Investigation No.: I.12-10-013
Exhibit No.: SDGE-20
Witness: Kenneth J. Deremer

# PREPARED REBUTTAL TESTIMONY OF
# KENNETH J. DEREMER
# ON BEHALF OF
# SAN DIEGO GAS & ELECTRIC COMPANY

## BEFORE THE PUBLIC UTILITIES COMMISSION
## OF THE STATE OF CALIFORNIA

**September 23, 2013**

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# PREPARED REBUTTAL TESTIMONY OF
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## I. INTRODUCTION

My rebuttal testimony regarding San Diego Gas & Electric Company (SDG&E)'s cost recovery proposal in Phase 2 of the San Onofre Nuclear Generating Station (SONGS) Order Instituting Investigation (OII) addresses the intervenor testimony dated September 10, 2013 of:

- Division of Ratepayer Advocates (DRA) – witnesses Truman Burns and Scott Logan; and
- The Utility Reform Network (TURN) – witness William Marcus.

My rebuttal testimony covers the cost recovery proposals of DRA and TURN, specifically addressing their proposals for recovery of SDG&E's investment in the steam generator replacement project (SGRP), remaining investment in non-SGRP assets, material & supplies (M&S), construction work in progress (CWIP), and operating & maintenance (O&M) expenses. My testimony also addresses the DRA and TURN proposals for the appropriate return on the remaining SONGS investment, as well as the effective date of the corresponding revenue requirement.

SDG&E agrees with DRA's and TURN's basic beliefs that given the permanent closure of SONGS Units 2 and 3, SDG&E's rates should be updated to reflect the assets that are no longer in service and that the cost savings associated with the new revenue requirements for the ongoing recovery of the capital-related and O&M costs should be applied as reductions to customer rates. However, SDG&E disagrees with many of the key elements of DRA's and TURN's cost recovery proposals. Furthermore, DRA and TURN fail to provide any basis in law or fact for their cost recovery proposals. Finally, TURN and more notably, DRA, have already jumped to conclusions concerning the SGRP and related prudency issues. Those issues will be the focus of Phase 3 of this OII, and therefore, DRA's and TURN's assertions regarding SGRP and prudency should not be considered now.

SDG&E maintains that the original proposal submitted in my direct testimony[1] is reasonable, appropriate and supported by California Public Utilities Commission (Commission) policy.

Specifically, my testimony rebuts the following points:

- DRA's recommendation that costs associated with the SGRP investment should be disallowed effective November 1, 2012 is premature and is contrary to Commission precedent for retired assets.
- DRA's proposal that the remaining investment associated with non-SGRP investments should be only partially recovered[2] and DRA and TURN's proposal that the remaining investment receive no return or zero return on common equity is not appropriate and deprives SDG&E a fair opportunity to recover the prudent and reasonable costs associated with its SONGS investment.
- DRA's recommendation to disallow all recovery of the CWIP balance is unreasonable and is inconsistent with policy set forth in prior Commission decisions, and additionally ignores the framework explained by Southern California Edison (SCE) and SDG&E concerning the delineation of remaining plant that is still considered used and useful and plant that is now retired.
- DRA's recommendation to remove costs of M&S and essentially disallow any recovery going forward is unreasonable and inappropriate.
- DRA's proposal for recovery of only 75% of O&M expenses is not appropriate for SDG&E since SDG&E currently balances 100% of its O&M costs billed by SCE through its authorized SONGS O&M balancing account.
- The DRA and TURN recommendations to utilize no return (DRA) or no return on common equity (TURN) on non-SGRP cost components denies SDG&E a fair opportunity to recover the costs associated with its investment made on behalf of SDG&E customers.

[1] Initially submitted on August 16, 2013 and modified on August 28, 2013.

[2] TURN permits recovery of the full remaining investment (TURN, p. 4), but DRA asserts only 75% should be eligible for recovery (DRA-3, p. 9).

- Intervenors' proposed effective dates for the revenue requirement changes do not coincide with the point of time when the SONGS assets were considered no longer used and useful.

## II. REMAINING COSTS ASSOCIATED WITH RETIRED SONGS INVESTMENT, INCLUDING SGRP, SHOULD BE RECOVERED AT REDUCED RETURN

As described in my direct testimony, SDG&E's investment in SONGS, including SGRP, has been previously authorized as prudent utility capital projects in prior Commission decisions, including Decision (D.) 06-11-026 and other relevant General Rate Case (GRC) decisions. As further explained in direct testimony, SCE identified a portion of the SONGS book investment that was necessary to continue the safe and efficient operation of the plant as it transitions to the decommissioning phase,[3] while the remainder of the investment would be transferred to retired plant. The un-amortized SGRP investment was classified into the retired plant category. Consistent with SDG&E's proposal for the recovery of retired plant, SGRP costs should be recovered over an accelerated 5-year period, with a reduced rate of return (ROR) of 5.07%.[4]

In its testimony, DRA asserts that given the permanent SONGS shutdown and given the principal cause was due to the failure of the replacement steam generators, SCE and SDG&E should not be allowed any recovery for the SGRP investment.[5] DRA's recommendation should be rejected. First, the role of the replacement steam generators in connection with the ultimate closure of the SONGS 2 and 3 units has yet to be determined and will be addressed in Phase 3 of this proceeding.[6] Therefore, cost recovery proposals based on DRA's unsubstantiated conclusions should not be considered at this time.

In addition, DRA ignores the fundamental principal, which has been re-affirmed in multiple previous Commission decisions, that utility investors fund these capital investments upfront on behalf of SDG&E ratepayers and that investor funds are returned to the investors over the lives of the projects. Ratepayers pay for these assets over the operational life of the assets. In the case where the asset is retired early, an accelerated recovery period would be appropriate.

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[3] SDG&E-18-A, p. 4.

[4] SDG&E-18-A, p. 7.

[5] DRA-03, p. 9.

[6] Both DRA and TURN acknowledge that SGRP issues will be reviewed in Phase 3. DRA-03, p. 5 and TURN-Marcus, p. 2.

A reduced ROR, like the one proposed by SDG&E, would be appropriate given the acceleration of recovery. As described in my direct testimony, the most recent example of this type of situation occurred with the retired legacy meters due to implementation of SDG&E's smart meters.[7] DRA fails to provide any justification for deviating from this long-standing practice. Therefore, DRA's recommendation to disallow recovery of SGRP in its entirety is not appropriate.

## III. NON-SGRP INVESTMENT SHOULD RECEIVE FULL RECOVERY OF INVESTMENT AS EITHER USED AND USEFUL OR RETIRED PLANT

In their testimonies, both DRA and TURN mistakenly lump all the non-SGRP remaining capital investment (excluding M&S and CWIP) into one bucket. This accounting treatment ignores the identification by SCE of those assets that would still be used and useful, (*i.e.*, needed for ongoing plant operations in transition to the decommissioning phase), and those assets that are retired due to the permanent closure.

DRA further recommends that SCE and SDG&E be permitted to recover 75% of these costs over 5 years with no return applied during the amortization period. DRA's basis for the 75% recovery reflects the approximate years of SONGS Units 2 and 3 operations (30 years) prior to shutdown in proportion to the total Nuclear Regulatory Commission (NRC) license life (40 years). While SDG&E does not dispute that the approximate operating life of the facility is 3/4 of the total license life, the relationship of this factor to the remaining SONGS investment costs is unclear and unsubstantiated by DRA. Once again, DRA fails to state whether the Commission has found this "proportional" approach acceptable in similar situations. One hundred percent of the costs associated with these assets were reasonably and prudently incurred to provide electricity to customers, and 100% of the costs should be recovered from customers, both for the portion that is still considered used and useful and the retired portion. To not provide for full recovery, would contradict directives provided in prior Commission decisions.

In addition, DRA's proposal denies any return on investment on the basis that the remaining investment: 1) no longer provides electricity, capacity or value to customers; 2) utilities are receiving accelerated recovery of (75%) of the investment; and 3) SCE has already taken charge in second quarter (2013) earnings in accordance with accounting requirements.[8]

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[7] SDG&E-18-A, p. 6.

[8] DRA-03, p. 9.

While each of those circumstances may be accurate, none of them provide a reasonable or even relevant basis for SDG&E to earn no return on its SONGS investment. Recovery of an asset that is out of service does not mean that it should receive no return. This has been consistently demonstrated in prior Commission decisions, and as described earlier and in direct testimony, most recently in SDG&E's recent GRC regarding legacy meters.[9] While SDG&E would agree that applying an accelerated recovery of a retired asset would most likely necessitate a reduced ROR – I proposed 5.07% - SDG&E does not agree that utility investors should receive no return for the un-reimbursed portion of its capital investment.

DRA incorrectly implies that it is the utilities' belief that capital investments in utility infrastructure, such as SONGS, are made exclusively for the benefit of shareholders.[10] SDG&E objects to DRA's incorrect inference. SDG&E fully realizes that investments in capital are done for the benefit of utility customers in the provision of safe and reliable electric (and gas) service. To clarify, these investments done for the benefit of utility customers are funded by the utility through its shareholders and debt holders. Therefore, the investment SDG&E's shareholders and debt holders put forth should be repaid over time at a fair and reasonable return.

DRA's assertion that the utilities should earn no return because of the accounting charge SCE took in the second quarter of 2013 has no relevance to this issue. While I may not be familiar with the particulars behind the SCE accounting adjustment, it is apparent that the charge was taken for accounting and financial reporting purposes, which are unrelated to the rate recovery proposals within the Commission's jurisdiction.

For non-SGRP remaining plant, TURN recommends recovery of full costs but at no return, or an overall ROR that contains no return on equity. Once again, TURN fails to provide any basis in law or fact to support its proposals. For SDG&E, under its current authorized capital structure, a ROR with no equity return would equate to a 2.43% overall ROR. This is in comparison to the 5.07% ROR SDG&E proposes, which reflects a ROR at the overall weighted cost of debt and preferred stock.[11] For the same reasons SDG&E provided above in response to DRA's recommendation, SDG&E staunchly disagrees with any proposal that contains no return

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[9] D.13-05-010 authorized recovery of legacy meters, associated with implementation of smart meters, at a reduced ROR.

[10] DRA-03, p. 4, lines 8-9 ("Investment in utility facilities is not done rendered exclusively for the benefit of shareholders.").

[11] SDG&E-18-A, p. 7.

on recovery of investment. Recovery of assets that are considered to still be used and useful should continue recovery at SDG&E's full authorized ROR of 7.79% through 2017 and then beginning in January 1, 2018, recover remaining investment over 3 years at reduced ROR of 5.07%, as stated in my direct testimony.

In response to TURN's alternate proposal for a return that contains no common equity return, SDG&E maintains such a level of return is neither fair nor reasonable to the utility common investor as it contains zero return on capital for the remaining un-recovered investment. SDG&E's proposal for a debt-equivalent return at least provides a return for the common investor that is equivalent to what a debt holder would receive. Given the acceleration of recovery, this would be a reasonable outcome for the investor under these circumstances. To simply provide no return to the common investor is unreasonable and sends an alarming message to the financial community regarding the expectation of recovery of utility investments.

## IV. CWIP INVESTMENT SHOULD BE TREATED CONSISTENTLY WITH PLANT PREVIOUSLY IN SERVICE AND RECOVERED ACCORDINGLY

DRA asserts that SDG&E should receive no cost recovery for outstanding CWIP, effective November 1, 2012. It asserts that "CWIP balances were never placed into commercial operation, were never 'used and useful' and therefore, should not be recoverable from ratepayers."[12] In support of this proposal, DRA provides the same unsubstantiated arguments it made for why SDG&E should not be allow a return on non-SGRP assets discussed, as restated in Section III above.

For the same reasons described above in Section III, DRA's bases for its CWIP proposal are incorrect. The fact that SONGS Units 2 and 3 have been removed from service and that SCE took an accounting charge in its second quarter 2013 financial statements do not constitute reasons for disallowance. In addition, as described by SCE and SDG&E in direct testimony,[13] the nature of nuclear facilities requires a longer lead time between capital investment and asset placement into service. The balance in CWIP as of May 31, 2013[14] was necessary to prepare the units for a return to service, which was the expectation until June 7, 2013, when SCE announced

[12] DRA-03, p. 13.

[13] SDG&E-18-A, p. 7; SCE-40, p. 9.

[14] The appropriate SDG&E CWIP balance applicable for plant at May 31, 2013 is $54 million as reflected in SDG&E-16 (Daley).

the permanent closure of SONGS. Furthermore, as explained in my direct testimony, a portion of the CWIP will be brought into service to support the ongoing operation at the facility in transitioning to the decommissioning process. While a portion of the CWIP will never be placed into service, the capital investment was made with the full intention of those assets being placed into service for a productive facility that had been in operation for approximately 30 years. Therefore, it should earn a return.

In its testimony, TURN places CWIP into categories: (1) the CWIP projects necessary for safe operation of the plant in a discontinued state; and (2) the CWIP projects not required for continued safe operation. The second category is further broken out by those started before January 30, 2012 and those started after January 30, 2012.[15] For the first category (necessary for safe operation), TURN would permit recovery using an allowance for funds used during construction (AFUDC) rate and ROR equal to the cost of debt. For those projects started before January 30, 2102 but are not required for continued safe operation, TURN would allow recovery (over 5 years) of the costs, but would deny the recovery of AFUDC.[16]

While TURN generally acknowledges that it is appropriate to recover the costs placed into CWIP, its recommendation for no AFUDC recovery for non-operating CWIP and a reduced AFUDC for CWIP needed for continued operation is not appropriate and unsubstantiated. The funding for CWIP was provided upfront by utility investors who should be fairly compensated for the use of these funds. The application of AFUDC has been a long-standing practice recognized and approved by the Commission in prior GRCs.

SDG&E's proposal is aligned to Commission practice. SDG&E proposes that CWIP categorized in a "used and useful" category receive the rate-based recovery[17] once the assets are placed into service. For CWIP categorized into a "retired" category, SDG&E requests that these balances immediately transfer to the retired SONGS plant account and be recovered as prescribed in Section III.C of my direct testimony.[18]

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[15] TURN-Marcus, p. 5.

[16] TURN defers addressing recovery of CWIP projects after January 30, 2012 to a later phase of this proceeding.

[17] SDG&E-18-A, p. 4-5.

[18] SDG&E-18-A, p. 5-7.

## V. MATERIALS AND SUPPLIES (M&S) COSTS SHOULD BE RECOVERED AS PART OF ASSETS USED AND USEFUL FOR PLANT OPERATIONS

DRA recommends that M&S inventory be disallowed for recovery since the SONGS plant is no longer in operation. This is the extent of the explanation that DRA provides to justify such a recommendation. In reaching its conclusion, DRA ignores the regulatory accounting treatment of M&S as used and useful assets and the historical need to provide continuous replenishment of smaller parts and items used for the operation of the units. As described in my testimony, SCE has identified a portion of the M&S that will be needed for ongoing activities. The remaining M&S can be redeployed or sold to third parties. It is therefore appropriate to recover the remaining M&S inventory over the same period as the other used and useful assets, with a reduction in the revenue requirement for any salvage proceeds.

TURN acknowledges that M&S should be permitted for recovery (over the remaining license period) although without a return or alternatively, zero return on equity. A full ROR comprising both the cost of debt and equity financing as proposed by SDG&E is appropriate since these M&S items have been supporting SONGS operations when the unit was in service, and because a portion of M&S will continue to support ongoing operations during decommissioning. TURN proposes a sharing mechanism (95% ratepayer and 5% shareholder) for the proceeds from salvage efforts. SDG&E does not oppose this mechanism, assuming the full recovery of the M&S costs are approved.

## VI. SDG&E SHOULD CONTINUE TO RECEIVE 100% RECOVERY OF O&M EXPENSES BILLED FROM SCE THROUGH ITS BALANCING ACCOUNT MECHANISM

In its testimony, DRA proposes that the utilities should be permitted to recover only 75% of their recorded O&M from June 1, 2013 through December 31, 2014.[19] DRA fails to provide a basis in law or fact for its proposal.

DRA's recommendation also fails to recognize that SCE and SDG&E have two different mechanisms for recovering O&M. Since SCE manages the O&M at the SONGS facility and separately bills SDG&E for its share of the costs, SDG&E has utilized the SONGS O&M balancing account (SONGSBA) since 2007 to record the actual costs billed from SCE against authorized revenues in rates. This ensures SDG&E customers only pay for the cost billed to SDG&E from SCE. As SCE reduces the O&M costs at SONGS, these savings will pass directly

[19] DRA-3, p. 10.

back to SDG&E customers through the balancing account. In addition, if decommissioning trust funds are used to cover any of these O&M costs, SDG&E's Trust fund will reimburse the SONGSBA for the relevant costs and SDG&E would reduce the amount of O&M otherwise recovered through the SONGSBA. For example, if severance costs are initially balanced through the SONGSBA and decommissioning funds later become available, SDG&E would reverse the postings of these costs in the SONGSBA.

## VII. SDG&E'S PROPOSED RATES OF RETURN AND AMORTIZATION PERIODS FOR USED AND USEFUL AND RETIRED PLANT RECOVERY ARE REASONABLE

Even in the areas where DRA allows for recovery of costs associated with the remaining SONGS investment, DRA denies any return on those costs. TURN generally takes the position that any cost recovery should be coupled with no return or a ROR that contains no return on equity. As described above in this rebuttal testimony and at length in my direct testimony, allowing no return on the recovery of the remaining SONGS investment denies utility investors a fair opportunity to recover their investment for a facility that has served to the benefit of the utility customers for 30 years. The various elements of the SONGS investment have been approved as prudent and reasonable investments in a succession of prior Commission decisions and recovery of these costs has afforded SDG&E the ability to maintain strong credit ratings to continue to attract capital at the lowest possible rates. In fact, setting an overall ROR equal to zero not only provides no return for the common equity holders, it further punishes them by actually producing a negative return on equity component (-4.68% for SDG&E[20]) since common investors would still be required to pay the combined long-term debt and preferred stock return – an obligation that still exists whether or not the SONGS assets are in rate base. Additionally, allowing a form of return, typically a reduced return for recovery of retired assets, has been a consistent practice in previous Commission outcomes associated with assets removed from service. TURN's alternate proposal for a ROR with no return on equity provides for the servicing of costs to the debt and preferred holders, but provides zero return to the common equity holders who should be fairly compensated at the level of the debt and preferred holders. SDG&E's proposal for the 5.07% reduced ROR for retired SONGS plant provides for a fair

[20] Reflects weighted returns of 2.26% and 0.17% for long-term debt and preferred stock, respectively, and a 52% common equity ratio, which were adopted in D.12-12-034.

return and is reasonable given the accelerated recovery of the assets. For plant that continues to be used and useful, full authorized return is appropriate as long as those assets continue to support operations and are being recovered over the life of the license period.

As it relates to the appropriate amortization period, TURN proposes that the period of amortization for a significant portion of the assets it permits for recovery should be over the original license life (2022), but at no return or no return on equity. This recommendation penalizes the utility investor and contradicts the basic premise, which has consistently been applied in prior Commission decisions, that the rate of return should comport with the amortization period. If the amortization period is through the expected life of the asset, then the return should align with the full authorized return. If the amortization period is shortened, a reduced rate of return, consistent with the return proposed by SDG&E, would be appropriate.

## VIII. EFFECTIVE DATE OF REVENUE REQUIREMENT SHOULD BE JUNE 1, 2013, WHICH COINCIDES WITH DECISION TO CLOSE SONGS UNITS 2 AND 3

TURN recommends that the effective date of the revenue requirement change for the removal of SGRP costs should be January 30, 2012 (approximate start of the outages) and that the effective date for the revenue requirement change for the non-SGRP components should be November 30, 2012, which generally comports with the California Public Utilities Code (P.U. Code) Section 455.5 (nine-month) period from the start of the outages. DRA asserts that the effective date of the revenue requirement change should be November 1, 2012, generally aligning it with the Section 455.5 period commencement for Unit 3. SDG&E disagrees with these interpretations and instead reads Section 455.5 to direct the Commission to examine the situation after nine months from when the outage commenced and leaves final determination to the Commission based on its investigation. The appropriate effective date for the removal from rate base for the retired assets should be the point when all measures to bring the plant back into service had been exhausted and that a final determination had been made by the plant operator (SCE) to permanently shut down the facility. TURN's proposal to remove SGRP from rate base at around the time the outages began (January 30, 2012, for Unit 3) preempts even the Section 455.5 period and ignores any and all efforts made by SCE to bring the units back into service up until June of 2013. For reasons described in my direct testimony, the effective date of June 1, 2013, the first day of the month when SCE announced the closure, is the appropriate point in time when the SONGS assets were no longer considered operational for ongoing service to customers.

## IX. CONCLUSION

As explained above, DRA's recommendation to deny recovery of a substantial portion of the remaining SONGS investment, including the entire portion of SGRP, CWIP and M&S and 25% of other non-SGRP is unreasonable, unsupported, and contrary to prior Commission practice. DRA's denial of any return on the portions of investment it does permit for recovery precludes utility investors from a fair reimbursement of return for capital they have advanced to fund a long-serving asset for the benefit of utility customers. TURN's proposal provides for a more reasonable recovery of the SONGS investment than DRA, but similarly denies a fair return, even in the case of its proposed alternate return that contains no return on equity. SDG&E's proposal for recovery of its share of the remaining SONGS investment at full return for assets continued to be used and useful and at a reduced return for the accelerated recovery of retired assets is reasonable for both utility customers and investors and is consistent with established Commission policy. DRA's and TURN's positions for the effective dates for removal of SONGS assets from rate base are not directed by P.U. Code Section 455.5 as they infer. More appropriately, the date should correspond to the point in time where it was determined that the assets could no longer be returned to service (June 1, 2013).

This concludes my prepared rebuttal testimony.