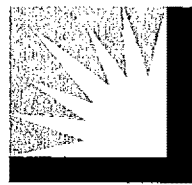


Application No.: A.07-11-011  
Exhibit No.: SCE-24, Vol. 1 *Exh. 24 A - EXCERPT*  
Witnesses: A. Canning  
R. Boada  
✓ P. Hunt  
D. Snow  
R. Fisher  
D. Klun  
R. Pierce

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SOUTHERN CALIFORNIA  
**EDISON**

An *EDISON INTERNATIONAL* Company

(U 338-E)

**2009 General Rate Case  
Rebuttal Testimony**

***SCE-24 Results of Operations (R/O)  
Volume 1***

Before the

**Public Utilities Commission of the State of California**

Rosemead, California  
May 13, 2008

1 increase in SCE's revenue requirement, which is calculated by reference to current projections of  
2 increases in the Consumer Price Index ("CPI"),<sup>38</sup> does not adequately capture increases in capital cost  
3 escalation.

4 In addition, as noted above, increases in capital-related costs depend not only on the escalation of  
5 capital equipment prices, but also on the growth in capital additions. The CPI, because it is only an  
6 index of prices, cannot properly capture SCE's growth in capital additions now, or the effect of past  
7 capital additions on current and future capital-related costs.

8 It is clear from the discussion above that DRA's three-percent recommendation or a CPI-  
9 indexing methodology grossly underfunds SCE's capital-related revenue requirement for 2010 and  
10 2011. But the underfunding problem arises even if SCE had no growth in real capital. Appendix B  
11 estimates how capital-related costs would change even if SCE had no growth in real capital during the  
12 average service life of its capital assets. The results of this appendix demonstrate the deficiencies of the  
13 CPI, even when increased by DRA's adder, for estimating capital-related cost increases at this time.  
14 The Commission should reject the use of the CPI for this purpose.

15 **F. SEPARATING DRA'S POST TEST YEAR RATEMAKING FROM ITS 2009**  
16 **RATEMAKING MASKS A STEALTH REDUCTION TO SCE'S CAPITAL BUDGET OF**  
17 **AT LEAST \$579 MILLION**

18 As discussed in further detail in the rebuttal testimony of Dr. Paul Hunt, DRA has committed a  
19 significant error – \$597 million – in its post-test year ratemaking (PTYR) proposal.<sup>39</sup> Sadly, this error is  
20 the product of DRA mimicking the approach it took in SCE's test year 2006 GRC. DRA's error is  
21 insidious, a consequence of its proposed adjustments to SCE's capital expenditure forecast. No DRA  
22 witness sponsored testimony to identify this hidden adjustment, which stems from a fundamental flaw in  
23 DRA's proposal, which I will describe in detail below.

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<sup>38</sup> Exhibit DRA-20, pp. 5-6.

<sup>39</sup> The actual hidden adjustment is likely much larger than \$597 million, but DRA only partially-adjusted 2010 capital expenditures in its RO model, and left 2011 capital expenditures empty.

1           However flawed its proposals are, DRA has at least relied upon conventional ratemaking  
2 principles to develop its test year 2009 revenue requirement, incorporating their proposed adjustments in  
3 the Commission-required Results of Operations Model (RO model). However, since DRA's proposed  
4 methodology for PTYR would adjust the overall test year 2009 revenue requirement by "CPI plus 1  
5 percent," it abandons the RO model for its 2010 and 2011 revenue requirement projections. When DRA  
6 made the decision to set aside the RO model and fundamental ratemaking principles by "bolting-on" the  
7 CPI-adjusted escalation to the more rigorous test year 2009 revenue requirement, DRA's fatal error  
8 became apparent.

9           SCE presents its capital forecast on a capital expenditure basis throughout the general rate case,  
10 just as it always has. The capital expenditures represent the cash outlays made by SCE for projects that  
11 provide service over numerous years. SCE also budgets on a capital expenditure basis. However, while  
12 capital expenditures represent the company's outlays for capital investments, SCE cannot begin  
13 recovering the capital investments until the asset is in-service and benefiting SCE customers. As  
14 described in Mr. Fisher's direct testimony,<sup>40</sup> capital expenditures with forecast in-service dates during  
15 the GRC cycle are identified and converted to capital additions. Capital additions are the capital  
16 expenditures, plus AFUDC and overheads. The in-service date for the project is integrated into the  
17 capital module of the RO model, to develop the weighted-average rate base. The rate base is developed  
18 on a weighted-average basis to identify which month the capital addition begins service, thereby  
19 ensuring that the revenue requirement forecast for the capital project (i.e. depreciation, taxes and return)  
20 commences in the month the asset enters service. For example, if the monthly revenue requirement for a  
21 capital project is \$1 million and the project begins operating in June, the project's annual revenue  
22 requirement for the first year would be \$6 million. If the project entered service in December of that  
23 same year, then the annual revenue requirement would be only \$1 million. Another important  
24 phenomenon to keep in mind is the project which enters service in December contributes only one-

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<sup>40</sup> Exhibit SCE-11, Volume 2, beginning on p. 6.

1 twelfth of an annualized revenue requirement in that initial year, but the following year will have a  
2 greater cost because it contributes a full year's worth of revenue requirement.

3         Additionally, some capital projects will have significant cash outlays over a period of months or  
4 years before they are completely built and enter service. When we are constructing an asset, we are  
5 making progress payments and incurring costs to procure parts of the capital asset. Standard accounting  
6 allows SCE to accrue Allowance for Funds Used During Construction (AFUDC) which recognizes the  
7 financing costs being incurred during construction. The AFUDC accrual is eventually added to the  
8 overall cost of the asset and recovered over its operating life. During this period before the asset enters  
9 service, the costs are recorded in Construction Work in Progress (CWIP), FERC account 107.

10         DRA's own capital witness, Mr. Greg Wilson, cogently summarizes this phenomenon in his  
11 testimony. Mr. Wilson states:

12         SCE's capital exhibits and supporting workpapers (as well as its RO computer model) are  
13 organized around capital expenditures. SCE's capital witnesses provide testimony regarding  
14 the magnitude of the direct capital dollars that are estimated to be spent each year, not how  
15 much is actually being booked to plant. SCE relies on its RO computer model to manipulate  
16 these direct capital expenditures and calculate the corresponding capital additions. DRA has  
17 studied SCE's RO model, and believes that it properly calculates plant additions. Therefore,  
18 DRA's analyses and recommended direct capital adjustments are also stated in terms of  
19 capital expenditures. When analyzing data in this format, the impact of recommended  
20 adjustments to capital expenditures may not show up in the year in which they are made. For  
21 example, suppose a capital project is scheduled to begin construction in 2008, but is not  
22 scheduled to be completed until 2009. If DRA was to recommend an adjustment to the 2008  
23 expenditures, there will not be a revenue requirement impact until 2009, when the project is  
24 completed, is booked to plant-in-service, and begins earning a return.<sup>41</sup>

25         Mr. Wilson's observations about the timing between costs incurred by SCE and the closing to  
26 rate base are also true in 2010 and 2011.

27         These two elemental principles in utility ratemaking – the development of a weighted average  
28 rate base to calculate the revenue requirement and the year-end CWIP balance – led directly to DRA's  
29 irreparable error when it developed its PTYR proposal.

30         SCE carries a large balance in CWIP at the end of each calendar year. It represents SCE's  
31 cumulative cost of capital projects, plus AFUDC, that have not yet been placed in service, and as such,

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<sup>41</sup> Exhibit DRA-13, p. 8, line 17, through p. 9, line 2.

1 have not yet been added to rate base to begin cost recovery. Once SCE enters the next calendar year,  
2 this CWIP balance begins to close to rate base over the ensuing months. The CWIP balance is also  
3 dynamic, with both debits and credits recording each month. However, for my testimony here, I'm  
4 concentrating on the fact that a significant portion of the 2009 year-end CWIP balance will close to rate  
5 base in 2010, just as much of the year-end 2010 CWIP balance will close to rate base in 2011. The  
6 DRA's own RO model has a year-end 2009 CWIP balance of \$1.5 billion – even after all of the  
7 adjustments of DRA witnesses for 2007 – 2009 were incorporated into its model. A fundamental flaw in  
8 DRA's methodology is that it does not recognize what to do with that CWIP balance; DRA just  
9 “strands” it. Stated another way, capital investments endorsed by DRA for 2007 – 2009, cannot be  
10 recovered in rates beginning in 2010.

11 The second contributor to DRA's hidden adjustments is the weighted average rate base. The  
12 majority of SCE's capital spending closes to rate base in the second half of each calendar year. This is  
13 due largely to workload scheduling, weather, and time taken to process invoices, etc. Much of the  
14 capital that closes to rate base in a given calendar year (2009, for example) will result in only a partial-  
15 year revenue requirement. The full, annualized revenue requirement for any given capital project is not  
16 manifest until the subsequent year. In the case of DRA's forecast in this general rate case, its Post-Test  
17 Year Ratemaking methodology – simply adjusting 2009 revenue requirement by CPI plus 1 percent –  
18 again strands much of the revenue requirement in 2010. In fact, DRA's own RO Model, provided to  
19 SCE shortly after its service of testimony on April 15, 2008, contains a revenue requirement for 2010 of  
20 \$4.706 billion, some \$74 million above the DRA forecast for 2010 in its PTYR testimony.<sup>42</sup> Even in the  
21 wake of DRA's unreasonable adjustments proposed for 2007 – 2009, and incorporated in its results of  
22 operation, the DRA's RO forecast for 2010 was still \$74 million above its CPI plus one-percent forecast  
23 described in Exhibit DRA-20.

24 As an analytical exercise for this rebuttal testimony, SCE used DRA's RO model and began  
25 cutting 2009 capital expenditures until the model forecast a 2010 revenue requirement equivalent to

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<sup>42</sup> Exhibit DRA-01, p. 2, line 7.

1 DRA's 2010 forecast of \$4.632 billion. Only after SCE had cut \$597 million of additional capital  
 2 expenditures beyond the amount which DRA witnesses had proposed in their respective testimony  
 3 volumes, did DRA's RO model forecast a revenue requirement equal to DRA's 2010 forecast for PTYR  
 4 in Exhibit DRA-01. This hidden adjustment of \$597 million in capital expenditures must be followed  
 5 by further, deeper cuts in 2010 capital expenditures to reach a revenue requirement equal to DRA's  
 6 forecast of \$4.772 billion for 2011. In other words, the DRA's capital expenditure adjustments for 2007  
 7 – 2009, while clearly unreasonable, would not even be small enough to conform to its 2010 forecast.

8 The table below shows the capital expenditures, including the hidden adjustment:

	Capital Expenditures (\$ Billions)				
	2007	2008	2009	2010	2011
DRA RO Model Capital Expenditures	2.106	2.257	2.686	3.680	
Adjustment to Conform to DRA PTYR Forecast			(0.597)	(1.436)	
DRA Adjusted Capital Expenditures	2.106	2.257	2.089	2.244	
SCE Capital Expenditures	2.254	2.548	3.378	3.687	3.538

9  
 10 Because of this significant error in DRA's methodology for PTYR, and for the other reasons  
 11 described in this exhibit, the Commission must reject DRA's proposal.

12 **G. SIMPLER IS NOT BETTER**

13 In support of its approach, DRA states that using the CPI as a basis for a post test year  
 14 mechanism is simpler than using SCE's "multiple indexes." But simpler is not better. DRA's  
 15 recommendation to adopt SCE's cost escalation methodology (see Section II.A above), which uses the  
 16 same indexes, is proof of this. However, in SCE's 2003 GRC Decision 04-07-022, the Commission  
 17 found "This [CPI] approach may be simple, but it has no other known benefit. Simplicity alone does not  
 18 prompt us to prefer it over SCE's approach, which provides for separate and therefore, we believe, more  
 19 accurate treatment of O&M expenses and capital related costs."<sup>43</sup>

20 In addition, general measures of inflation such as the CPI do not adequately track utility cost  
 21 increases because they do not reflect the same basket of labor, materials, and capital inputs used to  
 22 provide electricity service and their respective changes in input prices, do not reflect the increases in

<sup>43</sup> D.04-07-022, (mimeo), p. 272-273.

EXCERPT

BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) for Authority To, Among Other Things, Increase its Authorized Revenues For Electric Service In 2009 and To Reflect That Increase In Rates.

Application 07-11-011  
(Filed November 19, 2007)

Order Instituting Investigation on the Commission's Own Motion into the Rates, Operations, Practices, Services and Facilities of Southern California Edison Company.

Investigation 08-01-026  
(Filed January 31, 2008)

SOUTHERN CALIFORNIA EDISON COMPANY'S (U 338-E) OPENING BRIEF

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Dated: July 25, 2008

- DRA’s review of previous Commission decisions and settlements does not provide compelling evidence supporting DRA’s proposals.

#### **14.4 The Consumer Price Index Is Not An Appropriate Escalator For Utility Costs**

Both of DRA’s proposals are premised on the idea that the CPI is an appropriate index for utility costs. This idea is incorrect, because the CPI does not reflect the same basket of labor, materials, and capital inputs used to provide electricity service. The CPI only represents changes in the prices paid for goods and services that an average consumer purchases, and the CPI thus excludes large categories of the costs SCE regularly incurs.<sup>1314</sup> The Commission itself has recognized this.<sup>1315</sup> Because the CPI does not accurately track escalation in utility O&M costs or capital equipment costs, DRA’s secondary proposal is unworkable.

Of course, it is true that DRA’s primary proposal calls for escalation of SCE’s revenue requirement by 3% (CPI plus one percent) in 2009 and 2010. But this will also yield an inadequate increase, because SCE’s capital-related costs will be rising faster.<sup>1316</sup> Even if SCE had no growth in real capital, 3% would be an inadequate increase.<sup>1317</sup>

#### **14.5 DRA’s Proposal Contains A Stealth Reduction To SCE’s Capital Budget Of At Least \$579 Million**

Because DRA “bolted on” its post test year ratemaking proposal outside of its standard results of operation model, DRA’s analysis did not recognize that SCE will have a large construction work in progress (CWIP) balance at the end of 2009. DRA’s PTYR proposal can only be reconciled to its model if SCE’s 2009 capital expenditures were to be cut by \$597 million more than the explicit capital expenditure cuts DRA proposed in its testimony.<sup>1318</sup> In addition, SCE estimates that even greater reductions to SCE’s 2010 capital expenditures would be required to conform to DRA’s revenue requirement forecast for 2011. Over the two-year period 2009-2010, SCE’s capital expenditures would have to be reduced by over \$2 billion to meet DRA’s target.<sup>1319</sup>

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Continued from the previous page

<sup>1313</sup> Exhibit SCE-24A, pp. 18-22.

<sup>1314</sup> Exhibit SCE-24A, pp. 22-24.

<sup>1315</sup> D.04-07-022, (*mimeo*), p. 278.

<sup>1316</sup> Exhibit SCE-24A, pp. 17-18.

<sup>1317</sup> Exhibit SCE-24A, pp. 17-18, Appendix B.

<sup>1318</sup> Exhibit SCE-24A, pp. 18-22.

<sup>1319</sup> Exhibit SCE-24A, p. 22. In the table shown on this page, the total of “SCE capital expenditures” for 2009-2010 exceeds the total of “DRA adjusted capital expenditures” by approximately \$2.7 billion.