

Decision 97-12-041 December 3, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company
to Establish an Experimental Performance-Based
Ratemaking Mechanism. (U 902-M)

Application 92-10-017
(Filed October 16, 1992)

OPINION ON MIDTERM EVALUATION

ORIGINAL

1. Summary

The requirement that San Diego Gas & Electric Company (SDG&E) file a general rate case (GRC) for a 1999 test year is vacated, and the requirement for a GRC filing in future years is suspended. In lieu of a GRC, SDG&E is directed to include a 1999 cost-of-service showing in the distribution performance-based ratemaking (PBR) application that Decision (D.) 97-04-067 directed SDG&E to file by December 31, 1997. The midterm evaluation of SDG&E's experimental base rate PBR mechanism which was ordered in D.94-08-023 is concluded, and the requirement for a final evaluation of the experiment is suspended. The PBR experiment's revenue sharing mechanism and non-price performance incentives are retained for 1998. The proceeding is closed.

2. Background

D.94-08-023 established an experimental PBR mechanism as an alternative to the traditional GRC mechanism for setting SDG&E's gas and electric base rates. As part of the PBR experiment, SDG&E was excused from filing a GRC for 1996. The experimental mechanism was scheduled to remain in effect until the end of 1998, and SDG&E was ordered to file a GRC for 1999. However, the latter provision was made subject to further order of the Commission in recognition of the possibility that the PBR mechanism would be extended or replaced with a modified PBR mechanism, which could make a test-year 1999 GRC unnecessary.

D.94-08-023 ordered a midterm evaluation to assess the first half of the base rate PBR experiment and provide recommendations to the Commission on whether the PBR experiment should be continued, modified, or terminated at the end of 1998. A major purpose for conducting an evaluation at the midterm of the experiment was to allow SDG&E adequate time to prepare for a 1999 GRC should that be necessary. The midterm evaluation was to be a four-month process at the beginning of 1997.

D.97-04-067 dated April 23, 1997 modified an existing requirement that the major utilities file applications for PBR mechanisms for their electric distribution services. Among other things, it approved a proposal by SDG&E to file an application for a new gas and electric distribution PBR mechanism to become effective January 1, 1999, when the current PBR experiment expires. SDG&E had proposed to make the filing in September 1997, following the then-expected completion date of the midterm evaluation, so that the results of the midterm evaluation could be considered in the distribution PBR proceeding. The Commission provided that the application should be filed during the last three months of 1997.

D.97-04-085 granted a motion by SDG&E to suspend the requirement that it file a test year 1999 GRC. However, the Commission reserved the right to lift the suspension and reinstate the GRC requirement upon completion of the midterm evaluation. Noting the need for assurance that a new distribution PBR is implemented with an appropriate starting revenue requirement, the Commission provided that, in the absence of a test year 1999 GRC, SDG&E should include with its distribution PBR application either a distribution cost-of-service showing or an explanation why such a showing is unnecessary and inappropriate.

D.97-09-052 granted in part a motion by the Office of Ratepayer Advocates (ORA) to suspend the incentives in the base rate PBR experiment by suspending the electric price performance rewards and penalties. Other aspects of ORA's motion, including ORA's proposal to suspend the experiment's non-price incentives, were denied without prejudice.

3. Procedural History

Pursuant to Ordering Paragraph 3 of D.94-08-023 and Ordering Paragraph 2 of D.96-04-057, the Energy Division (successor to the Commission Advisory and Compliance Division) held a workshop on December 4, 1996 and the Administrative Law Judge (ALJ) held a prehearing conference on December 11, 1996 to establish procedures for the midterm evaluation. In lieu of a litigation schedule, the ALJ adopted SDG&E's proposal for a collaborative workshop process.

Workshops, settlement discussions, and additional prehearing conferences held over the next several months failed to yield agreement among the parties. By ruling issued on September 22, 1997 the ALJ established a comment process to resolve the midterm evaluation and the issues raised therein. Parties were asked to comment on limiting the scope of the midterm evaluation, using SDG&E's gas and electric distribution PBR application as the forum for consideration of the results of the base rate PBR experiment, vacating the requirement for a test year 1999 GRC filing by SDG&E, requiring SDG&E to include a 1999 cost-of-service showing in its distribution PBR application, and closing this proceeding upon completion of the midterm evaluation. Parties who proposed any change to the base rate experiment in its final year (1998) were directed to serve prepared testimony describing and supporting their proposals.

Comments were filed by SDG&E, Utility Consumers Action Network (UCAN), and ORA. SDG&E and UCAN filed reply comments. SDG&E, UCAN, and ORA submitted testimony with proposals for modification to the experiment.

4. Discussion

4.1 Adequacy of The Record

The September 22 ruling provided that any need for an additional round of comments, a prehearing conference, or evidentiary hearings would be determined after receipt of comments and prepared testimony. ORA believes hearings are not required to resolve the policy issues that have been raised. SDG&E does not believe evidentiary hearings are required to address its recommendations, but it believes hearings would be

required to address proposals by ORA and UCAN regarding the sharing mechanism and the experiment's non-price incentives.

We find that the comments and replies, and in part the prepared testimony, comprise a complete record for purposes of this decision, and that evidentiary hearings and further rounds of comments are not required. We decide the issues on policy grounds and in light of Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854) and our restructuring decisions. The modifications that we make to the mechanism for 1998 are predicated upon the mandates of electric industry restructuring and are not based upon any disputed factual issues regarding the asserted success or failure of the experiment to date. We identify the prepared testimony of Lee Schavrien, Robert Mark Pocta, and William B. Marcus as Exhibits MTE-1, MTE-2, and MTE-3 respectively. We do not receive the facts and the expert opinions in the prepared testimony as evidence, since there has not been an opportunity, or need, for cross-examination or rebuttal testimony. Instead, we consider the policy recommendations therein as extensions of the respective parties' filed comments.⁷

4.2 Scope and Disposition of the Midterm Evaluation

When the Commission ordered the midterm evaluation in D.94-08-023, it declined to set a heavy agenda for this planned four-month process. Two primary objectives that clearly are on the agenda are to determine whether the experimental PBR mechanism requires any modifications and to determine whether a GRC filing is needed for 1999. It is also apparent that the Commission expected that the midterm evaluation would provide useful information in the design of any replacement or modified PBR mechanism.

In D.96-04-057 the Commission stated that it wanted the midterm evaluation to provide an opportunity for parties to raise and have addressed their concerns about the

⁷ On October 14, 1997, the date reply comments were due, UCAN served proposed rebuttal testimony. SDG&E filed a motion to strike the rebuttal testimony on the grounds that the ALJ had not authorized rebuttal testimony and that it would constitute undue prejudice to permit only one party to submit rebuttal. For good cause shown, the motion is granted.

experiment as well as linkages between the experiment and electric industry restructuring. However, the Commission reiterated the policy of a limited agenda, and provided that the midterm evaluation should focus on any need for changes to the experiment.

This decision addresses proposals for modifying the experiment in its final year. It also addresses the need for a GRC filing for 1999. Even though the midterm evaluation has been disappointing because it has not yielded an agreed-upon assessment of the first half of this PBR experiment, despite the parties' initial belief that a collaborative process should be pursued, the two primary objectives of conducting the midterm evaluation noted earlier are being achieved.

The possibility that a continued midterm evaluation would eventually produce additional information which would be of value in the distribution PBR proceeding does not constitute a valid reason for continuing it. The major objectives for the midterm evaluation are being met. Moreover, as explained in the following section, the distribution PBR proceeding will provide a better forum for consideration of the lessons learned from the experiment that are relevant to the design of the new PBR. The midterm evaluation should be concluded.

4.3 Final Evaluation

In the 1994 hearings, SDG&E, the Division of Ratepayer Advocates (ORA's predecessor), and the Department of the Navy and all other Federal Executive Agencies jointly proposed (in Exhibit 101) that a final evaluation be undertaken on May 15, 1999 to examine the entire five-year experiment and recommend what modifications, if any, should be made to the base rate mechanism. Exhibit 101 identified eleven issues which the final evaluation should cover. D.94-08-023 directed the ALJ to "convene a prehearing conference no later than May 1, 1999 to establish the procedural protocol for the final evaluation of the base rate PBR experiment specified at page 31 of Exhibit 101." (D.94-08-023, Ordering Paragraph 3.)

Noting the mandate of Senate Bill (SB) 960 (Stats. 1996, Ch. 856) to resolve proceedings within 18 months, the September 22 ruling asked parties to comment on whether the final evaluation should take place in either the distribution PBR proceeding

or in a new proceeding initiated by SDG&E instead of in this docket. SDG&E prefers keeping this proceeding open for the final evaluation or, in the alternative, initiating a new proceeding. SDG&E recommends against using the pending distribution PBR proceeding on the grounds that a heavy agenda has already been ordered for it.

By the time the final evaluation is scheduled to commence in mid-1999, we intend to have already considered and adopted a replacement PBR for SDG&E. The greatest value of the lessons that can be learned from the 1994-98 experiment will be realized if those lessons can be applied in the initial design of the replacement mechanism, before it is implemented. Accordingly, while we share SDG&E's concern about adding too many issues to the distribution PBR proceeding, we find that it may be appropriate for SDG&E and other parties to raise one or more of the issues listed in Exhibit 101 in that proceeding. It simply may not be possible to evaluate SDG&E's distribution PBR application, and the positions of other parties, without consideration of the same issues that are targeted for review in the final evaluation. For example, whether SDG&E and our staff have worked together effectively in monitoring and evaluating the experiment may be an important factor in designing a monitoring and evaluation program for the new PBR mechanism.

This in turn leads us to question whether the value we originally saw in conducting the formal final evaluation will remain. At this time we will suspend the requirement for a final evaluation. If we later determine that a formal, final evaluation of the base rate PBR experiment will assist us in administering and improving the new gas and electric distribution PBR, we may reinstate the requirement. If we do so, we would determine the appropriate procedural forum at that time. In any event, due to the requirements of SB 960, we will not keep this proceeding open for the final evaluation.

4.4 GRC Filing Requirement

The September 22 ruling asked parties to comment on whether the requirement that SDG&E file a GRC for a 1999 test year should be vacated, and, if so, whether SDG&E should be required to include a 1999 cost-of-service showing in its December 1997 distribution PBR application. SDG&E strongly supports this proposal, and ORA

does not recommend that a traditional GRC be required for 1999. UCAN asserts that the underlying "bottom-up" methodology used in conducting traditional GRCs remains relevant. UCAN believes that the 1999 cost-of-service showing which SDG&E includes in its distribution PBR application should be, in effect, a traditional GRC for distribution.

In D.97-04-085, by which we suspended the requirement for a 1999 GRC, we described the numerous procedural requirements associated with a traditional GRC filing. In view of the burden these requirements impose, the limited resources of the Commission and the parties available at this stage of electric industry restructuring, our general preference for PBR regulation, the provision for a distribution PBR filing by SDG&E for implementation in 1999, and our belief that a cost-of-service showing can provide the basis for a reasonable starting revenue requirement, we are persuaded that we should now vacate the requirement.

The September 22 ruling also asked for comments on whether to suspend the requirement for any future test year GRC. SDG&E supports this approach, while ORA proposes that we order SDG&E to make a GRC or similar filing for a 2002 test year. We believe ORA's proposal is premature. Any need for a distribution GRC after 1999 can be addressed in the gas and electric distribution PBR proceeding or in any proceeding that may be established to monitor the new PBR mechanism. We place SDG&E on notice that we reserve the right to require a comprehensive GRC filing for 2002 as proposed by ORA or even earlier if we find that doing so is warranted.

4.5 Cost-of-Service Showing

There is general support for requiring SDG&E to include with its distribution PBR application a 1999 cost-of-service showing to establish a revised base revenue requirement for distribution. We have already made provision for a cost-of-service showing on a permissive basis in D.97-04-085. We now make this provision for a gas and electric cost-of-service showing mandatory.

ORA states that it would support using 1996 and 1997 actual expenses as a basis for establishing a revenue requirement for 1999. SDG&E would oppose this methodology. As already noted, UCAN believes that the showing should be the

equivalent of a GRC for distribution. For the same reasons that we have eliminated the requirement for a test-year 1999 GRC, we will not convert the cost-of-service showing to a distribution GRC in all respects except in name. We continue to believe, as we did when we issued D.97-04-085, that the general approach we prescribed for Southern California Gas Company in D.95-04-072 represents an appropriate model for SDG&E's upcoming PBR proceeding. We will not further resolve in this decision the methodology used by SDG&E in its cost-of-service showing.

UCAN recommends that the cost-of-service showing be required by December 1, 1997. SDG&E asserts this would unduly burden its staff since it is not prepared to complete the showing until late December. We have already provided that SDG&E may file its distribution PBR application any time during the fourth quarter of 1997, and we have provided that the cost-of-service showing should be included with the application. We will not require the showing to be filed on December 1, 1997.

4.6 Changes to the PBR Experiment for 1998

We have repeatedly stated our intention to maintain program stability during the term of the experiment. At this time the midterm evaluation forum should focus on any modifications to the base rate experiment which are asserted to be necessary for 1998. However, we recognize that electric industry restructuring legislation and our restructuring decisions, especially the provisions for an electric rate freeze and related transition cost recovery mechanisms that become effective in 1998, have impacted the PBR experiment. With this background in mind, we address the proposals for modifying the program.

4.6.1 The Sharing Mechanism

The base rate PBR experiment includes a revenue-sharing mechanism that allocates to ratepayers and shareholders, in varying percentages, combined gas and electric net operating revenues which exceed the target (Commission-authorized) rate of return plus 100 basis points. In D.96-12-077, which approved the electric utilities' cost recovery/rate freeze plans filed under Public Utilities Code Section 368, the Commission observed that the newly-required cost recovery mechanisms may distort

the intended PBR incentives. (D.96-12-077, pp. 15-16.) With respect to SDG&E, it provided that such problems could be addressed in the midterm evaluation. (*Id.*, p. 17.)

For electric service, D.97-10-057 (the streamlining decision) provides that any PBR sharing, rewards, and penalties would be added to or subtracted from billed revenues in calculating revenues available for recovery of uneconomic generation costs (headroom).² SDG&E proposes that any shared amount for 1997 (which would be computed in the May 1998 PBR report) be flowed into the Transition Cost Balancing Account (TCBA) in accordance with the streamlining decision. SDG&E recommends elimination of the sharing mechanism's provision for flowing shared revenues through the Electric Revenue Adjustment Mechanism (ERAM) account. For calendar year 1998, SDG&E recommends that the PBR sharing mechanism be suspended, and that it be vested with discretion to either retain profits above its authorized rate of return or apply such profits as a credit to transition costs.

UCAN proposes suspending the sharing mechanism and directing SDG&E to use any earnings in excess of the authorized revenue requirement as a credit against transition costs. ORA offers two alternative recommendations. Its preferred alternative, essentially the same as UCAN's proposal, is to eliminate the PBR sharing mechanism and require that SDG&E's actual earnings in excess of the authorized rate of return be used to reduce transition costs through a credit to the TCBA. ORA's secondary recommendation is to implement a sharing mechanism modeled after the one recently adopted in D.97-07-054 for Southern California Gas Company.

SDG&E's proposal for 1997 sharing is reasonable and will therefore be adopted. We find no reason to suspend the sharing mechanism for 1997 earnings. No party

² When comments on the midterm evaluation were filed, a proposed decision on streamlining tariffs and regulatory accounts had been issued in R.94-04-031/I.94-04-032. D.97-10-057, issued after the comments were filed, made no substantive changes to the relevant portions of the proposed decision.

proposes to keep the current sharing mechanism in place for 1998. However, for the reasons stated in the following discussion, we retain the PBR sharing mechanism for 1998 as well as 1997.

SDG&E's PBR sharing mechanism was intended by its proponents to be a safeguard for ratepayers against "windfall profits" and an incentive for the utility to achieve savings. (D.94-08-023, pp. 63-64.) Even though electric utility cost recovery mechanisms are currently focused upon the disposition of revenues collected under frozen rates and the use of headroom revenues to offset uneconomic generation and other costs that are eligible for recovery through the Competition Transition Charge (CTC), these objectives for the sharing mechanism continue to be important. In addition, the sharing mechanism was an integral component of the overall balancing of risks and rewards faced by shareholders and ratepayers. We are reluctant to remove such a key component of the overall PBR mechanism, because there is no assurance that doing so would result in a reasonable balancing of risks and rewards.

We note that the allocation of shared returns adopted in D.94-08-023 (84% electric, 16% gas) was based on 1993 authorized revenues. With the unbundling of electric services and the establishment of a distribution-only revenue requirement for 1998, these allocation factors are no longer valid. SDG&E's Advice Letter 1050-E/1070-G confirms this, showing that its proposed authorized electric and gas department PBR revenues for 1998 are 73% and 27% of total revenues, respectively. SDG&E should revise its Preliminary Statement to update the allocation factors to reflect unbundling of generation, transmission, and distribution services, and to reflect the adopted PBR revenue amounts for 1998.

4.6.2 Non-Price Incentives

The PBR experiment includes a reward/penalty mechanism to provide incentives for SDG&E to maintain and improve employee safety, customer satisfaction, and electric system reliability while it is also responding to incentives to reduce costs. ORA and UCAN propose suspending the non-price rewards while retaining the penalties for 1998. They argue that this is consistent with the streamlining decision's

prohibition on the accumulation of rewards and penalties in balancing accounts for recovery after the rate freeze period.

ORA and UCAN acknowledge that the streamlining decision provides (in Ordering Paragraph 17) that SDG&E's PBR rewards and penalties can be added to or subtracted from total billed revenues in calculating revenues available to offset uneconomic generation costs. However, ORA contends that the PBR performance incentives unnecessarily duplicate the incentive to maximize headroom and complicate the recovery of transition costs. UCAN similarly contends that there would be no means by which performance rewards could be differentiated from CTC collection, and that it is inappropriate to put the utility in a position of having to decide whether it would give greater priority to performance awards than to CTC.

We believe that the original objectives for the non-price incentives remain valid for 1998. Even though the PBR rewards and penalties can only affect headroom, and this may dull the effect of the intended incentives, we are not persuaded that the incentives are rendered ineffective. We will retain these PBR incentives for 1998.

4.6.3 Other Proposed Changes

In D.97-08-056 the Commission incorporated ERAM balancing revenues of \$21.1 million in SDG&E's unbundled distribution rate. ORA believes that prior undercollections should be allocated to the TCBA and not be incorporated into prospective distribution rates. D.97-08-056 also provided SDG&E an opportunity to update its revenue requirement to 1998 levels, but did not provide for a new sales forecast. ORA proposes that the Commission adopt an updated sales forecast in this proceeding.

Proposals to resolve asserted problems associated with D.97-08-056 exceed the scope of this midterm review. We will not consider them here.

Findings of Fact

1. The comments and replies, and in part the prepared testimony, comprise a complete record for purposes of this decision.

2. Two primary objectives of conducting the midterm evaluation are addressed by this decision's determination of whether a 1999 GRC is needed and by its disposition of proposals for modifications to the PBR experiment for 1998.

3. While we have targeted eleven issues for review in the final evaluation of the experiment in 1999, it may be necessary to address one or more of these issues before then in SDG&E's pending distribution PBR application.

4. A test year 1999 GRC filing by SDG&E is unnecessary in light of our provision for a 1999 cost-of-service showing.

5. It is premature to decide whether SDG&E should be required to file a GRC for any year after 1999, but we reserve the right to require a distribution GRC filing for the year 2000 or any future test year.

6. As a matter of policy, SDG&E should be required to include with its pending gas and electric distribution PBR application a 1999 gas and electric cost-of-service showing.

7. SDG&E's proposal for the disposition of any shared revenues is reasonable for 1997 and 1998.

8. Because the stated objectives for the sharing mechanism continue to be important, and the sharing mechanism is an integral component of the PBR experiment's balancing of risks, we should not suspend the sharing mechanism in the absence of assurance that doing so would reasonably balance risks and rewards.

9. SDG&E's Advice Letter 1050-E/1070-G shows that the 1998 electric distribution and gas department PBR revenue requirements are 73% and 27%, respectively, of total revenue requirements.

10. It has not been shown that using the non-price rewards in SDG&E's PBR mechanism to affect headroom would render the intended incentives ineffective.

11. Proposals to modify D.97-08-056 and to require an updated sales forecast are not within the scope of matters to be considered in this evaluation proceeding.

Conclusions of Law

1. Evidentiary hearings and further rounds of comments are not required to resolve the midterm evaluation of SDG&E's base rate PBR experiment.

2. The midterm evaluation of SDG&E's base rate PBR experiment should be terminated, and the final evaluation scheduled for 1999 should be suspended until further order of the Commission.

3. The requirement that SDG&E file a GRC application for a 1999 test year should be vacated, and the requirement that SDG&E file a GRC application for any test year after 1999 should be suspended until further order of the Commission.

4. SDG&E should be required to include a gas and electric cost-of-service showing in its distribution PBR application.

5. Any electric ratepayer sharing amounts for 1997 and 1998 should be credited as an offset to transition costs.

6. The proposals to suspend the sharing mechanism for 1998 should be denied.

7. D.94-08-023 should be modified by the Commission to the extent necessary to make and incorporate the changes adopted herein.

8. This proceeding should be closed.

ORDER

IT IS ORDERED that:

1. The requirement that San Diego Gas & Electric Company (SDG&E) file a general rate case (GRC) application for a 1999 test year is vacated.

2. Any requirement that SDG&E file a GRC application for a future test year after 1999 is suspended until further order of the Commission.

3. SDG&E shall include a gas and electric cost-of-service showing in its distribution performance-based ratemaking (PBR) application, which SDG&E will file not later than December 31, 1997 pursuant to Decision (D.) 97-04-067. The scope and methodology of the cost-of-service showing shall be in accordance with the discussion at pages 7 and 8 of D.97-04-085.

4. The midterm evaluation of SDG&E's experimental base rate PBR mechanism which was ordered in D.94-08-023 is concluded.

5. The requirement in Ordering Paragraph 3 of D.94-08-023 for a final evaluation of the base rate PBR experiment is suspended until further order of the Commission.
6. The following modifications to SDG&E's base rate PBR mechanism are adopted:
 - a. For 1997 and 1998, SDG&E shall record the electric department allocation of any amounts to be shared with ratepayers pursuant to the PBR experiment as a credit in the Transition Cost Balancing Account.
 - b. The allocation of shared earnings for the gas department is increased to reflect the gas department portion of adopted total 1998 PBR revenue requirements.
7. SDG&E should file an advice letter within 15 days at the effective date of this order to revise its Preliminary Statement to reflect the above order.
8. This proceeding is closed.
9. This order is effective today.

Dated December 3, 1997, at San Francisco, California.

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