Docket:	:	R.12-03-014
Exhibit Number	:	
Commissioner	:	Michel Peter Florio
Admin. Law Judge	:	David M. Gamson
DRA Witness	:	Yakov Lasko
	:	

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

REPLY TESTIMONY OF YAKOV LASKO

Order Instituting Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term Procurement Plans Track 1 – Local Reliability

(R.12-03-014)

San Francisco, California
July 23, 2012

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REPLY TESTIMONY OF YAKOV LASKO

Q1. What is the purpose of your reply testimony?

A1. Southern California Edison (SCE) requests that the Commission grant SCE the opportunity to file an application to adjust SCE's authorized capital structure "should new or renewed PPAs [power purchase agreements] (signed after the Commission's approval of this proposal) result in an increase in debt equivalence that causes a significant adverse impact on SCE's credit ratios."[1] My testimony responds to this request. SCE is concerned about the new or renewed PPAs that may be signed after the Commission's approval of SCE's request for authority to procure local capacity requirement (LCR) resources in Rulemaking (R.)12-03-014. SCE's claims that these new LCR PPAs could increase SCE's debt equivalence by an amount ranging from $0.9 billion to $2.9 billion, which SCE contends "could have serious adverse effects on SCE's credit metrics, diminishing SCE's creditworthiness, and even possibly trigger a downgrade of SCE's credit rating that would adversely impact SCE, its suppliers, and its customers."[2]

Q2. What does your reply testimony recommend?

A2. I recommend that the Commission deny SCE's request to file an application to adjust SCE's capital structure outside of SCE's regular cost of capital proceeding.

Q3. What is debt equivalence?

A3. Debt equivalence is a term used by credit rating agencies, specifically Standard & Poor's (S&P) and to a lesser extent Moody's Investors Service (Moody's), to describe the fixed financial obligations resulting from the company entering into long-term PPAs. The PPA contracts are considered to be debt equivalents by S&P and Moody's because the periodic payments are required to be made and the payments cannot be avoided without defaulting on the contract. The rating agencies' views vary on the financial treatment of PPAs. For example, S&P

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[1] 2012 Long-Term Procurement Plan Testimony of Southern California Edison Company on Local Capacity Requirements, June 25, 2012 (SCE Testimony) at. 28:7-8.

[2] SCE Testimony, at. 27:18 to 28:2.

uses a strict quantitative approach that imputes debt on the company's balance sheet, while Fitch Ratings (Fitch) has no debt imputation.

Q4. Should the Commission grant SCE an opportunity to file an application to adjust SCE's authorized capital structure outside its usual Cost of Capital Proceeding?

A4. No, the Commission should reject SCE's request for authorization to file an application to adjust SCE's authorized capital structure outside its usual Cost of Capital proceeding.[3] SCE proposes that the Commission allow SCE to request an adjustment in SCE's authorized capital structure solely based on the increase in debt equivalence that would result from potential new LCR PPAs. Debt equivalence is only one of the many components that are used to establish SCE's authorized cost of capital in the Cost of Capital Adjustment Mechanism. The authorized cost of capital is computed based on weighted average cost of long-term debt, common equity and preferred equity. As the market conditions change (such as risk-free rate, market risk premium, liquidity of funds, beta, growth rate projections, etc.), the assumptions that go into computation of cost of debt and equity will also change, which will affect SCE's cost of capital. Therefore, it is inappropriate to look at the impact of debt equivalence on SCE's cost of capital in isolation without considering all of the other components. The appropriate venue to consider the potential impact of new or renewed PPAs on SCE's debt equivalence is the Cost of Capital proceeding, not a separate application.

Finally, SCE in its *Testimony Supporting Southern California Edison's Application for Authority to Establish Its Authorized Cost of Capital for Utility Operations for 2013 and to Reset the Annual Cost of Capital Adjustment Mechanism,* Application (A.)12-04-045 filed on April 20, 2012, states on page one that "SCE is requesting the Commission continue with SCE's existing capital structure, the three-year cost of capital cycle and the cost of capital mechanism that governs SCE's cost of capital between applications." If SCE is concerned about the impact new LCR procurement contracts would have on SCE's debt equivalence in the immediate future, necessitating some kind of remedy between the three-year cost of capital cycle, it is unclear why

[3] See D.08-05-035, which established a multi-year cost of capital mechanism for SCE, as well as for Pacific Gas and Electric Company and San Diego Gas and Electric Company.

SCE requested that the Commission continue with SCE's three-year cost of capital cycle since it appears inconsistent with the request to adjust SCE's authorized capital structure in the LTPP proceeding. In A.12-04-045, SCE has requested to file its next Cost of Capital proceeding in early 2015 to be effective for 2016. SCE will have the opportunity to address the issue of debt equivalence in that Cost of Capital application.

Q5. What are key industry characteristics and drivers of credit risk?

A5. Credit risk refers to the risk that a borrower will default on any type of the borrower's debt obligations. Please refer to Appendix A, *Key Industry Characteristics And Drivers of Credit Risk*, for reference regarding regulated utilities' key industry characteristics and drivers of credit risk as determined by S&P. As shown by Appendix A, when S&P assigns an appropriate credit rating to a regulated utility, the credit rating agency considers many industry characteristics in which the utility operates and to what degree those characteristics drive credit risk. Debt equivalence is only one component of many credit risk drivers that would have an impact on Edison's credit rating. Therefore, if SCE is concerned about the impact debt equivalence would have on its credit ratings, it would be inappropriate to treat debt equivalence in a separate application outside of a comprehensive consideration of credit rating drivers in the Cost of Capital proceeding.

Q6. Please state your name, position and business address.

A6. My name is Yakov Lasko. I am an Analyst with the Division of Rateapayer Adovcates for the California Public Utilities Commission. I work at 505 Van Ness Avenue, San Francisco, CA 94102.

Q7. Are you the same Yakov Laskov who testified in the initial filing of June 25, 2012?

A7. Yes.

APPENDIX A

Key Industry Characteristics And Drivers Of Credit Risk

	Utilities regulated	Competitive power	Oil & gas downstream	Autos	Airlines
Industry dynamics and competitive environment					
Industry cyclicality	M	H	H	H	H
Ease of entry	L	M/H	H	M/H	M/H
Product cycle/obsolescence	L	L	L	H	L
Level of product quality	L	L	M	H	M
Disintermediation/substitution	L	L	L	L/M	L
Competition/commoditization	L/M	H	M	H	H
Pricing inflexibility	M	H	M	H	H
Business model stability	M	M/H	L	L/M	M
Demographic trends	L	L	M	H	L
Growth and profitability					
Growth outlook	L	M	L	M/H	L/M
Profit margin pressure/outlook	M	M/H	M	M/H	H
Earnings volatility	M	M/H	H	H	H
Operating considerations and costs					
Technological risk/change	L	L	L/M	L/M	L/M
Cost efficiency/pressures	M	H	M	H	H
Operating leverage	M/H	H	H	H	H
R&D costs	L	L	L	H	L
Energy cost sensitivity	H	H	H	H	H
Raw material cost sensitivity	H	H	H	H	L
Labor costs	M	M	M	H	H
Labor inflexibility/unrest	L	L	M	H	H
Pension costs/contingents	M	L	L/M	H	M/H
Environmental impact/costs	H	L	H	H	M/H
Marketing costs	L	L	M	H	L/M
Customer concentration	L	M	L	L	L
Supplier concentration	H	H	H	M	M
Risk management	M	H	M	M	M
Asset/plant quality and age/upkeep	M	H	H	M	M/H
Event risk sensitivity	M/H	H	H	M/H	H
Financial market volatility/sensitivity	M	M/H	L	M	M
Fashion/fad/design sensitivity	L	L	L	H	L/M
Capital and financing characteristics					
Capital intensity	H	H	H	H	H
Borrowing requirement	H	H	L/M	H	H
Interest rate sensitivity	L/M	L/M	L/M	H	L/M
Government, regulatory, and legal environments					
Regulation/deregulation	H	H	M	M/H	H
Government microeconomic and social policies	H	H	H	H	M/H
Litigiousness/legal risk	L	H	M	M	M

L = low driver of credit risk
M = medium driver of credit risk
H = high driver of credit risk