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Decision 97-07-059 July 16, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Order Instituting Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation.	Rulemaking 94-04-031 (Filed April 20, 1994)
Order Instituting Investigation on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation.	Investigation 94-04-032 (Filed April 20, 1994)

INTERIM OPINION

Background

On December 20, 1995, we issued Decision (D.) 95-12-063, as modified by D.96-01-009, the Preferred Policy Decision in our Rulemaking (R.) and Investigation (I.) regarding electric industry restructuring (R.94-04-031/I.94-04-032). In that decision, we found that a reduced return on equity was appropriate for those utility assets afforded transition cost recovery to reflect the reduced business risk associated with the recovery of the remaining net investment due to the imposition of a nonbypassable charge on distribution customers. (Preferred Policy Decision, mimeo, p. 124.)

On December 20, 1996, we issued D.96-12-088 (Roadmap 2 Decision) which provided an updated roadmap to accomplish the goals of electric restructuring, given the enactment of Assembly Bill (AB) 1890 (Stats., 1996, Ch. 854). This decision also addressed the impact of AB 1890 on several aspects of the Preferred Policy Decision. As part of this assessment, we sought comments from parties in various proceedings and issue areas. By Coordinating Commissioner's Ruling, issued on September 30, 1996, parties were asked to "address the positive and negative aspects of this reduction and to consider impacts, if any, AB 1890 might have had on this reduced rate of return on equity." (Coordinating Commissioner's Ruling, p. 6.) In D.96-12-088, we established that:

> "After reviewing all the comments on this issue, we are not persuaded that the return on equity set forth in the Preferred Policy Decision needs to be further reduced or increased. We are not convinced that the risks have changed so significantly with the enactment of AB 1890 to warrant any such change. Further, we agree with SDG&E [San Diego Gas & Electric Company] that the 90% of the embedded cost of debt as a reasonable rate of return on equity 'is appropriate.' We continue to believe that it will provide the right incentive for utilities to minimize transition costs, and thus, ratepayers will benefit.
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> "Further, we agree that AB 1890 confirms the rate of return on equity we adopted in the Preferred Policy Decision. PU [Public Utilities] Code Section 367(d) states, in pertinent part: 'Recovery of costs prior to December 31, 2001, shall include a return as provided for in Decision 95-12-063, as modified by Decision 96-01-009, together with associated taxes." (D.96-12-088, mimeo. at 33.)

On February 24, 1997, the Office of Ratepayer Advocates (ORA) filed a motion requesting an immediate ruling which would order Pacific Gas and Electric Company (PG&E), Southern California Edison Company (Edison), and SDG&E to implement the provisions regarding the reduced return on equity, which were affirmed by D.96-12-088. Timely responses to ORA's motion were filed by PG&E, Edison, SDG&E, and The Utility Reform Network (TURN).

ORA's Motion

ORA requests that the authorized revenue requirement be adjusted either as of the date of issuance of D.96-12-088 or no later than the date of its motion, to reflect the reduced return on equity. Because of the rate freeze, ORA believes that the utilities should be directed to establish memorandum accounts to track the difference in revenue requirements between the authorized revenue requirement and the maximum reduction in revenue requirements. This decrease in authorized revenue requirements would not result in reduced rates, because of the rate freeze in place through at least

December 31, 2001, but would result in increased "headroom" revenues.[1] ORA argues that this increased headroom would increase the likelihood that utilities' would be able to recover their transition costs within the specified time period and could result in early recovery of those costs, so that the rate freeze could end early.

ORA believes that this reduction in authorized revenue requirements would have been most appropriately applied beginning on January 1, 1997, because that is when we approved the commencement of the rate freeze, pursuant to D.96-12-077. In that decision, we also established interim balancing accounts to ensure that excess revenues collected under the rate freeze would be allocated to reducing transition costs. (D.96-12-077, mimeo. at pp. 12-13.) ORA thus recommends that a corresponding ratepayer benefit should also be enacted now.

Responses to the Motion

TURN supports ORA's proposal and emphasizes that the reduction in the return on equity portion of assets eligible for transition cost recovery will increase the likelihood of the utilities achieving full recovery of their stranded investment during the transition period. TURN also believes that this proposal will make recovery of transition costs more orderly, as required by PU Code § 330(t), because the reduced rate of return would be implemented at approximately the same time as the risk-reducing measures go into effect.

PG&E, Edison, and SDG&E recommend that we reject ORA's motion, because transition cost recovery will not begin until January 1, 1998; i.e., the non-nuclear generation assets will not receive accelerated depreciation treatment until that date. SDG&E states that D.96-11-060, the 1997 cost of capital decision, adopts an all-party settlement, to which ORA was a signatory. SDG&E believes that, in essence, by seeking a reduction to the return on equity on assets which are eligible for transition cost

[1] Headroom is the difference between frozen rate levels and the costs of providing service. Revenues beyond those required to provide service are then applied to offset transition costs.

recovery, ORA is undermining its position in the cost of capital proceeding, and essentially seeking a rehearing of D.96-11-060, which is out of time.

Edison agrees that the reduced rate of return is tied to the accelerated recovery of generation assets and argues that neither the rate freeze, the nonbypassable competition transition charge (CTC), nor implementation of the interim CTC justify applying a reduced return to generation assets. Edison also states that ORA's calculations are flawed, because it has included costs that are not eligible for accelerated depreciation and therefore not subject to a reduced return. Edison also contends that ORA's calculation of the reduced return is erroneous, because it is based on the 1997 authorized cost of debt.[2]

PG&E also agrees that accelerated recovery of the uneconomic generation assets must be authorized before the reduced return component is applicable and that ORA's proposal is premature because the essential elements of the transition cost recovery framework are not yet fully implemented. PG&E states that a reduced return is appropriate only when an asset is determined to be uneconomic and the utility seeks to accelerate the recovery of that asset through the application of CTC. Furthermore, PG&E states that the reduced return can only apply to fossil-fueled generation, pursuant to the Preferred Policy Decision. PG&E adamantly contends that granting ORA's motion would be tantamount to retroactive ratemaking and an effort to provide a windfall to ratepayers before all elements of the necessary transition cost recovery framework are firmly in place.

ORA's Reply

The assigned administrative law judge (ALJ) granted ORA's request to reply to the responses to its motion. This reply was filed on March 31, 1997. ORA now recommends that a Commission decision is the appropriate vehicle by which to

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[2] In D.96-04-059, we adopted the embedded cost of debt from the San Onofre Generating Stations 2 & 3 settlement as precedent for the calculation of the reduced rate of return and stated the cost of debt would remain fixed for the transition cost amortization period. (D.96-04-059, mimeo., pp. 8,9 and Conclusion of Law No. 3, p.17.)

implement its recommendation. ORA states that it does not seek to change the return on equity and the embedded cost of debt adopted in D.96-11-060, as SDG&E claims, but is requesting that the reduced return in equity adopted in the Preferred Policy Decision and affirmed in the Roadmap 2 Decision be applicable now, rather than being applied at the beginning of the transition period, January 1, 1998. Furthermore, ORA states that there is no discussion in the most recent cost of capital decision on either the impact of risk associated with electric restructuring or the impact of AB 1890.

ORA believes that the utilities' risk was further reduced by the Cost Recovery Plan Decision (D.96-12-077). Since we established that the rate freeze began on January 1, 1997 and that any 1997 Energy Cost Adjustment Clause or Electric Revenue Adjustment Mechanisms overcollections would be applied to transition cost recovery, rather than being refunded to ratepayers, ORA claims that this action increases the amount of headroom available to utilities by millions of dollars. ORA argues that it is therefore equitable to implement the reduced rate of return for transition cost eligible assets prior to the beginning of the transition period, commensurate with the utilities' opportunity to begin accruing headroom revenues. In addition, ORA asserts that the applicability of the reduced return on equity is not tied to a particular transition period, nor to whether depreciation is accelerated or not, but to the risk facing the utilities' investors.

Discussion

In the Preferred Policy Decision, we found that it was appropriate to reduce the cost of capital for generation assets eligible for transition cost recovery by setting the return on the percentage of the undepreciated asset financed by equity to a level of 10% below the long-term cost of debt. We also found that this reduced return was the appropriate measure of the reduced risk associated with these assets as the utilities recovered the net book value of such assets through accelerated depreciation. At the same time, we recognized that this 10% reduction could be eliminated by the utility divesting at least 50% of its fossil generation and stated that we would provide for a 10-basis point increase in return on equity for each 10% of fossil plants divested.

Furthermore, we articulated the following rationale in adopting the reduced return on equity for generation transition cost assets. We found that ratepayers should benefit to some degree from our treatment of transition costs and that it would be inappropriate to require ratepayers to bear the same costs they would have borne in the absence of moving toward a competitive framework, with the goals of introducing competition, customer choice, and rate reductions. We also found that it was equitable that shareholders recover somewhat lower revenues for transition cost assets than they would under traditional cost-of-service regulation and that assurance of full recovery would have the potential of providing perverse incentives to utility market behavior. The assurance of full recovery would allow the utility to remain indifferent to the level of transition costs and could even result in incentives to bid low in offering output to the Power Exchange, which could then depress the market-clearing price and further increase transition costs. Finally, we found that adopting a reduced return on equity was appropriate in light of the reduced risk of recovery and would not adversely impact the utilities' financial stability.

As stated in D.96-12-088, AB 1890 confirms the return on equity adopted in the Preferred Policy Decision. Although accelerated amortization of certain transition cost assets has not yet begun, the rate freeze commenced on January 1, 1997, pursuant to D.96-12-077. The utilities are using this interim period to accrue revenues to offset transition costs. Thus, while we have not yet finally determined which assets and costs are eligible for transition cost recovery, we have allowed the utilities to accrue headroom revenues prior to such findings and the beginning of the transition period.

Several issues have been raised in the motion and responses; however, there may be other issues to consider in establishing when the reduced rate of return should be applicable. We are reluctant to consider the merits of ORA's proposal without a full consideration of the ramifications of the many issues associated with the interaction of the rate of return and transition cost recovery. This motion has been filed and served in the electric restructuring rulemaking, but rate of return issues associated with transition cost recovery will be addressed in the transition cost proceedings (Application (A.) 96-08-001 *et al.*). (See, for example, the assigned ALJ ruling issued on April 28, 1997, in A.96-08-001 *et al.*) We will not rule on the merits of ORA's motion at this time, however, we will adopt ORA's procedural mechanism to establish memorandum accounts. Therefore, in order to preserve the Commission's ability to determine the appropriate start date of the applicability of the reduced return on equity, it is reasonable to require PG&E, Edison, and SDG&E to establish memorandum accounts to track the difference in revenue requirements stemming from the reduced return on equity for investment-related assets which are eligible for transition cost treatment. Although the amounts recorded in these memorandum accounts would ordinarily be made subject to refund, the rate freeze requires a slightly different treatment. Assuming that the disposition of these amounts is decided during the period of the rate freeze, these amounts are subject to being applied to offset transition costs, rather than considered a cost of service. To the extent that supplemental testimony or briefs are necessary to address this issue, parties will have the opportunity to present their views on this issue in Phase 2 of A.96-08-001 *et al.* In consultation with the assigned Commissioners, the assigned ALJ will determine how these issues should be addressed procedurally.

In compliance with this decision, within 10 days of the effective date of this decision, PG&E, Edison, and SDG&E shall file advice letters to establish memorandum accounts to track the difference in authorized revenue requirements stemming from the difference in the return on equity as established in D.96-11-060 and the reduced return on equity adopted in the Preferred Policy Decision and affirmed in the Roadmap 2 Decision, as applied to the investment-related assets for which the utilities seek transition cost recovery. The 1995 cost of debt figures should be used as a basis for these calculations, as established in D.96-04-059. These advice letters, if filed in compliance with this decision, shall be effective on the date filed.

Findings of Fact

1. D.96-12-077 established January 1, 1997 as the beginning of the rate freeze period.

2. D.95-12-063, as modified by D.96-01-009 established that a reduced return on equity was appropriate for those investment-related assets afforded transition cost recovery to reflect the reduced risk associated with these assets.

3. D.96-12-088 affirmed that a reduced return on equity was appropriate for generation-related assets eligible for transition cost recovery.

4. D.96-04-059 established that the 1995 cost of debt figures should be used to calculate the reduced return on equity for PG&E, Edison, and SDG&E, and that these figures should remain fixed.

Conclusions of Law

1. PU Code § 367(d) mandates that the rate of return adopted in the Preferred Policy Decision shall apply to transition cost assets.

2. In order to preserve the Commission's ability to determine when the reduced return on equity should be applied to investment-related assets eligible for transition cost recovery, it is reasonable to require PG&E, Edison, and SDG&E to establish memorandum accounts. These memorandum accounts shall track the difference in authorized revenue requirements stemming from the difference in return on equity adopted in D.96-11-060 and the Preferred Policy Decision, as applied to the investment-related assets for which the utilities seek transition cost recovery. The 1995 cost of debt figures for PG&E, Edison, and SDG&E shall be used as the basis for this calculation, as established in D.96-04-059.

3. The issues raised in ORA's motion should be considered in the transition cost proceedings, A.96-08-001 *et al.*, along with other rate of return issues.

4. This order should be effective today so that the memorandum accounts can be established in an expeditious manner.

INTERIM ORDER

Therefore, **IT IS ORDERED** that:

1. Pacific Gas and Electric Company (PG&E), Southern California Edison Company (Edison), and San Diego Gas & Electric Company (SDG&E) shall establish

memorandum accounts to track the difference in authorized revenue requirements stemming from the difference in the return on equity adopted in Decision (D.) 96-11-060 and the reduced return on equity adopted in D.95-12-063, as modified by D.96-01-009, and which was affirmed in D.96-12-088, and applied to the investment-related assets for which the utilities seek transition cost recovery. The 1995 cost of debt components for PG&E, Edison, and SDG&E shall be used as a basis for these calculations, as established in D.96-04-059.

2. These memorandum accounts shall bear interest at the three-month commercial paper rate, as stated in the Federal Reserve statistical release Form G.13 or its successor.

3. Within 10 days of the effective date of this decision, PG&E, Edison, and SDG&E shall file advice letters establishing the memorandum accounts as described in this decision. Advice letters filed in compliance with this order shall be effective on the date filed.

4. Because we have established that the merits of the Office of Ratepayer Advocates' motion shall be addressed in the transition cost proceedings, the executive director shall cause a copy of this order to be served on the service list to Application 96-08-001 *et al.*

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