land, when the benefit from the sale and replacement to SoCal is less than the 50% of gain that it would otherwise have to refund in rates. Sales of all or a portion of a distribution system qualifying for allocation to shareholders under the holding of Decision (D.) 89-07-016 (City of Redding II), 32 CPUC2d 233 (1989), would not produce any reduction in rates under PBR. There would be no adjustment in rates for purchase or sale of land acquired after implementation of PBR.

g) Cost of Capital

SoCal does not propose to make any changes in PBR indexed rates in response to changes in costs of capital, except in the event that the 12-month trailing average yield on long-term Treasury Bonds increases or decreases radically, i.e, more than 250 basis points from the DRI average rate for the calendar year

1997 forecast, as adopted in SoCal's1997 cost of capital proceeding.[10] During at least the minimum five-year term of PBR, SoCal proposes not to file annual cost of capital applications, and rates would not be adjusted for changes in the cost of debt, preferred or common equity capital, or changes in capital structure, unless variation exceeded the 250 basis point "trigger."

In the event that the trigger is exceeded by an increase in interest rates, SoCal proposes to have the option to file a cost of capital application; in the event of a 250 basis point decrease, SoCal would be required to file a cost of capital application. In either event the Commission would determine whether any change in rates was appropriate in light of all factors affecting the cost of capital. Any rate change, whether an increase or decrease, would be prospective only from the effective date of a Commission decision.

h) Effective Date and Term of PBR Rates

SoCal initially proposed that its PBR mechanism would become effective on January 1, 1997, and would continue for a minimum term of five years, through year-end 2001. However, the time required to process the application has not permitted implementation of a PBR by the original target date, necessitating an adjustment of the proposed implementation schedule. Under the revised schedule SoCal continues to propose a five-year minimum term for PBR, and thus the original dates for all events would be extended to dates corresponding to the additional time involved in concluding the proceeding. Assuming the Commission issues a decision placing PBR rates in effect on July 1, 1997, the minimum term of the PBR would expire on June 30, 2002.

SoCal proposes that no change be made in PBR indexing during the five-year minimum term of the proposed mechanism, except to the extent such express features as Z factor adjustments and cost of capital revisions require. SoCal therefore asks that we forgo provision for any formal midterm review process,

[10] See D.96-11-060.

continuous "forum" proceeding, or "off-ramp" that would permit or require suspension of the PBR during the initial five-year term.

SoCal proposes that the PBR continue automatically beyond the minimum period, unless changed at the behest of a party or the Commission. At any time after June 30, 2000, any party, or the Commission on its own motion, could institute a proceeding to change or replace the PBR mechanism effective on or after the expiration date.

i) Maintenance of Service Quality

In order to insure that SoCal's focus on increased productivity through cost reductions does not have a deleterious effect upon the quality of service, SoCal proposes a mechanism to ensure the maintenance of service quality during the period when the PBR rates are in effect. Originally, SoCal proposed a service quality guarantee for core customers based upon random customer telephone survey responses to questions concerning customer satisfaction with SoCal's call center response time; call center employee performance; field service employee response time; and field service employee performance. SoCal proposed the adoption of a benchmark for its performance, namely, the average recorded level of customer satisfaction for July 1993 through June 1996 in random surveys on these four service dimensions. A "deadband" below this benchmark would allow for some sampling error, but below the deadband the company would be required to reduce rates in increments of $1 million per year up to a maximum of $4 million per year for failure to meet the criterion. No incentive was proposed for exceeding the benchmark for customer satisfaction. SoCal proposed to retain its existing Service Interruption Credit (SIC) mechanism for service to noncore customers, but did not propose any other service guarantees for noncore customers in recognition that competition provides an incentive for SoCal to assure adequate, efficient, just, and reasonable service to noncore customer.

Subsequent negotiations among the parties produced a proposal for a somewhat different customer satisfaction measure. The concept of this proposal is essentially the same as that of the one it replaces in the original application.

j) Employee Safety

Originally, SoCal did not propose any specific safety performance measures for public, customer, or employee safety, on the assumption that existing federal and state safety laws and regulations mandate standards with which SoCal must comply. However, SoCal, TURN, and ORA have agreed to propose an annual employee safety standard which would be used to adjust rates if SoCal's performance fell below or above the standard by a material margin.

The proposed standard is 9.3 incidents per 200,000 hours worked, with a deadband of 1.0 incidents in each direction, measured annually from the Occupational Safety and Health Administration (OSHA) Recordable Injury and Illness Rate. Should the annual rate exceed 10.3 incidents, customers would receive a rate reduction through the annual rate adjustment filing process. Conversely, SoCal would receive a reward through the annual rate adjustment filing process if its performance were better than an annual rate of 8.3 incidents. The customer rate adjustment would be based upon $20,000 for each 0.1 point above or below the deadband.

k) New Products and Services

In its application SoCal seeks authorization to offer on a competitive and unregulated basis products and services that it has not previously offered. SoCal also seeks the authorization to provide support to its non-regulated affiliates in connection with their offering of new products and services. SoCal states that these new products and services would be provided entirely at shareholder risk, and would not be funded by the rates charged for utility services.

l) Rate Design Changes

SoCal proposes to include several changes in rate design in its program for PBR. These include changes in residential rate design, and a proposal for flexibility to negotiate rate discount agreements and offer optional rate schedules for certain core customers.

Currently, the company's monthly residential customer charge, which went into effect in 1996, is $5.00. Effective with PBR implementation, SoCal proposes to charge single-family and master meter residential customers a monthly customer charge of $7.11, and multifamily customers $5.47 per month. By January 1, 2001, SoCal proposes to charge a single-family and master meter residential customers a monthly customer charge of $13.57 and multifamily customers $10.35 per month (stated in 1996 dollars). Customer charges upon PBR implementation, and on each January 1 thereafter through 2001, would be increased by 1/5 of the difference between the 1996 customer charge of $5 and the aforementioned 2001 charges.[11] Corresponding reductions would be made in residential volumetric rates.

Upon implementation of PBR, SoCal also proposes to reduce the differential between residential volumetric Tier I and Tier II rates from the current 35% to 10%, and to maintain this relationship at least through the end of the minimum PBR period. SoCal claims that these proposed residential design changes are necessary to bring rates more into line with costs, as fixed residential customer-related costs are currently understated, and that the increased customer charges and decreased volumetric rates will reflect the true long-run marginal cost of gas service.[12]

SoCal proposes to be granted authority to negotiate rate discount agreements with individual core customers, and to offer core rate schedules that customers meeting the applicability requirements would have the option to select. The proposed discounting flexibility would apply only to the "base rate" element of core bundled rates. Under SoCal's proposal, negotiated agreements of less than five years' duration would not require Commission approval prior to becoming effective.

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[11] SoCal recommends that these customer charge rate level adjustments be made on January 1 of each year in order to coincide with the other annual rate changes under the PBR index formula.

[12] SoCal proposes certain other changes in rate design in addition to these basic changes. SoCal proposes to update the submetering credit for master meter customers, and to index that credit; to reduce baseline allowances in climate zone 1 from the current 50 therms to 46 therms in winter and from the current 15 therms to 14 therms in summer, with similar reductions in climate zones 2 and 3; and to modify non-residential core rate design.

Optional core rate schedules would become effective upon filing with the Commission without the requirement of prior Commission approval, and could be withdrawn by SoCal upon 30 days' notice to the Commission, unless otherwise specified by the terms of the schedule. SoCal's authorized rates would be the default rates for qualified customers who do not want to avail themselves of the optional schedules.

m) Storage Costs

SoCal proposes to apply the PBR rate index to the base rate elements that recover the cost of storage which is currently bundled in core and noncore rates. This request was not in the original application, but was later included in its request in response to a proposal by ORA to eliminate the Noncore Storage Balancing Account (NSBA) and put SoCal wholly at risk for market demand for the costs allocated to unbundled noncore storage service when the PBR rates become effective. SoCal asserts that its request is consistent with the overall concept that PBR substitutes for a general rate case, in which the revenue requirement for bundled storage costs would otherwise have been adopted by the Commission. SoCal states that because it is proposing to be at risk for throughput under PBR, it would also be at risk for the recovery of the portion of storage costs that is bundled in transmission rates.

n) Monitoring and Evaluation

SoCal states that it recognizes the need for the Commission to monitor the functioning of the PBR mechanism and to be prepared to evaluate the program at the conclusion of the minimum term. Nevertheless, SoCal urges the elimination of a significant number of existing reporting and recordkeeping requirements, and advocates the avoidance of new reporting requirements insofar as possible, in the interest of simplifying and streamlining regulation.

o) Base Margin

SoCal initially proposed a starting base margin which represented a $61.2 million reduction as compared to its 1995 authorized level. Following several revisions in response to discussions with ORA, SoCal's final position is a $110 million reduction in margin compared to the 1995 authorized level. SoCal and ORA have agreed upon a variety of base margin items, and the individual items are described, along with our resolution, in the discussion below.

III. Discussion

A. *Introduction: Performance-based Ratemaking*

In general, performance-based ratemaking refers to any of a variety of ratemaking mechanisms designed to improve utility performance and also return financial benefits to the utility's ratepayers. Its purpose is to break the direct link between costs and rates by inserting "an independent and explicit incentive [for the utility] to increase efficiency through lowering costs," so that ratepayers will not have to bear the risk of inefficient utility operation. (D.96-09-092, mimeo., p. 14, September 20, 1996.) The mechanism itself is intended to emulate an unregulated market.

The basic PBR concept involves two basic steps:

> "First, the PBR regulator sets an initial price based on the utility's observed and projected costs. Next, the regulator provides the utility with incentives to reduce these costs and pass some of the resulting savings onto the consumer. To assure that the utility does not achieve costs savings simply by cutting safety, reliability or quality, the PBR system must also include a quality-control mechanism." Navarro, *"The Simple Analytics of Performance-based Ratemaking: A Guide for the PBR Regulator"* (Yale Journal on Regulation 13:1 (Winter 1996), p. 107.)

The hallmarks of the PBR system under the previous practice of this Commission are an incentive device to encourage cost reduction and revenue enhancement, and a device to ensure sharing of the savings produced thereby with customers.

We first replaced traditional rate case regulation with PBR in D.89-10-031, which placed the two major California local exchange telecommunications companies under an incentive form of regulation. The mechanism we adopted is often called "CPI-X" regulation. As we explained in our most recent PBR decision, D.96-09-092, which adopted PBR regulation for SCE:

"This form of PBR regulation adopts starting rates based on an analysis of utility costs with these rates then updated in each subsequent year by a rule which includes expected changes in input prices, CPI, and productivity, X. . . . [W]e refer to this price less productivity adjustment, or CPI-X, as the update rule.

"To make this update of utility rates independent of the utility's costs, the price and productivity values should come from national or industry measures and not from the utility itself. The independence of the update rule from the utility's own costs allows PBR regulation to resemble the unregulated market where the firm faces market prices which develop independently of its own cost and productivity. In contrast, traditional regulation often updates rates through a review of the utility's own costs and productivity. The form of this PBR update rule of "price less productivity" or CPI-X arises from the unregulated market where, independent of demand response, a firm's output price will change to reflect changes in its input prices less its change in productivity, where productivity is simply the change in the firm's outputs less its change in inputs, both value weighted.

"Finding a measure for the price term in the update rule requires a choice between a general price index such as the well-known CPI or an industry specific index. The former choice involves less controversy but uses a general approximation to industry specific prices, and this approximation can work reasonably well during periods of generally low inflation. While the latter choice clearly tracks industry costs more closely, it does engender more controversy because often it requires construction of a new industry specific price index to track industry price changes closely. Complexity readily arises in the construction of price indices; for example, an accurate current price index for labor requires a weighted average wage for...many different classifications of workers from clerks to system engineers.

"The productivity measure should come from a forecast of industry-specific productivity. However, such studies are not common and most published econometric studies not only assume efficient operation but also use historical data. In D.89-10-031, we relied on a study of AT&T's historical productivity and expert judgment in setting the productivity value for the local exchange utilities. Realizing that technological change in telecommunications offered the opportunity for substantial productivity and wanting to encourage increased efficiency in utility operations, we added a "stretch" factor to set the productivity value or X.

"We note that improved efficiency can arise from three sources: adopting more efficient technology in meeting current demand, realizing economies of scale when expanding the operation, or reducing existing inefficiencies in the current operation. ... [P]articularly in the distribution business, the first source of productivity may contribute only selectively toward greater efficiency and lower rates. The incentives of this PBR should discover the opportunities to increase the efficiency of the current operation and thereby lower rates.

"In D.89-10-031, we also adopted a net revenue sharing rule which allows the utility to keep some of the increased net revenue which occurs if the utility can reduce its costs. Adoption of this rule should increase the utility's incentive to reduce costs. Allowing the utility to retain some of the net revenue from cost reduction efforts also resembles the competitive market where a firm can increase its profits by lowering its costs. Combined with the use of independent prices, the use of a net revenue sharing rule emulates the outcome of a competitive market.

"Thus, we see PBR as emulating the competitive process to encourage utility management to make decisions which resemble an efficient or competitive outcome. An efficient utility will control rates which benefits ratepayers. However, we want to ensure fairness to ratepayers, employees, and shareholders in the PBR process. This requires balancing potentially conflicting interests. The utility can increase short run profits through reducing variable costs, but without revenue sharing such cost reductions will not lower rates. Moreover, such reductions not only can affect staff immediately but the service quality impact may only appear much later." (D.96-09-092, mimeo., pp. 14-16.)

We have already expressed our preference for replacing traditional cost-of-service regulation with performance-based regulation in those areas of the electric services industry which exhibit natural monopoly attributes. See Order Instituting Rulemaking and Order Instituting Investigation in R. 94-04-031 and I.94-04-032 ("Blue Book"). Our policy favoring that deployment of PBR reflects our successful experience with it in the field of telecommunications. Certainly, we are favorably disposed to using PBR wherever it would further our regulatory goals and policies.

At the commencement of I.94-04-003, the SCE proceeding, supra, we stated our goals for undertaking the development of PBR. These included:

- Improving the efficiency and performance of the utility;
- Improving incentives and removing disincentives for utility cost reductions;
- Simplifying and streamlining the regulatory process;
- Moving rates for all customer classes, in real dollars, steadily down the national average for investor-owned utilities;
- Maintaining a reasonable opportunity for the utility to earn a fair rate of return; and
- Maintaining and improving quality of service.

We still regard these as our general goals in evaluating any PBR proposal, and as the policy yardstick for measuring SoCal's proposal in the present instance.

We have embraced PBR in concept with the clear recognition of our "fundamental and enduring duty to protect California's consumers of [energy]," a duty which we have pledged not to change during the transition to a streamlined and more efficient regulatory approach. (Blue Book, p. 34.) This means that, despite our preference for PBR, we will not approve any PBR proposal just because it encourages efficiency on the part of the utility. The other part of the equation, protection of ratepayer interests, must also be satisfied.

B. The SoCal PBR Proposal Must be Modified to be Acceptable, but Much of SoCal's PBR Proposal Is Consistent with our Stated Goals for PBRs

We have examined SoCal's proposal on the threshold question of whether elements of the proposed mechanism conflict with existing Commission decisions and orders, or with the policies we have articulated above. Consistent with the parties testimony, we conclude that in several respects it does. We must therefore modify SoCal's PBR to conform to these overriding principles.

1. The SoCal PBR Proposal Violates the Terms of the Global Settlement

Both the Commission's Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN) criticize SoCal's proposal as being inconsistent with the Global Settlement. That agreement was adopted in final form by the Commission in D.94-07-064, 55 CPUC2d 452 (1994), and governs a number of aspects of ratemaking for SoCal's gas utility operations for the period from August 1, 1994, through July 31, 1999, when it expires.

TURN asserts that there are five inconsistencies between SoCal's PBR proposal and the Global Settlement which preclude adoption of SoCal's proposal in its present form. First, TURN states that SoCal's proposal to base rates upon 1996 adjusted throughput violates a provision of the Global Settlement that requires rates instead to be based upon 1991 throughput. Second, TURN argues that SoCal's proposal to extend the cost allocations adopted by the Global Settlement beyond the term of that agreement would violate a provision requiring cost allocations to be determined in the 1998 Biennial Cost Allocation Proceeding (BCAP). Third, TURN alleges that the proposal to use one definition of a "normal" temperature year for setting rates, and another for allocating costs between classes, to the detriment of the core class, also violates the Global Settlement. Fourth, TURN claims that SoCal's proposal to index rates, thus doing away with the authorized revenue requirement allocated by the Global Settlement, violates the settlement. Fifth, TURN argues that the proposal to eliminate the CFCA violates the Global Settlement, because the continued operation of that account was a basic assumption underpinning the settlement. We conclude that SoCal's PBR proposal conflicts with the Global Settlement at least in some of these respects, and that the proposal will have to be modified to avoid these conflicts.

Section II, paragraph 1, of the Global Settlement states:

> "SoCal shall calculate rates based on 1991 actual throughput, with [specified adjustments] for the five-year period

> commencing upon the date that this [settlement] becomes effective." (55 CPUC2d 458.)

Notwithstanding this language, SoCal proposes to use 1996 customer count and core throughput, normalized for average temperature conditions, to set throughput because it would be "fair and reasonable" to do so. This would vary the express language of the Global Settlement. Moreover, it would not be consistent with the table of specified average year volumes and customer counts for basing cost allocation and calculating rates during the period covered by the Global Settlement. See Global Settlement Implementation Appendix, Section C.1, paragraph 2 (55 CPUC2d at 469).

As justification for this variance, SoCal argues that its proposal would also eliminate the CFCA, and that use of the Global Settlement throughputs would impose upon it a $39 million annual revenue penalty because of the resultant undercollection. We do not find SoCal's position to be persuasive. The Commission has a strong policy favoring settlements as a means of resolving issues in its proceedings, and we will not undermine that policy by changing the terms of a settlement after it becomes a Commission order.

In addition to expressly providing that cost allocation and rates during the five-year term of the Global Settlement would utilize specific throughput volumes based upon adjusted 1991 data, the Global Settlement also reflects the parties' intent that the cost allocation be terminated by the 1998 BCAP. Under the PBR, by contrast, the cost allocation would continue for the entire PBR period, some two and one half years beyond the term of the Global Settlement. The significance, as explained by TURN witness Florio, is that SoCal's approach would harm core customers because of the underlying temperature assumption used to develop the throughput for the purposes of calculating core rates. The company now uses 1506 annual heating degree days (HDDs) to define an average temperature year under the Global Settlement. SoCal's suggested reduction would reduce the average year forecast of throughput by 5%. The lower measure of HDDs suggested by SoCal for use in designing core rates would deny ratepayers the benefit of the lower throughput forecast for purposes of cost allocation.[13]

The Global Settlement contemplates that there will be a specific allocation of costs to customer classes during its five-year term. Section II, paragraph 3, sets up a memorandum account to track the variance between costs allocated to noncore and wholesale markets and SoCal's actual noncore and wholesale revenues. By contrast, the PBR would not have explicit costs allocated to noncore and wholesale markets, or an annual cost used to develop the effective rates for noncore transportation service. As explained by witness Florio, the Global Settlement,

> "plainly contemplated that there would be an authorized revenue requirement that was allocated between the core and noncore markets during the entire term of the settlement. The fact that SoCal would now like to shift to a program of rate indexing cannot overcome the deal that the company made." (Ex. 55, p. 20, l. 11-16.)

Consequently, we cannot accept this feature of the PBR proposal.

TURN argues that the Global Settlement mechanism implies that revenue variations are to be passed onto core ratepayers through the CFCA, and that elimination of the CFCA would therefore violate the intent of the Global Settlement. We agree. The Global Settlement would be unworkable without the CFCA, and SoCal's proposal would therefore violate the terms of that agreement.

2. The Absence of a Sharing Mechanism is Inconsistent with Commission Policy

In most respects, SoCal's proposal fits our model of PBR. However, the proposal omits any mechanism for sharing the savings between shareholders and ratepayers. Instead, SoCal argues that the productivity factor (or "X" factor) utilized in adjusting rates annually, and particularly the "stretch" component incorporated into that productivity factor, should be considered an "upfront" device that will adequately

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[13] SoCal is now willing to accept the figure of 1330 HDDs in place of the 1316 HDDs it originally proposed, but the result is essentially the same.

compensate for lack of an after-the-fact mechanism to allocate savings, because it creates a downward pressure on costs and, therefore, rates. We disagree.

In previous PBR proceedings we have rejected substitution of a productivity factor for a sharing mechanism for SDG&E and for SCE. There are several reasons for this. First, PU Code § 728 imposes upon us a duty to insure that utility rates are maintained at a level that is just and reasonable. This can only be assured if the overall level of profits is effectively controlled by placing a practical limit on how far the utility is willing to go to earn a share of the marginal profit. The consequence is that profits, and therefore rates, are maintained at reasonable levels.

A sharing mechanism is the ultimate "safety net" for ratepayers, as it corrects for the possible adoption of a productivity factor that turns out to be overly conservative, understating the productivity increases which the utility is actually able to achieve. With a sharing mechanism, if the utility attains productivity increases that exceed the adopted productivity factor, the resultant profits must be shared with the ratepayers rather than going solely to the utility. SoCal argues that this would "dilute" its incentives to achieve greater productivity goals, but we see no reason why we should fix a productivity index based upon imperfect forecasting techniques, and permit it to remain undisturbed for a five-year period, based upon speculation that this mechanism will adequately benefit the ratepayers. If the utility is actually able to reap benefits above the level reflected by the adopted productivity factor, it would not be "just and reasonable" to require ratepayers to be satisfied with only the share of savings based upon attaining the productivity estimate made at the outset of the program.

SoCal admits that the reduction in its rate base alone will result in an increase in its rate of return of 87 basis points. This is simply a consequence of depreciation of its rate base rather than cost-cutting. A sharing mechanism would insure that the ratepayers will receive their fair share of the rewards of improved productivity, however those rewards are achieved. Because a PBR with a sharing mechanism simultaneously allows higher profits than at present, and lower rates due to increased productivity, a sharing mechanism creates the potential for a "win-win" situation.

3. The SoCal PBR Must be Modified Because It Does not Simplify Regulation

Certain features of SoCal's PBR proposal would also be contrary to the Commission's goal of simplifying regulation under performance-based ratemaking. Rather than eliminating balancing accounts and reducing the degree of Commission oversight, SoCal's proposal introduces altogether new concepts, the WNM and the EEAF, to reduce its level of risk. Monitoring the operation of these new devices will add to, rather than lessen, the Commission's regulatory tasks, representing a movement away from the Commission's goal of lessening the regulatory burden that is ultimately borne by ratepayers.

4. Certain Features of the Proposal are not Related to Performance-based Ratemaking, and Should not be Adopted by the Commission as an Aspect of SoCal's PBR Proposal

SoCal's proposal includes some features that are extraneous to a scheme which encourages efficiency on the part of the utility through a system of incentives. Instead, these additional features appear to have been included by SoCal as a "wish list" of items which, if authorized, would enhance the potential profitability of SoCal without rewarding ratepayers in kind. Specific examples include the proposals for major changes in residential rate design, and gain on sale exceptions, which appear to be designed only to enhance SoCal's profitability without any relation to ratepayers' interests. Residential rate design issues were addressed by the decision in SoCal's BCAP, adopted on April 23, 1997.

We are also mindful that we should not make any major changes in general industry policy in a proceeding which involves a single utility, such as this one. Questions of new products and services and gain on sale are broad ones which potentially apply to an entire class of utilities, and any major changes should be adopted in a generic proceeding to insure that they will apply evenhandedly to all utilities in the class. We must therefore refrain from addressing such proposals in this proceeding.

5. Conclusion: The SoCal PBR Methodology must be Modified for Adoption by the Commission

In recognition of these conceptual problems, we cannot adopt the PBR proposal advanced by SoCal. Doing so would contradict important Commission policies and orders, and would represent an abdication of our responsibility to ratepayers. Although we favor performance-based ratemaking as a tool for regulating utilities in the current regulatory environment, we must in some respects replace SoCal's proposal with a program which more accurately advances our regulatory goals.

C. The Commission's Adopted PBR

In this section we enumerate the essential features of our adopted PBR for SoCal. This PBR will become effective immediately. Insofar as possible it retains the elements of the SoCal proposal, but it includes changes that bring it into conformance with other decisions, goals, and policies of the Commission.

The features we adopt are: (1) the productivity index (inflation less productivity); (2) the quantity indexed; (3) exclusions and adjustments; (4) offramps and termination provisions; (5) service quality, customer satisfaction, and safety incentives; and (6) monitoring and evaluation provisions. We also establish the amount of the base margin for indexing.

1. Indexing Method

As earlier explained, we must first select the overall index (price index minus "X") to be applied to the indexed quantity in order to obtain the subsequent years' base rates.

a) Inflation Measure

SoCal is proposing an inflation measure (the GUPI) based upon a weighted average of the recorded indices of labor O&M, nonlabor O&M, and capital-related costs. In the GUPI, the measure for labor O&M is the index of average hourly earnings of workers in gas production and distribution as reported by the U.S. Bureau of Labor Statistics. The measure for nonlabor O&M is the DRI/McGraw Hill nonlabor O&M index for gas utilities. The inflation measure for capital-related costs would be based on the DRI/McGraw Hill indices for capital service prices and for the price of gas distribution capital goods. These measures would be weighted according to the average of expenditures in each category for the past five years.

SoCal proposes that rates for a year would be set using the latest available forecasts for the GUPI elements for that forthcoming year at the time that SoCal makes its annual PBR rate formula rate filing, but that the next year's rate filing would include an adjustment to "true up" any difference between the forecast and actual GUPI.

SoCal originally proposed to use a weighting of input price inflation based on SoCal's own historical ratio of labor expense, nonlabor expense and capital inputs to total costs. ORA proposed using a weighting that was the average of gas operations for SoCal, Pacific Gas and Electric Company (PG&E), and SDG&E. The rationale for ORA's recommendation was that it would make it easier for the Commission to administer PBRs for the three major gas utilities it regulates. In any event, a broader-based price index is consistent with the Commission's disinclination to use company-specific indexes.[11] SoCal has accepted ORA's alternative.

We adopt the approach to price indexing proposed by ORA.

b) *Productivity Factor*

As explained earlier, the productivity or "X" factor consists of two parts. The first component is a historic measure of industry productivity. The second component represents an additional productivity target, or aspiration measure, which is based upon potential incremental productivity improvement that the utility can expect to achieve over and above the historical average. SoCal refers to this as the "stretch" factor, or "consumer dividend," because it creates downward pressure on costs and, by extension, on rates.

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[11] SCUPP/IID propose a weighting based on five to ten western U.S. gas utilities. This proposal is vague and undefined; the exact companies are not identified and there is no basis for comparing it to other parties' positions. It would not simplify the Commission's administration of PBR, and we will not adopt it.

(1) Industry Productivity Measure

SoCal proposes using a historical industry productivity measure of 0.5%. This figure was developed from the Christensen Associates study, and elicited little criticism from the parties. We adopt the 0.5% historical industry productivity figure.

(2) "Stretch" Factor

The second component, the "stretch" factor, is more problematic. SoCal proposes that this component also be fixed at 0.5%, and claims that this is a liberal figure in relation to the productivity gains it expects to be able to achieve beyond the historical average.

ORA advocates a 1% stretch factor, double that proposed by SoCal. This would produce a total productivity factor of 1.5%. TURN/Department of General Services (DGS) supports ORA's estimate as reasonable in the long run, but believes that the pendency of the Enova-Pacific Enterprises merger will cause an increase in productivity. This is based upon the experience of witness Marcus, who testified that during the period of the SCE-SDG&E merger proposal, (1) staff members sought jobs outside the company because of organizational uncertainty and were not all replaced because of the possibility of postmerger job consolidations, and (2) capital spending was curtailed. Thus, TURN/DGS recommends adoption of a 1.5% stretch factor while the merger application is pending.

Although the subject of merger savings is not a part of our consideration here, we believe that the pendency of the merger proceeding distinguishes this period of time from that which was examined in developing SoCal's productivity and stretch factors. Given the nature of management's motivation, it is indeed likely that capital spending will be curtailed and expenses otherwise forgone before the merger is consummated or disapproved. We therefore believe that the stretch factor proposed by SoCal is likely to be conservative.

SoCal's objection to the adoption of a stretch factor greater than 0.5% is based primarily on the number of multiples of historical productivity that each figure represents. Thus, SoCal states that ORA's suggestion of a 1.5% total productivity factor would be three times the historical average, and TURN/DGS's 2.5% figure would be five times the historical average. SoCal argues that this would not be reasonable.

We find that ORA's suggestion comes as close to the mark as any, particularly in view of the likelihood that disproportionately large productivity gains may be on the near-term horizon. It is appropriate to "set the bar high" in the expectation that SoCal will, indeed, stretch to maximize productivity. Were we to set too low a goal, SoCal's benefit could come at the expense of the ratepayers, even allowing for a sharing mechanism. There would be no advantage to adopting such a PBR over traditional ratemaking methodology. Nevertheless, we recognize that productivity improvements are not likely to occur all at once. Both cost reductions and revenue enhancements may take several years to come to fruition. We recognized this in D.9-09-092 in SCE's PBR when we adopted an "X" factor, including a stretch factor, which ramped up from 1.2% to 1.6% over the life of the PBR. We believe it is appropriate to take a similar approach here.

We will adopt a stretch factor that increases incrementally over the initial five-year PBR timetable resulting in an X factor of 1.1% in Year 1, 1.2% in Year 2, 1.3% in Year 3, 1.4% in Year 4, and 1.5% in Year 5.

c) *Quantity Indexed*

SoCal proposes to index rates directly, rather than indexing total authorized margin or authorized margin per customer, for several reasons. First, SoCal contends that this mechanism will put it at risk for the level of customer demand (throughput), and that this is the direction in which the Commission wants to move; SoCal points to the Commission's recent adoption of rate indexing for SCE to support this contention. SoCal also argues that this mechanism will best prepare it for the transition to a competitive marketplace, and will change its corporate culture. SoCal claims that rate indexing will allow the elimination of a major balancing account, the CFCA, and thus simplify regulation. Finally, SoCal argues that this approach is consistent with the direction the Commission has already taken by putting SoCal at risk for a specific throughput for most noncore customers under the Global Settlement.

We do not find SoCal's arguments persuasive in relation to its unique circumstances. First, the probability of risk to the shareholders is far lower than SoCal suggests, because realistic throughput forecasts indicate a growing core market.[15] In addition, SoCal's president, Mr. Mitchell, acknowledged on cross-examination that the company continues to seek new throughput opportunities, such as business ventures in Mexico. Under traditional regulation, a portion of the cost of these ventures would be allocated to the resultant new loads, reducing rates for existing customers. This would not be true under PBR. In light of these realities, we prefer not to give SoCal carte blanche to increase its throughput and apply what will almost surely be a positive index each year (reflecting inflation in excess of productivity) to actual throughput.

Preservation of the CFCA, at least through the period covered by the Global Settlement, is central to this indexing method. The Global Settlement establishes throughput based on the 1991 level. SoCal has agreed to this through the term of the agreement. Although the Global Settlement does not specifically refer to the CFCA, as SoCal says, once throughput is fixed in this fashion, the CFCA handles overcollection or undercollection from sales variations. Retention of CFCA is therefore implicit in the Global Settlement, as the mechanism will not work properly without it.

As we have already explained, retention of the CFCA in connection with throughput variations requires the use of revenue indexing. This is required by the Global Settlement. Other provisions of the Global Settlement also require the existence of a revenue requirement. These include "a memorandum account to track the variance between the costs allocated to the noncore and wholesale markets

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[15] See, for example, Exh. 62A, Attachment 7, p. 25: SoCal projects systemwide sales growth of 3.4% between the years 1996 and 2000, principally in the high-margin residential sector.

and [SoCal's] actual noncore and wholesale mechanisms," which is calculated using "a debit entry equal to one twelfth (1/12) of the authorized annual cost used to develop the effective rates for noncore transportation service including EOR [Enhanced Oil Recovery]." (TURN/DGS Opening Brief, p. 9, quoting Global Settlement, Section II, para. 3 and Implementation Appendix, p. 21.) These features preclude rate indexing, and must be retained until expiration of that agreement.

Another circumstance unique to SoCal compels us to adopt indexing of the revenue requirement, rather than rates. Specifically, the proposed Enova-Pacific Enterprises merger will create a need to track savings, which cannot be accomplished with rate indexing. Although the merger application is not directly relevant to the SoCal PBR proposal, we take notice that if we approve the merger, we will have to determine the amount of merger savings in that proceeding. Those savings are expressed in the same terms as the total revenue requirement. Indexing the total revenue requirement will enable that sum to be deducted from the pre-merger totals. On the other hand, if rates are indexed where throughput forecasts are no longer calculated, then savings cannot be passed back to customers. This means that if we were to adopt rate indexing now, we would have to revisit the subject in the merger proceeding and translate the PBR results in order to insure consistency after the merger takes place, if it is approved.

Finally, we conclude that revenue rather than rates must be indexed because SoCal's rate base is declining at the time the PBR is to go into effect. SoCal's proposal to index rates, which would fix SoCal's rate base at the 1996 level and index it for at least five years thereafter, fails to recognize this fact. Rate indexing would benefit SoCal's shareholder because its capital spending is declining. This is an important fact, as SoCal's earnings will consequently increase by 87 basis points more than its currently authorized rate of return as the sole result of depreciation.[16]

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[16] SCUPP/IID considers this fact sufficient to justify retention of traditional ratemaking for SoCal rather than moving to a PBR system at this time. That course would be contrary to our policy of favoring PBR, and we believe it is too extreme. Alternatively, SCUPP/IID proposes a

The operation of depreciation is best understood in relation to the level of a utility's capital expenditures. If a utility's plant additions increase more than its plant is depreciated, rate base and associated taxes will grow. On the other hand, if the utility's plant additions are lower than its depreciation expense, the level of depreciated plant, and hence rate base, will decline. SoCal's additional capital expenditures are less than depreciation, thus significantly reducing rate base as well as the amount of return and of associated taxes. This is because SoCal is experiencing low customer growth (Exh. 52, pp. 4-5). The low customer growth rate is reducing investment requirements to a level lower than its depreciation expense, and its rate base is declining.

As explained by SCUPP/IID witness Yap, SoCal's 1995-1999 Financial Plan sets out the Company's projection of the decline in its average rate base. The table and chart on page 8-5 of the Financial Plan shows a decline beginning in 1995, acknowledging the trend: "Depreciation exceeds capital expenditures in traditional markets beginning in 1995." See Exh. 52, p. 5 (SCUPP/IID - Yap). This projection is consistent with SoCal's 1995 10-K report to the Securities Exchange Commission (SEC), which reflects a 3.4% decrease in rate base for 1995. The 10-K report projects 1996 capital expenditures of $224 million, while SoCal's Summary of Earnings Table for 1996 filed in this proceeding projects $255 million in depreciation (Exh. 24, Table 12-A). When compared to the $231 million capital expenditure level and $237 million depreciation level that accompanied the 3.4% reported decline in rate base during 1995, it is clear that the decline in rate base is accelerating. (Exh. 52, p. 5 (SCUPP/IID - Yap.))

Under traditional ratemaking, declining rate base tends to reduce rates. Declining rate base results in lower depreciation expense, return, and

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methodology which would separately index the O&M portion and the capital portion of the base margin rate. This would correct for the declining rate base, but would provide an incentive for SoCal's management to substitute capital for O&M expenses wherever possible, thus perpetuating one of the disadvantages of traditional ratemaking.

associated taxes, which are reflected in lower rates. But if rate base is "frozen" and rates are indexed, they will rise despite the fact that rate base is declining.

d) *Adopted Indexing Formula*

For the reasons we have described, it is necessary to index SoCal's *revenues*, rather than rates. SoCal's rate indexing proposal, however, is easily adapted into an equivalent revenue-indexing mechanism. SoCal's rate indexing proposal is

PBR rates (year 2) = PBR rates (year 1) *x* (1 + inflation - productivity)

This is a standard price cap formula, in its basic form identical to the ones we have adopted for Pacific Bell and GTEC, and for Southern California Edison.[17] Recognizing that by definition SoCal's revenues are the product of rates and the quantity of gas sold or transported (throughput), this formula can be translated into an equivalent revenue setting mechanism:

PBR revenue requirement (year 2) = PBR revenue requirement (year 1) *x* (1 + inflation - productivity + growth in throughput)

Since throughput by definition is average throughput per customer times the number of customers, the last term—growth in throughput—can be decomposed further into the sum of customer growth and growth in throughput per customer. Making this substitution in the revenue indexing formula results in SoCal's proposal for rates translated into its equivalent for indexing revenues:

PBR rev. req. (year 2) = PBR rev. req. (year 1) *x* [1 + inflation - productivity + customer growth + growth in throughput per customer]

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[17] Typically such formulas include as well a term for so-called "Z factors." The Z-factor term is ignored in the above discussion just to keep things simple.

Finally, this formula can be converted into its equivalent for revenue requirement *per customer*[18] by deleting the customer growth term on the right hand side:

PBR rev. req. per customer (year 2) = PBR rev. req. per customer (year 1) x [1+inflation - productivity + growth in throughput per customer]

Like SoCal, ORA proposes to index rates using the same, standard inflation minus productivity format. Its proposal, translated into the equivalent revenue per customer indexing formula, therefore looks exactly the same as SoCal's depicted above. The only difference--as described earlier--is that ORA proposes a 1.5 percent productivity factor, while SoCal's is 1.0 percent.

Unlike SoCal and ORA, TURN/DGS proposes to index revenues directly. Like the two other parties' proposals, its indexing mechanism is driven by inflation, productivity and customer growth. However, because the proposal is not based on indexing rates, it does not reward the utility with additional revenues from increasing throughput per customer. Additionally, it includes a minus 1.41% constant term in the formula[19] that is missing from the other two. Perhaps most importantly, it does not give the same *weight* to the common factors it shares with the SoCal and ORA proposals—inflation, productivity and customer growth. TURN/DGS's indexing mechanism assigns less weight to inflation and the productivity offset, and more weight to customer growth, in determining the utility's revenue requirement. TURN/DGS's revenue indexing proposal for revenue per customer is:[20]

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[18] Actual customers are used to calculate customer growth and convert revenue per customer into total revenues.

[19] This number, because it is negative, could be interpreted as an additional productivity offset.

[20] TURN/DGS provide formulas both for indexing total revenues and revenues per customer. The differences in the parameters, however, are insignificant. TURN/DGS argues that a *long-run* PBR indexing mechanism should index revenues per customer. *See* Exh. 63, p. 20 (TURN/DGS - Marcus).

PBR rev. req. per cust. (year 2) = PBR rev. req. per cust. (year 1)
x [1 + 0.610 x inflation - 0.610 x productivity
+ 0.605 x cust. growth - 1.41%]

Although the TURN/DGS formula relies upon essentially the same set of factors as SoCal's and ORA's the difference in *results* is not insignificant. With the throughput per customer term dropped in the SoCal and ORA proposals for directness of comparison, the results for a 1.0 percent customer growth rate and inflation of 3 percent are:[21]

<u>SoCal</u>
PBR Rev. Req. per cust. (year 2) = (1 + .03 - .01) x PBR Rev. Req. per cust. (year 1)
= 102% of PBR year 1 Rev. Req. per customer

<u>ORA</u>
PBR Rev. Req. per cust. (year 2) = (1 + .03 - .015) x PBR Rev.Req. per cust. (year 1)
= 101.5% of PBR year 1 Rev. Req. per customer

<u>TURN/DGS</u>
PBR Rev. Req. per cust. (year 2)
= [1+ 0.610 x (.03 - .015) + 0.605 x .01 - .0141] x PBR Rev. Req. per cust. (year1)
= 100.11% of PBR year1 Rev. Req. per customer

A PBR mechanism provides an incentive to utilities to cut costs by disconnecting their rates from their *actual* costs. Traditional ratemaking sets rates and revenues on the basis of utilities' actual costs. The poor cost-cutting incentives provided by such ratemaking are too well known to repeat here. A PBR mechanism, on the other hand, sets a *limit* for revenues or rates—independent of the utilities subsequent actual cost performance—based on the general factors that drive costs: inflation, customer and output growth, with an offset for productivity gains.

This does not mean, however, that we cannot ignore special circumstances that may affect a specific utility's costs. We agree with TURN/DGS that

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[21] The omission of the average throughput per customer factor is not trivial. SoCal Gas' forecast of throughput growth is 2 percent per year; for customers, 1 percent growth. The

an indexing method should be chosen which, among other things, would leave ratepayers at least as well off under PBR as they would have been under traditional ratemaking. Without some assurance to that effect, there is no real "consumer dividend" for ratepayers from adopting PBR.

In this context, SoCal (and ORA's) approach fails to take into account its specific circumstances, and therefore omits an important consideration that needs to be taken into account in setting its indexing formula. As noted in the previous section, SoCal's projected plant expenditures are less than projected depreciation, thus significantly reducing future rate base and the associated amount of return and taxes. The low customer growth rate SoCal is experiencing is reducing investment requirements to a level lower than its depreciation expense, and its rate base is declining.

Two utilities could face the same inflation and have the same level of productivity (X), but could have very different trajectories in revenue requirements if one was growing more rapidly and had an increasing rate base and the other was growing more slowly and faced declining rate base. A simple inflation minus X indexing formula—for revenue per customer—would give the same revenue increase to both utilities, possibly yielding a windfall for one and a loss for the other.

Thus, if one is constructing a single "X" factor, it may not be sufficient to construct that factor from a historical factor productivity study plus a stretch, as SoCal and ORA have proposed. Neither SCE nor SDG&E claimed that they would face rate base declines, as SoCal forecasts that it will. TURN/DGS's methodology attempts to take into account SoCal's current investment plans over the next five years. However, while we agree with the basic logic of the TURN/DGS approach, we are unwilling to go so far as to adopt its proposed formula. The formula relies on a complex regression analysis, underlying which is a set of assumptions and variables. One important assumption is that the projected rate base decline will occur as

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implied growth in throughput per customer therefore is 1 percent. When this effect is included in the SoCal and ORA proposals, the respective escalation factors become 103% and 102.5%.

SoCal has projected in its 1996-2000 financial plan. SoCal's future investment plans may well vary due to a variety of factors, including the rate of customer growth and the incentives afforded by this PBR decision. The TURN/DGS approach assumes that SoCal's management will have no control over the extent of future capital investments. While we agree that the general trend is likely to be as presented in the 1996-2000 financial plan, we cannot rely on the exact numbers in that plan as the mathematical basis for the indexing formula.

As noted earlier, the indexing formula is intended to give utility management the incentive to improve productivity through reasonable management of costs and practices that are within its control. Thus, the productivity factor takes into account expected gains on an industry-wide level, and adds a stretch factor to provide a "consumer dividend" and account for the fact that implementation of the PBR necessarily will require increased productivity if the utility is to receive a fair benefit from the new system. We also adjust the base margin to ensure that the utility is starting from a reasonable starting point, just as we would under traditional ratemaking. TURN/DGS makes the case that the same concept should be applied to rate base. If rate base is falling due to factors extrinsic to the PBR, returns will increase unless an adjustment is made, and vice versa. While this issue was not introduced in other PBR cases, it is a legitimate consideration.

We would prefer to adopt a method to take rate base changes into account outside of the indexing formula. A methodology such as a direct revenue offset or adjustment of the benchmark rate of return could accomplish this. However, no party has proposed such a method, and we must rely upon the indexing methodology, in which rate base factors are effectively translated into productivity. SoCal estimates in its comments on the Proposed Decision (p. 4) that the impact of the TURN/DGS formula may result in an effective productivity factor as high as 2.9 percent, which is 1.4 percent above the 1.5 percent final stretch "X" factor. This suggests that it may be possible to translate directly the TURN/DGS formula into a straight productivity figure and thus roughly reconcile the TURN/DGS concept with the indexing methodologies adopted in other PBRs.

Since some of the capital spending decisions in the future are presumed to be under SoCal management's control, we find it reasonable to adopt a lower effective X factor than the 2.9 percent imputed from the TURN/DGS methodology. Accordingly, we will adopt a 1.0 percentage point increase to the ramped stretch productivity factor. Our final adopted productivity "X" factor will be 2.1 percent in year 1; 2.2 percent in year 2; 2.3 percent in year 3; 2.4 percent in year 4; and 2.5 percent in year 5.

The PBR indexing formula therefore that we adopt is:

$$\text{PBR rev. req. per customer (year 2)} = \text{PBR rev. req. per customer (year 1)} \times [1+\text{inflation} - X],$$

with our adopted "X" factors described in the previous paragraph.

2. Sharing Mechanism

SoCal proposes that there be no adjustment in rates during the minimum five-year PBR period to share with ratepayers any difference between its recorded rate of return and a benchmark rate of return. We reject this aspect of SoCal's proposal, and require a sharing mechanism as part of the PBR for SoCal.

ORA, SCUPP/IID, SCE, and TURN/DGS advocate the inclusion of a sharing mechanism as an integral feature of SoCal's PBR, and two specific proposals have been advanced for our consideration. ORA's proposal would allow SoCal to retain all profits up to the level of 75 basis points above authorized rate of return (ROR), and 50% of any profits earned above that benchmark level. ORA states that earnings at the 75 basis point benchmark level will enable SoCal to keep $37.5 million of its revenues as a reward for its efforts, and above this level SoCal would net additional rewards, albeit at a proportionately lower rate. By contrast, TURN/DGS urges us to adopt a mechanism which shares cost savings with ratepayers on a progressive basis. This approach affords better insurance for ratepayers in the event that the productivity factor turns out to be unrealistically low, and profits therefore to be excessive.

TURN/DGS recommends as our basic model the PBR we adopted for SCE in D.96-09-092. That mechanism shares both profits and losses within "bands" above and below the benchmark return on equity (ROE). Under this approach, shareholders receive all of the gains and losses up to 50 basis points above and below the benchmark rate of return, which we termed the inner band. Our intent in so doing was to assign shareholders the responsibility for the gains and losses associated with routine operation. (Id., mimeo., p. 42.) Beyond the inner band, from 50 to 300 basis points, the shareholder share of gains rises continuously from 25 through 100%, while the ratepayer share correspondingly declines from 75 to 0%. This we defined as the middle band. The shareholders receive all gains 300 basis points above the benchmark and remain responsible for all losses more than 300 basis points below the benchmark.

TURN/DGS proposes one alteration to this mechanism. In recognition of the fact that SoCal will not be exposed to revenue fluctuations due to short-run temperature based sales fluctuations if we retain the CFCA, TURN/DGS recommends that the level of the inner band should be reduced to no more than 25 basis points, or be eliminated altogether. We agree. The allowance of the inner band for SCE was partially to account for weather-based sales fluctuations that were beyond the discretion of utility management. For SoCal we will retain the CFCA as part of the PBR and limit the inner band to 25 basis points to account for minor fluctuations in operations. Thus shareholders will receive 100% up to the level of 25 basis points above the benchmark ROR, and an increasing percentage in steps from 25 up to 300 basis points, above which level they will receive 100%. We refer to a mechanism of this type, where the utility share of net revenue increases as its earned return becomes greater than the benchmark return (and the ratepayer share correspondingly decreases), as progressive sharing.

Between 25 basis points above the benchmark ROR and 300 basis points above the benchmark, we will adopt 8 bands. The more bands that exist, the greater the potential to move into a new band and for shareholders to collect an increasing marginal share of the higher profits. The first band will be from 25 to 50 basis points above the benchmark. In this band, shareholders will receive 25% of the marginal revenues in the band and ratepayers 75%. Each successive band will see an increase of 10% in the incremental share allocated to shareholders and a decrease of 10% in the ratepayers share. The sixth band will fall between 150 and 200 basis points above the benchmark, with shareholders receiving 75% and ratepayers 25%. The seventh band will be between 200 and 250 basis points above the benchmark, and shareholders will receive 85% and ratepayers 15%. The eighth band will be between 250 and 300 basis points above the benchmark; shareholders will receive 95% and ratepayers 5%.

Under this system, shareholders may gain up to 68% of the increment up to 300 basis points above the benchmark. However, as shareholders may keep all of the increment above 300 basis points above the benchmark (subject to the offramp discussed below), it is possible for shareholders to gain significantly more than 68% of the increment. For example, if returns are 400 basis points above the benchmark, shareholders would retain 76% of the increment. This system gives an excellent and increasing incentive to shareholders, and is fair to ratepayers who receive both the "consumer dividend" in the productivity formula and a larger share of early (and presumably easier) productivity gains.

We do not perceive a need to impose any sharing below the ROR benchmark, except for the offramp provisions discussed below. Even under traditional cost-of-service ratemaking, we have never guaranteed the utility its authorized ROR. Our PBR mechanism is designed to allow SoCal to "stretch" for higher levels of revenue, and to keep a progressively greater amount of what it is able to earn. By setting the proper ROR benchmark, we will calibrate the mechanism so that it rewards improvements which exceed that baseline, and accomplishes the efficiency gains that we intend for the benefit of the ratepayers by providing for progressive sharing above the benchmark. We will set the ROR benchmark at the current ROR.

Shareholders	Ratepayers		Basis Points
100	0	* 2 years	300
95	5		250
85	15		200
75	25		150
65	35		125
55	45		100
45	55		75
35	65		50
25	75		25
100	0		
Benchmark Rate of Return			
100	0	* 2 years	-175

Sharing Mechanism

We have focused on the question of how cost changes are dealt with in a rate PBR versus revenue PBR. Our decision to adopt a revenue PBR has much to do with our view of the appropriate treatment of cost reductions. We now turn to the treatment of revenue increases (also called revenue enhancements) in this PBR. SoCal may be able to increase net revenues in several ways. As discussed elsewhere in this order, SoCal may be able to expand current service offerings unrelated to the provision of natural gas (such as meter repair), or offer new products or services. SoCal may increase revenues through pricing flexibility approved in this order. SoCal may also experience customer growth or increases in usage per customer.

With the exception of throughput increases, SoCal can benefit from each of the methods of revenue enhancement discussed above. Revenue enhancement increases productivity, and improved productivity is one of the primary goals of performance-based regulation. We believe the adoption of this PBR will encourage SoCal to seek out both cost reductions and revenue increases. If revenue increases occur, they will be factored along with associated costs into the total rate of return calculation that is a part of the revenue PBR. If any revenue increases push SoCal into the sharing range, or further into the sharing range (as discussed below), both SoCal shareholders and ratepayers will benefit from the productivity increases.

3. Exclusions

SoCal proposes that several cost categories handled by existing regulatory mechanisms be excluded from the PBR. These would be preserved, and would maintain their separate existence for adjudication by the Commission. The proposed exclusions are as follows:

- Catastrophic Event Memorandum Account (CEMA). The Commission authorized all utilities to establish this account under Resolution no. E-3238 (July 24, 1991) as a reaction to the 1989 Loma Prieta earthquake to record the costs of restoring utility service to customers; repairing, replacing, or restoring damaged utility facilities; and complying with government agency orders resulting from declared disasters. It was designed to expedite and facilitate prompt response by utilities in restoring services disrupted by declared disasters. SoCal proposed to exclude CEMA from PBR so that it will fulfill its intended purpose. ORA initially recommended that CEMA expenses be reviewed using Z-factor criteria to determine potential recovery (Exh. 107, p. 63), but subsequently stipulated that CEMA be treated as an exclusion.

- <u>Hazardous Substance Cost Recovery Account (HSCRA).</u> This mechanism is a long-term performance-based cost recovery mechanism for hazardous substance and insurance litigation costs related to hazardous substance sites identified by the utility for cost recovery from third parties, insurance carriers and ratepayers.

- <u>Low Emission Vehicle (LEV) Program.</u> In D.93-07-054, 50CPUC2d 452, the Commission ordered that all funding for utility LEV programs was to be established separate from the normal general rate case proceedings, and required all energy utilities to file separate applications for funding of six-year LEV programs under specified guidelines established in that decision. SoCal complied with that requirement. In D.95-11-035, -- CPUC2d -- (1995), the Commission allowed continued ratepayer funding of LEV fleet expenses subject to a one-way balancing account, and specified the treatment of the costs of customer-site stations. SoCal proposes that capital-related costs for utility LEV and customer-site stations remain in the PBR Base Margin showing, and that all expenses covered under the one-way balancing account be excluded from PBR and continue as a separate regulatory funding mechanism.

- <u>Regulatory Transition Costs.</u> SoCal proposes that all regulatory transition costs whose regulatory treatment is in the process of being determined at the federal and local levels to be excluded from the PBR to be separately resolved by the Commission. These matters are not subject to reasonable estimation, and SoCal describes them as both significant and potentially volatile. Transition costs identified by SoCal consist of Take-or-Pay (TOP) costs, Minimum Purchase Obligation (MPO) Transition costs, PITCO/POPCO[22] Transition costs, and the Interstate Transition Cost Surcharges (ITCS).

[22] These acronyms, respectively, refer to Pacific Interstate Transmission Company and Pacific Offshore Pipeline Company, both of which are SoCal affiliates.

- **<u>Wheeler Ridge Interconnection Costs and Revenues.</u>** D.95-04-078, -- CPUC2d -- (1995), in SoCal's 1994 BCAP, sets forth the adopted incremental ratemaking treatment for the Wheeler Ridge facilities. SoCal states that implementation requires that Wheeler Ridge interconnection costs and revenues be excluded from PBR.

- **<u>Mandated Social Programs.</u>** SoCal proposes that mandated social programs such as California Alternate Rates for Energy (CARE) and the low-income Direct Assistance Program (DAP) should be excluded from PBR because they are created by legislative or administrative mandate, and are not within SoCal's control.

- **<u>Gas Costs and Pipeline Demand Charge.</u>** Gas costs and pipeline demand charges for core sales customers are forecasted and recovered through rates adopted in BCAPs. SoCal proposes to exclude these charges from PBR to maintain the existing BCAP cost recovery system.

- **<u>Costs Imposed by the Commission.</u>** SoCal proposes that certain costs imposed by the Commission, such as intervenor compensation fees and costs related to Commission staff - supervised management of financial costs should be excluded from PBR because they are subject to separate cost recovery treatment.

There is no longer any serious dispute concerning exclusion of these items. All of them appear to be appropriate for exclusion from the PBR mechanism, because they are beyond the control of SoCal's management, or are subject to recovery through other existing ratemaking mechanisms. We will approve these proposed exclusions.

4. "Z" Factors

We agree with SoCal that events which qualify as Z factors should be handled outside of the PBR mechanism. We also agree that the adopted procedure must insure that there is no double-counting of Z factor events in the inflation index.

We will adopt the following procedure proposed by SoCal to handle Z factors under PBR.

When a potential Z factor event occurs, SoCal will promptly advise the Commission of its occurrence and establish a memorandum account for the event. The notification of the event will provide all relevant information about the event, such as a description, the amount involved, and the timing, and will advise of the establishment of the memorandum account. This notification will be followed by a supplement to the annual rate adjustment procedure for Commission review.

For each event, SoCal's shareholders will absorb the first $5 million per event of otherwise compensable Z factor adjustments. This will be accomplished through the operation of a "deductible." The deductible is cumulative for each Z factor event from year to year, and is exhausted when the cumulative Z factor costs exceed the deductible amount. The deductible is separately applicable to each Z factor event.

To implement the adjustment, we adopt SoCal's proposal for use of a formula based on the level of integration with the GUPI to avoid double-counting the Z factor event in the inflation index. This formula is based upon the extent to which the Z factor impact is captured in the GUPI, and excludes that amount. SoCal will have the burden of proof in a Z factor proceeding to demonstrate both the total cost of the Z factor event, and the percentage of such cost estimated to be captured within the GUPI.

ORA initially recommended that CEMA become a Z factor. However, ORA and SoCal have agreed to recommend that CEMA be treated a an exclusion rather than a Z factor. As part of the agreement SoCal will maintain commercial insurance for earthquake and other disaster coverage unless major adverse changes to premium levels occur in the future. We will adopt the agreement between ORA and SoCal.

5. Core Pricing Flexibility

SoCal has proposed that it be given the flexibility to offer optional tariffed rates and to negotiate discounted rates with core customers. Any discounts would be applied to the base rate portion of the default PBR rate (i.e., gas costs would not be discounted). With its proposed elimination of the CFCA, SoCal's shareholders would be at risk for any discounts provided to customers. SoCal proposes that optional tariffs and discounted rates be priced no lower than short-run marginal cost and go into effect on the date of filing.

ORA supports SoCal's request to be able to offer discounted rates provided that shareholders bear 100% of the risk associated with revenue shortfalls and that the price floor for contracts is long-run marginal cost. ORA also supports the concept of optional tariffs for the core but opposes authorizing them at this time, because SoCal has provided insufficient information. Therefore, ORA recommends that SoCal either submit an application that would allow for consideration of specific optional tariffs, as occurred for SCE, or to approve optional tariffs on a case by case basis.

Allowing for negotiated rates and optional tariffs will provide SoCal with opportunities to increase utilization of its system, which benefits ratepayers. Under our adopted sharing mechanism, incremental revenues translate into benefits for both ratepayers and shareholders, providing SoCal with the incentive to more efficiently operate the system. Therefore, allowing SoCal to enter into negotiated contracts and offer optional tariffs is consistent with our PBR goals.

We would prefer to authorize optional tariff offerings with more details than SoCal has provided in its application. However, because shareholders will be entirely at risk for the revenue shortfalls, we will allow SoCal to negotiate discounts and offer optional tariffs, provided that the price floor is above class average long-run marginal cost (LRMC) and allow the tariffs to be effective upon 20 days after filing unless protested on the basis that the price floor is below class average LRMC.[23] If protested, the optional tariff filing will proceed through the normal advice letter

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[23] Nothing in this decision is intended to prevent parties from protesting such filings on any other basis, as well.

process. The optional tariffs must be available to all similarly situated customers that meet the eligibility criteria. If SoCal wishes to offer rates that are customer specific or targeted at some subset of a class and therefore below the class average LRMC, then additional information must be submitted, consistent with information required for long-term contracts under the Expedited Application Docket (EAD), and the contract or tariffs will be subject to Commission approval through the EAD process. Contracts with terms of five years or longer must be approved by the Commission. Consistent with allowing SoCal to offer core customers discounts, we will also allow SoCal to offer firm noncore customers negotiated discounts of less than five years' duration. Negotiated contracts must be filed with the Commission, but the confidentiality provisions in place for noncore contracts will also apply for core contracts.

Electric utilities who retain the Electric Revenue Adjustment Mechanism (ERAM) and offer discounted rates for which shareholders are at risk must currently include an adjustment to ERAM to ensure that ratepayers are not at risk for any revenue shortfall associated with discounted rates. Because we have retained the CFCA, we direct SoCal to develop an adjustment mechanism to the CFCA to ensure that ratepayers are isolated from any risk of revenue shortfall associated with discounted core rates or optional tariff offerings.

6. Implementation Date

The rates based upon our adopted base margin shall become effective July 1, 1997. We recognize that changing objectives as a result of implementing PBR mid-year may create implementation problems and therefore the PBR mechanism shall become effective as of January 1, 1998, unless SoCal elects to operate under the mechanism effective as of January 1, 1997.

7. "Offramp" Provisions

SoCal proposes that the Commission not terminate or modify the PBR mechanism before its minimum term, even if SoCal's recorded rate of return falls below or rises above any particular level during that period, and proposes to take full risk for the level of its earnings under PBR for at least the proposed minimum duration of the PBR mechanism. For the protection of both SoCal and its ratepayers, we conclude that this should not be the case.

a) *Cost of Capital Trigger*

Although SoCal proposes not to make any changes in PBR indexed rates for changes in cost of capital, it proposes an exception in the event that the 12-month trailing average yield on long-term Treasury Bond increases or decreases more than 250 basis points from the forecast average rate for calendar year 1997, as adopted in D.96-11-060 in SoCal's 1997 cost of capital application. Thus, SoCal acknowledges the need for an escape valve, or offramp of sorts, in the event of a dramatic change in the cost of capital.

Under the proposed mechanism, SoCal would have the option to file a cost of capital application in the event that the 250 basis point "trigger" were exceeded. In the event of a 250 basis point decrease, SoCal would be required to file a cost of capital application. In either event, the Commission would determine whether any change in rates was appropriate in light of all factors affecting the cost of capital. Any rate change, whether an increase or decrease, would be prospective from the effective date of a Commission decision.

ORA generally supports the trigger mechanism concept, but proposes a somewhat different approach to cost of capital. The principal differences between SoCal's proposal and ORA's proposal are that: (1) ORA's mechanism would not be triggered unless actual interest rates changed by more than 150 basis points and the then-current DRI forecast was for interest rates to continue to be at least 150 basis points different from the benchmark interest rate under PBR; and (2) if ORA's threshold were triggered, there would be an automatic adjustment of rates according to a pre-established formula. SCUPP/IID also supports the basic concept of using a triggering mechanism with a single-index PBR, and prefers ORA's proposal over SoCal's.

We prefer ORA's approach over that proposed by SoCal for two reasons. First, that approach is more sensitive to a realistic level of interest-rate savings. Secondly, it is a system which will not involve as great a level of regulatory burden on the Commission, because a cost of capital application would not have to be filed when the trigger level was reached.

We adopt for SoCal the ORA triggering mechanism for changes in cost of capital during the PBR period, coupled with the "MICAM" mechanism for rate adjustment that we recently adopted for SDG&E in D.96-06-055.

b) Rate of Return Offramp

SoCal opposes any offramp which would have the effect of allowing or requiring suspension or modification of the PBR mechanism before the expiration of the five-year minimum term in the event that SoCal earns a specified amount more or less than the benchmark rate of return. SoCal argues that this would result in dilution of the penalties for poor performance and rewards for superior performance, and tend to defeat or impair the incentive provided by the mechanism for the utility to operate efficiently.

As part of its proposal for a sharing mechanism, ORA advocates an offramp mechanism to protect both ratepayers and SoCal from significant deviations from anticipated earnings under this new and untested PBR system. For upside deviation, ORA proposes an offramp trigger set at 300 basis points above authorized earnings for two consecutive years. For downside deviation, ORA proposes an offramp at 175 basis points below authorized earnings for two consecutive years. This proposal conforms well to the sharing mechanism we adopt and is very similar to the approach we have taken with SDG&E. We also prefer an offramp "trigger" device to the adoption of an interim PBR with a shorter duration, which is the approach espoused by TURN.

We will adopt ORA's rate of return offramp proposal. The PBR mechanism will be subject to a motion for voluntary suspension if SoCal reports two consecutive years of net operating income that is at least 175 basis points below its authorized rate of return. Either SoCal or ORA may file this motion seeking suspension of the PBR mechanism. If the motion is granted, suspension of the PBR would be required. If SoCal reports return of 300 or more basis points above its authorized rate of return for two consecutive years, the PBR mechanism will automatically be suspended, and we will conduct a formal regulatory review to determine what, if any, changes in the ratemaking mechanism are required.

c) *Mid-course Review*

Although SoCal opposes any regulatory change to the PBR system prior to expiration of the 5-year minimum term (except for the cost of capital trigger), the experimental nature of the PBR and SoCal's own unique circumstances compel us to conclude that there is a need for reexamination of the program before five years elapse.

First, according to the Global Settlement, the expiration of that agreement on July 31, 1999, will alter SoCal's ratemaking environment and require the institution of a BCAP. As SoCal's witness Van Lierop acknowledges,

> "The Global Settlement requires that [SoCal] file a BCAP application in October of 1998 with rates to become effective on August 1, 1999. The key purpose of this BCAP filing is to terminate the provision in the Global Settlement that rates and cost allocation be based on 1991 throughput. . . . [SoCal] proposes that "shadow rates" - adopted in this proceeding - go into effect as actual base rates on August 1, 1999, which will terminate the 1991 throughput provision with respect to base rates. The 1998 BCAP filing is still required to replace 1991 throughput, with a forecasted throughput level for the purpose of determining exclusions surcharges. [SoCal] proposes that the 1998 BCAP be used to adopt surcharges and cost-of-gas rates for the remainder of the PBR period, i.e., from August 1, 1999 to December 31, 2001." (Exh. 11, pp. 69-70.)

This in itself establishes the need for a mid-course proceeding, currently anticipated to be in the form of the 1998 BCAP, to revisit certain of the issues in this PBR.

Notwithstanding explicit language to the contrary in the Global Settlement, SoCal's PBR proposal is premised upon retaining the inter-class cost allocation based on 1991 throughput for the entire PBR period, which extends well beyond the August 1, 1999, expiration of the Global Settlement. TURN's witness Florio testified that this would be particularly harmful to core customers, because the effect of the SoCal proposal would be to reduce the average year forecast of throughput by 5%, while at the same time denying core ratepayers the benefit of the lower throughput forecast for purposes of cost allocation. (Ex. 55, pp. 16-17.) Consistency must be assured through the 1998 BCAP or its equivalent.

TURN asserts that there is another reason why cost allocation issues must be resolved in the 1998 BCAP. In the current (1996) BCAP, ORA, and TURN have proposed certain refinements to the Commission's LRMC methodology which SoCal claims to exceed permissible cost allocation changes as defined by Section C.5 of the Global Settlement's Implementation Appendix. In the current BCAP we may conclude that these changes must await the expiration of the Global Settlement. However, SoCal's PBR proposal would preclude the allocation of base margin among customer classes from consideration in the 1998 BCAP, because the rates set in this proceeding (as indexed) will remain in force beyond the Global Settlement's expiration. Consequently, ORA and TURN would be foreclosed from proposing adjustments to the LRMC methodology well beyond the expiration of the Global Settlement unless there is a mid-course review.

The merger application of Enova Corporation and Pacific Enterprises, which is currently pending before us, also portends significant changes in SoCal's ratemaking environment. Approval of the merger application could result, for example, in alteration of the base margin, particularly if there are significant productivity gains due to what SoCal has characterized as "synergies" such as the consolidation of administrative and general office functions of the merged parent companies. Although we have declined to examine the financial implications of the pending merger application in this proceeding, we cannot turn a blind eye to the probability that the merger may have considerable impact on SoCal, requiring some adjustment of the PBR.

We have also identified a number of features of SoCal's PBR proposal which are simply not appropriate for inclusion. Among these features are changes in residential rate design, additional pricing flexibility, and gain on sale. To the extent that these items were not addressed in SoCal's current BCAP, they should be addressed in the next BCAP (or its successor proceeding).

Finally, SoCal, ORA, and TURN have agreed to recommend that a mid-course review be undertaken to examine the status of customer service quality indicators, including the penetration of the CARE program. The 1998 BCAP (or its successor) could be utilized as a vehicle for conducting this review.

In recognition of these circumstances, we conclude that there is a need for a mid-course evaluation of SoCal's PBR, and that SoCal's 1998 BCAP (or its successor) should serve as the forum for that effort. In that proceeding, we will address the issues of SoCal's throughput forecast, cost allocation, rate design, and other matters which may come to light from the interim results of SoCal's PBR experience.

d) Termination

Under SoCal's proposal, the PBR would remain in effect at least five years from its inception. Based upon this minimum term, SoCal proposes that any party, or the Commission on its own motion, could institute a proceeding to change or replace the PBR mechanism upon its expiration. ORA and SCUPP/IID object to the automatic continuation of SoCal's PBR. ORA proposes that the PBR be formally evaluated near the conclusion of the five-year PBR term to provide the Commission with a complete evaluation of the PBR mechanism.

ORA proposes that SoCal be required to notify the Commission and all parties of record of its intention to file either a general rate case application or a PBR application 24 months prior to the end of the PBR cycle. If SoCal indicates that it plans to file a general rate case application rather than a PBR application, ORA will submit its master data request to SoCal within one month after SoCal notifies the Commission. Thereafter, the procedural schedule would follow the rate case plan in accordance with R.87-11-012. Alternatively, ORA proposes that if SoCal notifies the Commission that it desires to continue with a PBR program, SoCal should be required to file a PBR application no less than 18 months prior to the end of the PBR cycle. In its filing, SoCal should provide both an evaluation of its existing PBR program and a recommendation as to what modifications should be made to the PBR mechanism for the future.

ORA witness Bower specifies the issues that, at a minimum, should be addressed in its filing requesting continuation of PBR. These are:

- Was SoCal successful in meeting or beating the adopted benchmarks?

- What happened to system average rates over the period of the PBR? How did this compare to the average national rate and to the overall rate of inflation?

- If SoCal was successful, how were the reductions accomplished? What types of expenses were reduced? Were there any side effects of the expense reduction?

- What was the operating environment of SoCal over the PBR period? Were there developments that either made it easier or more difficult to achieve the established goals? If so, what were those developments?

- Did the Commission and SoCal work together effectively in the process of monitoring and evaluating the PBR? If not, what parts of the monitoring and evaluation process did not work?

- Did the Commission and SoCal work together effectively in the event of any interim modifications to the PBR? If not, how could this process have been improved?

- Did the PBR demonstrate a more or less efficient method of regulation than the conventional general rate case method? What specific features of the PBR were either better or worse?

- Were the specific performance indicators in this PBR adequate to measure the effectiveness of the PBR? If not, how should the performance indicators be modified?

- Was SoCal successful in maintaining a stable credit rating over the term of the PBR? What other financial measures should be examined? What was SoCal's annual ROE and ROR performance over the PBR, and how did that compare to the company's authorized numbers? How did this performance compare to SoCal's historical record for periods prior to the PBR?

- What other consequences of the PBR were identified, if any? What was the impact of those consequences on the PBR? What was the impact of those consequences on SoCal, its ratepayers, the environment, and others? Were the consequences positive or negative?
- Considering the results of the PBR, what should be the next steps? Should the PBR be continued? If so, what "start up" conditions should prevail? Should those alternatives include a return to the general rate case or attrition process? (Exh. 107, pp. 16-18 - 16-19.)

ORA's proposal is well considered. Although we have no disinclination to continue SoCal's PBR beyond the five-year minimum, there is a need to insure that the system does not continue indefinitely without being subjected to one scrutiny, and to insure that it is meeting its intended goals and furthering our regulatory policy. The procedure for continuing the PBR outlined by ORA is far less onerous than the requirements for filing a GRC, and is appropriate for evaluation of a program that has been in force for five years, as contrasted with the three-year life of a GRC.

We will adopt ORA's proposal.

8. Service Quality, Customer Satisfaction, and Safety Incentives

By its nature, customer satisfaction is difficult to measure and to quantify. SoCal's original proposal to measure ongoing customer satisfaction by using an index figure generated considerable controversy, resulting in a great deal of discussion among the parties during the course of the hearing. The outcome of these negotiations was a joint position on behalf of SoCal, ORA, and TURN, which is set forth in Exh. 210. That exhibit provides a comprehensive joint recommendation for measures to ensure that customer satisfaction, service quality, and employee safety performance will be maintained in SoCal's PBR environment.

The four primary features of this comprehensive plan are:

- Individual targets would be established for each of the four key service attributes, with each service attribute carrying a potential rate reduction should the performance level for that attribute fall below its prescribed target and deadband. These four key service attributes are:

  (1) Customer satisfaction with the telephone customer service representative (CSR);

  (2) Customer satisfaction with the scheduling of an appointment for a field service call;

  (3) Satisfaction with the field Appliance Service Representative (ASR); and

  (4) Percentage of on-time arrival for the service call;

- An additional call center "prescriptive" performance standard would require 80% of all telephone calls to be answered within 60 seconds for regular calls, and 90% of all leak and emergency telephone calls to be answered within 20 seconds. SoCal would be subject to rate reduction for failure to meet these targets.

- In addition to rate incentives, SoCal would assume responsibility to provide reports to the Commission, on a quarterly basis, containing monthly data on several service quality indicators, as follows: level of telephone busy signals, percentage of estimated meter readings, leak response time, percentage of missed appointments, and percentage of customer problems resolved on the first service call.

- The Commission will undertake a mid-course review of the status of the customer service quality indicators.

The program specifies penalties for failure to attain goals below a deadband. Aggregate penalties of more than $4 million will trigger an investigation by the Commission.

SCE objects that the service program does not provide for rewards for attaining levels above the goals. This overlooks the purpose of our quality control efforts, which is to ensure that standards of service are upheld at least at current levels despite the adoption of PBR, and particularly that cost cutting will not result in the degradation of service and safety. We are concerned that if we provide rewards for the attainment of higher levels, we will encourage efforts to overdeliver service, thereby increasing the cost to provide service. The cost of the rewards would be passed along to customers through higher rates. This would be contrary to our purpose in adopting PBR. We have already described the terms to which SoCal, ORA, and TURN have agreed relative to attainment of the employee safety standard. As contrasted with the customer satisfaction provisions, this part of the agreement provides for both rewards and penalties.

The program agreed to by SoCal, ORA, and TURN is a rational and systematic approach to insuring the maintenance of service quality, customer satisfaction, and safety. We adopt that program as part of our order.[24] We also adopt the parties' recommendation to conduct a midterm review of the operation of these features. As stated above, we have selected the 1998 BCAP (or its successor) as the vehicle for conducting this review.

9. Additional Customer Service Issues

SoCal states that there are two additional unresolved issues which pertain to the customer satisfaction measure. First, in the event that SoCal is authorized to implement a late payment charge with respect to its core customers, TURN proposes additional service quality measures, with potential monetary penalties, pertaining to the mailing of customer bills and the posting of customer payments. Second, SCUPP/IID seeks to increase the amount of the SIC, which SoCal offered to its noncore customers as part of the Capacity Brokering Settlement in 1991. SoCal opposes both of these measures.

SoCal's proposal to impose a late payment charge on overdue balances for both core and noncore customers bears no immediate relationship to its

[24] The portion of Exh. 210 which sets forth that program is included in our Order as Appendix A.

proposal to move to a PBR system of ratemaking. Accordingly, TURN's responsive proposal to impose standards on the date of bill mailing and payment posting, and penalties in the event that those standards are not met, is equally immaterial for this PBR. There is no logical nexus between the economic incentives under PBR, or the related provisions to insure service quality, and this controversy over administrative processing of bills. We therefore decline the request for additional service incentives relating to billing and payment, and defer the matter of instituting a late payment charge to a more appropriate Commission proceeding.

SCUPP/IID's request for an increase in the SIC is apparently intended to protect noncore customers from service interruptions caused by deferral of maintenance, replacements, and expansion of facilities. The SIC was originally negotiated as part of the 1991 Capacity Brokering Settlement, which was approved by the Commission in D.91-11-025, 41 CPUC2d 668 (1991). Specific provisions which apply to SoCal in that settlement allow SoCal to offer a performance guarantee in its tariffs by providing the customer with a credit equal to $2.50/dth of gas for curtailment episodes, with a maximum credit of $5 million in any calendar year. SCUPP/IID proposes that we make this penalty mandatory, adopt a higher $10 million initial penalty, and increase the penalty ceiling every time the maximum penalty is triggered.

We perceive no reason to adopt this measure as part of the quality assurance measures for SoCal's PBR. SoCal states that there have been no curtailments of intrastate transmission service since the SIC was implemented, and SCUPP/IID has not demonstrated any change in circumstances which would justify an increase in SoCal's penalty exposure. Moreover, for noncore business, SoCal faces significant competitive threats in the form of interstate pipeline bypass, alternate fuel consumption, and cheap imported electricity. Thus market forces, rather than penalties, will provide the impetus for service quality assurance for noncore customers.

10. Monitoring and Evaluation

Because PBR is intended as a means to reduce the need for periodic reexamination of a utility's financial results through the GRC process, its success depends upon an effective program of monitoring and evaluation. In order to discharge our responsibility, we must be in a position to understand and evaluate the performance of SoCal's PBR during interim periods between formal proceedings.

SoCal proposes to file a detailed annual advice letter to implement the annual PBR rate adjustment and report on the customer service performance measures, including any rate adjustment associated with customer service measures. This annual advice letter would be comprehensive in that it would include all elements of the PBR indexing and adjustment mechanisms, i.e., inflation, productivity, Z factors, and customer service refunds, if any. SoCal proposes to file this annual advice letter on October 1 to allow sufficient time for review and approval so that the rates can become effective January 1, and to furnish supporting documentation and workpapers to the appropriate staff divisions on October 1.

Apart from this advice letter filing, SoCal's proposal for monitoring and evaluation consists principally of recommendations for the discontinuation of many current reporting requirements in the interest of streamlining the regulatory process. SoCal proposes to eliminate or modify approximately ten reports. (See Exh. 107, Table 16-1.) Four of these reports are required by Commission General Orders and apply to all energy utilities.

ORA in its comments states that a procedural mechanism is needed so that SoCal can report its earnings annually. ORA does not object to the annual October 1 filing proposed by SoCal, but proposes that an additional annual filing be made to review the performance of the PBR during the previous calendar year. ORA notes that both telephone and energy utilities which currently operate under adopted PBR mechanisms are required to make annual filings to report on the performance of the PBR during the previous year. Telephone utilities are required to file sharable earnings advice letters evaluating the prior year's operating results no later than April 1 of each year. (D.89-10-031, Ordering Paragraph 16.) SDG&E must file a draft of its performance report by April 15, and a final version of the report by May 15. (D.94-08-023, p. 80.) SDG&E's filing includes a review not only of any sharable earnings, but also reviews the reliability, safety, customer satisfaction, and price performance components of the SDG&E PBR. SCE is required to file an annual performance report similar to the SDG&E report by March 31 of each year. (Advice Letter 1191-E, as adopted by Resolution E-3478.) ORA also requests an extended time period for the review of the performance report to allow parties more time than the usual amount for advice letter protests. ORA suggests the following schedule:

April 1 - SoCal provides a draft sharable earnings advice letter to appropriate Commission staff, which includes workpapers detailing operating results for SoCal's base rates.

July 1 - Commission staff can submit a report on its audit or analysis of SoCal's draft sharable earnings results.

July 10 - SoCal files its final performance advice letter, with supporting workpapers.

July 31 - Protests in accordance with General Order 96-A can be filed.

ORA, SCUPP/IID, and SCE object to the modification or elimination of existing reporting requirements. As ORA witness Bower states:

> "If the Commission is to successfully implement a monitoring and evaluation plan, it must continue to receive these reports. These reports will be essential tools in evaluating SoCal's performance under the PBR mechanism. The Commission will have the opportunity to evaluate the usefulness of these reports in a PBR environment and determine whether the reports should be modified, eliminated, or expanded. Some reports may prove to be essential while others may prove to be unnecessary. DRA [now ORA] recommends that SoCal continue to provide nine of the ten reports it proposes to eliminate." (Exh. 107, pp. 10-11.)

We acknowledge that reduction of regulatory paperwork in the interest of improving efficiency is certainly a worthy goal. It is not, however, an integral part of PBR. We would like to reduce the volume of reports for all utilities, not just SoCal. Particularly for those which are required by a Commission general order, a generic proceeding would be required in order to change the requirement. We cannot discriminate in favor of SoCal by eliminating reporting requirements in this proceeding merely because it would reduce SoCal's regulatory burden. The proposal to do so bears no direct relationship to the institution of a PBR system.

We will adopt SoCal's proposal for an annual PBR advice letter filing but deny its request to modify or eliminate any current reporting requirement in the interest of maintaining our ability to monitor and evaluate SoCal's performance under PBR for the present.[25] The existing reporting requirements, plus SoCal's annual PBR advice letter filing, will enable the Commission to monitor and evaluate SoCal's PBR program, and should remain in place until changed through mid-course review or other proceeding, as appropriate. We will also require an annual PBR performance report similar in scope to the SDG&E annual performance report, and will adopt ORA's suggested schedule for review of the filing. The filing should not only review the PBR performance including a report of any sharable earnings, but should also report on the service quality, customer satisfaction, and safety incentives which we have adopted. Finally, any party who wishes to receive a copy of the draft filing to be made on April 1 should make such a request to SoCal, and such requests should be honored by the Company.

D. New Products and Services

As we summarized earlier in this decision, SoCal seeks the ability to offer new products and services, either itself or through an affiliate, without prior Commission approval. It also asks us to agree that the Commission not regulate the prices, terms, and conditions for new products and services; that the profits or losses from new products and services flow entirely to shareholders; and that existing products and services that are offered on an unbundled basis in the future be treated in

[25] Other requirements, such as that which obligates SoCal to obtain our express permission before closing any branch offices, are also unaffected by this decision. (See D.92-08-038, 15 CPUC2d 301 (1992).)

the same manner as new utility-related products and services. SoCal's proposal is opposed by ORA, SCE, TURN, and others, on a number of grounds.

On December 9, 1996, Enron Capital and Trade Resources, New Energy Ventures, Inc., the School Project for Utility Rate Reduction, and the Regional Energy Management Coalition, TURN, UCAN, and XENERGY, Inc. (collectively, Petitioners) filed a petition which, for procedural reasons, was accepted as a motion in the electric restructuring docket. In their motion, the Petitioners requested the Commission to issue an order instituting a rulemaking to establish standards of conduct governing relationships between natural gas local distribution companies (like SoCal) and electric utilities and their affiliated, unregulated marketing entities. The Petitioners also requested that the utilities be required to have their nonregulated activities conducted by their affiliate companies, rather than the utility itself, subject to the affiliate standards. The Petitioners stated that the utility providing services within a monopoly structure should be required to limit its actions to those services, so that equal treatment among competitors can be ensured. It was pointed out in response to the motion that the Petitioners' motion was opposed to the proposal offered here by SoCal. In the rulemaking drafted for the Commission's consideration, staff recommended that this aspect of SoCal's proposal be consolidated with the rulemaking to assure that SoCal and its affiliates would not be placed at an unfair advantage *vis a vis* the other California energy utilities and their affiliates.

In the rulemaking and investigation docket (OIR) opened April 9, 1997, in response to the motion, we provided instead "...that our decision in the PBR docket on flexibility in introducing new products and services may be interim." (R.97-04-011, I.97-04-012.) We also stated that "[e]ntry by the energy utilities and their affiliates into the unregulated market for energy products and services should be on an equal footing with respect to regulatory posture." (Id.)

Although the OIR explicitly preserved the opportunity in this proceeding to adopt an interim order with respect to SoCal's proposal for flexibility in introducing new products and services, we decline to do so at this time. Now that we have carefully reviewed SoCal's proposal and the opposing pleadings, we believe it would be premature, at best, to allow SoCal to offer new products and services in competitive markets on an unregulated basis while requiring SoCal's competitors, the remaining energy utilities, to participate in the rulemaking and investigation before allowing them to offer the same services into the same markets on an unregulated, untariffed basis.

SoCal may choose to make the same proposal, or to modify it, in our affiliates rulemaking and investigation. A number of questions arise from this proposal that may need further consideration.

First, SoCal has not clearly specified the types of products or services which it seeks authority to offer on an unregulated basis. During the course of this proceeding, SCE and Enron each raised legitimate concerns about the types of services that SoCal would seek to offer on an unregulated basis, particularly concerning the unbundling of traditional services. In response, SoCal states that with respect to the service unbundling of concern to Enron and SCE, SoCal "expects" to file separate regulatory and ratemaking applications. This pledge leads to two further questions: (1) If SoCal will not be offering on an unregulated basis the services and products which are of concern to SCE and Enron, what products and services will it seek to offer? and (2) Is SoCal's "expectation" that it will seek further authority before unbundling any traditional services, a binding pledge not to do so, pending further regulatory approval?

Second, SoCal has not offered explicit criteria to define the relevant markets into which SoCal seeks entry on an unregulated basis. What criteria and process should the Commission utilize in determining the relevant market, the degree of competition or the extent of SoCal's market power? For example, SoCal has asked that it be able to unbundle existing elective after meter services (such as pilot lighting or appliance inspection) and offer these services on an unregulated basis "where there is no market power." (Exh. 144, p. 2.) However, SoCal has not explained how to determine, or who will determine, that SoCal has no market power with respect to a particular product or service.

One particular aspect of SoCal's proposal which is of concern to us is SoCal's assertion that it is considering offering new products and services in "either competitive markets which already exist...or are ripe for competition." (Exh. 7, p. 27.) As SCE observes, "Plainly, the fact that SoCalGas believes a market is 'ripe for competition' is a far cry from finding that a market is, in fact competitive...Under this proposal SoCalGas could conceivably unbundle a regulated monopoly bundled service into several unregulated monopoly unbundled services and then charge monopoly prices for them." (Exh. 50, pp. 17-18.) This issue needs further review.

We also note SoCal's argument that the Commission should presume that if SoCal does not currently offer a service, it cannot have market power with respect to it, and it is therefore a competitive service. By the very nature of SoCal's monopoly position in the energy and energy services market, its access to comprehensive customer records, its access to an established billing system, and its "name brand" recognition, it may be that SoCal enjoys significant market power with respect to any new product or service in the energy field.

Third, SoCal has not proposed what regulatory tools would be used to prevent cross-subsidization between the services SoCal would continue to provide on a monopoly basis and those it would provide as competitive services. In its rebuttal testimony to ORA, SoCal argues that the opportunity for a utility to cross-subsidize the launch of competitive services would be virtually eliminated. (Exh. 119, p. 11.) SoCal's argument seems to rest on the premise that because its PBR proposal contains no sharing mechanism, all profits would accrue to shareholders, and management is consequently free to distribute all revenues which it derives from the monopoly enterprise in any manner it sees fit. Elsewhere in this decision we expressly require SoCal's PBR to contain a sharing mechanism. But even if the absence of a sharing mechanism, cross-subsidization cannot be permitted.

SoCal may renew its request along with its competing utilities, properly defined and detailed, in the newly instituted OIR. The level of detail which we would expect of a proposal to offer new products and services is equivalent to that which we set forth when we adopted the three categories of services for telecommunication products and accompanying accounting safeguards. (See D.89-10-031.)

While we are deferring consideration of SoCal's proposal regarding new products and services, we are not changing anything in this decision with regard to SoCal's ability to provide services currently offered or to apply to offer new products or services. SoCal currently offers certain services beyond the provision of natural gas. For example, SoCal currently provides meter repair services for SDG&E at its shop. This service, and others like it, may continue (subject to our jurisdiction). SoCal may also use the appropriate application or advice letter process to seek our approval to offer new products or services. We will consider any such filing in the normal course of review, and we will coordinate any such decision with our conduct of the proceeding on affiliate transactions, R.97-04-011 and I.97-04-012.

If SoCal expands its current service offerings and/or gains approval for new products or services, SoCal may be able to increase net revenues. We see this as a type of productivity improvement that would be consistent with the goals of PBR. Under the PBR we adopt in this order, returns above the target arising from either cost decreases or revenue increases will be shared between ratepayers and shareholders.

E. Base Margin

1. Introduction

SoCal now proposes that the base rates for 1997 be developed by applying the PBR index to a starting level of rates based upon SoCal's 1996 operating budget. After SoCal filed its supplemental showing in May 1996, its proposed base margin was $1,451,981,000, which represented a $61.2 million reduction in gas margin as compared to the 1995 authorized level. ORA's Base Margin Report (Exh. 106), with errata filed December 2, 1996, proposed a starting margin of $1,235,376,000. ORA's proposal excluded Demand-Side Management (DSM), Research, Demonstration & Development (RD&D), and Direct Assistance Program (DAP) expense from base margin, but even allowing for this, the gap between ORA's and SoCal's position was $170 million as the proceeding entered the evidentiary hearing stage.

As the hearing neared its conclusion, several of the parties filed joint testimony which recommended the resolution of eight base margin and two policy issues (Exhs. 200-210). This reduced the difference between ORA's and SoCal's position to $71.7 million. We must now consider the recommended resolution of these issues and resolve those issues as to which there is still no agreement.

As is our practice with general rate case orders, we address these items on an exception basis. We do not address accounts or funding requests which were not at some point excepted to, or those which do not require our attention in order to ensure that they comply with the law or Commission policy. In such instances we implicitly find the utility's proposal to be reasonable.

2. Nonlabor Escalation Rate

In developing their estimates of reasonable base rates for the various cost categories, parties used a base year and escalated or deflated it to correspond to the test year, depending on the base year applied. ORA proposes a nonlabor escalation rate of 2.23% for such purposes. SoCal proposed a rate of 3.72% but did not oppose ORA's recommended rate. SoCal recommends, however, that the Commission use the same value to deflate 1996 dollars as it uses to inflate 1995 dollars in order to make consistent the showings of ORA and SoCal. We adopt ORA's proposed inflation rate as reasonable as well as ORA's recommendation to use the 1995 numbers in the record.

3. Customer Accounts (Accounts 901, 902, 903, 904, Sub-Account 184.103)

For customer accounts generally, ORA, TURN, and SoCal ultimately agreed to a level of expenses for customer accounts. They jointly recommend a level of $111.77 million for accounts 901, 902, and 903 and sub-account 184.103. They also recommend a reduction of $0.3 million for account 904 to recognize a reduction in industrial uncollectibles. The parties' joint recommendation recognizes $7 million in estimated benefits derived from SoCal's implementation of its Customer Information System (CIS). It also provides that costs for the administration of the CARE program would be appropriate until and unless a party other than SoCal administers the program. We adopt these recommendations.

4. Late Payment Charges

SoCal proposes a late payment charge to be assessed on customers who do not pay their bills on time. The parties recommend different approaches with regard to the implementation of a late payment charge and the appropriate late payment charge rate. As we have already stated, however, the institution of a late payment charge bears no direct relationship to the PBR proposal, and therefore should not be a part of this proceeding. We decline to adopt that part of SoCal's proposal here.

5. Gas Storage, Transmission, and Distribution Expenses

SoCal, TURN, and ORA agreed to total expenses of $20.37 million for gas storage and $25.017 million for gas transmission. SoCal observes that the amounts are in 1995 dollars and must be adjusted to account for inflation. We adopt the stipulated amounts and adjust them consistent with SoCal's recommendation.

SoCal and ORA do not dispute the estimated expenses for gas distribution. ORA's estimate is somewhat lower than SoCal's as a result of its estimated escalation factor, which SoCal does not dispute, and which we have adopted. We therefore adopt gas distribution expenses of approximately $176 million, which is a reduction in these accounts of about $35.3 million from levels recorded for 1994.

6. Marketing Expenses

ORA, TURN, and SoCal resolved any differences that initially existed for expenses associated with DSM, other marketing expenses not related to demand side management ("non-DSM marketing"), and the DAP, which is designed to provide conservation measures to low-income customers. The parties recommend DSM costs of about $27 million be included in a one-way balancing account rather than as part of base rates. TURN and DGS support this proposal.

The stipulation between ORA and SoCal also recommends that other marketing costs be reduced from the existing level of $29.14 million to $24.136 million and that capital costs for the Energy Resource Center would remain in base rates. Consistent with the parties' recommendations, we adopt total base rate marketing expenses of $24.136 million.

Funding and administration for DAP was not fully resolved in the stipulation. SoCal proposes a reduction in direct assistance funding from $18 million to $12 million. SoCal observes that the program is not cost-effective and that it is having difficulty finding new DAP customers because of program saturation.

Natural Resources Reference Council (NRDC) proposes retaining the $18 million funding level, arguing that the cost-effectiveness of the program has always been marginal and that SoCal has not justified changing funding on this basis. NRDC also observes that only 33% of income eligible households have received DAP help, contrary to SoCal's view that the market has been saturated.

We adopt SoCal's reduced funding levels in recognition that fewer customers are available to take advantage of the program as a result of the program's success. We also grant SoCal's request for increased program flexibility which would permit it to put the weatherization component of the program out to bid, among other things. We do not adopt any flexibility which would change SoCal's discretion to use the funds for other programs.

7. Administrative and General Accounts

a) Consultant Fees (Account 920)

Account 920 includes funds for outside consultants. ORA recommends disallowing $94,000 for a consultant hired for this proceeding because the consultant's work appears speculative after the test year. SoCal replies that it requires the funding for monitoring and evaluation of its PBR mechanism. We reject SoCal's argument, which appears to presume regulatory activity will increase as a result of PBR regulation. We adopt ORA's adjustment to this account.

b) Executive Compensation (Account 920 and 921)

TURN recommends adjusting labor costs by $0.606 million to reflect what it believes to be excessive compensation to executives. TURN observes that ORA's compensation study finds executive compensation to be almost 13% above market even though ORA does not recommend any reduction in SoCal's labor cost request. TURN's adjustment would amount to about 0.19% of SoCal's total request for employee compensation.

SoCal argues that its executive compensation rates are comparable to those offered to individuals working in markets from which SoCal recruits. It does not, however, present any evidence to support its argument. We therefore adopt TURN's adjustment to executive compensation.

c) *Outside Expenses*

(1) Stock Options Expenses (Account 923)

SoCal offers high level employees stock options as part of their compensation plans. ORA recommends that the Commission disallow expenses associated with stock options for executives, which ORA believes raises SoCal's long-term incentive levels to 21% above market levels. ORA observes that SCE's and PG&E's stock options programs are funded entirely by shareholders, and that the incentives are rewards for financial accomplishments which do not benefit ratepayers.

SoCal responds that ORA has improperly isolated a single element of SoCal's total compensation package. SoCal observes that ORA does not dispute that total compensation at SoCal is not above market levels. Isolating stock options expenses would therefore reduce the package of total compensation further.

We concur with SoCal that as long as its total compensation levels are appropriate we will not dictate how SoCal distributes compensation among various types of employment benefits.

(2) Lobbying Expenses

Following some initial disagreement regarding appropriate lobbying expenses, SoCal and ORA resolved their differences, proposing to reduce SoCal's request by $0.4 million. We adopt their agreement.

(3) Affiliate Transactions

SoCal pays its parent company for some services pursuant to direct billings which reflect specific services. ORA recommends a disallowance of $1.924 million of such affiliate costs sought by SoCal following an audit of related expenses. ORA proposes the disallowance on the basis that SoCal had failed to provide any meaningful documentation of $4.02 million worth of services provided to it by its parent, Pacific Enterprises. It is especially concerned with the lack of documentation for $3.32 million of law department charges.

SoCal replies that ORA and its auditors are not the "arbiters of how much documentation is 'enough.'" It argues that the law department of Pacific Enterprises could be expected to spend most of its resources on SoCal's needs because SoCal is the largest of the Pacific Enterprise companies. Finally, the SoCal level of funding for legal expenses is an estimate of 1996 expenses, not an accounting of actual expenses for 1995.

SoCal has the burden to demonstrate the reasonableness of its requests. In this instance, SoCal failed to provide sufficient documentation to support its request. However, SoCal submitted *some* documentation, which is adequate and to justify some payment by ratepayers for the services of SoCal's parent company. We therefore adopt ORA's recommendation of disallowing approximately 50% of SoCal's request, and allowing the rest.

(4) Multifactor Allocation Formula (Account 920)

SoCal pays its parent company for some services on the basis of indirect allocations to SoCal in cases where direct billings for specific services are not practical. ORA opposes elements of the formula SoCal uses to allocate such costs. Specifically, ORA would weigh operating expenses and payroll more heavily than assets. Applying ORA's methodology to the relevant costs, ORA recommends a disallowance of $2.939 million less than SoCal requests.

ORA believes SoCal's allocation to new lines of business – less than two tenths of a percent – is unrealistic. It would increase the amount to 20%.

SoCal responds with various arguments, among which are that its formula is used by other utilities and other jurisdictions, and that its other business units are designed to assist in new product development for sister units

SoCal responds that it is not anticipating a reduction in these costs in the near future. Although they might decrease at some point as a result of corporate restructuring, SoCal argues that it has not asked for recovery of cost increases which might occur at some unspecified point and should therefore not be required to forgo uncertain decreases.

We reject ORA's adjustment in this account on the basis that ORA has not demonstrated that SoCal will stop using the facilities in question during the test year.

e) *Injuries and Damages (Account 925)*

Account 925 includes funds for compensating employees for injuries and damages sustained at the workplace. ORA recommends a $1.9 million reduction in SoCal's estimate for Account 925 to recognize employee reductions and associated reduced costs for this account. SoCal argues ORA inappropriately reached its estimate by applying year end accruals of employee settlements in lawsuits rather than looking to actual cash payments to estimate these revenues.

Consistent with existing policy, we adopt SoCal's recommended level of funding in this account using actual cash payments as the basis for estimating net costs.

f) *Franchise Fees (Account 927)*

ORA and SoCal resolved most issues concerning franchise fees, arguing that this proceeding should not be a forum for changing the franchise fee methodology, and that estimates adopted in this proceeding would include $23.31 million in revenues from miscellaneous services. SoCal and ORA did not agree on the appropriate rate for franchise fees. We adopt SoCal's number, because ORA's is based on an assumption that the methodology would be changed. ORA stipulated to retain the methodology in deriving a level of revenues; we therefore apply SoCal's rate for consistency.

and are not independent of SoCal. SoCal also argues that its affiliates are considerably smaller than SoCal in terms of employees and assets.

The record suggests that the purpose of SoCal's affiliates is to promote new product development which is not related directly to utility expenses that would be recoverable here. If that were not the case, there would be scant reason to create such entities, considering the potential inefficiencies of having utility operations in two separate units. We are not concerned with how other jurisdictions view SoCal's allocation methods so much as we are inclined to consider the method on its merits. We find that ORA's method is superior to the one proposed by SoCal, and we adopt that method.

(5) Law Department Rent (Account 923)

SoCal receives its legal services from its parent company, Pacific Enterprises, which bills SoCal for related costs. ORA recommends an adjustment of $889,669 to reflect billings by Pacific Enterprises for rental of property to house the Legal Department. The billings are in excess of the actual costs of the Gas Company Tower lease. SoCal responds that the adjustment would be unfair because the rate is nearly identical to that paid at the Gas Company Tower. SoCal believes ORA should not be able to penalize the company for a lease cost that was reasonable at the time SoCal entered into it, even if prevailing market rates are considerably lower.

We have made adjustments to the Gas Company Tower lease to reflect unused space, and by implication the effects of the Law Department's remaining at another location. ORA has not demonstrated that the Law Department's lease is unreasonable. We therefore adopt SoCal's request for the costs of the Law Department's lease.

d) Insurance Expenses (Account 924)

ORA believes corporate reorganization will cause eight facilities no longer to be useful. Elimination of these facilities and the costs to insure them, according to ORA, will offset increases in insuring remaining facilities. ORA recommends a $16,000 reduction over SoCal's estimate.

g) *Regulatory Commission Expenses (Account 928)*

Account 928 includes funds for the costs of participating in regulatory commission activities. ORA recommends about $26,000 less in this account than SoCal. ORA uses the 1994 level and adds inflation for 1996. SoCal adds certain expenses and 1995 inflation to the 1994 level.

We adopt ORA's adjustment to recognize the likelihood that regulatory Commission expenses should not be increasing in the foreseeable future.

h) *Rents (Account 931)*

(1) Gas Company Tower

ORA recommends a disallowance of $5.384 million to reflect unused space at the Gas Company Tower, SoCal's corporate headquarters. ORA's recommended disallowance is based on ORA's assertion that 131,063 square feet of the site's 550,000 square feet is vacant.

ORA's recommendation is based on the analysis of its auditor, Overland. In its audit, Overland found that about 25% of the rentable space at Gas Company Tower was vacant, assuming that 375 employees would be moved to the Gas Company Tower. Based on SoCal's records, Overland concludes that SoCal has conducted "continuing review" of excess real estate rather than dispose of it or use it for company operations. ORA rejects company promises to move more employees to the Gas Company Tower, because such promises have not been fulfilled in the past. Specifically, ORA refers to SoCal's stated intent to move its Law Department to the Gas Company Tower during SoCal's last general rate case, which the Commission relied upon in granting associated funds for the Gas Company Tower.

SoCal responds that it has developed plan to occupy 97% of the Gas Company Tower in 1997. It presents a timeline which it developed shortly prior to hearing in this proceeding. Its witness asserts that at the time of the hearing the Gas Company Tower was 89% occupied. SoCal argues that it would not make sense for it to have sublet the unused space at the Gas Company Tower in the depressed Los Angeles rental market. SoCal states it attempted to sublease Gas

Company Tower space but, at a market rental value of $13 to $15 a square foot, the revenue would have barely covered SoCal's building operations costs.

SoCal claims that the fact that the Law Department did not relocate to Gas Company Tower is irrelevant. SoCal states that the relocation was deferred because of the need to house displaced employees at the Gas Company Tower, and because of the "extraordinary" cost of relocating the Law Department library.

ORA responds that the Commission should give no weight to the move plan, because the moves have been previously found to be uneconomic or are for personnel from CIS who are to be terminated. ORA argues that SoCal's analysis of future use of the Gas Company Tower assumes the company requires 120 workstations for equipment that is appropriately located on employee desks and 273 spaces for contractors, though only 140 contractors were expected to work for the company after December 1996. ORA also observes that Overland's report is generous because it does not account for 153 employees who have left the company since the audit was completed.

SoCal leased the space under a 20-year contract beginning in 1991. We originally reviewed the costs of the Gas Company Tower lease in D.92-11-017. In that order, we disallowed a portion of the excess space at Gas Company Tower on the basis that SoCal had not demonstrated the reasonableness of the costs. Subsequently, we reinstated much of the disallowance in D.93-12-043.

We begin by rejecting SoCal's argument that ORA is improperly relitigating this matter. As SoCal itself observes, D.93-12-043 permitted a reconsideration of the findings of that order with a showing of changed circumstances. ORA is seeking to demonstrate changed circumstances which would justify additional disallowances.

Indeed, circumstances have changed since 1994. Occupancy in the Gas Company Tower, assuming SoCal's analysis is correct, was 85% in 1995 and less than 80% in 1996. SoCal's assertion that the Gas Company Tower was 89% occupied at the time of hearing was refuted by ORA's auditors after a physical