

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION

RESOLUTION E-3492

June 25, 1997

RESOLUTION

RESOLUTION E-3492. SAN DIEGO GAS & ELECTRIC COMPANY (SDG&E). PROPOSED INVESTMENT MANAGEMENT AGREEMENT BETWEEN SDG&E NUCLEAR FACILITIES DECOMMISSION MASTER TRUST COMMITTEE AND NISA INVESTMENT ADVISORS.

ADVICE LETTER 1033-E, FILED APRIL 25, 1997

SUMMARY

This Resolution approves an Investment Management Agreement (Agreement) between the SDG&E Nuclear Facilities Decommissioning Master Trust Committee (Committee) and NISA Investment Advisors, L.L.C. (NISA) and authorizes the Commission's Executive Director or his designee to sign the Agreement on behalf of the Commission.

BACKGROUND

In Order Instituting Investigation 86, the Commission conducted an extensive investigation on its own motion into decommissioning nuclear power plants owned by California utilities. In Decision (D.) 87-05-062, the Commission adopted externally managed trust funds as the vehicles for accruing decommissioning funds. In that decision, the Commission also established guidelines for the trust agreements.

In response to D.87-05-062, SDG&E established two trusts, one to hold contributions which qualify for an income tax deduction under Section 468A of the Internal Revenue Code (Qualified Trust), and another to hold the remaining funds (Nonqualified Trust). By Resolution E-3060, dated November 25, 1987, the Commission approved SDG&E's trust agreements.

In relevant part, Section 3.01 of both trust agreements provides for the establishment of a Nuclear Facilities Decommissioning Master Trust Committee. Subject to Commission approval, the Committee is authorized to appoint one or more investment managers to direct investments of all or part of the trust assets. To date, the Commission has approved the Committee's appointments of Delaware Investment Advisors and Brown Brothers Harriman & Company, as fixed-income managers, and Fidelity Management Trust Company and State Street Global Advisors, as equity managers, to direct the investment of the trusts.

The Commission has set forth its limitations on the nuclear utilities' trust fund investments in a series of Decisions. Most recently, D.95-07-055 authorized that up to 50% of the fair market value of Qualified Trust funds may be invested in publicly traded equity securities, 40% of which may be invested in non-U.S. equity securities. Therefore, the fixed-income allocation must be at least 50% for the Qualified Trust. D.95-07-055 also provides for Investment Management Agreements to be approved via the Commission's Advice Letter process.

In the subject Advice Letter, SDG&E is requesting Commission approval to hire a third fixed-income manager, who will focus primarily on taxable securities. SDG&E states that under the proposed Agreement with NISA, the Qualified Trust will be invested within the levels authorized by the Commission and will provide appropriate diversification among its fixed-income managers to maximize after-tax returns on a risk-adjusted basis. In this Advice Letter, SDG&E is also requesting the Commission's Executive Director or another designee sign the Agreement on behalf of the Commission.

NOTICE/PROTESTS

Public notice of this advice letter was made by publication in the Commission calendar and by SDG&E's serving copies of this filing on utilities and interested parties, including parties in OII 86.

There were no protests to AL 1033-E.

DISCUSSION

In its meeting on January 15, 1997, SDG&E's Nuclear Facilities Decommissioning Master Trust Committee, in a 5-0 vote: (1) approved retaining NISA as another fixed-income Investment Manager under the Qualified Trust, (2) authorized the execution of an Investment Management Agreement between NISA and the Committee, and (3) authorized an initial funding of approximately \$20 million to NISA from existing fixed-income managers. The Committee's decision to retain NISA to manage fixed-income securities was based on evidence presented to it by its staff, NISA's presentation at the meeting, and the independent judgment of Committee members.

A recent review by the Committee's staff of SDG&E's fixed-income investment allocation concluded that the drop in the Qualified Trust federal tax rate to 20% and the return of municipal/Treasury yield ratios towards historical levels make a strong case to increase the Qualified Trust's fixed-income investment allocation towards taxable securities. These two factors directly influence one of SDG&E's key decision variables into fixed-income investment allocation, the comparison of after-tax yields of fixed-income asset classes. This comparison indicated that taxable securities in the short to intermediate maturity range exhibited higher after-tax yields versus tax-exempt securities, while tax-exempt securities in the long maturity range retained higher after-tax yields.

Given that SDG&E's current Qualified Trust fixed-income investment managers specialize in managing diversified tax-exempt municipal portfolios, it was appropriate to introduce another fixed-income manager who concentrates on taxable securities. The staff believes that this decision ensures that the Qualified Trust fixed-income portfolio remains properly diversified to maximize after-tax returns while minimizing its risk characteristics.

SDG&E based its search for the fixed-income manager on its findings in the recently filed 3-year report to the Commission which requires that current and potential substitute fixed-income investment managers be evaluated. Following the evaluation of the available information, NISA was recommended to manage taxable fixed-income securities in SDG&E's Qualified Trust, benchmarked to a U.S. Treasury Index, plus a twenty (20) basis point after-tax adder.¹ The Committee's staff recommended the benchmark, as a simple and accurate measurement of a fixed-income investment manager's relative and absolute performance, because taxable U.S. Treasuries are generally reflective of the investment opportunities in the Qualified Trust.

NISA Investment Advisors is located in St. Louis, Missouri and has 15 fixed-income nuclear decommissioning accounts totaling \$870 million. At the January 15, 1997 meeting, NISA representatives gave a presentation to SDG&E's NDT Committee that reviewed NISA's management team and briefly described a fixed-income strategy focusing on taxable securities for the Qualified Trust. The NISA representatives related NISA's fixed-income investment process—which emphasizes tax management, sector allocation, and security trading as the primary sources of benchmark outperformance—and presented a sample portfolio that contained 90% treasury/government securities with the remainder in California municipal securities.

The Committee was impressed by NISA's people, process and performance. Therefore, upon approval by the Commission, the Committee proposes to execute an Investment Management Agreement with NISA which, with the exception of the fee schedule, is substantially the same as Investment Management Agreements previously approved by the Commission.

The Committee intends to fund the NISA fixed-income account with (1) a tax efficient liquidation of Qualified Trust tax-exempt fixed-income investments and (2) new contributions allocated to the Qualified Trust until the Committee-approved taxable fixed-income target investment allocation is reached, at which time, new contributions will be allocated along the Trust's target asset allocation.

¹ The selected benchmark is weighted 45% by the Merrill Lynch 1 to 10 year U.S. Treasury benchmark and 55% by the Merrill Lynch 10 year-plus U.S. Treasury benchmark. Combining U.S. Treasury benchmarks of different maturities was necessary for SDG&E to obtain its desired duration.

In support of its request for Commission approval of hiring NISA to manage the taxable fixed-income security investment allocation in the Qualified Trust, SDG&E has proved:

- Minutes of the January 15, 1997 Meeting of the Nuclear Decommissioning Trust Committee
- Proposed Investment Management Agreement
- Manager Profile and Presentation Materials of NISA Investment Advisors

FINDINGS

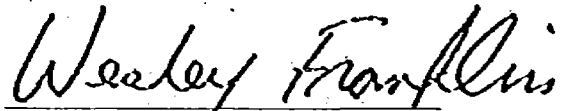
1. In D.87-05-062, the Commission required externally managed trust funds to finance the decommissioning of nuclear power plants.
2. D.95-07-055 requires that the fixed-income allocation must be at least 50% for the Qualified Trust and that all Investment Management Agreements must be approved by the Commission via the Advice Letter process.
3. In its meeting on January 15, 1997, SDG&E's Nuclear Facilities Decommissioning Master Trust Committee, in a 5-0 vote: (1) approved retaining NISA as a fixed-income Investment Manager under the Qualified Trust, (2) authorized the execution of an Investment Management Agreement between NISA and the Committee, and (3) authorized an initial funding of approximately \$20 million to NISA from existing fixed-income managers.
4. The NISA Qualified Trust portfolio will be benchmarked to a U.S. Treasury Index, plus a twenty (20) basis point after-tax adder. The benchmark is a simple and accurate measurement of an investment manager's relative and absolute performance. The taxable U.S. Treasury benchmark is generally reflective of the investment opportunities in the Qualified Trust.
5. The proposed Investment Management Agreement between the SDG&E NDT Committee and NISA is substantially the same as Investment Management Agreements previously approved by the Commission, with the exception of the fee schedule.
6. The proposed Investment Management Agreement is in compliance with applicable Commission requirements and should be approved.

THEREFORE, IT IS ORDERED that:

1. The Investment Management Agreement executed by the San Diego Gas and Electric Company Nuclear Facilities Decommissioning Master Trust Committee and NISA Investment Advisors, L.L.C. is approved.
2. The Commission's Executive Director or his designee is authorized to sign the Agreement on behalf of the Commission.

This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on June 25, 1997. The following Commissioners approved it:



WESLEY M. FRANKLIN

Executive Director

P. Gregory Conlon, President

Jessie J. Knight, Jr.

Henry M. Duque

Josiah L. Neeper

Richard A. Bilas

Commissioners