BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U338E) 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 12-04-015 (Filed April 20, 2012)
And Related Matters.	Application 12-04-016 Application 12-04-017 Application 12-04-018

PACIFIC GAS AND ELECTRIC COMPANY (U 39 M)
REPLY COMMENTS ON PROPOSED DECISION

Pacific Gas and Electric Company (PG&E) submits its reply comments on the proposed decision (PD) for the 2013 cost of capital (COC). PG&E's comments respond to several arguments in the opening comments filed by The Utility Reform Network (TURN), the Federal Executive Agencies (FEA), the Energy Producers and Users Coalition (EPUC), and Southern California Edison Company (SCE).[1] First, PG&E disagrees with TURN, FEA and EPUC's criticism of the PD for adopting a reasonable range for the return on equity (ROE) above the intervenor and DRA modeling results. Second, PG&E maintains that SCE and EPUC err in claiming that an electric-only utility ROE should be higher than the ROE for combination utilities like PG&E.

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[1] San Diego Gas & Electric Company (SDG&E), Southern California Gas Company (SoCalGas) and Reid also filed comments on the PD. The Division of Ratepayer Advocates did not file comments.

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I. The Intervenor And DRA Financial Modeling Results Were Unreasonably Low And Do Not Merit Greater Weight

TURN, EPUC and FEA's (Intervenors) comments complain that the lower bound of the PD's ROE reasonable range is above the financial modeling results recommended by them and DRA. TURN states the PD adopts ROE ranges that effectively ignore the financial modeling results of DRA, TURN, EPUC, FEA and Reid. (TURN comments, p. 1) EPUC expresses the same sentiment, "the PD seemingly ignores the non-utility model results". (EPUC comments, p. 6.) FEA essentially takes the same position. Of course, the premise behind the intervenors' complaint is that their modeling results should have a significant impact on the Commission's determination of a reasonable range and the resulting ROE. Their modeling results, however, are so low relative to several important benchmarks, that their results merit little if any weight.

For instance, the record is clear that the range of nationally authorized electric utility ROEs in the first half of 2012 was in the 10 to 10.4 percent range, even using EPUC's evidence in Exhibit 31, page 5. (Ex. 53; EPUC comments, p. 4.) Yet the DRA, EPUC and FEA range of modeling results shown in Table 1 of TURN's comments are approximately 100 to 200 basis points lower, with DRA's falling approximately 200 to 300 basis points lower. Even TURN's range of 9.2 to 9.6 percent is below the range of national authorized ROEs, while PG&E's reasonable range of 10.2 to 11.4 percent overlaps the national range. By this benchmark, the intervenors' and DRA's modeling result ranges are unreasonable compared to the national average.

The intervenors also press the point that interest rates are lower, so the utilities' ROE's should be lower.[2] At the same time, the intervenors ignore other important parts of the picture. For instance, there needs to be a sufficient difference between utility long-term debt yields and ROE to make common equity attractive to investors versus utility debt, which has a higher priority for payment than equity. Exhibit 153 (page 1), PG&E's update exhibit, shows a 2013

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[2] The utilities have proposed reductions to their currently authorized ROEs for 2013. The argument is simply over how much the reduction in the currently authorized ROE should be.

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forecast cost for AA utility bonds of 4.40 percent. The 7.6-7.8 percent low boundaries of the FEA and DRA ranges are only approximately 340 basis points higher than the AA utility bond rate. PG&E believes 340 basis points is not a sufficient differential between common equity returns and utility bond rates. PG&E witness Avera noted the increase in the yield spread between BBB utility and 30 year treasury indicated that the additional compensation investors require to take on higher risk has increased, and "because common stock investors are the last in line with respect to their claim on a utility's cash flows, higher yield spreads imply an even steeper increase in the additional return required from an investment in common equity." (Avera, Ex. 23, p. 1-12, lines 1 to 10.) Intervenors' recommended reasonable ROE ranges, however, do not recognize this fact.

The record also established that as interest rates go down, the risk premium goes up for common equity. PG&E's opening brief (pages 23-24) discussed the evidence on the increase in market risk premium since the last COC case:

> Moreover, it is clear that MRPs have increased since the last time the Commission set PG&E's cost of capital in D.07-12-049. In that decision, the Commission noted that FEA's ROE expert Gorman used a 5.30 percent MRP, while DRA's expert Woolridge used a 4.14 percent MRP. (D.07-12-049, *mimeo*, p. 17.) In this proceeding, both Messrs. Gorman and Woolridge are using higher MRP's in their CAPMs, i.e. 6.60 percent for Mr. Gorman (FEA/Gorman, Ex. 32, p. 35, lines 6 and 12) and 5.01 percent for Dr. Woolridge (DRA/Woolridge, Ex. 24, p. 4-43, line 16; Tr. 395, lines 1 to 6.)

This factor also establishes that the decrease in interest rates does not lead to a commensurate decrease in the ROE required by investors. Instead the decrease in the ROE is significantly less.

The bar graph presented on page 7 of TURN's comments is also instructive. It shows that the decrease in national authorized ROEs between 2009 and 2011 was only 26 basis points. Between 2008 or 2010 and 2011, the decrease in the national average ROE was even smaller. Meanwhile, the PD would decrease PG&E's ROE 95 basis points, from 11.35 to 10.4. This decrease is much larger than the decrease in the national average ROE over the comparable time period. Thus TURN's bar graph does not support the intervenors' arguments for further reductions to PG&E's 2013 test year ROE.

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II. No Differential In Authorized ROE Between An Electric-only Utility And A Combination Electric And Gas Utility Is Warranted

SCE argues that since it is an electric utility, it should have a higher ROE than a combination utility like PG&E. SCE bases its claim on the historical differential between electric and combination electric/gas utilities' ROEs of approximately 20 basis points. (SCE comments, p. 5.) SCE also presents a table displaying higher SCE ROEs over PG&E's ROEs from 2003-2008 in its comments (page 5) to support its position. SCE states that these results are due to two factors. The first factor mentioned is different business risks faced by electric utilities and combination utilities. The second factor is SCE specific risk from a more highly leveraged capital structure. EPUC also briefly suggests that SCE and PG&E should have different ROEs, although EPUC does not elaborate on this point. (EPUC comments, p. 4.) PG&E disagrees with these parties, and maintains that a careful review of the information presented by SCE does not support any differential between the ROEs for SCE and PG&E.

SCE claims that the 20 basis point ROE spread between combination utilities and electric utilities presented by SDG&E witness Morin reflects "different business risks faced by electric utilities compared to the more diversified combination utilities." (SCE comments, p. 5.) However, Dr. Morin's testimony does not claim any difference in business risk between electric and combined utilities. (See, Morin, Ex. 6, p. 25.) Nor is there anything in the record that would establish any significant difference in business risk between electric utilities and utilities providing both gas and electric service.

SCE also claims that the historic spread between its ROE and PG&E's ROE is due to different business risks and greater leverage in SCE's capital structures. However, the decisions cited in SCE's table do not support SCE's position that the business risks for electric utilities are different than for combination utilities. For instance, D.02-11-027 provided that SCE's ROE would be governed by its Performance Based Ratemaking (PBR) mechanism, until its GRC was

decided.[3] (D.02-11-027, p. 28.) However, the decision does not mention any business risk differences between SCE and PG&E in setting SCE's ROE for the subsequent period.

The 2004 and 2005 cost of capital decisions (D.04-12-047 and D.05-12-043) adopted the ROEs for SCE and PG&E shown in the table on page 5 of SCE's comments, but the decisions did not articulate any basis for the difference. So there is no reason to attribute the ROE spread to difference in business risk between SCE and PG&E. Similarly, D.07-12-049 did not identify any difference in business risk between the utilities when it added 50 basis points to both SCE and PG&E's ROE in the business risk section. (D.07-12-049, pp. 29-31.)[4]

SCE also claims that its capital structure is more leveraged than PG&E's. However, that statement fails to consider how SCE's preferred stock should be treated, i.e. as debt, equity, or apportioned between debt and equity. The total credit impact of preferred stock depends on the particular attributes of the preferred stock, but perpetual preferred stock typically receives 50 percent equity and 50 percent debt treatment by the credit rating agencies. (Bijur, Ex. 21, p. 1-15, lines 4-6, and ftn. 22; Boada, Ex. 17, p.38, ftn. 82.) If 50 percent of SCE's 9 percent preferred were treated as debt and 50 percent were treated as equity, SCE's equity ratio would be the same as PG&E's. Consequently, there is no difference in leverage between SCE and PG&E that would justify different ROEs for the two utilities.

III. Conclusion

For the reasons discussed above, the Intervenors' complaints about inadequate weight being given to their financial modeling results should be rejected. In addition, PG&E maintains that there is no credible reason for different electric utility and combination utility ROEs in this case based on either business risk or leverage. However, PG&E maintains that the PD's ROE range is too low and agrees with SCE that the adopted ROE should be higher.

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[3] D.02-11-027, p. 26, also adopted the same reasonable ROE range for SCE and PG&E of 10.8 to 11.8 percent. However, SCE's ROE under its PBR was 11.6 percent.

[4] D.07-12-049 (page 35) does mention one reason for giving SCE a slightly higher ROE, which was related to credit quality, not business risk.

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Respectfully Submitted,

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