BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U338-E) for Authorized Cost of Capital for Utility Operations for 2008.	Application 07-05-003 (Filed May 8, 2007)
Application of San Diego Gas & Electric Company (U 902-M) for Authority to: (i) Increase its Authorized Return on Common Equity, (ii) Adjust its Authorized Embedded Costs of Debt and Preferred Stock, (iii) Increase its Overall Rate of Return, and (iv) Revise its Electric Distribution and Gas Rates Accordingly, and for Related Substantive and Procedural Relief.	Application 07-05-007 (Filed May 8, 2007)
Application of Pacific Gas & Electric Company for Authority to Establish its Authorized Cost of Capital for Electric Utility Distribution Operations and Gas Distribution for Test Year 2008 and to Establish an Annual Cost of Capital Adjustment Mechanism.	Application 07-05-008 (Filed May 8, 2007)
	(consolidated)

OPENING BRIEF OF SAN DIEGO GAS & ELECTRIC COMPANY FOR TEST YEAR 2008 COST OF CAPITAL

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SUMMARY OF RECOMMENDATIONS

Pursuant to Rule 13.11 of the California Public Utility's Commission ("Commission" or "CPUC") Rules of Practice and Procedure, San Diego Gas & Electric Company ("SDG&E") hereby provides a summary of its recommendations in this proceeding. Specifically, SDG&E recommends the Commission:

i) approve SDG&E's current capital structure consisting of 45.25% long-term debt, 5.75% preferred stock, and 49.00% common equity; embedded costs of long-term debt of 5.62% and preferred stock of 7.25%, as updated in SDG&E's Late-Filed Exhibit No. 65, submitted on September 20, 2007;

ii) find that SDG&E's SONGS-specific risk is commensurate with that of Southern California Edison ("SCE") and thus authorize SDG&E a San Onofre Generating Station ("SONGS")-specific ROE that is the same as authorized for SCE;

iii) authorize a return on common equity of 11.60% for SDG&E's electric and gas distribution operations;

iv) authorize an overall rate of return of 8.64%, reflecting the September 20, 2007 updated embedded costs of long-term debt and preferred stock; and

v) approve SDG&E's Debt Equivalence Mitigation Proposal in Phase 1 of this proceeding.

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OPENING BRIEF OF
SAN DIEGO GAS & ELECTRIC COMPANY
FOR TEST YEAR 2008 COST OF CAPITAL

I. INTRODUCTION AND BACKGROUND

Pursuant to the Rules of Practice and Procedure of the Commission's and the procedural schedule set forth in the June 21, 2007 Scoping Memo issued by Administrative Law Judge Galvin in this proceeding, SDG&E hereby files its Test Year 2008 Cost of Capital Opening Brief. In accordance with the requirements of the Scoping Memo and the June 14, 2007 pre-hearing conference, SDG&E presented expert

testimony on the 2008 test year cost of capital issues set for Phase 1 of the proceeding,[1] including those issues related to capital structure, embedded costs of debt and preferred stock, return on common equity (ROE) and impacts of debt equivalency ("DE").[2]

SDG&E presented substantial record evidence supporting Commission authorization of an ROE of 11.60%, which is commensurate with the returns on equity of similar businesses of similar risk, in accordance with longstanding United States Supreme Court precedence set forth in the *Bluefield* and *Hope* cases.[3] In addition, SDG&E sees no need to revise its currently authorized capital structure if its debt equivalence mitigation/equity rebalancing proposal ("DE Mitigation Proposal") is approved.

During the course of the proceeding, no party contested SDG&E's authorized capital structure consisting of 45.25% long-term debt, 5.75% preferred stock, and 49.00% common equity. There is also no dispute over SDG&E's embedded costs of debt and preferred stock. Therefore, the only authorizations at issue are SDG&E's ROE, SDG&E's SONGS-specific ROE, and approval of SDG&E's DE Mitigation Proposal.

With respect to the appropriate ROE, not only do the financial models support an increased authorized ROE of 11.60%, but SDG&E also presented evidence that the risks faced by SDG&E are comparable to those of Pacific Gas & Electric Company ("PG&E") and SCE and that when compared to a larger proxy group of companies bearing similar risk profiles, SDG&E's ROE should be no less than 11.60%. In addition, SDG&E faces

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[1] Phase 2 of the proceeding is set for early 2008 to "address cost of capital mechanisms that could replace annual cost of capital proceedings and may address information which rating agencies deem important in assessing the utilities' debt costs and equity returns and how they select comparable companies." Scoping Memo at p. 2.

[2] No party in this proceeding contests SDG&E's proposed cost of long-term debt, preferred equity or capital structure. On September 20, 2007, SDG&E submitted its late-filed exhibit 65 updating its estimated 2008 costs of embedded debt and preferred stock. As a result of slightly higher costs of long-term debt of 5.62% and preferred stock of 7.25%, SDG&E's overall rate of return ("ROR") is 8.64%.

[3] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944).

risks on its SONGS investment that are comparable to those of SCE, and thus SDG&E requests a SONGS-specific ROE commensurate with the ROE authorized to SCE for its investment in SONGS.[4]

SDG&E presented record evidence of the adverse credit impacts associated with significant new power purchase agreements ("PPA") for meeting the state-wide renewable standard and replacing the California Department of Water Resource ("DWR") energy contracts. These impacts include additional debt that will be recorded on SDG&E's balance sheet for financial reporting purposes due to FIN 46(R) consolidation of qualifying PPA counterparties. Such impacts also include substantial debt imputation by Standard & Poor's ("S&P") that weighs on SDG&E's credit profile due to its adverse impacts on SDG&E's key credit ratios. The unfavorable credit impacts from PPA DE also affects SDG&E's determination of "buy-versus–build" for new sources of power.

If not appropriately mitigated, these same negative credit impacts ultimately will hinder SDG&E's ability to meet its capital needs and operate its business under reasonable terms with its various counterparties and vendors. In response to this very real threat to its credit profile, SDG&E requests Commission approval of a contract-by-contract equity rebalancing mechanism that alleviates the problematic effects of FIN 46 (R) debt consolidation or imputed debt (i.e., DE) at the time customers receive the benefits of the PPA at issue. SDG&E strongly believes that its DE Mitigation Proposal is more fair, precise and efficient than advance, periodic adjustments to its authorized capital structure. Indeed, the Commission previously approved the concept and application of a similar equity rebalancing mechanism in R.01-10-024, allowing SDG&E

[4] SCE's current ROE for its SONGS investment is 11.60%.

recovery of DE related costs associated with the Otay Mesa Energy Center PPA.[5]

II. FINANCIALLY HEALTHY UTILITIES ARE NECESSARY TO SUPPORT CALIFORNIA'S LEADERSHIP ROLE AND TO CARRY OUT ITS AMBITIOUS ENERGY INITIATIVES

The Commission has embarked on a number of challenging, ground-breaking energy policies in this State to ensure that California's energy needs are adequately met. Indeed, the comprehensive, ambitious goals set forth in the State's Energy Action Plan ("EAP")[6] prescribe significant changes to the way in which regulated utilities will plan for, procure and implement new energy resources.[7] This Commission has set aggressive energy efficiency, demand-side management and renewable energy goals; specified a preferred loading order of energy resources and has re-engaged in its review of market mechanisms such as MRTU and capacity markets. The Commission has opened new dockets to address climate change, greenhouse gas emissions and is considering revisiting direct access.

Undoubtedly, the Commission's leadership role in reviewing almost every aspect of the energy market in California goes far beyond what other states are doing. Considering that SDG&E, SCE and PG&E are instrumental to the success of the Commission's energy policy goals, the State's three regulated electric utilities should not be placed at risk for recovery of their respective costs of capital/revenue requirements. Certain parties in this proceeding would prefer that the Commission authorize unreasonably low ROEs, but their recommendations ignore the real risks faced by the utilities in this challenging and dynamic environment. These risks introduce new levels of uncertainty into the marketplace that real investors must consider at the same time that

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5 *See* D.06-09-021.
6 EAP I and II.
7 Exh. 13 (SDG&E: Schneider Direct), p. MMS 2.

SDG&E is preparing to make significant investments in infrastructure to promote and support California's energy action plan. It is difficult to ascertain exactly what this uncertainty means to investors, but given California's recent history with energy policy, it is one that should be seriously evaluated.[8] By ensuring that its regulated utilities remain financially healthy, the Commission will be sending meaningful signals to equity and bond investors supporting the unprecedented levels of capital expenditures of the investor owned utilities ("IOUs"), securing continued investment in California's ambitious energy initiatives.[9]

III. STANDARD OF REVIEW

Not only do the intervenors' recommendations for extremely low ROEs place the Commission at risk in achieving its regulatory vision for energy policy in California, but they also ignore the fundamental legal principles underlying regulation of a public utility's rate of return. These bedrock principles are set forth in the seminal United States Supreme Court cases *Bluefield* and *Hope*. In the *Bluefield* case, the Court determined that a public utility is entitled to rates that will permit it to earn a return on the value of the property equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings that are accompanied

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[8] Tr. Vol 3, p. 218 (SDG&E: Schneider). In response to Aglet's question, "[i]n your opinion, do the risks associated with all of these events taken together exceed the risk that faced SDG&E during the financial crisis of 2000 and 2001?", SDG&E witness Schneider states, "in May of 2000 I did not think there were significant risks. By June the world had changed. Sometimes you just don't know."

[9] Tr. Vol 3, pp. 217-218 (SDG&E: Schneider). "You know, we are dealing with a substantial sea change in California right now with the lofty goals on renewable portfolio standards, the difficulty of the market to economically deliver on those goals. And I am very concerned about that right now, as well as the CDWR energy replacement and the economic costs associated with those replacements. It does seem that prices right now are quite substantial in the marketplace for replacement capacity. That is of concern to me. All of these taken into consideration with a . . . $4 billion infrastructure investment program to me is a very significant, you know, energy activity and event taking place in California right now."

by corresponding risks and uncertainties.[10] The Court also provided that the authorized return should be reasonable and should maintain the utility's ability to support its credit requirements and enable it to raise the capital necessary for the proper discharge of its public duties.[11]

The Court in the *Hope* case went further by emphasizing that revenues must be sufficient to cover capital costs and that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[12] Accordingly, the standard of review articulated by the United States Supreme Court requires the Commission to authorize a return on common equity that is:

1. commensurate with returns on investments in other firms with similar risks;
2. sufficient to enable SDG&E to maintain its financial integrity;
3. sufficient to maintain SDG&E's creditworthiness; and
4. sufficient to allow SDG&E to attract new capital in the financial markets on reasonable terms.

As is the case in all prior Commission decisions on utility costs of capital, the Commission must exercise its judgment, in light of the evidence, to meet the standards articulated by the United States Supreme Court. Accordingly, SDG&E has presented the Commission with substantial record evidence of a range of ROEs from accepted financial models utilizing a reasonable set of input assumptions. SDG&E has also supplied evidence of the various business and regulatory risks faced by the company in comparison to a larger proxy group of similar companies, as well as the other California IOUs that should help guide the Commission in its determination of a return on common

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[10] 262 U.S. 679 at 692.
[11] *Id*. at 693.
[12] 320 U.S. 591 at 603.

equity that satisfies the *Hope* and *Bluefield* standard of review.

IV. THE RECORD EVIDENCE SUPPORTS AN 11.60% ROE FOR SDG&E

Much like any other valuation appraisal, the Commission must consider the evidence that provides the most accurate and comprehensive data available to inform its judgment in assessing a just and reasonable ROE. In that regard, SDG&E has provided both qualitative information (company and proxy group risk assessments) as well as quantitative data derived from five financial models used by real world investors in determining a firm's reasonable rate of return. In so doing, SDG&E has fairly and reasonably selected a proxy group of publicly traded companies that, in the aggregate, reflects SDG&E's business and risk profile.[13]

SDG&E has provided policy testimony from its Senior Vice President and Chief Financial Officer, attesting to the fact that SDG&E "competes in the same capital markets and has a similar risk profile as the other California Investor Owned Utilities (IOUs)."[14] Moreover, SDG&E witness Schneider, in his capacity as Treasurer and Director of Finance, has shown that the investment community views the California IOUs as having similar risks and that representatives of SDG&E have been asked directly by equity investors why its authorized ROE is much lower than the other California IOUs.[15]

Understandably, for companies facing similar risks operating in similar business environments, it is entirely reasonable for investors to expect the California IOUs to have comparable ROEs.[16] Currently however, SDG&E's authorized ROE is 10.70%, PG&E's is 11.35% and SCE's is 11.60%. With a 65 and 90 basis point difference between

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[13] Exh. 45 (SDG&E: Hayes Direct), p. GHH 3.
[14] Exh. 1 (SDG&E: Arriola Direct), pp. DVA 1, 9.
[15] Exh. 12 (SDG&E: Schneider Direct), p. MMS 9.
[16] Exh. 1 (SDG&E: Arriola Direct), p. DVA 9

SDG&E and the other California IOUs, it is no wonder that SDG&E witness Arriola, a seasoned financial executive, testifies that the current SDG&E ROE of 10.70% is "neither appropriate, fair nor reasonable."[17] The substantial evidence adduced in the course of this proceeding supports that view.

A. Financial Model Results Support an Increase in ROE

1. SDG&E's models are simple, straightforward and transparent.

In determining an appropriate range of ROEs for comparable utilities, all of the parties in this proceeding relied on the results of accepted financial models; however, the ultimate results vary substantially. While the use of models invariably requires a certain amount of judgment in selecting model inputs, it is notable that *all* of the intervenors have subjectively chosen to substantially overweight the results of a single model result -- the discounted cash flow ("DCF") model.[18] By arbitrarily assigning significant weight to one model, the intervenors improperly skew ROE model results downward. The Commission should view such obvious "cherry-picking" tactics with a great deal of skepticism.

On the other hand, SDG&E presents a simple, straightforward and transparent set of mathematically derived results representing five equally-weighted financial models widely used by the investment community. The five models SDG&E used include a DCF model, two variants of the risk premium model ("RP"), the capital asset pricing model ("CAPM") and the Fama-French ("FF") model. SDG&E has provided the Commission a diversity of accepted financial models, acknowledging that "no single model is an infallible gauge of return – rather, each one is a piece of evidence about the

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[17] Exh. 1 (SDG&E: Arriola Direct), p. DVA 10.
[18] AGLET/UCAN/TURN give DCF 50% weight; DRA (apparently) gives DCF 100% weight and FEA gives DCF 50% weight.

true, underlying return and each one provides a sanity check on the other model's results. Such a multi-method approach mirrors the behavior of capital-market participants, who will gather and process as much data as practicable when assessing a potential investment."[19]

While the intervenors may question SDG&E's use of the FF model, Mr. Hayes, a Financial Manager and practitioner in the field of corporate finance, explains that the FF model:

> "is used in the real world by people who have money at stake. There are hedge funds and money managers who are using Fama/French explicitly to run their portfolios. Valuation experts are now using Fama/French in their assessments. Mutual fund advisors are also looking to aspects of the Fama/French model to advise their clients."[20]

Witness Hayes goes on to explain that the FF model is used by practitioners because it has greater explanatory power than the CAPM model – a model which has been historically accepted for use by this Commission.[21]

It is important to remember that the use of the FF model is intended to provide yet another data point to further inform the Commission's judgment. As Mr. Hayes explains, "no single model is infallible" and thus equal consideration of all financial model results is entirely appropriate. For this reason, and given that subjective assignment of weight to any particular model only distorts the picture, SDG&E assigns no arbitrary weighting to any of the models. SDG&E's financial models produce the following range of ROEs {10.36%, 10.86%, 11.11%, 11.73%, 13.89%}, the simple arithmetic average of which is approximately 11.60%.

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19 Exh. 45 (SDG&E: Hayes Direct), pp. GHH 2 - 3.
20 Tr. Vol. 4, p. 516 (SDG&E: Hayes).
21 *Id.*

2. Intervenor criticisms of SDG&E's model inputs are unfounded.

Intervenors DRA[22] and FEA[23] argue that SDG&E's DCF model inputs are flawed based on what they view as overly optimistic analysts growth forecasts.[24] However, as Mr. Hayes aptly states, "Wall Street analysts and analyst-consensus services still exist. If the analysts' work were truly as poor as the intervenors maintain, investors – who have real money at stake – would have already abandoned brokerage-house analysts for alternative data sources."[25]

Moreover, the issue of purported analyst bias is refuted by a survey of nine published academic studies. Seven of these studies find ***no*** evidence of overly optimistic analysts growth forecasts and two of the studies within this group find that any such optimism has been declining significantly over time (in fact, one of these two studies finds that analyst forecasts for the S&P 500 are actually pessimistic over the last four years of the study).[26] Even DRA's witness grudgingly concedes on cross examination that his graphs[27] purportedly depicting variances between analysts' growth forecasts and actual data in support of DRA's contentions of overly optimistic analysts can be simply explained, at least in part, by the fact that a forecast, by nature, does not account for future nonrecurring events or special charges such as one-time write offs or other unforeseeable economic dislocations while actual data does.[28]

3. Intervenor data lack credibility.

It is also notable that DRA admits its equity return recommendations for the three

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[22] Division of Ratepayer Advocates.
[23] Federal Executive Agencies.
[24] Exh. 44 (FEA: Hill Direct), p. 75; Exh. 34 (DRA: Woolridge Direct), p. 5-3.
[25] Exh. 46 (SDG&E: Hayes Rebuttal), p. GHH 10.
[26] Exh. 46 (SDG&E: Hayes Rebuttal), Appendix B-1.
[27] Exh. 34 (DRA: Woolridge Direct), pp. 5-4, 5-8.
[28] Tr., Vol. 4, pp. 468 – 471 (DRA: Woolridge).

utilities (including 9.60% for SDG&E) "are low by historical standards."[29] Yet DRA argues that its low recommendations are reasonable based on its view that: i) interest rates are at a low; ii) the 2003 tax law reduces the tax rates on dividend income and capital gains lowering the pre-tax return required by investors; and iii) the market risk premium has declined.

However, with respect to DRA's first contention, SDG&E points out that credit spreads at SDG&E as well as SDG&E's industry group have widened, meaning that borrowing costs and equity risk premia are increasing.[30] SDG&E witness Schneider provides a concrete example of the "credit crunch" caused by deteriorating investor confidence punctuated by the fact that the SDG&E credit spread quoted on a bond due in 2035 has increased by approximately 25% from January 1, 2007 to August 21, 2007.[31] In fact, a number of parties acknowledge that long-term interest rates have rebounded from historic lows and are on the rise.[32]

As to DRA's second reason (effects of the 2003 tax law) in support of its low ROE recommendations, SDG&E pointed out on cross examination that the tax law cited by DRA contains an automatic sunset provision terminating the tax benefit on December 31, 2008.[33] Thus, investors are fully aware that any tax benefits resulting from the cited 2003 tax law are fleeting and of little consequence when valuing a stream of future dividends over the life of the firm.

DRA's third rationale regarding allegedly declining market risk premia is

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[29] Exh. 34 (DRA: Woolridge Direct), p. 4-52.
[30] Exh. 13 (SDG&E: Schneider Rebuttal), p. MMS 8.
[31] Exh. 13 (SDG&E: Schneider Rebuttal), pp. MMS 8 - 9.
[32] Exh. 34 (DRA: Woolridge Direct), p. 4-26; Exh. 4 (SCE: Hunt Direct), pp. 25 - 26.
[33] Jobs and Growth Tax Relief Reconciliation Act of 2003, amended by Public Law No. 108-27, Section 303. "All provisions of and amendments made by this title shall not apply to taxable years beginning after December 31st, 2008. And the internal revenue code of 1986 shall be applied and administered to such years as if such provisions and amendments have never been enacted."

similarly not supported by the record evidence on multiple grounds. First, as SDG&E witness Hayes explains, practitioners (including the California State Board of Equalization) continue to use the Morningstar long-horizon expected equity risk premium. Indeed, the Commission has previously relied on the same Morningstar data in determining the appropriate risk premia to use in its CAPM analysis.[34] Moreover, one of the best indicia that SDG&E's market risk premium is appropriate can be found in the testimony of Aglet's witness Reid. Specifically, Aglet finds that market risk premia "in the range of 4.55% to 7.52% are reasonable for use in this cost of capital proceeding."[35] This result is entirely consistent with the market risk premium of 7.1% used in SDG&E's calculations. Interestingly, while discounting SDG&E's use of the CAPM financial model in this proceeding, DRA witness Woolridge sees no problem in using the CAPM analysis to estimate the cost of a firm's equity in his "ValuePro" software sold to investors over the internet.[36]

Also, when the concept of market-to-book ratios used by DRA to "test the reasonableness" of its equity cost rate recommendation was further scrutinized, DRA's witness conceded that his graphs depicting the relationship between estimated ROEs and market-to-book ratios for Value Line electric companies, gas distribution companies and water utilities were fraught with "data issues."[37] In either event, given that DRA's witness agrees that regression lines are commonly used to extrapolate data within the range of data presented,[38] and that at least for the electric companies depicted on DRA's graph (Graph 2-6), a market-to-book ratio of "1" lies within the data range, the algebraic

[34] Exh. 46 (SDG&E: Hayes Rebuttal), p. GHH 12.
[35] Exh. 54 (AGLET/TURN/UCAN: Reid Direct), p. 11.
[36] Tr. Vol. 4, p. 451 (DRA: Woolridge); Exh. 37: "ValuePro Stock Valuation Model".
[37] Tr. Vol. 4, pp. 459, 467 (FEA: Hill).
[38] Tr. Vol. 4. p. 463 (DRA: Woolridge); Exh. 39 (SDG&E).

solution to DRA's market-to-book regression yields an ROE of approximately 5.19% for electric companies![39] Considering that DRA's witness agrees that long-term utility bonds are currently yielding approximately 6.0%,[40] no sane investor would choose a higher risk equity returning 5.19% over a lower risk bond yielding a 6.0% return. Clearly, DRA's market-to-book analysis yields absurd results and, consistent with SCE witness Hunt's observation, "is inaccurate and unreasonable" when applied "to a real world situation."[41] Obviously, DRA's market-to-book test of reasonableness fails miserably and cannot be used to support DRA's admittedly low ROE recommendations.

Similarly, FEA's ROE results are suspect based on a selective and rather arbitrary screen of proxy group companies that have at least 70% of revenues from their electric operations. As FEA's witness concedes, the threshold of 70% was based solely on his subjective judgment informed only by experience.[42] FEA indicates that its subjective threshold excludes both electric and gas distribution companies based on a purported difference in the risk of gas distribution. However, Mr. Hill's experience-based screen fails to recognize, and indeed contradicts, a history of Commission precedent that recognizes parity between electric and gas distribution operations[43] and thus calls into question the weight that should be given to all of FEA's subjective modeling inputs – at least in those cases where judgment was based solely on its expert's "experience."

Likewise, Aglet's argument that the "Commission should compare utility ROEs

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[39] Exh. 39 (SDG&E).
[40] Tr. Vol. 4. p. 456 (DRA: Woolridge).
[41] *Id.* at p. 387.
[42] Tr. Vol. 4, pp. 488, 489 (FEA: Hill).
[43] *See* D.99-06-057. In FOF 15, the Commission found that "[g]as distribution utilities are similar to electric utility distribution operations." In FOF 16, the Commission further held that it "has historically authorized nearly the same returns for gas and electric utility operations." In FOF 22, the Commission found that "[t]he reasonable return on equity, capital structure, cost of capital, and rate of return for the gas distribution operations of PG&E and SDG&E are the same as for their electric distribution operations."

with utility pension fund returns"[44] lacks credibility as Aglet's witness Marcus is devoid of ***any*** corporate pension experience or pension actuarial/accounting expertise necessary to even begin to argue such comparability.[45] Aglet's apples-to-oranges comparisons are unfounded and, as PG&E witness Dr. Avera attests, "pension return assumptions are not comparable to the ROE used in utility ratemaking. The same is true for nuclear decommissioning fund returns."[46] As PG&E witness Fetter explains, the laws governing pension plans, such as ERISA, set standards that have the practical effect of "limiting the decisions of pension managers so as to emphasize conservatism" and therefore pension returns do not correlate with utility ROEs.[47]

B. The Business and Regulatory Risks Faced by SDG&E Are Significant

The testimony of SDG&E witness Schneider demonstrates where SDG&E fits relative to the business and regulatory risks of a large proxy group of similar companies. Mr. Schneider's analysis determines that SDG&E's risk is found within the middle-to-upper range of the proxy group and thus corroborates the 11.60% ROE returned by the financial models as a fair and reasonable return for SDG&E.[48] This result is based on a number of business and regulatory risk factors faced by SDG&E, including significant investment risk, energy market uncertainty and regulatory risks.

1. SDG&E's business risks are unprecedented.

Over the next five years, SDG&E plans on spending approximately $4 billion in capital investments, over half of which consist of CPUC-jurisdictional investments. To put this figure in perspective, SDG&E's capital expenditures will average about $900

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[44] Exh. 57 (AGLET/TURN/UCAN: Marcus Direct), p. 2.
[45] Tr. Vol. 5, pp. 598 – 599 (Aglet/TURN/UCAN: Marcus).
[46] Exh. 24 (PG&E: Avera Rebuttal), p. 1-61.
[47] Exh. 24 (PG&E: Fetter Rebuttal), pp. 2-12, 2-13.
[48] Exh. 12 (SDG&E: Schneider Direct), pp. MMS 17 - 18.

million per year, which is over 200% of historic investment levels.[49] SDG&E's free cash outflows as a percentage of its total book capitalization are the largest of its proxy group.[50] This unprecedented level of capital expenditures is needed as SDG&E reenters the electric generation business; to relieve transmission constraints; to invest in new technologies such as advanced metering infrastructure ("AMI"); to replace expiring DWR contracts; and to meet the Commission's aggressive 20% renewables target that requires SDG&E to procure an additional 963 GWh of renewable energy within the next two years.[51]

Re-entering the electric generation business raises substantially different risks than those encountered in the transmission and distribution ("T&D") business. SDG&E witness Schneider explains the risks associated with operating large-scale, complex generating technologies including operating risk, downtime and replacement power risks associated with repair and maintenance events. In addition, modern generating technologies such as those employed at the Miramar and Palomar Generating Stations differ significantly from the Encina and South Bay steam plants built circa 1960.[52]

SDG&E is also investing heavily in new technologies such as AMI to better serve its customers. Approximately 2.3 million electric and natural gas meters will be replaced or retrofitted. While this advanced metering technology will open the door to greater customer information and the potential for more efficient consumption of energy by end-

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[49] Tr. Vol 2, p. 165 (SDG&E: Schneider). "There is a correlation as far as investments and traditional regulation, rate-of-return regulation that would provide a certain level of net income as a derivative to growth in rate base. I believe bond rating agencies would understand that. But at the same time they would also understand the pressures associated with incorporating or having those investments incorporated into a company's rate base. In fact, most recently Moody's has issued a report expressing concern regarding the entire electric industry regarding that potential risk."

[50] Exh. 12 (SDG&E: Schneider Direct), p. MMS 18.

[51] *Id.* at pp. MMS 3, 7.

[52] *Id.* at pp. MMS 4 – 5.

users, it also represents entirely new business processes adding both cost management and collection risks to SDG&E's daily distribution operations.[53]

Similarly, SDG&E faces a slew of risks associated with meeting the Commission's renewables goals[54] and anticipates that in order to meet those goals, SDG&E will have to expand its transmission system to transport power from remotely located renewable energy sources to load centers. Consequently, SDG&E plans to invest up to $2.0 billion in transmission resources to meet these requirements. Of this amount, SDG&E expects to invest approximately $1.2 billion in the Sunrise Powerlink project.

In addition, SDG&E's investment risk is amplified by its minority investment in the San Onofre Nuclear Generating Station. SDG&E has identified considerable construction and cost risks associated with SONGS-related capital projects, including for example, SCE's steam generation replacement project ("SGRP")[55] expected to cost approximately $926 million. The SGRP and similar future capital projects create significant SONGS-specific risks, for which SDG&E has little control.[56] Because SDG&E faces the same risk as SCE in SONGS, while very little of such risks can be mitigated by SDG&E due to its minority ownership interest, SDG&E is separately and expressly seeking a SONGS-specific ROE commensurate with the ROE authorized for SCE's investment in SONGS.

In confidential supplemental testimony received into the record under seal,

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[53] *Id.* at MMS 9.

[54] Tr. Vol. 3, p. 244 (SDG&E: Schneider). "When you look at – which I believe is a very aggressive desire to get to 20 percent by 2010. Most of the other states in the nation are looking at, although they might have renewable standards, they are looking at 2015-2020… I'm real concerned about its effect on risk for the three utilities."

[55] In D.06-11-026, the Commission stated, "[t]he settlement, included as Attachment A to this decision, provides that SDG&E will defer its request for an increased ROE on its investment in SONGS to the next Cost of Capital Proceeding."

[56] Exh. 12 (SDG&E: Schneider Direct), pp. MMS 5 – 7.

SDG&E explained the significant levels of electric power resources it will need to meet demand in its service area.[57] SDG&E anticipates meeting this need utilizing a combination of utility owned generation and PPAs. Indeed, Table 1 of SDG&E's confidential supplemental testimony illustrates the level of *new* PPAs needed during the planning horizon depicted to replace expiring DWR contracts and to meet the State's renewable standards.[58] S&P applies a 25% risk factor to SDG&E's obligations under such PPAs, which is estimated to amount to an additional $453 million of debt equivalence imputed to SDG&E's capital structure.[59] Given that SDG&E will likely need to enter into additional PPAs (above the levels depicted in Table 1) to meet the expected load demand as described above, SDG&E's actual debt equivalence will greatly exceed that amount. The estimated debt equivalence associated with new PPAs represents a 64% increase[60] over the level of $703 million associated with SDG&E's existing PPAs as calculated by S&P in its most recent publication.[61] Clearly, debt equivalence has a very real and materially increasing, adverse impact to SDG&E's credit profile.[62]

2. SDG&E faces significant regulatory risks.

SDG&E's business risks are compounded by the regulatory and legislative risks in California. SDG&E must manage its business risks in a dynamic and uncertain energy market environment. California has taken a leadership role among states in many areas of energy regulation embarking on a hybrid market structure that lies somewhere between

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[57] Confidential Exh. B (SDG&E), p. 12.
[58] *Id.* at pp. 3 - 4.
[59] *Id.* at p. 5.
[60] *Id.*
[61] *Id.* at p. 3.
[62] *Id.* at p. 6.

full regulation and competitive markets. However, with energy markets in California in a state of flux, SDG&E is presented with significant regulatory uncertainty.

Apart from the regulatory lag for the long lead-times associated with building new generation, transmission and distribution infrastructure, SDG&E must also contend with an array of multiple agency initiatives, oversight and overlapping jurisdiction that can erratically alter the way energy markets work. For instance, the California Independent System Operation ("CAISO") has proposed an electricity market redesign ("MRTU") which is fraught with delay and uncertainty, thus increasing asset valuation, cost allocation and resource adequacy risks for SDG&E.

Similarly, the Commission recently issued a proposed decision in R.07-05-025 initiating a rulemaking to determine whether, when, or how Direct Access should be restored in California. Depending on the length, breadth, and outcome of what is expected to be a heavily litigated proceeding, Direct Access creates substantial uncertainty for SDG&E as SDG&E could be faced with stranded costs and higher levels of debt equivalency in the event the utilities are required to take on a portion of existing DWR contracts.[63]

The uncertainty associated with California's environmental leadership initiatives cannot be overestimated. SDG&E faces a myriad of uncertainties resulting from what is expected to be far-reaching Commission regulation of greenhouse gas emissions and new policies addressing climate change. The impacts from such evolving environmental regulation will be felt across SDG&E's operations.[64] Combined with other agency involvement (California Energy Commission, CAISO) and looming federal regulatory

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[63] Exh. 12 (SDG&E: Schneider Direct), pp. MMS 10 – 11.
[64] *Id.* at MMS 12 – 13.

overlap, SDG&E's regulatory risk is undoubtedly heightened.[65]

With respect to decoupling and the use of balancing accounts, SDG&E notes that neither FEA nor Aglet[66] recommends a lower ROE due to California regulatory balancing accounts and decoupling measures. SDG&E agrees. Balancing accounts primarily address procurement activity and costs associated with sales forecasts varying from actual sales and SDG&E agrees with Aglet that it continues to bear a second order sales risk because all utility costs are not fixed. Moreover, in a moderate climate like San Diego where sales forecasts tend to be relatively stable, balancing accounts only address a small portion of SDG&E's overall risk.[67]

3. SDG&E's risks fall within the middle to upper range of its proxy group and SDG&E faces risks similar to those of PG&E and SCE.

In analyzing the business and regulatory risks facing SDG&E against those of its comparable proxy group, and considering the results of the quantitative modeling analyses using a reasonable set of inputs, a fair and reasonable ROE that satisfies the *Bluefield* and *Hope* standards should be no less than 11.60%.[68] In comparing the business and regulatory risks specific to SDG&E to those of a comparable set of firms comprising the proxy group, SDG&E is found to be within the middle-to-upper range of risk. The financial models are consistent with this risk analysis resulting in an average 11.60% ROE that lies just above the 11.11% median of the range produced by the models {10.36%, 10.86%, 11.11%, 11.73% and 13.89%}.

Moreover, SDG&E has provided substantial evidence that it faces risks similar to

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65 *Id.* at MMS 14.

66 References to Aglet include Utilities Consumers Actions Network (UCAN) and The Utilities Reform Network (TURN) under their joint representation in this proceeding.

67 Exh. 13 (SDG&E: Schneider Rebuttal), pp. MMS 12 - 13.

68 Exh. 12 (SDG&E: Schneider Direct), p. MMS 18.

PG&E and SCE, with current authorized ROEs of 11.35% and 11.60%, and requested ROEs of 11.70% and 11.80%, respectively. Indeed, the record reflects that SDG&E faces the same regulatory environment, competes in the same capital markets, faces comparable procurement challenges and has similar planned investments in emerging and unproven technologies when compared to the other California IOUs.[69] In fact, real investors with real money at stake have weighed in on their view of comparability of the three electric utilities when asking representatives of SDG&E why its authorized ROE is much lower than the other California electric IOUs.[70]

Bond investors have also weighed in on this issue of comparability and, based on a comparison of SDG&E's bond yields versus PG&E and SCE, have concluded that SDG&E faces very similar risks as the other two California IOUs.[71] The uncontroverted record evidence reproduced below[72] depicting bond yields of the three California IOUs shows that bond yields, in absolute terms, have not only increased since the 2005 cost of capital proceeding (D.05-12-043), but also that as of August 3, 2007, the bond spreads between SDG&E and the other two California utilities have become virtually non-existent. Clearly, such hard evidence of the capital markets' perspective demonstrates that all three IOUs are viewed as having very similar risks.

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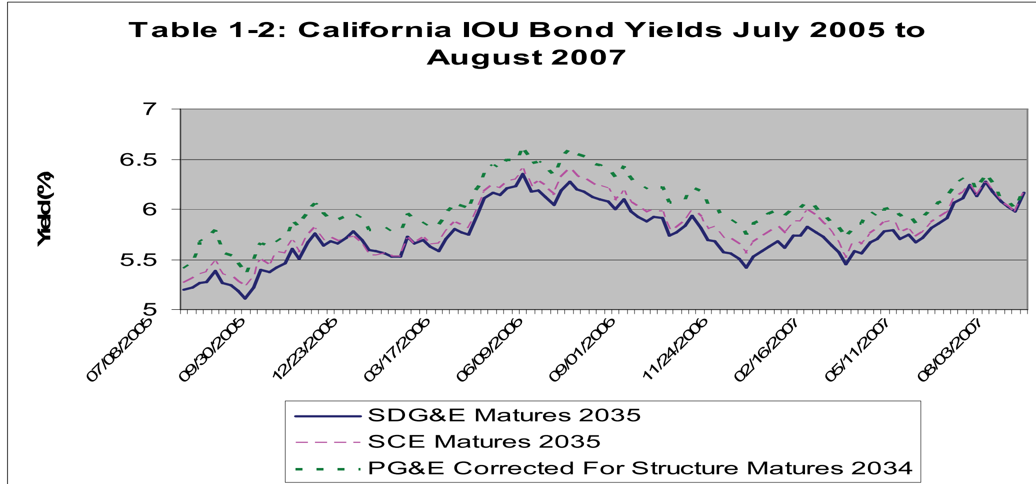
[69] *Id.* at MMS 9.
[70] *Id.*
[71] Exh. 13 (SDG&E: Schneider Rebuttal), p. MMS 4.
[72] *Id.* at MMS 5.



V. SDG&E'S DE MITIGATION PROPOSAL ECONOMICALLY ADDRESSES PPA DE AND FIN 46(R) CONSOLIDATION ISSUES

A. DE Mitigation is Necessary to Maintain SDG&E's Financial Health

During SDG&E's resource planning and selection process, SDG&E operates under principals of "least-cost, best-fit" in choosing resources to fill its net procurement positions. SDG&E bid solicitations are transparent and heavily scrutinized by various stakeholders and ratepayer interests. While SDG&E expects to fill its resource need through a combination of purchased power and utility owned generation, given the estimated $453 million of near-term PPA debt imputation and approximately $703 million of DE for existing PPAs,[73] debt equivalence poses a serious threat to SDG&E's credit profile and financial health.[74] Indeed, Tables 3 and 4 of SDG&E's supplemental

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[73] Exh. 2 (SDG&E: Wang), p. 7.

[74] Tr. Vol. 3, p. 237 (SDG&E: Schneider). In this regard, Mr. Schneider states "[y]ou just don't know what is going to degrade and what condition is ultimately going to put the company in a position where its credit gets downgrade. Our biggest concern and our position is we want to maintain neutrality with respect to the commercial arrangements that we continually assess, particularly given the significant activity taking place right now in the – and again the replacement of the CDWR contracts and the renewables. But I want the company to be in a position of it's not looking at a buy scenario with a PPA versus a build scenario and looking at it and saying, well, gee, if I enter into a PPA, I incur potential balance sheet implications, and I have a certain lack of control. There are factors that sort of weigh against the ownership option. I'm trying to put things on an equal footing to take the economics and carry them through ratemaking. And I believe that that's a proposal that we want to put in front of this Commission for review and consideration because it's key in having that assessment be neutral."

testimony (reproduced below) illustrate the adverse impacts of DE on SDG&E's credit ratios.[75] These two tables clearly demonstrate that SDG&E can expect such levels of DE to distort its credit ratios to the point that they fall outside the range of the S&P guidelines for maintaining its current credit rating.[76]

Table 3 – SDG&E Financial Ratios with and without PPA Debt Equivalence

	2008	2008	Pro Forma Post Effective	S&P Guidelines for Business Profile 5
	Without PPA Debt Equivalence	Including Existing PPA Debt Equivalence ($703MM)	Including All PPA Debt Equivalence ($1156MM)	
	Current ROR Current Cap	Current ROR Current Cap	Current ROR Current Cap	'A' Rating
FFO / Adjusted Debt	**25.5%**	**20.4%**	**17.7%**	30% - 22%
Adjusted Total Debt / Total Capitalization	**50.6%**	**56.5%**	**59.6%**	42% - 50%
Funds From Operations Interest Coverage	**5.66**	**4.53**	**3.99**	4.5x - 3.8x

Table 4 – SDG&E Financial Ratios for Current and Requested ROR

	2008	Pro Forma Post Effective	S&P Guidelines for Business Profile 5
	Including Existing PPA Debt Equivalence ($703MM)	Including All PPA Debt Equivalence ($1156MM)	
	Current ROR Current Cap	Current ROR Current Cap	'A' Rating
FFO / Adjusted Debt	**20.4%**	**17.7%**	30% - 22%
Adjusted Total Debt / Total Capitalization	**56.5%**	**59.6%**	42% - 50%
Funds From Operations Interest Coverage	**4.53**	**3.99**	4.5x - 3.8x
	Requested ROR Current Cap	Requested ROR Current Cap	
FFO / Adjusted Debt	**20.8%**	**18.0%**	30% - 22%
Adjusted Total Debt / Total Capitalization	**56.3%**	**59.4%**	42% - 50%
Funds From Operations Interest Coverage	**4.59**	**4.04**	4.5x - 3.8x

SDG&E has explained that Commission approval of SDG&E's DE Mitigation Proposal would not favor purchased power as a resource option over building new generation, but instead retains neutrality and provides a means for SDG&E to recover the costs associated with maintaining its credit quality and credit-adjusted capital structure

75 Exh. 2 (SDG&E: Wang), p. 7.
76 *Id.*

when entering into PPAs.[77] This approach is consistent with other Commission precedent that recognizes the effects of DE and directed the utilities to take DE into account during the bid evaluation process[78] and precedent that found the published S&P methodology to be the most reasonable to use in that process.[79]

SDG&E's DE Mitigation Proposal addresses both the impacts from PPA debt imputation and any variable interest entity ("VIE") debt consolidation required under FIN 46(R). VIE consolidation under FIN 46(R) requires SDG&E to include debt associated with VIEs' financial data in its Securities and Exchange Commission ("SEC") filings. As a result of such consolidation, SDG&E's capital structure leverage will increase if the VIEs are highly leveraged. To further demonstrate this point, SDG&E submitted its most recent 10-Q report in the record to show how the Otay Mesa Energy Center ("Otay Mesa") VIE was consolidated onto SDG&E's balance sheet.[80]

Because of the substantial increased debt imputed to SDG&E via S&P's PPA debt imputation and through FIN 46(R) VIE debt consolidation, SDG&E requests approval of a DE Mitigation Proposal. The Proposal's equity rebalancing mechanism precisely offsets the increased debt to SDG&E's credit capital structure on a contract-by-contract basis and receives cost recovery only when the contract benefits are delivered to ratepayers.[81] SDG&E believes that its proposal is superior to an all-encompassing advance mitigation approach and fits well with its MICAM mechanism. In addition,

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77 Exh. 13 (SDG&E: Schneider Rebuttal), pp. MMS 17 – 19.
78 D.04-06-011.
79 D.04-12-048, p. 62.
80 Exh. 13, Appendix B (SDG&E: Schneider). "SDG&E Quarterly Report 10-Q" for the period ending June 30, 2007.
81 Tr. Vol 2, p. 190 (SDG&E: Schneider). "We are proposing to have an equity rebalancing mechanism that looks at each particular PPA arrangement, and ensure that as we look at the least-cost, best-fit options, and the risk associated with them, the company isn't disadvantaged from a financial context into pursuing those."

SDG&E's proposal avoids the possibility of over-collections as it adjusts equity levels only in specific amounts necessary to offset the debt impacts of PPAs.[82] As discussed above, the Commission has previously approved (and a number of intervenors supported) this more timely and accurate approach for recovery of SDG&E's DE costs associated with the Otay Mesa PPA.

B. SDG&E's DE Mitigation Proposal Should Be Approved in Phase 1

SDG&E is requesting that the Commission take action in Phase 1 of this proceeding to establish a policy that preserves SDG&E's credit profile and financial health.[83] The adverse credit impacts of PPAs for SDG&E are substantial and growing, and thus SDG&E has raised the issue in at least three other proceedings to address this concern.[84] In each case, SDG&E's mitigation proposal was deferred to the instant cost of capital proceeding. In the interim, SDG&E has entered into additional PPAs[85] and expects to continue entering into new PPAs, as discussed above. Accordingly, and to address the issue of PPA debt equivalence, SDG&E formally presented its DE Mitigation Proposal in its cost of capital application and supporting testimony submitted on May 8, 2007. SDG&E believes that its proposal is ripe for Commission consideration (and approval) as is entirely within the scope of issues set for this phase (Phase 1) of the proceeding in accordance with the Scoping Memo issued on June 21, 2007.[86]

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[82] Exh. 12 (SDG&E: Schneider Rebuttal), p. MMS 21.

[83] Tr. Vol. 2. p. 200 (SDG&E: Schneider). "The concern I have is that it is hard to know exactly when and how credit has deteriorated to a point of a downgrade or any change in credit quality. Our position is to try to maintain neutrality with respect to the credit ratings that we currently operate under."

[84] SONGS SGRP proceeding at A.06-04-018; SDG&E's Long-Term Procurement Proceeding ("LTPP") R.06-02-013; and SDG&E's Peaker Application at A.07-05-023.

[85] J-Power and Wellhead purchased power agreements.

[86] Scoping Memo, p. 2, stating, "[t]he first phase of this proceeding shall address SCE, SDG&E and PG&E's test year 2008 cost of capital. Issues impacting the utilities' test year 2008 cost of capital include the appropriate ratio of debt, preferred stock and equity; appropriate costs of debt, preferred stock, and equity; ***impact of debt equivalency; and related revenue requirement recovery***." (emphasis added)

Indeed, SDG&E and other parties submitted testimony in Phase 1 of this proceeding on the specific issue of debt equivalence from PPA debt imputation and FIN 46(R) VIE consolidation and on SDG&E's proposed DE Mitigation mechanism.[87] Moreover, intervening parties in Phase 1 hearings thoroughly cross-examined SDG&E's witnesses over debt equivalence and SDG&E's proposal for mitigation.[88]

Phase 2 of this proceeding was set to address mechanisms that could replace annual cost of capital proceedings and information which rating agencies deem important in assessing the utilities' debt costs and equity returns and how they select comparable companies.[89] With respect to these Phase 2 issues, SDG&E notes that it currently operates under its Market Indexed Capital Adjustment Mechanism ("MICAM") and does not expect to propose any changes in the second phase of this proceeding.

Furthermore, it is important to understand that SDG&E's MICAM and DE Mitigation Proposal are separate and distinct[90] "because the MICAM purely looks at interest rate changes, not necessarily market conditions or other offerings" and therefore any adjustments associated with the DE Mitigation Proposal would be "outside of the MICAM."[91] Consequently, there is simply no rational basis to defer consideration of SDG&E's DE Mitigation Proposal to a subsequent phase of this proceeding. Further

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87 Exh. 1; Exh. 2/B; Exh. 12; Exh. 13; Exh. 44 (FEA); Exh. 34 (DRA);
88 Tr. Vol. 1, pp. 16, 17, 23, 24, 25, 30 (Arriola cross examination by Aglet); TR. Vol. 2, pp. 168 – 184 (Schneider cross examination by FEA); TR. Vol. 2, pp. 187 - 191 (Schneider cross examination by Aglet); TR. Vol. 3, pp. 207 – 211, 219, 220 (Schneider cross examination by Aglet).
89 Scoping Memo, p. 2.
90 Tr. Vol. 3. p. 238 (SDG&E: Schneider).
91 Tr. Vol. 1, p 44 (SDG&E: Arriola).

delay by the Commission on this issue is unwarranted.[92]

VI. CONCLUSION

WHEREFORE, for the forgoing reasons, and in reviewing the substantial record evidence in Phase 1 of this proceeding, the Commission should: i) re-authorize SDG&E's current capital structure consisting of 45.25% long-term debt, 5.75% preferred stock, and 49.00% common equity; approve its embedded costs of long-term debt of 5.62% and preferred stock of 7.25%, as updated in SDG&E's Late-Filed Exhibit No. 65, submitted on September 20, 2007; ii) find that SDG&E's SONGS-specific risk is commensurate with that of SCE and authorize a SONGS-specific ROE that is the same as authorized for SCE; iii) authorize a return on common equity of 11.60% for SDG&E's electric and gas distribution operations; iv) authorize an overall rate of return of 8.64%, reflecting the September 20, 2007 updated embedded costs of long-term debt and preferred stock;

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[92] Tr. Vol. 1, p. 49 (SDG&E: Arriola). "The company is involved today, through various RFO processes, it is trying to enter into contracts, negotiating terms and everything to start replacing some of these contracts that would – I'm not sure, in 2010, '11 and '12. So it is something that takes a long time, given the market conditions, given the developers' needs to perhaps construct a facility. So it is not something that you can just go into the market and buy a contract tomorrow. It is a timely process. So we are in the market today trying to enter into contracts two to three, four years down the road." In addition, Mr. Arriola states that it would not be prudent for the company to wait until a contract expires before it begins negotiations to enter into replacement contracts.

v) approve SDG&E's DE Mitigation Proposal in Phase 1 of this proceeding; and vi) grant all other relief as is reasonable and necessary.

Respectfully Submitted,

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September 27, 2007

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing **OPENING BRIEF OF SAN DIEGO GAS & ELECTRIC COMPANY FOR TEST YEAR 2008 COST OF CAPITAL** on each party named in the official service list for proceeding A.07-05-003, A.07-05-007, and A.07-05-008 by electronic service, and by U.S. Mail to those parties who have not provided an electronic address.

Copies were also sent via Federal Express to Commissioner John Bohn and the Assigned Administrative Law Judge Michael J. Galvin.

Executed this 27th day of September 2007, at San Diego, California.

/s/ Deanna M. Gutierrez
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