California Regulation: Still Waiting

Special Report

Overview

Regulation Key to Ratings: Under Fitch's rating methodology, the jurisdictional regulatory compact is a key factor in the evaluation of creditworthiness for utility operating companies and their corporate parents.

Delay in Rate Proceedings a Concern: Certain developments have injected a measure of uncertainty into the regulatory compact in California, including a delay in the release of final decisions in Southern California Edison Co. (SCE, issuer default rating [IDR] 'A–'), San Diego Gas & Electric Co. (SDG&E, IDR 'A'), and Southern California Gas Company (SCG, IDR 'A') general rate case (GRC) proceedings; public scrutiny of the California Public Utilities Commission (CPUC) and Pacific Gas & Electric Company (PG&E, IDR 'BBB+') in the wake of the September 2010 San Bruno tragedy; appointment of three new CPUC commissioners for terms that began in 2011 by Governor Jerry Brown; and concern regarding levels of authorized returns and the mechanism to facilitate interim cost of capital (CoC) adjustments and its duration.

Extended Nuclear Plant Outage: The ongoing unscheduled outage that began in January 2012 at the San Onofre Nuclear Generating Station (SONGS) and related cost recovery issues are also question marks for investors, and will have an important effect on the creditworthiness of SCE and its corporate parent, Edison International (EIX; IDR 'BBB'/Outlook Stable).

Downgrades Possible: Fitch believes regulation in California is likely to remain supportive of existing credit ratings for PG&E, SCE, SDG&E, and SCG, notwithstanding these uncertainties. The California utilities have above-average rating levels and significant adverse regulatory decisions, indicating an unexpected deterioration to the regulatory compact in California would likely lead to future credit rating downgrades for PG&E, SCE, SDG&E, SCG, and their respective corporate parents.

Related Research

Fitch Rates PG&E's Senior Unsecured Notes 'A–'; Outlook Stable (August 2012)

Fitch Affirms Edison International at 'BBB' & So. California Edison Co. at 'A–'; Outlook Stable (April 2012)

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Balanced Regulatory Environment

Appendix A of this report includes charts summarizing earned versus authorized returns on equity (ROE) for PG&E, SCE, SCG, and SDG&E. As indicated in the charts, the large California investor-owned utilities (IOUs) have been able to consistently earn at levels at or above their authorized ROEs, with the recent notable exception of PG&E, due in large part to the forward-looking and balanced approach to ratemaking adopted and implemented by the CPUC since the energy crisis of 2000–2001.

PG&E's earnings and financials have been pressured by incremental San Bruno-related operating costs that are not being recovered in rates, totaling $778 million through the second quarter of 2012. Fitch calculates total costs on a cumulative basis, including accruals for third-party liabilities and other San Bruno-related items, approximate more than $1.3 billion.

The CPUC has long used forward-looking test years in GRC filings. Attrition rate increases in the two years following the test year are also permitted to recover anticipated, rising operating costs due to inflationary pressures. GRCs are usually filed on a three-year cycle. Cost-of-capital issues are bifurcated from GRC proceedings.

In addition, California is one of the few jurisdictions to implement revenue decoupling for both electric and gas utilities. Purchase power and fuel costs are recovered outside of base rate cases, through balancing accounts. Major capital projects are pre-approved, either through the GRC process or single-issue proceedings before the commission.

These regulatory mechanisms collectively provide California-based IOUs a reasonable opportunity to earn their authorized ROEs, and are reflected in Fitch's credit ratings.

Fitch does not expect the make-up of the CPUC to result in a meaningful change to the balanced regulatory compact in the state. The CPUC is likely to vote in lower ROEs than those currently proposed by the utilities, in Fitch's opinion.

However, Fitch expects CPUC-authorized returns to remain above recent industry average levels. This view reflects Fitch's belief that the Brown administration and the CPUC view financially sound IOUs to be critical to the achievement of the state's energy policy goals, which will require significant investment in renewables, energy efficiency, and transmission.

Fitch expects PG&E, SCE, SDG&E, and SCG to invest approximately $11 billion–$12 billion in 2012 and capex to remain elevated for several years, underscoring the need for the California utilities to be able to access capital markets at reasonable rates.

Pending Issues and Expectations

San Bruno

Fitch expects the CPUC to mete out a large fine for PG&E Corporation (PCG) subsidiary PG&E for its role in the September 2010 San Bruno pipeline explosion that resulted in eight deaths, injuries, and property damage. The company has reserved $200 million pretax in anticipation of a CPUC decision.

Fitch lowered the IDRs of PCG and PG&E one notch in December 2011 to 'BBB+', to reflect the ongoing financial impact of the San Bruno pipeline disaster, which has resulted in significantly higher operating costs and an expected fine in the hundreds of millions of dollars.

PG&E is the subject of a CPUC natural gas pipeline safety order initiating rulemaking (OIR) and three orders initiating investigations (OIIs) as summarized in the table below. In addition to PG&E, the natural gas pipeline safety OIR required Sempra Energy subsidiary operating utilities SDG&E and SCG to file plans to address natural gas pipeline safety, related investment, operating expense increases, and cost recovery.

PCG has been involved in negotiations to settle San Bruno regulatory and legal investigations with relevant parties, and Fitch expects management to continue efforts to resolve the uncertainty and financial exposure associated with the tragedy as quickly and effectively as possible.

A proposed administrative law judge (ALJ) decision in the OIR is expected to be issued later this month, and a final commission decision is expected in September 2012. PG&E filed its pipeline safety enhancement plan (PSEP) in August 2011 in compliance with the OIR. The OIR will consider PG&E's PSEP investment and prospective recovery of future PSEP-related costs.

PG&E's credit metrics have weakened as a result of the large incremental operating costs being absorbed by the company to enhance pipeline safety and comply with CPUC rulings. Recovery of prospective costs incurred by the utility to meet natural gas transmission safety standards is crucial to the utility's creditworthiness. Further delay in issuing a proposed ALJ and final commission decision in the OIR proceeding would likely lead to adverse credit rating actions by Fitch.

Fitch's current PG&E ratings assume that the utility will not recover $778 million of costs incurred to address pipeline safety-related issues since the September 2010 San Bruno pipeline explosion and fire. They also assume that PG&E will have to pay a large fine and will be allowed to recover prospective costs associated with its PSEP.

Fitch believes SDG&E and SCG will be permitted to defer and recover pipeline safety investment and related costs on a timely basis. As a result, the utilities are not expected to be adversely affected by the OIR. A final OIR decision for SDG&E and SCG is expected in the first quarter of 2013.

Summary of Key San Bruno-Related Natural Gas Pipeline Proceedings

Proceeding	ALJ Proposed Decision	Expected CPUC Final Decision	Brief Description
Gas Pipeline Safety OIR	8/6/12[a]	9/6/12	Proceeding to improve natural gas pipeline safety and establish regulatory mechanisms for the recovery of related costs for PG&E, SDG&E, SCG, and Southwest Gas.
Recordkeeping OII	·	February 2013	Focuses on PG&E's safety record keeping practices for its entire natural gas pipeline system.
Class Location OII	·	·	Examines PG&E's practices with regard to operation of pipelines in high population density areas.
Gas Pipeline OII	·	November or December 2012	Broad investigation to determine if PG&E violated applicable law, rules, orders requirements and industry safety standards in connection with the San Bruno accident.

[a]Scheduled release date has passed. A decision is expected to be issued imminently. ALJ – Administrative law judge.
OIR · Order initiating rulemaking. PG&E · Pacific Gas & Electric Company.
SDG&E · San Diego Gas & Electric Company. SCG · Southern California Gas Company.
Source: Company filings, Fitch Ratings.

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Pending GRCs

The delay in the issuance of ALJ-proposed and final decisions in pending SCE, SDG&E, and SCG GRCs is likely a function of the incremental workload created by the San Bruno tragedy and the unusual circumstance of having GRCs filed in the same year by SCE and Sempra Energy subsidiaries SDG&E and SCG.

The CPUC has issued a memorandum account indicating that rates to be authorized in its final decision in SCE, SDG&E, and SCG's pending GRCs will be retroactive to Jan. 1, 2012. Fitch does not expect the delay to have a meaningful adverse effect on the utilities' creditworthiness.

The ALJ in SCE's GRC issued a draft order extending the statutory deadline for a final decision 60 days to Oct. 30, 2012, and stating that an ALJ-proposed decision will be issued by Aug. 30, 2012.

Fitch notes that PG&E filed its notice of intent in its 2014 GRC, which the company expects to file with the commission before year-end 2013. PG&E has indicated that it will request a $1.25 billion (18%) rate increase in 2014 and attrition rate increases of $500 million in both 2015 and 2016.

Overview of Pending California General Rate Cases

Company	Requested Rate Increase ($ Mil.)	Test Year
Pacific Gas & Electric	1,249	2014
Southern California Edison	809	2012
San Diego Gas & Electric	235	2012
Southern California Gas	268	2012

Source: Company filings.

CoC Proceeding

With current interest rates and market return expectations materially lower than those prevailing at the time of the last CoC proceeding, Fitch believes it is likely the CPUC will push authorized ROE lower in the utilities' pending CoC proceeding. However, the outcome should prove to be manageable within the operating utilities' current credit rating profiles, in Fitch's opinion.

PG&E, SCE, SDG&E, and SCG filed their initial CoC testimony on April 20, 2012, requesting lower weighted average returns of capital and modest reductions to monthly electric and natural gas bills. Requested ROEs are lower than previous levels, with the exception of SCG, as outlined in the table below. The table delineates currently authorized ROEs and those requested in the current proceeding.

The commission has bifurcated the proceeding into two phases, the first of which will address capital structure and CoC issues. A second proceeding will consider the duration of the CoC and an appropriate trigger mechanism to facilitate interim changes in authorized ROE.

CoC Summary Data

	ROE		Equity Capital		Impact on Rates
(%)	Current	Requested	Current	Requested	($ Mil.)
Pacific Gas & Electric	11.35	11.00	52	52	(98.0)
Southern California Edison	11.50	11.10	48	48	(128.0)
San Diego Gas & Electric	11.10	11.00	49	52	(7.7)
Southern California Gas	10.82	10.90	48	52	(1.4)

CoC – Cost of capital. ROE – Return on equity.
Source: Company filings, Fitch Ratings.

In their filings, the utilities have proposed continuing the existing trigger mechanism, which ties changes in authorized returns to a bond index that is reviewed annually. If certain parameters are not exceeded during the duration of the CoC, the authorized ROE will not be reset.

In Fitch's view, the separation of CoC from other GRC issues is a constructive feature of California regulation. PCG, SDG&E, and SCE have operated under the current CoC mechanism since 2007. Prior to that, CoC proceedings were filed annually. Fitch believes the multiyear trigger mechanism requested by the IOUs in their CoC testimony provides a measure of consistency that is supportive of credit quality.

Fitch believes that the CPUC's final CoC decision may push authorized returns somewhat lower than levels requested by the utilities. Fitch expects authorized returns at the end of the CoC proceeding to remain well above the industry average authorized ROE of approximately 10.1%. An unexpectedly large adjustment downward to authorized ROEs by the commission would be an adverse development, in Fitch's opinion.

A final decision in the capital structure phase of the CoC proceeding is expected by year-end 2012, and a decision in the second phase to consider the trigger mechanism is expected in the first half of 2013.

SONGS Outage

The 1,250-MW, two-unit SONGS has been out of service since January 2012. The plant is operated by SCE, which owns a 78% interest in the plant. Sempra Energy subsidiary SDG&E owns a 20% interest.

SCE replaced the SONGS steam generators in 2010 and 2011. The CPUC has approved expenditures of $665 million for SCE's share of the steam generator replacement project, of which approximately $593 million has been incurred by SCE through June 30, 2012.

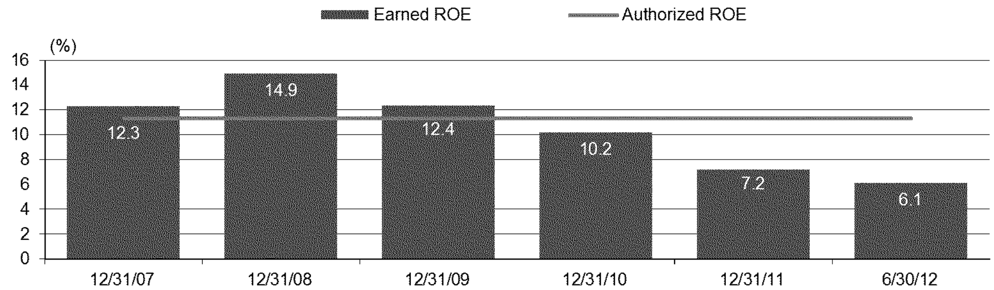
SCE is evaluating plans to correct the steam generator problem and will submit remedies to the Nuclear Regulatory Commission (NRC) in compliance with the confirmatory action letter (CAL) issued by the agency on March 27, 2012. The NRC issues CALs to licensees to resolve specific issues in a timely and effective manner. At this juncture, it is clear that both units will remain out of service through summer 2012, and that a projected return to service depends on further testing and analysis. SCE has incurred outage-related repair and testing costs of $48 million through second-quarter 2012, and plans to spend an additional $25 million to return Unit 2 to service. Since Unit 2 experienced considerably less tube damage than Unit 3, it may be returned to service ahead of Unit 3, operated at reduced power with a midcycle outage to assure safe operation.

The CPUC has several mechanisms through which it may review expenditures related to the SONGS outage. Approved steam generator replacement costs are subject to a reasonableness review once final costs for the project have been submitted by the utility for recovery in rates. Replacement power costs incurred due to the SONGS outage are recoverable, along with other purchase power and fuel costs through the energy resource recovery account, and subject to an annual reasonableness review.

Once SONGS has been out of service for nine months, SCE is required to notify the CPUC, and the commission may remove the plant from rate base within 45 days of notification. Fitch expects the CPUC to initiate proceedings to address the issue in November 2012.

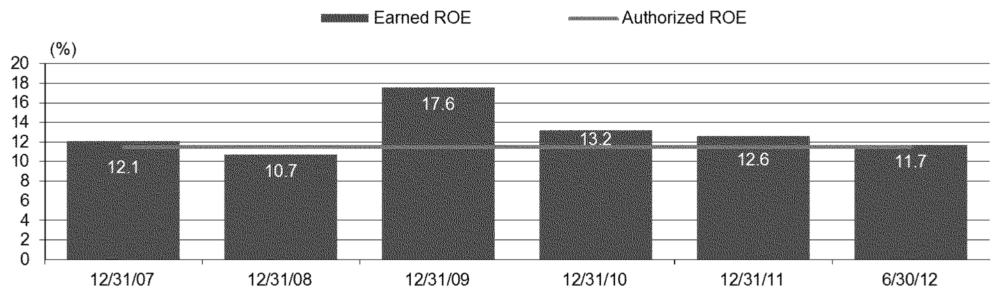
Appendix A

PG&E Corporation — BBB+



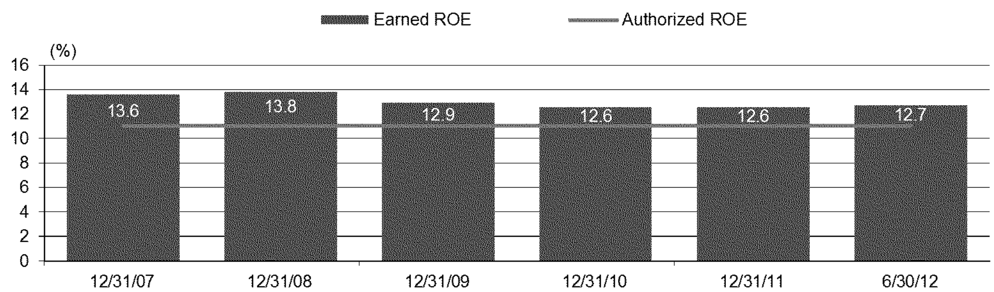
ROE – Return on equity.
Source: Company reports, Fitch Ratings.

Southern California Edison Co. — A–



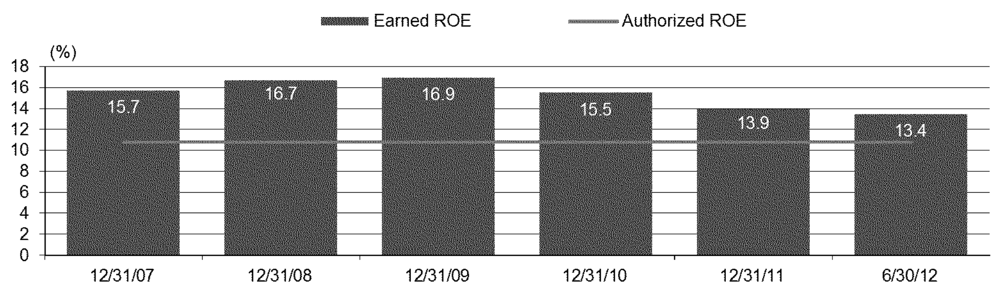
ROE – Return on equity.
Source: Company reports, Fitch Ratings.

San Diego Gas & Electric — A



ROE – Return on equity.
Source: Company reports, Fitch Ratings.

Southern California Gas Co. — A



ROE – Return on equity.
Source: Company reports, Fitch Ratings.

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