

Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2020 Cost of Capital
Application: A.19-04-017
Exhibit: SDG&E-12 Chapters 1 and 2

SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)
PREPARED REBUTTAL TESTIMONY OF CONCENTRIC ENERGY ADVISORS
(WILDFIRE RISKS POST-AB 1054)

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



A  Sempra Energy utility®

August 21, 2019

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AND JAMES M. COYNE
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1 **SAN DIEGO GAS & ELECTRIC COMPANY**
2 **PREPARED REBUTTAL TESTIMONY JOHN J. REED AND JAMES M. COYNE**

3 **I. INTRODUCTION**

4 **Q. Please state your names, affiliation, and business address.**

5 **A. My name is John J. Reed. I am Chairman and Chief Executive Officer (“CEO”) of**
6 **Concentric Energy Advisors, Inc. (“Concentric”) and CE Capital, Inc.**

7 My name is James M. Coyne, and I am Senior Vice President of Concentric
8 Energy Advisors, Inc.

9 **Q. On whose behalf are you testifying?**

10 **A. We are submitting this Rebuttal Testimony on behalf of San Diego Gas & Electric**
11 **Company (“SDG&E” or the “Company”), a subsidiary of Sempra Energy (“Sempra”), a**
12 **publicly traded holding company.**

13 **Q. Have you previously provided testimony in this proceeding?**

14 **A. Yes. We provided Direct Testimony on April 22, 2019 and Supplemental Direct**
15 **Testimony on August 1, 2019.**

16 **II. PURPOSE AND OVERVIEW**

17 **Q. What is the purpose of your Rebuttal Testimony?**

18 **A. Our rebuttal testimony addresses the evidence presented by the intervening parties**
19 **regarding our supplemental testimony and the risks associated with wildfire liabilities and**
20 **the effect of Assembly Bill 1054 (“AB 1054”) on the risk profile of SDG&E and the**
21 **appropriate adjustment to its authorized return on equity (“ROE”). We respond to the**
22 **direct testimonies of Mr. Michael P. Gorman on behalf of Energy Producers & Users**
23 **Coalition (“EPUC”), Indicated Shippers, and The Utility Reform Network (“TURN”),**
24 **Mr. Karl Richard Pavlovic on behalf of Utility Consumers’ Action Network (“UCAN”)**

1 and Protect Our Communities (“POC”), Dr. Richard McCann on behalf of the
2 Environmental Defense Fund (“EDF”), Mr. Kevin W. O’Donnell on behalf of the Federal
3 Executive Agencies (“FEA”), and the County of San Diego (collectively “intervening
4 witnesses”) submitted on August 1, 2019 and August 16, 2019, with respect to the risks
5 associated with wildfire liabilities and proposed allowed ROE for SDG&E following the
6 passage of AB 1054.

7 **Q. What are your key conclusions and recommendations ?**

8 **A. Our key conclusions are as follows:**

- 9 • Prior to the passage AB 1054, our analysis identified a wildfire risk
10 premium in the range of 1.87 to 6.50 percent. We concluded that a risk
11 premium of 3.4 percent best represented the wildfire liability risk borne by
12 SDG&E’s shareholders. In our Supplemental Direct Testimony, we have
13 updated our analysis to reflect the implementation of AB 1054, in contrast
14 to the California legislative and regulatory mechanisms in force at the time
15 of our Direct Testimony. Based on our updated analysis, we recommend
16 an ROE adjustment in the range of 1.23 to 1.72 percent, and a midpoint of
17 these results of 1.48 percent. We continue to recommend the risk
18 adjustment presented in our Supplemental Direct Testimony, reflecting the
19 impacts of AB 1054, in combination with Dr. Morin’s estimated ROE, as
20 it provides a fair and reasonable ROE for SDG&E’s shareholders.

- 21 • We are not suggesting a separate wildfire premium in our analysis that is
22 outside the scope of traditional regulatory finance. Instead, our analysis
23 supports SDG&E’s aggregate ROE proposal. Wildfire liabilities
24 distinguish the Company’s financial, business, and regulatory risks
25 relative to Dr. Morin’s proxy group. Dr. Morin’s proxy group does not
26 include any other companies that are subject to the same level of
27 business risk associated with catastrophic wildfire liabilities as the
28 Company, nor the regulatory risk associated with the inability to recover
29 liabilities that California utilities are subject to under the doctrine of
30 inverse condemnation. Our approach to measurement of incremental risk
31 to help inform the Company’s overall ROE recommendation is entirely
32 consistent with the scope of this proceeding.

- 33 • In deriving our estimate of the appropriate risk adjustment, we place most
34 weight on the Estimated Loss Approach, the Insurance Approach, and the
35 CAT Bond Approach. None of the intervening witnesses provided an
36 alternative view to these market-based analyses of the risk borne by
37 shareholders.

1 • Some of the intervening witnesses suggest that AB 1054 has eliminated
2 the shareholder risks associated with wildfire liabilities. With the
3 enactment of AB 1054, the shareholder risks we identified in our Direct
4 Testimony have been reduced, but not eliminated. There remain
5 significant uncertainties as to the degree to which shareholders will be
6 responsible for any future wildfire-related liabilities, and we have taken
7 this into account in our updated recommendation.

8 • Some of the intervening witnesses suggest that the risk adjustment should
9 be set aside to fund future wildfire liabilities. However, the adjustment to
10 the Company's ROE is not intended to fund wildfire liabilities. Rather it
11 is intended to measure investors' expectations and offer a reasonable
12 return to investors for the risk that they will be subject to unrecoverable
13 costs associated with wildfire liabilities. The same is true for the equity
14 return in general; it is an estimate of the appropriate return to investors for
15 bearing the risk of investing in a utility's common stock. In effect,
16 shareholders are self-insuring for all wildfire liabilities that are not
17 recoverable through insurance, AB 1054's "Wildfire Fund," or rates, and
18 require a return willing to bear this risk.

19 **Q. Do any of the intervenor witnesses provide support for an ROE adjustment related**
20 **to the risks associated with wildfire liabilities?**

21 **A. Yes, Mr. O'Donnell suggests that a 50 basis point adjustment is appropriate for SDG&E**
22 **unless the State of California implements a plan to reverse inverse condemnation.¹ Since**
23 **AB 1054 did not directly address the issue of inverse condemnation, and there has been**
24 **no subsequent legislation, this risk remains.**

25 Mr. Gorman appears to select the upper end of his range as his final ROE
26 recommendation for SDG&E in recognition of "a wildfire ROE premium."² However,

¹ *Direct Testimony and Exhibits of Kevin W. O'Donnell, CFA, on behalf of The Federal Executive Agencies* (August 1, 2019) ("FEA Aug. 1 Testimony (O'Donnell)") at 64:17-18; *Direct Testimony of Kevin W. O'Donnell, CFA, on behalf of The Federal Executive Agencies Regarding the Applicants' Supplemental Testimony* (August 16, 2019) ("FEA Aug. 16 Testimony (O'Donnell)") at 30:2-3.

² *Direct Testimony and Exhibits of Michael P. Gorman on behalf of Energy Producers & Users Coalition ("EPUC"), Indicated Shippers, and The Utility Reform Network ("TURN")* (August 1, 2019) ("TURN Aug. 1 Testimony (Gorman)") at II-5 (Table 4) and Chapter II, Exhibit MGP-3. Mr. Gorman only testifies on behalf of TURN regarding SDG&E's application.

1 his calculation of a 65 basis point ROE adjustment is based on incremental debt costs,
2 and therefore, an incomplete measure of the risks borne by equity investors.³

3 Nonetheless, Mr. Gorman includes an ROE adjustment for the risks associated with
4 wildfire liabilities, subsequent to the passage of AB 1054, in his final recommendation.

5 In addition, Dr. McCann observes that the share prices for the holding companies
6 of the California utilities decreased significantly in 2017 and 2018. While we take issue
7 with Dr. McCann's analytical approach, we observed a similar change in the share prices
8 of Edison International and Pacific Gas and Electric Corporation ("PG&E Corp.") in our
9 Direct Testimony. And based on that change in share prices, we can conclude that
10 investors increased their return requirements for California utilities at that time.

11 While Mr. Rothschild contends that wildfire risk should not impact the ROE, and
12 further analysis is required with regard to Beta coefficients, he observed "that Edison
13 International's option-implied beta has increased since the Camp Fire."⁴ Edison
14 International's primary operating subsidiary is Southern California Edison Company
15 ("SCE"), which operates exclusively in the State of California, suggesting that investors
16 have increased their return requirements relative to the broader market since the 2018
17 Camp Fire.

18 **Q. How is the remainder of your Rebuttal Testimony organized?**

19 **A. The remainder of our Rebuttal Testimony is organized as follows:**

³ TURN Aug. 1 Testimony (Gorman) at V-10:11 to V-11:8.

⁴ A. Rothschild, *Report on the Cost of Capital Test Year 2020* on behalf of the Public Advocates Office, California Public Utilities Commission (August 1, 2019) ("Cal PA Aug. 1 Testimony (Rothschild)") at 50:7-8. All references to Mr. Rothschild's testimony are to the redacted version unless otherwise specified.

1 In Section III, we respond to the testimony of EPUC, Indicated Shippers, and
2 TURN witness, Mr. Gorman;

3 In Section IV, we respond to the testimony of UCAN and POC witness, Mr.
4 Pavlovic;

5 In Section V, we respond to the testimony of EDF witness, Dr. McCann;

6 In Section VI, we respond to the testimony of FEA witness, Mr. O'Donnell;

7 In Section VII, we respond to the testimony of the County of San Diego; and

8 In Section VIII, we summarize our conclusions and recommendations.

9 **III. RESPONSE TO MR. GORMAN**

10 **Q. Please summarize Mr. Gorman's testimony and recommendations as they relate to**
11 **the assessment of risks associated with wildfire liabilities.**

12 **A. Mr. Gorman concludes that legislative actions, including Senate Bill 901 ("SB 901") and**
13 **AB 1054, as well as "policy signals" from Governor Newsom and California Public**
14 **Utilities Commission ("Commission" or "CPUC") actions have fully mitigated**
15 **shareholder risk from liabilities associated with California wildfires.⁵ Mr. Gorman also**
16 **disagrees with the relevance of CAT Bond pricing as a measure of shareholder risk to**
17 **wildfire liabilities.⁶ Further, Mr. Gorman proposes an alternative proposal to adjust the**
18 **Base ROE if the Commission recognizes "any wildfire risk unique to California," based**
19 **on an analysis of credit spreads.⁷ Mr. Gorman's analysis suggests an incremental**
20 **adjustment of 0.65 percent (65 basis points) is the maximum incremental ROE**

⁵ TURN Aug. 1 Testimony (Gorman) at V-1:14-16.

⁶ *Id.* at V-7:10-18.

⁷ *Id.* at V-10:5 to V-11:8.

1 adjustment “to a California utility to compensate it for wildfire damage cost risk, inverse
2 condemnation rule risk, or other risk of operating under conditions caused by extreme
3 weather and natural disaster events.”⁸

4 **Q. What are your primary areas of disagreement between you and Mr. Gorman?**

5 **A.** We take issue with Mr. Gorman on a number of points: (1) the effect of legislative and
6 regulatory policies on shareholder risk; (2) how the CAT Bonds provide relevant pricing
7 data that serves as a suitable proxy to determine how to measure the cost associated with
8 the risk of financial exposure to wildfire liabilities; and (3) whether risk adjustment
9 measures based on debt costs provide sufficient information to be applied to the risks to
10 which equity shareholders are exposed.

11 **A. The Effects of Regulatory and Legislative Actions on the Company’s Risk**
12 **Profile**

13 **Q. Does the Assigned Commissioner’s Scoping Memo and Ruling suggest that there**
14 **should be no adjustment to the Company’s Base ROE?**

15 **A.** Mr. Gorman points to the ACR issued July 2, 2019, and to the determination that “[t]he
16 Commission will not consider a separate wildfire adder in the scope of this proceeding”⁹
17 to conclude that the Commission will reject any proposal to address this risk through a
18 separate risk premium.¹⁰ However, the ACR clearly states that “[a]dditional risk factors,
19 including financial, business, and regulatory risks, that should be considered in setting the
20 utilities’ authorized return on equity” are within the scope of this proceeding.¹¹ On July

⁸ *Id.* at V-11:4-6.

⁹ *Assigned Commissioner’s Scoping Memo and Ruling* (July 2, 2019) (“Scoping Ruling”) at 3.

¹⁰ TURN Aug. 1 Testimony (Gorman) at V-1:5-6.

¹¹ Scoping Ruling at 3.

1 8, 2019, Administrative Law Judge (“ALJ”) Stevens found as “reasonable” SCE’s
2 interpretation of the scoping memo as establishing “that while the Commission will not
3 consider a separate, stand-alone return on equity (ROE) adder for wildfire risk, it will
4 consider wildfire risk among the many risks when determining an authorized ROE. We
5 [SCE] also understand the utilities’ overall ROE requests—which reflected all risks
6 including wildfire risk—to remain pending before this Commission.”¹²

7 To be clear, the risks associated with wildfire risks are not a separate and distinct
8 risk that fall outside the scope of traditional regulatory finance. These risks may have
9 their origin in the risk of a wildfire occurring. But they manifest themselves as risks to
10 shareholders through the process of allowing or disallowing cost recovery for these
11 liabilities. In this regard, they are no different than risks arising from many other external
12 events. While the wildfire liabilities affect the California investor-owned utilities in a
13 manner unlike companies operating in other jurisdictions, these risks can be captured
14 within a cost of capital framework familiar to regulators. Wildfire liabilities distinguish
15 the Company’s financial, business, and regulatory risks relative to Dr. Morin’s proxy
16 group. Dr. Morin’s proxy group does not include any other companies that are subject to
17 the same level of business risk associated with catastrophic wildfire liabilities as the
18 Company, nor the regulatory risk associated with inability to recover liabilities that
19 California utilities are subject to under the doctrine of inverse condemnation. While
20 these risks are based on shareholders’ exposure to wildfire liabilities, the ultimate
21 recommendation of Mr. Folkmann is determined with Dr. Morin’s Base ROE

¹² ALJ Stevens July 8, 2019 email to service list in A.19-04-014, *et al.* in response to July 5, 2019 email from C. Torchia to ALJ Stevens and service list.

1 recommendation, and an adjustment for financial, business, and regulatory risks
2 incremental to the risk profile of the proxy companies contained in Dr. Morin's analysis.
3 Our approach to measurement of incremental risk and the Company's overall ROE
4 recommendation is entirely consistent with the scope of this proceeding.

5 **Q. Do you agree with Mr. Gorman that recent legislative actions fully mitigate**
6 **shareholder risks arising from California wildfires?**

7 **A. No. As described throughout our Supplemental Direct Testimony, with the enactment of**
8 **AB 1054, the shareholder risks we identified in our Direct Testimony have been reduced,**
9 **but not eliminated. The primary benefits to shareholders from AB 1054 are: (1) a**
10 **revised prudence standard; and (2) establishing a cap on wildfire related expenses that**
11 **have been found to be imprudently incurred. However, there remain significant**
12 **uncertainties as to the degree to which shareholders will be responsible for any future**
13 **wildfire-related liabilities. In particular, uncertainty remains as to how the revised**
14 **prudence standard will be applied,¹³ and when the Wildfire Fund will be exhausted and**
15 **unable to fund claims in excess of the liability cap.¹⁴ Accordingly, we updated our risk**
16 **assessment using the three primary methodologies utilized in our Direct Testimony to**

¹³ Moody's, *San Diego Gas & Electric Company: Update following outlook change to positive*, dated Aug. 2, 2019 ("Moody's Aug. 2 Report") at 5 ("The application of this revised prudency standard by the CPUC in a credit supportive manner would likely strengthen our view of the credit supportiveness of the regulatory environment in California. However, this is likely to take some time as it remains to be seen how challenging it will be for the intervenors to create serious doubt, an undefined term and subject to the CPUC's interpretation."); S&P Global Ratings, *San Diego Gas & Electric Co. Ratings Affirmed, Outlook Revised to Stable from Negative*, dated July 30, 2019 ("S&P July 30 Report") at 2 ("If the [C]ommission does not implement AB 1054 in a credit-supportive manner then much of the new law's credit-supportive elements related to the revised standards of a utility's reasonable conduct could potentially be negligible.").

¹⁴ S&P July 30 Report at 1-2 (noting that, if the wildfire fund is exhausted, SDG&E "loses the credit benefit of using the [wildfire] fund as a source of liquidity and more importantly loses the credit protection of the liability cap," leaving only the revised prudence standard).

1 revise our estimate of an incremental risk adjustment to 1.48 percent, representing a 57
2 percent reduction from our original estimate to reflect the risk mitigating provisions and
3 the uncertainty of its future application.

4 **Q. Does the revised prudence standard suggest that shareholders will be protected**
5 **from wildfire liabilities if they exercise prudent management?**

6 **A. It is not clear how the Commission will apply the new prudence standard in future cost**
7 **recovery proceedings. The CPUC denied SDG&E recovery of all the costs associated**
8 **with the 2007 wildfires in the Company’s Wildfire Expense Memorandum Account**
9 **(“WEMA”) application, but the Federal Energy Regulatory Commission (“FERC”)**
10 **approved SDG&E’s recovery of all FERC-jurisdictional costs associated with the same**
11 **fires. This demonstrates that a prudence standard is subject to interpretation, and the**
12 **CPUC standard has been materially different from other jurisdictions.¹⁵ AB 1054 revises**
13 **the prudence standard. But even the Filsinger Wildfire Fund Durability Analysis**
14 **(“Filsinger Report”), produced by an expert retained by Governor’s Newsom’s office,**
15 **suggests that the effect of the new prudence standard will change over the course of ten**
16 **years with a 75 percent likelihood of an imprudence finding in the first year, and a 25**
17 **percent likelihood of an imprudence finding in the tenth year – indicating that the revised**
18 **prudence standard may be applied in a different manner than at FERC. Mr. Gorman**
19 **contends that “[t]he state, including this Commission, has given very strong indications**
20 **that shareholders will be protected from the risk of bearing wildfire costs that do not**

¹⁵ See *Prepared Rebuttal Testimony of Bruce A. Folkmann, Policy Overview* (August 16, 2019) (“Ex. SDG&E-07 (Folkmann Rebuttal)”) at 7:13-9:5.

1 result from imprudent management.”¹⁶ However, he provides no basis for this “strong
2 indication,” and we see no evidence that credit or equity analysts agree that risk to
3 shareholders has been eliminated. While we would agree that there is an increased
4 likelihood that the prudence standard will be applied in a manner more consistent with
5 other jurisdictions, we revised our analyses in our Supplemental Direct Testimony to
6 reflect the remaining risk that still exists.

7 **Q. Do you agree with Mr. Gorman that the proxy companies used to measure the Base**
8 **ROE “capture the universal concept that utilities are not allowed to recover costs**
9 **that are the result of imprudent management”¹⁷?**

10 **A. While I agree that all utilities are not allowed to recover costs associated with imprudent**
11 **management, I disagree that the standard of “imprudent management” is applied**
12 **consistently across all jurisdictions. Mr. Gorman contends that “the prudent management**
13 **standard is a risk of investing in utilities, reflected in observable utility stock valuations,**
14 **and therefore it is already included in the measurement of a fair Base ROE that is derived**
15 **from market data applied to comparable risk samples.”¹⁸ However, this ignores that each**
16 **jurisdiction’s interpretation of the “prudent management standard” varies. As previously**
17 **mentioned, we have direct evidence that the Commission’s standard of “prudent**
18 **management” has deviated from FERC, as demonstrated in the Company’s WEMA**

¹⁶ TURN Aug. 1 Testimony (Gorman) at V-2:8-10.

¹⁷ *Id.* at V-3:11-13.

¹⁸ *Id.* at V-3:20-23.

1 application.¹⁹ The Commission's precedent creates an incremental regulatory risk
2 relative to the standard applied in other jurisdictions, and therefore demonstrates that this
3 risk is not reflected in Dr. Morin's proxy group companies. Further, the greater
4 frequency and magnitude of wildfires in California in high population centers exposes
5 SDG&E and the state's other electric utilities to greater exposure, even if the same
6 standards for prudence were applied.

7 Mr. Gorman states that if there is a specific utility that experiences a higher
8 likelihood of wildfire liabilities, investors may avoid this risk "by simply investing in a
9 different utility company or by removing management that fails to conduct itself in a
10 prudent manner."²⁰ That does not eliminate the need for assessing the higher return
11 requirement that the Company faces to attract needed capital, given that the Company
12 cannot "avoid" this risk by simply choosing to invest elsewhere. For a utility operating in
13 California, an investor would require a higher return to invest in a company that
14 experiences a higher likelihood of wildfire liabilities, and a greater risk of disallowance
15 of cost recovery for these liabilities, relative to the alternative. The risks associated with
16 wildfire liabilities are a combination of frequency and magnitude of exposure,
17 management actions, and a Commission's interpretation of what constitutes a utility that
18 "conducts itself in a prudent manner." Therefore, you could have two companies that
19 conduct themselves in the same manner but operate in different jurisdictions with
20 different exposures and interpretations of what constitutes "prudent management." In that

¹⁹ See Moody's, *FAQ on the credit implications of California's new wildfire law*, dated August 6, 2019 ("Moody's Aug. 6 Report") at 4 (discussing the different application of prudence review between jurisdictions).

²⁰ TURN Aug. 1 Testimony (Gorman) at V-4:8-10.

1 case, the exposure to wildfire liabilities is a product of the regulatory environment, and
2 therefore represents a regulatory risk that is beyond the company's control. A pertinent
3 example of this is SDG&E. The Company has a highly regarded wildfire mitigation
4 program and has not been involved in a substantial wildfire since 2007. Yet it has
5 experienced multiple credit rating downgrades and a higher cost of equity because of the
6 overall regulatory environment.

7 As such, investors would require a higher return for the company with such an
8 incremental regulatory risk. While the revised prudence standard in AB 1054 is expected
9 to reduce the incremental risk relative to precedent, the application remains uncertain,
10 and therefore investors still require a higher return to invest in California utility
11 companies. As discussed above, investors in SDG&E must be awarded a fair and
12 reasonable return for the actual risks they bear.

13 **B. Relevance of CAT Bond Pricing Information**

14 **Q. Please describe Mr. Gorman's basis to conclude that CAT Bonds are an inadequate**
15 **measure of the risks associated with wildfire liabilities.**

16 **A. Mr. Gorman concludes that CAT Bonds are not comparable to the measure of the equity**
17 **return investors require for the risks associated with wildfires, explaining that "If the debt**
18 **interest on these Cat Bonds were included in cost of service, then the utility would have**
19 **the bond principal set aside in a trust fund as an insurance reserve that could be used to**
20 **pay wildfire damage claims."**²¹ **But this is directly analogous to the ROE adjustment we**
21 **have proposed. If wildfire liabilities exceed the Company's insurance coverage,**
22 **shareholder funds will be required to pay the wildfire damage claims. As such, the only**

²¹ *Id.* at V-5:8 to V-6:23.

1 distinction is whether investors in CAT Bonds are required to pay wildfire damage
2 claims, or investors in the Company's equity are required to pay wildfire damage claims.
3 Mr. Gorman suggests it is appropriate to include the debt interest on CAT Bonds in the
4 Company's cost of service to compensate investors in CAT Bonds for their exposure to
5 wildfire liabilities. This is of course true, since the CAT bonds are essentially a
6 supplemental form of insurance. However, he fails to explain why it is not appropriate to
7 include an adjustment to the ROE for shareholders for the same exposure to wildfire
8 liabilities above the level covered by the combination of CAT bonds and insurance.

9 The Company uses a CAT Bond as part of its insurance liability coverage to
10 mitigate the risk of its wildfire liabilities, and the Company has included the debt interest
11 costs associated with this in its cost of service. Shareholders bear the risk for all
12 liabilities above the utility's insurance liability coverage. As a practical matter, the
13 Company is seeking to compensate shareholders for this incremental risk and include it in
14 its cost of service through an authorized ROE based on the same principles by which it
15 recovers the interest costs associated with its CAT Bond.

16 **Q. Does an ROE adjustment create "the potential for shareholder windfalls" that Mr.**
17 **Gorman describes?**²²

18 **A.** No, it does not, any more than paying an insurance premium creates a potential windfall
19 for the insurer. The ROE adjustment provides an adequate return for the risks borne by
20 shareholders associated with wildfire liabilities. The ROE adjustment is not intended to

²² *Id.* at V-6:3-23.

1 “prefund financial liabilities that might or might not occur.”²³ Instead, the ROE
2 adjustment is intended to compensate investors for the real risks they are required to bear.

3 Again, this is analogous to the CAT Bond example that Mr. Gorman describes.
4 Investors in a CAT Bond commit capital that will be used to fund wildfire liabilities if
5 wildfire liabilities are incurred. For that risk, CAT Bond investors are compensated with
6 a return. If there is a wildfire, investors would keep interest earned up to that point, and
7 lose their principal as it will be used to fund wildfire liabilities. If there is no wildfire,
8 investors would keep the interest earned, and retain their principal. Similarly, under the
9 proposed ROE adjustment, investors are retaining only the return on invested capital, and
10 shareholders bear the risk of funding wildfire liabilities if there is a wildfire. To be clear,
11 the Company has not proposed any opportunity for shareholders to retain funds intended
12 to “prefund financial liabilities” as Mr. Gorman has described. The ROE adjustment is
13 not intended to create a reserve account, but instead to provide shareholders with an
14 appropriate return for shareholders to bear the risk of future wildfire liabilities.

15 **Q. Do the regulatory mechanisms contained in AB 1054 change the risks to which**
16 **shareholders are exposed?**

17 **A. Yes, as described in detail in our Supplement Direct Testimony, AB 1054 contains**
18 **elements that mitigate, in part, risks associated with wildfire liabilities. However, we**
19 **disagree with Mr. Gorman’s assertion that the measures adopted under the policy**
20 **framework in AB 1054 “combine to leave shareholders with very little risk – arguably**
21 **less risk than they have had historically.”²⁴ While the measures contained in AB 1054**

²³ *Id.* at V-6:7.

²⁴ *Id.* at V-8:19-20.

1 provide protections that leave shareholders with a lower level of risk than they had
2 immediately before its enactment, there remains a considerable level of risk above what
3 investors experienced prior to: 1) the increased prevalence of wildfires; 2) the
4 application of the doctrine of inverse condemnation applied to investor-owned utilities;
5 and 3) the CPUC's divergence from FERC in its prudence finding in SDG&E's WEMA
6 application.

7 **C. The Relevance of Debt Costs as an Estimate of Equity Investor Risk**

8 **Q. Please describe Mr. Gorman's proposed estimate of an appropriate ROE
9 adjustment for risks associated with wildfire liabilities.**

10 **A. Mr. Gorman observes that the credit ratings of California utilities were decreased by one
11 to three notches between 2017 and 2019. On that basis, he concludes that the spread
12 between A-rated utility bonds and Baa-rated utility bonds (a three notch difference)
13 "should be used as a ceiling on the increment for an authorized ROE available to a
14 California utility to compensate it for wildfire damage cost risk, inverse condemnation
15 rule risk, or other risk of operating under conditions caused by extreme weather and
16 natural disaster events." Mr. Gorman estimates this ROE adjustment to be 0.65 percent
17 (65 basis points).²⁵**

18 **Q. Do you agree with Mr. Gorman's analysis of debt costs as an appropriate measure
19 for the risks to equity investors?**

20 **A. No, we do not. To the extent the Company's debt costs have increased over the last three
21 years as a result of increased risks to debt investors, those are appropriate to reflect in the
22 Company's cost of debt. However, these are an incomplete measure of the risks borne by**

²⁵ *Id.* at V-10:11 to V-11:8.

1 equity investors, and therefore have limited relevance in measuring the incremental cost
2 of equity to shareholders. In part, this is because the credit rating agencies clearly
3 anticipated that some form of wildfire liability relief would be enacted and held off on
4 further downgrades of California utility debt until the degree of relief was known.²⁶

5 In addition, the risks faced by debt-investors and equity-investors are
6 fundamentally different. While wildfire liabilities may cause a change in a company's
7 credit rating, and its cost of debt, this does not capture that risk borne by shareholders.
8 Credit ratings are intended to measure the likelihood that a company will meet its debt-
9 payment obligations, and debt investors require a return commensurate with the risk that
10 the company will fail to meet that obligation. However, equity investors bear the residual
11 risk associated with ownership, and have a claim on cash flows only after debt holders
12 are paid. As such, debt and equity securities are exposed to different risks, and therefore
13 require different returns. Virtually all shareholder equity can be eroded prior to any
14 losses to debt holders due to their respective seniority. Equity financing carries no
15 repayment obligation and is therefore much riskier than a debt investor's position. In the
16 case of wildfire liability claims, it is shareholders who are ultimately responsible for
17 liabilities in excess of the company's insurance coverage or any insurance funds made
18 available through AB 1054.

²⁶ See, e.g., S&P Global Ratings, *Credit FAQ: Will California Still Have an Investment-Grade Investor-Owned Electric Utility?*, dated Feb. 19, 2019 ("S&P Feb. 19 Report") ("[a]bsent concrete steps taken by regulators and/or politicians to reduce the risks for California's electric utilities, S&P Global Rankings could lower the ratings on Edison, SCE, and SDG&E by one or more notches – indicative of the possibility that the ICR on these companies could be below investment grade before the start of the 2019 wildfire season"), available at https://www.capitaliq.com/CIQDotNet/CreditResearch/RenderArticle.aspx?articleId=2168627&SctArtId=467165&from=CM&nsl_code=LIME&sourceObjectId=10866063&sourceRevId=14&fee_ind=N&exp_date=20290218-21:25:39.

1 **IV. RESPONSE TO MR. PAVLOVIC**

2 **Q. Please summarize Mr. Pavlovic's testimony and his conclusions related to the risks**
3 **associated with wildfire liabilities.**

4 **A. Mr. Pavlovic concludes that an adjustment to SDG&E's ROE does not account for, or**
5 **mitigate, the Company's catastrophic wildfire risk based on three assertions:**

- 6 (1) there is no quantifiable cost-causative nexus between SDG&E's
7 capital costs and operating expenses incurred due to catastrophic
8 wildfires and SDG&E's [*sic*] equity return on rate base that
9 supports such an adjustment;
- 10 (2) a wildfire adjustment to SDG&E's equity return would violate the
11 fundamental ratemaking principle that costs and expenses are only
12 recovered through rates after the costs and expenses have been
13 prudently incurred; and
- 14 (3) an adjustment to return on equity is not the form of mitigation
15 recommended by the rating agencies that have recently
16 downgraded SDG&E's credit ratings due to the perceived increase
17 in SDG&E's risk of catastrophic wildfires.²⁷

18 We respond to each of these points below.

19 **A. Catastrophic Events and Ratemaking Principles**

20 **Q. Do you agree with Mr. Pavlovic's comparison of SDG&E's exposure to wildfire**
21 **risks to other catastrophic events?**

22 **A. No. Mr. Pavlovic disagrees that catastrophic wildfires pose a unique risk relative to**
23 **utilities operating in other jurisdictions because "all utilities operate under the risk of**
24 **costs and expenses incurred due to catastrophic equipment/infrastructure failures and**

²⁷ *Prepared Reply Testimony and Direct Testimony of Karl Richard Pavlovic on Behalf of Utility Consumers' Action Network and Protect Our Communities Foundation, Cost of Capital* (August 16, 2019) ("UCAN Aug. 16 Testimony (Pavlovic)") at 2:20-3:16; *Prepared Direct Testimony of Karl Richard Pavlovic on Behalf of Utility Consumers' Action Network and Protect Our Communities Foundation, Cost of Capital* (August 1, 2019) ("UCAN Aug. 1 Testimony (Pavlovic)") at 4:1-10.

1 natural disasters”²⁸ However, the magnitude and frequency of these events in California
2 exceeds those in other jurisdictions,²⁹ and the doctrine of inverse condemnation magnifies
3 that risk by making utilities strictly liable for liability damages caused by their own
4 facilities, regardless of negligence and other causes.³⁰ In the examples of other
5 catastrophic events offered by Mr. Pavlovic (hurricanes, mudslides, tornadoes, hailstorms
6 and flooding), utilities’ financial exposure would be limited to utility assets affected by
7 the event, and expenses associated with restoring service. In these examples, the utilities
8 are not exposed to the total liabilities for all property damages affected by the
9 catastrophic event as is the case with wildfire damages under the doctrine of inverse
10 condemnation. Therefore, the magnitude of potential liabilities associated with wildfires
11 for utilities in California does not compare to the potential liabilities of utilities with other
12 catastrophic events.³¹

13 In addition, the CPUC’s divergence from FERC precedent in its prudence finding
14 for cost recovery of liabilities is unique relative to other jurisdictions. While Mr.
15 Pavlovic cites a total of \$306 billion in weather-related damages to the U.S. in 2017, he
16 does not identify what portion of these costs were costs borne by utility companies, and
17 of these costs, those not recoverable through rates.³²

²⁸ UCAN Aug. 1 Testimony (Pavlovic) at 5:6-8.

²⁹ See Moody’s Aug. 6 Report at 2.

³⁰ *Id.* at 2.

³¹ See S&P Feb. 19 Report, available at https://www.capitaliq.com/CIQDotNet/CreditResearch/RenderArticle.aspx?articleId=2168627&SctArtId=467165&from=CM&ns_l_code=LIME&sourceObjectId=10866063&sourceRevId=14&fee_ind=N&exp_date=20290218-21:25:39.

³² UCAN Aug. 1 Testimony (Pavlovic) at 5:12-15.

1 Q. Are utilities generally permitted to recover the costs associated with catastrophic
2 events through rates?

3 A. Generally, we agree with Mr. Pavlovic's characterization that "the capital costs and
4 operating expenses that constitute the remaining risk can be recorded as a regulatory asset
5 and then recovered from ratepayers via amortization in base rates and/or reconciling
6 surcharges."³³ While Mr. Pavlovic's clarifies that "[t]hese accounting and ratemaking
7 mechanisms are conditioned on the utility's having operated in a reasonable and prudent
8 manner,"³⁴ the determination of what constitutes a reasonable and prudent manner is
9 subject to each regulator's interpretation of that standard. Mr. Pavlovic contends that
10 because of AB 1054, "SDG&E's wildfire risk has been reduced to the residual risk of
11 disallowed costs due to unreasonable and imprudent operation."³⁵ As discussed above,
12 California's application of the prudence standard as it relates to wildfire liabilities has
13 been materially different from other jurisdictions. AB 1054 offers a revised prudence
14 standard, but it remains uncertain as to how that standard will be applied. As such, it is
15 uncertain as to whether SDG&E will be able to recover liabilities associated with
16 wildfires under the same standard that other jurisdictions would consider a reasonable
17 and prudent manner.

³³ *Id.* at 7:7-9.

³⁴ *Id.* at 7:14-15.

³⁵ *Id.* at 3:14-15.

1 **Q. How does the principle of cost causation apply to the ROE as it relates to wildfire**
2 **liabilities?**

3 **A. The determination of the adjustment to the Company's ROE for the risks associated with**
4 **wildfires is not a quantification of past costs incurred, but instead an estimate of the**
5 **incremental equity return required by investors to bear the risk associated with future**
6 **unrecoverable shareholder liabilities. If there are potential future shareholder liabilities,**
7 **this affects shareholders' return requirements. Mr. Pavlovic asserts, "[a]s regards the**
8 **issue of a wildfire risk adjustment to ROE, the quantitative probability of wildfire costs**
9 **being borne by shareholders is irrelevant."³⁶ All else equal, given the choice between a**
10 **company with a low probability of wildfire costs being borne by shareholders, and a**
11 **company with a high probability of wildfire costs being borne by shareholders, an equity**
12 **investor will have different return requirements for an investment in each company.**

13 Mr. Pavlovic concludes that "a wildfire adjustment to equity return would allow
14 SDG&E to recover through rates wildfire costs and expenses that SDG&E has not yet
15 and may never incur."³⁷ However, this is not what we have proposed in our Direct
16 Testimony or our Supplemental Direct Testimony. The adjustment to the Company's
17 ROE is not intended to recover wildfire costs and expenses, but rather, it is intended to
18 offer a reasonable return to investors for the risk that they will be subject to
19 unrecoverable costs associated with wildfire liabilities. The same is true for the equity
20 return in general - it is an estimate of the appropriate return to investors for bearing the
21 risk of investing in a utility's common stock. The cost is an opportunity cost, as

³⁶ *Id.* at 4:9-10.

³⁷ *Id.* at 8:9-10.

1 measured against other investments of comparable risk. In effect, shareholders are self-
2 insuring for all wildfire liabilities that are not recoverable through insurance, the Wildfire
3 Fund, or rates. For this risk, utilities are entitled to a fair rate of return sufficient to attract
4 capital under the basic tenets of the landmark decisions by the United States Supreme
5 Court, notably *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W.*
6 *Va.*, 262 U.S. 679 (1923) ("*Bluefield*"), and *Fed. Power Comm'n v. Hope Nat'l Gas Co.*,
7 320 U.S. 591 (1944) ("*Hope*"). And we have quantified the return required for this risk
8 based on the analytical approaches initially provided in our Direct Testimony and
9 updated in our Supplemental Direct Testimony.

10 **B. The Relevance of Credit Rating Agencies Recommendations on the Cost of**
11 **Equity**

12 **Q. Please describe Mr. Pavlovic's criticism of the ROE recommendation on the basis of**
13 **credit rating agency recommendations.**

14 **A. Mr. Pavlovic summarizes the collective recommendations of Standard and Poor's**
15 **("S&P"), Moody's Investors Service ("Moody's"), and Fitch Ratings ("Fitch"). S&P,**
16 **Moody's, and Fitch recommend "(1) reform of regulatory procedures for recovery of**
17 **wildfire costs and expenses and (2) repeal or reform of wildfire inverse condemnation**
18 **liability" to stabilize SDG&E's credit rating and stabilize its credit outlook.³⁸ On that**
19 **basis, Mr. Pavlovic concludes that that an adjustment to the ROE is not a form of risk**
20 **mitigation.³⁹**

³⁸ UCAN Aug. 1 Testimony (Pavlovic) at 9:19-10:1.

³⁹ *Id.* at 9:15-10:1.

1 Q. Is an ROE adjustment that recognizes the incremental risks associated with wildfire
2 liabilities intended to mitigate the risk and stabilize the Company's credit rating?

3 A. No, it is not. As discussed in our response to Mr. Gorman, debt investors and equity
4 investors are exposed to different risks, and therefore require different returns. Just as the
5 credit rating agencies downgraded the California utilities (which suggests a higher cost of
6 debt), we are performing a risk analysis for equity investors, and have concluded that
7 there is a higher cost of equity due to potential wildfire liabilities. And much like the
8 credit rating agencies, we agree that regulatory reforms, or legislative reforms, can, and
9 have mitigated the risks to investors. However, absent full mitigation, equity investors
10 continue to bear the risk for potential wildfire liabilities, and the cost of equity should
11 reflect that. While Mr. Pavlovic questions "whether the SDG&E witnesses have actually
12 analyzed the impact [of] AB 1054 provisions on SDG&E's wildfire risk,"⁴⁰ we discuss
13 the level of risk mitigation provided under AB 1054 at length in our Supplemental Direct
14 Testimony, and we revised our analytical approaches and our ROE adjustment
15 recommendation accordingly. The updated ROE adjustment factor we have
16 recommended is not intended to provide credit stability, but instead recognizes similar
17 risk factors to those observed by the credit rating agencies, and its effect on equity
18 investors and their return requirements. Contrary to Mr. Pavlovic's summary above,
19 inverse condemnation was not repealed or reformed. As such, our recommendation has
20 nothing to do with risk mitigation; it provides for risk compensation for the remaining, or
21 unmitigated, risk to shareholders.

⁴⁰ *Id.* at 8:3-4.

1 Q. Does AB 1054 eliminate risks to shareholders?

2 A. No, it does not. Mr. Pavlovic claims that “AB 1054 eliminates SDG&E’s long-term
3 wildfire risk by defining a Catastrophic Wildfire Proceeding through which wildfire costs
4 found by the Commission to be just and reasonable will be recovered from ratepayers
5 through a fixed charge.”⁴¹ However, as discussed in our Supplemental Direct Testimony,
6 the shareholder risks we identified in our Direct Testimony have been reduced, but not
7 eliminated. Given the prior discrepancy between the CPUC and FERC with regard to the
8 cost recovery standard for wildfire liabilities, it is not clear how the CPUC will apply the
9 new prudence standard in future cost recovery proceedings. While Mr. Pavlovic suggests
10 that “proof of prudent reasonable conduct to be satisfied by a safety certification,”⁴² the
11 determination of cost recovery is still subject to a regulatory proceeding in which other
12 parties may raise doubts as to the “reasonableness of the electrical corporation’s
13 conduct,”⁴³ at which point the utility has the burden of dispelling that doubt and proving
14 its conduct reasonable.

15 As discussed in our response to Mr. Gorman, the prudence standard is subject to
16 interpretation, as demonstrated by the Filsinger Report, assuming that the effect of the
17 new prudence standard will change over the course of ten years with a 75 percent
18 likelihood of an imprudence finding in the first year, and a 25 percent likelihood of an
19 imprudence finding in the tenth year. While we would agree that AB 1054 has reduced
20 the likelihood of an imprudence finding, and there is an expectation that the prudence

⁴¹ *Id.* at 10:4-6.

⁴² *Id.* at 11:15-16.

⁴³ California Public Utilities Code Section (“Cal. Pub. Utils. Code §”) 451.1(c).

1 standard will be applied in a manner more consistent with other jurisdictions, we revised
2 our analyses in our Supplemental Direct Testimony to reflect that there is a remaining
3 unmitigated level of risk.

4 **V. RESPONSE TO DR. MCCANN**

5 **Q. Please summarize Dr. McCann's testimony and his conclusions related to the risks**
6 **associated with wildfire liabilities.**

7 **A. While Dr. McCann does not make an ROE recommendation, he is critical of the utility**
8 **witnesses' recommendations, and suggests that there is no market evidence that an**
9 **adjustment to the ROE is appropriate despite our several market-based analyses**
10 **introduced in our Direct Testimony and updated in our Supplemental Direct Testimony.**
11 **Dr. McCann is also critical of certain elements of the proposed calculations of the ROE**
12 **adjustments. In addition, Dr. McCann takes issue with the fact that there is no proposed**
13 **mechanism to make funds available to pay for future wildfire liabilities.**

14 **Q. Do you agree with Dr. McCann's conclusions?**

15 **A. No, we do not. Dr. McCann ignores our application of market data in our analytical**
16 **approaches and claims to be the sole witness relying on market prices. Yet his analyses**
17 **are deeply flawed. Given that his analysis provides little relevant information as to the**
18 **effect of wildfire liabilities on the risk profile of the California utilities, his conclusions**
19 **cannot be supported. Further, Dr. McCann's suggestion that an adjustment to the ROE**
20 **constitutes the Commission "simply awarding free money to shareholders"⁴⁴**
21 **demonstrates a misunderstanding of the approaches we used to determine the appropriate**

⁴⁴ *Prepared Direct Testimony of Richard McCann, Ph.D. on Authorized Cost of Capital for Utility Operations for 2020 on behalf of The Environmental Defense Fund* (August 1, 2019) ("EDF Aug. 1 Testimony (McCann)") at 20.

1 ROE adjustment. Shareholders remain exposed to potential wildfire liabilities that are
2 not recoverable through insurance, the Wildfire Fund, or rates. This represents a risk that
3 is not reflected in Dr. Morin's proxy group companies. Therefore, utilities are entitled a
4 fair rate of return that reflects this incremental risk.

5 **A. Market-Based Analyses of the Risks to California Utilities**

6 **Q. Please summarize Dr. McCann's analyses of market prices of the California**
7 **utilities.**

8 **A. Dr. McCann provides a long-term analysis of the share prices of Edison International,**
9 **PG&E Corp., and Sempra relative to the Dow Jones Utilities Index from 1998 through**
10 **2019. Then, based on the cumulative average growth of these share prices from January**
11 **2000 to three different points in time, Dr. McCann concludes:**

- 12 1) California utility shares have significantly outpaced industry
13 average returns since January 2000, and since March 2009;
- 14 2) California share prices only decreased significantly after the
15 wildfire events that have been tied to specific *market-perceived*
16 negligence on the part of the electric utilities in 2017 and 2018;
17 and
- 18 3) Other events and state policy actions do not appear to have a
19 measurable sustained impact on utilities' valuations.⁴⁵

20 Dr. McCann also claims that there is no other analysis of market prices in the
21 proceeding and that "[a]t no point did any witness present an analysis of market prices or
22 behavior that would indicate that investors priced a risk premium into the utilities' share
23 prices or the returns on equity."⁴⁶

⁴⁵ EDF Aug. 1 Testimony (McCann) at 7:4-10 (emphasis in original).

⁴⁶ *Id.* at 4:8-10.

1 Q. Do you agree with Dr. McCann's analytical approach?

2 A. No. As a preliminary matter, Dr. McCann's assertion that we did not present an "analysis
3 of market prices" is demonstrably false. Our Direct Testimony included an entire section
4 of the "Implied Risk From Recent Stock Declines." Within that section, we presented a
5 similar analysis of share prices of Edison International, PG&E Corp., and Sempra
6 compared to a broader utility index. However, our analysis also described the limited
7 information that can be discerned from that approach. In addition, our Industry Risk
8 Approach, Insurance Approach, and CAT Bond Approach all relied on market-based
9 prices.

10 Dr. McCann presents his analysis of Edison International, PG&E Corp., and
11 Sempra as an analysis of "California Utilities," but this is not true. All three companies
12 are holding companies that own California utilities. But over the period studied by Dr.
13 McCann, these holding companies have also owned (and some continue to own)
14 significant assets that are either unregulated or have operations outside of California. As
15 we noted in our Direct Testimony, Sempra recently acquired Energy Future Holdings
16 Corp., for \$9.45 billion, which includes a majority stake in Oncor Electric Delivery
17 Company LLC. However, Dr. McCann's analysis does not adjust, or even acknowledge,
18 the fact that only a portion of Sempra's total holdings are CPUC-jurisdictional assets.⁴⁷
19 As described by Dr. Morin, "Sempra Energy is a diversified multi-activity company, and
20 that if SDG&E were a publicly-traded stand-alone entity, its beta would be much higher,

⁴⁷ See Ex. SDG&E-07 (Folkmann Rebuttal) at 4.

1 given its extraordinarily high relative risks.”⁴⁸ As such, it is not possible to discern from
2 Dr. McCann’s analysis to what degree Sempra’s stock price performance has been
3 influenced by CPUC-jurisdictional operations, or other unregulated or non-California
4 business segments.

5 With regards to PG&E Corp. and Edison International, there are similar issues
6 that Dr. McCann does not address. PG&E filed for bankruptcy twice over Dr. McCann’s
7 analytical period. While Dr. McCann makes note of this in Figure 1, he does not make
8 any adjustment to his analysis. As to Edison International, Dr. McCann does not even
9 acknowledge that one of its former subsidiaries, Edison Mission Energy, filed for Chapter
10 11 bankruptcy in 2012 and transferred the assets in 2014. While these events have
11 undoubtedly affected the stock performance of the holding companies, Dr. McCann’s
12 oversimplified analysis considers only the stock prices of these companies on three dates
13 (December 12, 2012, July 13, 2017, and July 18, 2019) relative to the stock prices in
14 January 2000 to infer how California utility risk has changed over these periods.

15 **Q. Are there other flaws in Dr. McCann’s analysis?**

16 **A. Yes, there are. Even if the stock prices of Edison International, PG&E Corp., and**
17 **Sempra could be considered representative of California utilities, it is unclear why Dr.**
18 **McCann would begin his analysis at the outset of the California electricity crisis, which**
19 **had a significant effect on California utility valuations from 2000 to 2003.**

20 In addition, Dr. McCann compares adjusted stock prices for Edison International,
21 PG&E Corp., and Sempra to the Dow Jones Utility Index values. The stock prices are

⁴⁸ *Prepared Direct Testimony of Roger A. Morin, Ph.D.* (April 2019) (“Ex. SDG&E-04” (Morin)) at 55:17-20.

1 adjusted for both stock splits and dividends, but the Dow Jones Utilities Index does not
2 adjust index values for dividends (stock splits are accounted for). An adjustment for
3 dividends applied only to the stock prices, but not the benchmark index, distorts his
4 analysis.⁴⁹ As such, Dr. McCann's conclusion that "California utility shares have
5 significantly outpaced industry average" is due in part to the effect of overstating the
6 performance of the "California utility shares."

7 **Q. Do you agree with Dr. McCann's conclusions from his analysis?**

8 **A. No, we do not. First, Dr. McCann's conclusion that "California utility shares have**
9 **significantly outpaced industry average returns since January 2000 and since March**
10 **2009" is based on an analysis that is flawed for the reasons discussed above. In summary,**
11 **the analysis does not isolate the effect of California utilities, does not adjust for**
12 **anomalous events and transformational changes in the holding companies' underlying**
13 **business segments, and makes adjustments to the holding companies' prices that are not**
14 **accounted for in the benchmark index.**

15 In addition, Dr. McCann concludes "California share prices only decreased
16 significantly after the wildfire events have that been tied to specific *market-perceived*
17 negligence on the part of the electric utilities in 2017 and 2018," but provides no
18 evidence that the share prices were affected by the market's perception of negligence.

19 While we observed a similar change in the share prices of Edison International and

⁴⁹ Reported "close prices" are adjusted for splits. The "adjusted close price" used in Dr. McCann's analysis is adjusted for both dividends and splits. However, the reported "close prices" for the Dow Jones Utility Index are identical to the "adjusted close prices" because there are no explicit dividends associated with the index. The index is calculated based on "close prices" and not adjusted for dividends. The more appropriate comparison would be using "close prices" for both stock prices and the benchmark index.

1 PG&E Corp. in our Direct Testimony, we limited our conclusions to what we could
2 observe in the data. Based on that analysis, we can conclude that investors increased
3 their return requirements for California utilities at that time. However, without offering
4 any evidence to support Dr. McCann's claim that this was due to "market-perceived
5 negligence," it is unclear how he can make this claim. Dr. McCann does not even
6 acknowledge the discrepancy between the CPUC and FERC with regard to the cost
7 recovery standard for wildfire liabilities, so it is unclear how he is able to make a clear
8 determination as to the perception of negligence.

9 Nonetheless, if one accepts Dr. McCann's claim that there is market evidence that
10 the valuation of California utilities has been adversely affected by potential wildfire
11 liabilities, this only supports our conclusion that investors have increased their return
12 requirements for California utilities.

13 **Q. Does Dr. McCann present any other analysis based on market data?**

14 **A. Yes, Dr. McCann calculates an "implied market ROE" for Edison International, PG&E**
15 **Corp., and Sempra, and compares that to an average of other investor-owned utilities and**
16 **CPUC authorized ROEs. To determine the "implied market" ROE for the California**
17 **utilities' holding companies, Dr. McCann assumes that each company is able to earn its**
18 **CPUC-authorized ROE for the holding company's entire equity base. For example, Dr.**
19 **McCann assumes Sempra's first quarter 2019 income can be derived by multiplying its**
20 **10.3 percent authorized ROE by Sempra's book value per share of \$71.06. He then**

1 divides this assumed income by Sempra's stock price of \$125.86 to derive an "implied
2 market ROE" of 5.8 percent.⁵⁰

3 **Q. What can you conclude from this analysis?**

4 **A. There is little meaningful information that can be derived from this analysis because it**
5 **contains flaws that are similar to Dr. McCann's analysis of share prices of Edison**
6 **International, PG&E Corp., and Sempra relative to the Dow Jones Utilities Index. Once**
7 **again, Dr. McCann has conflated the holding companies of the California utilities and**
8 **California utilities themselves. In the example discussed above regarding Sempra, Dr.**
9 **McCann is applying the CPUC-jurisdiction ROE of 10.3 percent to Sempra's entire book**
10 **value, despite the fact that SDG&E and Southern California Gas Company comprise 57**
11 **percent of Sempra's total assets as of 2018.⁵¹ Sempra Energy's remaining assets include**
12 **either non-regulated companies or non-California regulated entities. Both the book value**
13 **per share and the stock price for Sempra take into account Sempra's other business**
14 **segments, but Dr. McCann has assumed that all segments will earn equivalent to a**
15 **CPUC-authorized return. Given that Dr. McCann's implied ROE analysis includes a**
16 **return based on CPUC-regulated income, but an equity base that includes both CPUC-**
17 **regulated and non-CPUC-regulated assets, the analysis has little bearing on the**
18 **appropriate regulated return for SDG&E.**

⁵⁰ EDF Aug. 1 Testimony (McCann) at 10 (Figure 2) and 13 (Figure 3). $(10.3\% \times \$71.06) / \$125.86 = 5.8\%$

⁵¹ SEC Form 10-K for the fiscal year ended December 31, 2018, Sempra Energy, at F-160, available at <http://investor.sempra.com/static-files/be0f5abc-9fba-4782-bf8e-a96ccdf78d25>. Of the reported assets for SDG&E and Southern California Gas Company, a portion are FERC-jurisdictional, and therefore not subject to the CPUC-authorized ROE.

1 **B. Dr. McCann's Response to the Utilities' Direct Testimony**

2 **Q. Does Dr. McCann address the utilities' analysis of an ROE adjustment due to risks**
3 **associated with wildfire liabilities?**

4 **A. Yes, he does. Dr. McCann criticizes the utilities' analyses because they include an**
5 **assumption that 100 percent of liabilities in excess of insurance will be borne by**
6 **shareholders and not ratepayers, observing "that is not consistent with any proposals that**
7 **the utilities have presented at the Commission and is also inconsistent with Assembly Bill**
8 **1054 just enacted as state law."⁵² Our Direct Testimony was submitted prior to the**
9 **enactment of AB 1054, but our Supplemental Direct testimony responds to this point and**
10 **updates this assumption accordingly.**

11 Dr. McCann also claims our analysis is flawed by applying the ROE adjustment
12 to the total shareholder equity return which "adds a risk premium to the return on the
13 natural gas capital that does not incur that risk."⁵³ In this proceeding, since we are
14 determining the ROE for SDG&E, which includes gas and electric assets, we must
15 therefore assess the risk to an equity investor in the entirety of SDG&E. Because we
16 apply the incremental cost of that risk to all of SDG&E's assets, including gas and
17 electric, we have effectively reduced the ROE adjustment by spreading that cost across
18 all of the Company's assets. By comparison, Southern California Gas Company is a
19 separate entity owned by Sempra, with gas-only assets. Therefore, we do not include
20 Southern California Gas Company's assets in our calculation, and we do not recommend
21 an ROE adjustment to that entity. Dr. McCann's assertion that we "do not weight the

⁵² EDF Aug. 1 Testimony (McCann) at 18-19.

⁵³ *Id.* at 19.

1 ROE premium added for wildfire liabilities appropriately in adjusting the overall ROE”⁵⁴
2 is misplaced, as we have effectively attributed no incremental risk to the gas assets in our
3 calculation, which has the effect of reducing the overall ROE adjustment. All else equal,
4 if we applied this adjustment solely to the electric assets, it would have the effect of
5 increasing the ROE adjustment by a larger amount on the electric side, as offset by no
6 adjustment on the gas side of SDG&E. Overall, the results would have been the same.

7 **Q. Does Dr. McCann address the utilities’ revised ROE estimates in light of AB 1054?**

8 **A. Yes, he does. Dr. McCann speaks broadly to all proposals and generally summarizes the**
9 **utilities’ approaches as follows:**

- 10 1) Guess at the likely average annual liability from future wildfires
11 (note that only five large fires have been caused by utility
12 equipment since 2007 according to evidence available in this case).
- 13 2) Determine the likely payouts covered by the state fund established
14 by AB 1054 and additional insurance coverage purchased by the
15 utility and expensed to ratepayers, after adjusting for payouts likely
16 being less than the initial requests.
- 17 3) Guess at the likely amount of the remaining liability cost that will
18 be disallowed by the Commission, without determining the reason
19 for the disallowance, including ranges up to 75%. None of the
20 utilities have provided evidence supporting their estimates of
21 disallowances, unless they are admitting that their negligence
22 accounts for roughly that amount of the remaining liabilities.
- 23 4) Roll the disallowed amount back as an addition to the base
24 ratebase and calculate the increase in the ROE to cover the
25 disallowed funds that will instead by [*sic*] recovered from
26 ratepayers indirectly through a higher ROE.⁵⁵

⁵⁴ *Id.*

⁵⁵ *Prepared Rebuttal Testimony of Richard McCann, Ph.D. on Authorized Cost of Capital for Utility Operations for 2020 on Behalf of The Environmental Defense Fund (August 16, 2019) (“EDF Aug. 16 Testimony (McCann)”) at 2-3.*

1 However, there are several mischaracterizations and errors in Dr. McCann’s
2 summary of our approach. For starters, Dr. McCann’s dismissive account of the average
3 annual liability estimates as a “guess” discounts the detailed risk modeling that was
4 performed by the Company, and relied on in our analysis. As described in our Direct
5 Testimony, the Company is developing a risk assessment for its wildfire risk in
6 preparation for its upcoming Risk Assessment Mitigation Phase filing for the CPUC.
7 That risk assessment includes risk modeling that incorporates several wildfire-related
8 items, including:

- 9 • wildfire behavior (*i.e.*, the utilization of vegetation, topography, and
10 weather patterns to estimate fire growth);
- 11 • housing prices;
- 12 • climate change; and
- 13 • risk-reducing effects of SDG&E’s existing wildfire mitigation
14 activities.⁵⁶

15 To characterize this risk assessment that is subject to CPUC oversight as a
16 “guess” is misleading and belittling to the mitigation process.

17 In addition, we did not “guess at the likely amount of the remaining liability cost
18 that will be disallowed by the Commission.”⁵⁷ We instead relied on the assumptions used
19 by the energy advisory firm retained by Governor Newsom’s Strike Force. As described
20 in our Supplemental Direct Testimony, based on the Filsinger Report, there is an
21 expectation that an average of 70 percent of liabilities will be determined to be imprudent

⁵⁶ *Prepared Direct Testimony of Concentric Energy Advisors, Wildfire Risk Premium*, Chapter 1 (April 2019) (“Ex. SDG&E-05 (Concentric) Ch. 1”) at 35. All references to Concentric’s direct testimony are to the redacted version unless otherwise specified.

⁵⁷ EDF Aug. 16 Testimony (McCann) at 2.

1 over the first three years of the Wildfire Fund, and that the average likelihood of being
2 found to be imprudent over the 2020 to 2030 period is 50 percent.

3 Finally, we did not “calculate the increase in the ROE to cover the disallowed
4 funds,”⁵⁸ or roll any disallowed amount into ratebase. These statements demonstrate a
5 fundamental misunderstanding of the analysis we performed. We did not calculate our
6 proposed ROE adjustment to recover anticipated disallowed costs. Our market-based
7 approaches estimate the return requirement for investors to bear the risk associated with
8 potential future disallowances, not the disallowances themselves. By definition, risk is a
9 forward-looking concept that involves uncertainty. The notion that this is a proposal to
10 “recover disallowances through this disingenuous backdoor method,”⁵⁹ is simply false.

11 **Q. Does the ROE adjustment eliminate the incentives for prudent management of the
12 Company’s system?**

13 **A. No, it does not. Dr. McCann claims that “under the utilities’ proposals, the utilities will
14 have no incentive to prudently manage their systems to mitigate fire risk “⁶⁰ However,
15 this is prohibited under AB 1054, which does not eliminate the prudence standard, but
16 aligns it with other jurisdictions. And any significant wildfire will have multiple negative
17 effects upon a utility, creating every incentive to mitigate risk as much as possible. As
18 discussed in our response to Mr. Pavlovic, the determination of cost recovery is still
19 subject to a regulatory proceeding in which other parties may question the utilities’**

⁵⁸ *Id.* at 3.

⁵⁹ *Id.*

⁶⁰ *Id.*

1 conduct, at which point the utility has the burden proving its conduct reasonable.⁶¹ By all
2 accounts, SDG&E has taken extensive steps to mitigate wildfire risks and has not been
3 involved with a significant wildfire since 2007. Yet it still faces an increased cost of
4 equity due to risks posed by California's wildfire liability regime.

5 **Q. Do you agree with Dr. McCann's proposed calculation of an ROE adjustment on a**
6 **debt equivalence basis?**

7 **A. No.** Dr. McCann has characterized PG&E and Southern California Edison Company's
8 approach to adjusting the ROE for wildfire liability as similar to calculating the debt
9 equivalence for purchased power agreements ("PPA"). To be clear, this is not the
10 approach that we have proposed. However, Dr. McCann suggests that an ROE
11 adjustment "should only apply to the debt equivalence of the expected liability or the
12 amount insured."⁶² He then provides an example that appears to be similar in certain
13 respects to S&P's method of imputing debt for power purchase agreements ("PPAs"). As
14 described by Dr. McCann:

15 if the wildfire liability is \$15 billion and the probability of shareholders
16 incurring that cost is 50% and the total shareholder book value for other
17 assets is \$30 billion, and the wildfire risk premium is 6%, the weighted
18 risk premium should be 6% times \$7.5 billion divided by the total of the
19 debt-equivalent liability and the book value (\$45 billion), so the final ROE
20 risk addition equals 1%.⁶³

21 Dr. McCann provides no basis for his logic or inputs, so we cannot interpret his
22 result or its significance. Nevertheless, we disagree with the proposal that wildfire
23 liabilities should be treated as debt equivalents. We are estimating the risk to

⁶¹ Cal. Pub. Utils. Code § 451.1(c).

⁶² EDF Aug. 1 Testimony (McCann) at 19.

⁶³ *Id.*

1 shareholders, and as such, the most relevant approaches are based on the incremental
2 effects on the ROE, with market-based inputs to the analysis. In prior ratings analyses,
3 S&P has applied an adjustment methodology that imputes debt to the balance sheets of
4 utilities with significant PPA obligations because those PPAs are fixed-cost obligations
5 with known terms for a fixed number of years, like debt. The wildfire risk borne by
6 SDG&E's shareholder is not similar in any manner. Further, if the level of imputed debt
7 for PPAs becomes significant, the utility faces the need to rebalance its equity level to
8 maintain a capital structure that does not threaten its credit rating. Dr. McCann does not
9 take this into consideration either, which has the effect of understating the true cost
10 imposed on investors for bearing wildfire risks.

11 **C. Reserve Funds for Wildfire Liabilities**

12 **Q. Please describe Dr. McCann's criticism that an ROE adjustment is at odds with a**
13 **mechanism to create a reserve fund for wildfire liabilities.**

14 **A. Dr. McCann is critical of any adjustment to the ROE because none of the utilities**
15 **"propose a mechanism that would assure that those funds would be available to pay out**
16 **to wildfire victims or for other costs."⁶⁴ However, this is what AB 1054 provides, and we**
17 **have updated our recommendation to account for this effect in our Supplemental Direct**
18 **Testimony. The application of the reserve fund remains somewhat uncertain, and there**
19 **are limits to shareholder protections, so there remains a risk to shareholders.**

20 Dr. McCann also characterizes the ROE adjustment as "the Commission is simply
21 awarding free money to shareholders who can simply walk away from the utilities,
22 withdrawing their equity through dividends and selling shares to avoid paying their share

⁶⁴ *Id.* at 19-20.

1 of the costs.”⁶⁵ Dr. McCann’s characterization of this situation defies market principles
2 and logic. Under these circumstances, an investor cannot simply “walk away” from the
3 realization of this risk and sell their shares, since the liability associated with this
4 outcome will certainly depress the trading price of the utility’s common stock. Also, as
5 described in our response to Mr. Gorman, the ROE adjustment is not intended to fund
6 future wildfire liabilities, but instead to provide shareholders an appropriate return to bear
7 the risk of potential future wildfire liability.

8 Dr. McCann appears to fundamentally misunderstand our analysis by concluding
9 that the utilities “speculate about how much of those [wildfire] costs will be disallowed
10 by the Commission before any evidence has been presented, and proposed ROEs that
11 lock in those speculated amounts”⁶⁶ Our recommended ROE adjustment is not an
12 estimation of expected future disallowances. Rather, we have used several market-based
13 approaches to determine the return requirement for investors to bear the risk associated
14 with potential future disallowances.

15 Shareholders remain exposed to potential wildfire liabilities that are not
16 recoverable through insurance, the Wildfire Fund, or rates, and this represents a risk that
17 is not reflected in Dr. Morin’s proxy group companies. For this risk, utilities are entitled
18 a fair rate of return sufficient to attract capital under the basic tenets of *Hope* and
19 *Bluefield*.

⁶⁵ *Id.* at 20.

⁶⁶ *Id.* at 9 [clarification added].

1 **Q. Has Dr. McCann accurately described your CAT Bond Approach?**

2 **A. No, he has not. Dr. McCann suggests that the closest example presented to creating a**
3 **reserve fund “is of SDG&E issuing a catastrophic event bond, but then Concentric dilutes**
4 **that option by combining it with two others that do not involve setting aside any funds.”⁶⁷**
5 **Our CAT Bond Approach looks at transactions on CAT Bonds to derive a market-based**
6 **indication of an appropriate ROE adjustment for shareholders. The Company has issued**
7 **a CAT Bond, and it limits the Company’s exposure to wildfire liabilities in the same**
8 **manner as traditional liability insurance. We apply the CAT Bond investors’ return**
9 **requirements as an estimate for the compensation required for any investor to accept the**
10 **risk of wildfire liabilities that are not covered through other means. We have not**
11 **proposed any assurances to set aside funds “to pay out wildfire victims or for other**
12 **costs.”⁶⁸ As stated above, we are using this market-based information to estimate an**
13 **appropriate return for shareholders, not to fund future wildfire liabilities.**

14 **VI. RESPONSE TO MR. O’DONNELL**

15 **Q. Please provide an overview of Mr. O’Donnell’s testimony.**

16 **A. Mr. O’Donnell provides an analysis of each of the applicants’ cost of equity, with a**
17 **primary focus on the methodologies that are used to derive the Base ROE. Overall, he**
18 **characterizes the requested ROEs as “excessive and punitive in that the requested ROEs,**
19 **unless updated and lowered by the IOUs, do not take into account the lower risk**
20 **associated with the recently enacted AB 1054.”⁶⁹ To that point, we have updated our**

⁶⁷ *Id.* at 20.

⁶⁸ *Id.* at 19-20.

⁶⁹ FEA Aug. 1 Testimony (O’Donnell) at 7:6-9.

1 recommendation in our Supplemental Direct Testimony to explicitly take into account the
2 effect of AB 1054 on the Company's risk profile.

3 **Q. Does Mr. O'Donnell acknowledge that an adjustment to the ROE is warranted due**
4 **to the incremental risk associated with wildfire liabilities?**

5 **A. Yes, he does. Mr. O'Donnell suggests that a 50 basis point adjustment is appropriate**
6 **unless the State of California implements a plan to reverse inverse condemnation.**
7 **Specifically, he states "The stock of SEMPRA is still somewhat in the shadow of inverse**
8 **condemnation and, for that reason, I believe a 9.5% ROE is warranted. Again, however,**
9 **if the State of California implements a plan to reverse inverse condemnation, the ROE**
10 **should be set no higher than 9.0%."**⁷⁰ **Since AB 1054 did not address the issue of inverse**
11 **condemnation, and there has been no subsequent legislation, this risk remains. It is not**
12 **clear how Mr. O'Donnell derives a 50 basis point ROE adjustment, but he recognizes the**
13 **incremental risks to shareholders associated with wildfire liabilities. However, 50 basis**
14 **points is an inadequate adjustment to provide shareholders an adequate return for the**
15 **residual risk that they bear for wildfire liabilities. Mr. O'Donnell claims that he arrived**
16 **at his 50 basis point recommendation based on "market estimates of the required return**
17 **and not, as Concentric did, various mathematical formulations that omit obvious risk**
18 **mitigation measures."**⁷¹ **However, Mr. O'Donnell's proxy group does not include any**
19 **other companies that are subject to the same level of business risk associated with**
20 **catastrophic wildfire liabilities as the Company, and his analysis of Sempra's stock price,**
21 **much like Dr. McCann's analysis, does not address the fact that only a portion of**

⁷⁰ *Id.* at 29:26-30.

⁷¹ FEA Aug. 16 Testimony (O'Donnell) at 30:3-5.

1 Sempra's total holdings are CPUC-jurisdictional assets. By comparison, all of our
2 "mathematical formulations" are based on market-data, specific to the Company's risk
3 profile, and have been adjusted for the risk mitigation measures contained in AB 1054.

4 **Q. Please describe Mr. O'Donnell's analysis of Sempra's stock price performance and**
5 **the relevance of the conclusions he draws from his analysis.**

6 **A. Mr. O'Donnell points to Sempra's closing stock price on July 23, 2018, compared that to**
7 **its price on July 19, 2019, and concludes "The fact that equity investors in SEMPRA**
8 **have bid up the price of the stock is a clear indication that the market feels the recent**
9 **wildfire legislation is a positive development for the Company and that its future is**
10 **good."**⁷² **As a preliminary matter, it is difficult to determine how Mr. O'Donnell is able**
11 **to discern how "the market feels" or whether or not "the future is good" for Sempra based**
12 **on an observation stock prices on two different days. There are several factors that can**
13 **affect a stock price on any given day, some specific to the subject company, and some**
14 **based on broader capital market conditions. Suggesting that the future of the company**
15 **and the effect of AB 1054 can be derived from a comparison of stock prices of Sempra**
16 **on two days, one year apart, is a gross oversimplification and can lead to flawed**
17 **conclusions.**

18 **Q. Do you have additional concerns with Mr. O'Donnell's analysis of Sempra's stock**
19 **price?**

20 **A. Yes, we do. As described in response to Dr. McCann, Sempra is the holding company of**
21 **SDG&E, and SDG&E represents approximately only 32 percent of Sempra's total**

⁷² *Id.* at 22:16-18.

1 assets.⁷³ Consistent with Dr. Morin’s observation, due to Sempra’s diversified
2 operations, measures of its stock price performance likely understate the risks borne by
3 SDG&E.⁷⁴ As noted in the Forbes article cited by Mr. O’Donnell, “The new utility law
4 also benefits Sempra though less so: Its California electric utility is less than a quarter of
5 overall earnings versus 100 percent for Edison and PG&E,”⁷⁵ reflecting Sempra’s
6 operations after its acquisition of Energy Future Holdings Corp. As such, it is not
7 possible to discern from Mr. O’Donnell’s observation of Sempra’s stock price on two
8 days how Sempra’s stock price performance has been influenced by risks related to
9 wildfire liabilities, the effect of AB 1054, or other unregulated or non-California business
10 segments. Mr. O’Donnell’s conclusion that “the investment community clearly disagrees
11 with the Concentric analysis, as evidenced by the tremendous jump in the SEMPRA
12 stock,”⁷⁶ is unfounded because he only analyzes the performance of SDG&E’s holding
13 company and presents no evidence as to how the other business segments have changed
14 over his limited analytical period. Even if the stock price of Sempra could be considered
15 representative of SDG&E, Mr. O’Donnell provides no benchmark comparison for
16 Sempra’s performance. Mr. O’Donnell asserts, “If consumers were truly frightened by

⁷³ SEC Form 10-K for the fiscal year ended December 31, 2018, Sempra Energy, at F-160, available at <http://investor.sempra.com/static-files/be0f5abc-9fba-4782-bf8e-a96ccdf78d25>. Of the reported assets for SDG&E and Southern California Gas Company, a portion are FERC-jurisdictional, and therefore not subject to the CPUC-authorized ROE.

⁷⁴ Ex. SDG&E-04 (Morin) at 55:17-20.

⁷⁵ Forbes, *California’s Wildfire Reset: Unequal Benefits*, dated July 24, 2019 (as cited by FEA Aug. 16 Testimony (O’Donnell) at 22-23). There is an error with the hyperlink provided by Mr. O’Donnell. The Forbes article is available at: <https://www.forbes.com/sites/greatspeculations/2019/07/24/californias-wildfire-reset-unequal-benefits/#826095d81974>.

⁷⁶ FEA Aug. 16 Testimony (O’Donnell) at 29:13-14.

1 the alleged risks cited by Concentric, the stock of SEMPRA would not have jumped by
2 nearly 30% in the past year alone.”⁷⁷ However, he provides no analysis as to how the
3 broader equity market has performed, or other changes in capital market conditions that
4 could have an effect on Sempra’s stock price performance.

5 Based on a review of equity analyst research of Sempra, there are several factors
6 other than SDG&E’s risk profile that affect the equity investors valuation of Sempra and
7 have likely had an effect on Sempra’s stock price performance. For example, in 2018
8 Sempra completed its acquisition of Energy Future Holdings Corp., which includes a
9 majority stake in Texas utility, Oncor Electric Delivery Company LLC. As Guggenheim
10 summarizes in its analysis of Sempra, there have been several factors that likely affected
11 Sempra’s stock price performance from 2018 to 2019 including its international business
12 segments, and its LNG operations. Specifically, Guggenheim notes:

13 **Following a very active 2018, Sempra’s 2019 investor day delivered**
14 **the consistent message we were looking for:** simplification underpinned
15 by strong regulated growth. While the sale of the South American
16 business remains underway, management has continued to refocus on its
17 US utilities, where a very strong investment opportunity set has led to one
18 of the company’s largest-ever investment cycles. Roughly \$22bn will be
19 invested in California and Texas between now and 2023, with
20 management also floating another ~\$1.8bn in incremental opportunities
21 across the utilities. **We see many of these incremental items as**
22 **achievable**, as they rely on either underlying growth (e.g. transmission in
23 Texas) or policy direction (e.g. EVs/emissions in California). While
24 policy in Mexico remains a slight overhang in our view, it is
25 counterbalanced by an improved outlook for the LNG business. **On the**
26 **LNG front, management unveiled a \$30mm increase for Cameron**
27 **phase 1 earnings thanks to improved cost visibility, and also**
28 **highlighted traction on both the Cameron Phase II and ECA Phase II**
29 **developments.**⁷⁸

⁷⁷ *Id.* at 29:14-16.

⁷⁸ Guggenheim, *SRE: Simplicity is the Ultimate Sophistication...*, dated March 27, 2019 at 1 (emphases in original).

1 As such, Mr. O'Donnell's analysis has little relevance in assessing the relative
2 risk profile of SDG&E and provides little information that can be used to conclude how
3 AB 1054 may have affected investors' perception of risks related to wildfire liabilities.
4 Most importantly, we are not proposing to apply a risk premium to all of Sempra, or even
5 all of Sempra's California utilities; we are attempting to determine the appropriate ROE
6 for SDG&E, reflecting the risks that are unique to this business.

7 **Q. Do you agree with Mr. O'Donnell's summary of the market's reaction to the holding**
8 **companies of California utility stocks over the past year?**

9 **A. No, we do not. Mr. O'Donnell points to an article from the July 23, 2019 issue of Forbes**
10 **entitled "California's Wildfire Reset; Unequal Benefits," to point to a "positive trend" in**
11 **California utility stocks.⁷⁹ However, the article cited by Mr. O'Donnell points to several**
12 **unmitigated risk factors that have an effect on investors' views of risk, and that we have**
13 **incorporated in our revised ROE adjustment contained in our Supplemental Direct**
14 **Testimony. Again, we must be cautious of any analysis that does not isolate the effect of**
15 **California utilities from the holding companies of California utilities, as the article**
16 **acknowledges.⁸⁰ Nonetheless, Mr. O'Donnell points to the following quotation from the**
17 **Forbes article: "But California has delivered on Governor Gavin Newsom's pledge for a**
18 **legislative fix to state utilities' bottomless liability for wildfire damages."⁸¹ Forbes'**
19 **characterization of AB 1054 as a fix for the "bottomless liability for wildfire damages" is**

⁷⁹ Forbes, *California's Wildfire Reset: Unequal Benefits*, dated July 24, 2019 (as cited by FEA Aug. 16 Testimony (O'Donnell) at 22:24-23:6 and n.40), available at: <https://www.forbes.com/sites/greatspeculations/2019/07/24/californias-wildfire-reset-unequal-benefits/#826095d81974>.

⁸⁰ *Id.*

⁸¹ *Id.*

1 nuanced, but apt. In effect, AB 1054 places bounds on shareholders' exposure to wildfire
2 liabilities such that they are no longer "bottomless." However, this does not fully
3 mitigate the risks to shareholders. The article cites several uncertainties as described in
4 the following excerpts:

- 5 1) AB 1054 does not "end the doctrine of 'inverse condemnation,'
6 under which utilities are ultimately liable for the cost of wildfires
7 in which power lines are involved."
- 8 2) "That means power companies will continue to be under scrutiny
9 during the state's increasingly long dry season."
- 10 3) "It also remains to be seen just how various state agencies will
11 respond when there are future wildfires, and how rigorously
12 utilities will be judged on the prudence standard."
- 13 4) "These decisions will have a major impact on how quickly the
14 wildfire fund utilities choose is exhausted."⁸²

15 In our Supplemental Direct Testimony, we specifically identified each of these
16 same uncertainties, as described in the following excerpts:

- 17 1) "The legal standard known as inverse condemnation was
18 unchanged by AB 1054, and utilities remain legally liable when
19 their equipment is a cause of a wildfire ignition."
- 20 2) "The impact on the CPUC's determination of prudence is
21 uncharted water with significant impact on shareholders."
- 22 3) "The risk reducing effect of the adoption of the 'industry norm' for
23 prudence depends on how the CPUC implements the standard for
24 utilities operating under the Wildfire Fund."
- 25 4) "There are ongoing concerns about the Wildfire Fund's
26 durability."⁸³

⁸² *Id.*

⁸³ *Prepared Supplemental Testimony of Concentric Energy Advisors, Wildfire Risk Premium, AB 1054, Chapter 1* (August 1, 2019) ("Ex. SDG&E-05-S (Concentric) Ch. 1") at 4:20-5:16.

1 The revised analyses in our Supplemental Direct Testimony address these
2 uncertainties and takes them into account in our revised ROE adjustment
3 recommendation. As such, our recommended ROE adjustment reflects the risks known
4 to investors that are associated with remaining uncertainties for shareholder exposure to
5 wildfire liabilities.

6 **Q. Has the Company's prior precedent for recovery of wildfire liabilities "been**
7 **rendered obsolete",⁸⁴ as described by Mr. O'Donnell?**

8 **A. No, it has not. Mr. O'Donnell points to our Supplemental Direct Testimony's reference**
9 **to CPUC precedent associated with SDG&E's WEMA application, and concludes "With**
10 **the passage of AB 1054, such orders have been rendered obsolete. This Commission has**
11 **been charged with taking its direction from the California Legislature in order to**
12 **implement the measures contained in AB 1054 in an appropriate manner."⁸⁵ As**
13 **discussed above, the Forbes article cited by Mr. O'Donnell points to the uncertainty**
14 **associated with the application of the prudence standard.⁸⁶ It also points to the current**
15 **standard, observing "Currently, the California Public Utilit[ies] Commission disallows**
16 **costs, even if utilities follow best practices to prevent wildfires," suggesting that this is**
17 **still information that is relevant to the investment community.⁸⁷ In our Supplemental**

⁸⁴ FEA Aug. 16 Testimony (O'Donnell) at 25:27-28.

⁸⁵ *Id.* at 25:27-30.

⁸⁶ Forbes, *California's Wildfire Reset: Unequal Benefits*, dated July 24, 2019 (as cited by FEA Aug. 16 Testimony (O'Donnell) at 22:24-23:6 and n.40) ("It also remains to be seen just how various state agencies will respond when there are future wildfires, and how rigorously utilities will be judged on the prudency standard."), available at: <https://www.forbes.com/sites/greatspeculations/2019/07/24/californias-wildfire-reset-unequal-benefits/#826095d81974>.

⁸⁷ *Id.*

1 Direct Testimony, we observed, “[t]here is no precedent for the CPUC operating under
2 the revised prudence standard articulated in AB 1054”⁸⁸ As such, it remains unclear as
3 to how the CPUC will apply the directive it has received from the California Legislature
4 and what constitutes “an appropriate manner” to implement the measures contained in
5 AB 1054. In our Supplemental Direct Testimony, we have modified our assumption that
6 the only relevant precedent of a CPUC prudence review is the WEMA decision, and
7 modified our analysis to reflect the uncertainties acknowledged in the article cited by Mr.
8 O’Donnell.

9 Mr. O’Donnell also contends that our assumption with regard to the application of
10 the prudence standard fails to consider “what happens if the CPUC establishes a high bar
11 as to the presumption of prudence.”⁸⁹ As discussed in our response to Dr. McCann, we
12 acknowledge that this is uncertain and consider a range of values based on the Filsinger
13 Report’s expectation that an average of 70 percent of liabilities will be determined to be
14 imprudent over the first three years of the Wildfire Fund, and that the average likelihood
15 of being found to be imprudent over the 2020 to 2030 period is 50 percent. We relied on
16 the assumptions used by Filsinger – the energy advisory firm retained by Governor
17 Newsom’s Strike Force and cited by Moody’s.⁹⁰

⁸⁸ Ex. SDG&E-05-S (Concentric) Ch. 1 at 5:3-4.

⁸⁹ FEA Aug. 16 Testimony (O’Donnell) at 26:5-6.

⁹⁰ Moody’s, *Rating Action: Moody’s affirms San Diego Gas & Electric’s ratings; outlook remains negative*, dated July 12, 2019 at 1-2.

1 Q. Did Mr. O'Donnell question other assumptions made in your analysis of the
2 updated ROE adjustment contained in your Supplemental Direct Testimony?

3 A. Yes, Mr. O'Donnell also suggests that we do not consider the possibility "that the
4 California IOUs could also seek legislation or a CPUC rulemaking proceeding that would
5 increase funding for the Wildfire Fund to replenish spent funds. The Concentric analysis
6 did not examine the possibility of replenishing the Wildfire Fund at some point in the
7 future."⁹¹ The analysis in our Supplemental Direct Testimony was performed in direct
8 response to AB 1054. The prospect of future legislation or an unprecedented CPUC
9 rulemaking that would enable an expansion of the Fund is not pondered within AB 1054.
10 Further, there is no evidence to suggest that this is a likely outcome. It is entirely
11 speculative. As we noted in our Supplemental Direct Testimony, "the life of the Fund
12 will depend on the CPUC's prudence findings (which determine whether the Fund is
13 reimbursed), and the actual losses of all three utilities,"⁹² and there is substantial
14 uncertainty as to each of these components. Speculating as to the probability of
15 increasing funds available to the Wildfire Fund would have a *de minimis* effect on our
16 analysis, given the magnitude of the uncertainty associated with the life of the Wildfire
17 Fund.

18 Mr. O'Donnell also calls into question the uncertainty that the Wildfire Fund
19 Administrator ("Administrator") may recommend a lower insurance level. In Mr.
20 O'Donnell's view, the only scenario he envisions "in which the Wildfire Fund
21 Administrator would order a reduction in insurance would be if the Wildfire Fund was

⁹¹ FEA Aug. 16 Testimony (O'Donnell) at 26:30-27:4.

⁹² Ex. SDG&E-05-S (Concentric) Ch. 1 at 5:29-31.

1 over-funded.”⁹³ While we agree that the Administrator recommending a lower insurance
2 level is unlikely and likely inappropriate given the current risks posed to the Company,
3 AB 1054 enables the Administrator to do so, and it is therefore an uncertainty in light of
4 the legislation. However, given that this is an unlikely scenario, our updated analysis
5 provided in our Supplemental Direct Testimony makes no change to the Company’s
6 assumed insurance level as a result of this uncertainty. Therefore, Mr. O’Donnell’s
7 disagreement on this point has no direct bearing on our analysis.

8 **Q. What are your conclusions with regard to Mr. O’Donnell’s testimony?**

9 **A. Mr. O’Donnell characterizes our analysis as a “mathematical smokescreen” and describes**
10 **the uncertainties associated with AB 1054 (and recognized by an article he cites) as**
11 **“hypothetical risks.”⁹⁴ However, his criticisms are either without merit or based on**
12 **flawed analyses of SDG&E’s holding company – rather than direct market-based**
13 **evidence of the return required for SDG&E’s shareholders to bear the risk associated**
14 **with wildfire liabilities. In addition, Mr. O’Donnell’s characterization of our**
15 **recommended ROE adjustment as “higher dividend payouts to stockholders that cannot**
16 **be used in the future to replenish the Wildfire Fund,”⁹⁵ demonstrates a misunderstanding**
17 **our proposal. Our recommendation is to provide a reasonable return to investors for the**
18 **risks they currently bear and does not preclude any efforts to replenish the Wildfire Fund,**
19 **or any other efforts for constructive reform in the State of California. If future legislative**

⁹³ FEA Aug. 16 Testimony (O’Donnell) at 27:19-20.

⁹⁴ *Id.* at 28:27-32.

⁹⁵ *Id.* at 29:5-6.

1 or regulatory reforms change that risk profile, that would be the appropriate time to
2 reconsider the risk adjustment.

3 To determine what is a fair and reasonable return for the Company, we analyzed
4 the return investors require for the risks that they bear. By definition, a risk arises from
5 uncertainty. With Mr. O'Donnell's proposition that there is a potential regulatory or
6 legislative remedy, there is uncertainty, and therefore a risk for which investors must be
7 compensated. Our analysis captures the principal uncertainties and risks remaining after
8 the implementation of the legislation. The risks to shareholders have been reduced by
9 AB 1054, but not eliminated.

10 **VII. RESPONSE TO COUNTY OF SAN DIEGO**

11 **Q. Please provide an overview of Supplemental Testimony of County of San Diego.**

12 **A. The County of San Diego submitted testimony criticizing our recommendation for an**
13 **updated ROE risk adjustment on the following basis:**

- 14 1) The request for an ROE adjustment due to wildfire risk is outside
15 the scope of this proceeding;
- 16 2) AB 1054 reinforces the impropriety of including an ROE adder
17 that shifts liability to ratepayers without regard to whether SDG&E
18 acted reasonably and show that it has been a prudent manager of its
19 facilities;
- 20 3) For rates to be just and reasonable, SDG&E must have acted
21 reasonably. SDG&E seeks via its requested rate increase to shift
22 the risk to ratepayers even in cases where it is later determined that
23 SDG&E acted unreasonably.⁹⁶

⁹⁶ *Supplemental Testimony of County of San Diego (AB 1054) (August 16, 2019) at 1-3.*

1 **Q. How do you respond to the Supplemental Testimony of County of San Diego?**

2 **A. As a preliminary matter, the County of San Diego does not put forth any direct evidence**
3 **that responds to our approach, but is limited to legal arguments regarding the**
4 **appropriateness of any ROE recommendation that reflects the risks associated with**
5 **wildfire liabilities borne by shareholders. As such, there is little information to which we**
6 **can respond. In our responses to the other intervening witnesses, we have addressed the**
7 **issues raised by the County of San Diego. To briefly summarize:**

- 8 1) The Scoping Ruling issued July 2, 2019 clearly states that
9 “[a]dditional risk factors, including financial, business, and
10 regulatory risks, that should be considered in setting the utilities’
11 authorized return on equity” are within the scope of this
12 proceeding.⁹⁷ The risks associated with wildfire risks are not a
13 separate and distinct risk that fall outside the scope of traditional
14 regulatory finance, and wildfire liabilities distinguish the
15 Company’s financial, business and regulatory risks relative to Dr.
16 Morin’s proxy group. Our approach to measurement of
17 incremental risk and the Company’s overall ROE recommendation
18 is entirely consistent with the scope of this proceeding, as
19 confirmed in ALJ Stevens’ July 8, 2019 email to the parties.
- 20 2) The revised prudence standard in AB 1054 is expected to reduce
21 the incremental risk relative to precedent, but the application
22 remains uncertain, and therefore investors still require a higher
23 return to invest in California utility companies. Under the basic
24 tenets of *Hope* and *Bluefield*, SDG&E must be awarded a fair and
25 reasonable return for the actual risks it bears.
- 26 3) The CPUC denied SDG&E recovery of all the costs associated
27 with the 2007 fires in the Company’s WEMA application, but
28 FERC approved SDG&E’s recovery of all FERC-jurisdictional
29 costs associated with the same fire, demonstrating that a prudence
30 standard is subject to interpretation. As such, the CPUC standard
31 has been materially different from other jurisdictions and
32 represents a risk that distinguishes the Company’s financial,
33 business, and regulatory risks relative to Dr. Morin’s proxy group

⁹⁷ Scoping Ruling at 3.

1 and other utilities and should be recognized in the determination of
2 a fair and reasonable return.

3 **VIII. CONCLUSION**

4 **Q. What is your conclusion with regard to your recommendation?**

5 **A. Concentric maintains that the recommended risk adjustment presented in our**
6 **Supplemental Direct Testimony, reflecting the impacts of AB 1054, in combination with**
7 **Dr. Morin's estimated ROE, provides a fair and reasonable ROE for SDG&E's**
8 **shareholders.**

9 **Q. Does this complete your Rebuttal Testimony?**

10 **A. Yes.**

Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2020 Cost of Capital
Application: A.19-04-017
Exhibit: SDG&E-12 Chapter 2

SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED REBUTTAL TESTIMONY OF TODD A. SHIPMAN, CFA
CHAPTER 2
(WILDFIRE RISKS POST-AB 1054)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA



A  Sempra Energy utility®

August 21, 2019

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1 **SAN DIEGO GAS AND ELECTRIC COMPANY**
2 **PREPARED REBUTTAL TESTIMONY TODD A. SHIPMAN**

3 **I. INTRODUCTION**

4 **Q. Please state your name, affiliation, and business address.**

5 A. My name is Todd A. Shipman. I am an Executive Advisor with Concentric Energy
6 Advisors, Inc. (“Concentric”), which has its headquarters at 293 Boston Post Road West,
7 Suite 500, Marlborough, Massachusetts 01752.

8 **Q. On whose behalf are you testifying?**

9 A. I am submitting this Rebuttal Testimony regarding wildfire risks post-AB 1054¹ on
10 behalf of San Diego Gas & Electric Company (“SDG&E” or the “Company”), a
11 subsidiary of Sempra Energy, Inc. (“Sempra”), a publicly traded holding company.

12 **Q. Have you previously provided testimony in this proceeding?**

13 A. Yes. I provided Direct Testimony on April 22, 2019 and Supplemental Direct Testimony
14 on August 1, 2019.

15 **II. PURPOSE AND OVERVIEW**

16 **Q. What is the purpose of your Rebuttal Testimony?**

17 A. My rebuttal testimony addresses the direct testimony of Mr. Michael P. Gorman on
18 behalf of Energy Producers & Users Coalition (“EPUC”), Indicated Shippers, and The
19 Utility Reform Network (“TURN”),² and the direct and rebuttal testimonies of Mr. Karl
20 Richard Pavlovic on behalf of Utility Consumers’ Action Network (“UCAN”) and

¹ Assembly Bill (“AB”) 1054, Stats. 2019, Ch. 79.

² *Direct Testimony and Exhibits of Michael P. Gorman on behalf of EPUC, Indicated Shippers, and TURN* (August 1, 2019) (“TURN Testimony (Gorman)”). Mr. Gorman only testifies on behalf of TURN regarding SDG&E’s application.

1 Protect Our Communities (“POC”),³ with respect to rating agency actions and comments
2 in the wake of the passage of AB 1054 as they pertain to the risks associated with
3 wildfire liabilities and proposed authorized return on equity for SDG&E.

4 **Q. What are your key conclusions on the implications to SDG&E’s cost of equity of the**
5 **rating agencies’ reactions to AB 1054?**

6 **A. My key conclusions are as follows:**

7 Credit ratings are an independent and reliable measure of a company’s risk that
8 are used by investors and other interested parties to assist in assessing risk. For utilities,
9 regulatory risk is a major component of the analysis. The recognition of growing risks
10 surrounding the severe wildfires that have occurred in California in recent years and the
11 regulatory response to the developments have resulted in multiple ratings downgrades.
12 Reversing the credit quality deterioration and restoring ratings to previous levels would
13 require an improvement in financial risk that implies an equity return premium for
14 SDG&E.

15 The enactment of wildfire reform legislation has improved the risk profile of
16 SDG&E, but it has not restored the regulatory environment and the regulatory compact in
17 the state to the *status quo ante*. The rating agencies recognized the improvement by
18 changing their outlooks on the Company, but no ratings upgrades have resulted.

19 The regulatory response to the wildfire issue has altered investors’ perception of
20 regulatory risk in California, as measured by the assessment of S&P Global Ratings

³ *Prepared Direct Testimony of Karl Richard Pavlovic on Behalf of Utility Consumers’ Action Network and Protect Our Communities Foundation, Cost of Capital* (August 1, 2019) (“UCAN Aug. 1 Testimony (Pavlovic)”); *Prepared Reply Testimony and Direct Testimony of Karl Richard Pavlovic on Behalf of Utility Consumers’ Action Network and Protect Our Communities Foundation, Cost of Capital* (August 16, 2019) (“UCAN Aug. 16 Testimony (Pavlovic)”).

1 (“S&P”). The greater regulatory risk is likely to extend well into the future despite
2 legislative efforts to lessen it.

3 Rating agencies regularly communicate with investors on the factors that can
4 cause ratings to change. Their identification of the effect of possible legislative and
5 regulatory changes on the ratings of California electric utilities is not designed to be a
6 comprehensive list of recommendations. The agencies are expressly prohibited from
7 offering any kind of advice, so their communications to investors should not be
8 considered as advocacy.

9 **Q. How is the remainder of your Rebuttal Testimony organized?**

10 **A. The remainder of my Rebuttal Testimony is organized as follows:**

11 In Section III, I respond to the Direct Testimony of TURN witness, Mr. Gorman;

12 In Section IV, I respond to the Direct Testimony and Rebuttal Testimony of
13 UCAN and POC witness, Mr. Pavlovic; and

14 In Section VII, I summarize my conclusions and recommendations.

15 **III. RESPONSE TO MR. GORMAN**

16 **Q. Do you agree that, as Mr. Gorman claims, AB 1054 has had a “profound stabilizing
17 effect on utility companies”⁴ based on rating agency reactions to the legislation?**

18 **A. No. Mr. Gorman misconstrues the rating actions of the rating agencies after the passage
19 of the legislation. As I recounted in my Supplemental Direct Testimony, the resumption
20 of mostly stable outlooks by the rating agencies indicates only that the legislation offers a
21 limited and incomplete solution to the challenge that wildfire risks pose to electric utility**

⁴ TURN Testimony (Gorman) at IV-14:15.

1 credit quality.⁵ There is nothing profound about it. While the positive aspects of AB
2 1054 were recognized and acknowledged in the change in ratings outlooks, the overhang
3 of uncertainties about the implementation of the legislation and elevated risk that remains
4 due to a lack of reform of the application of inverse condemnation to utilities continues to
5 hinder credit quality. The lower ratings caused by wildfire risk are still in place.

6 **Q. Why do the rating agencies view the legislation as falling short of restoring the**
7 **credit quality of SDG&E?**

8 **A. Their assessment of the effect of the reform is clear. As stated by S&P, “[w]hile we**
9 **expect that the measures within AB 1054 will protect credit quality over the medium**
10 **term, and support the company’s business risk profile, longer-term risks exist.”⁶ The**
11 **medium term that S&P alludes to is essentially the time frame for its stable outlook, so**
12 **the company is still at risk of downgrades beyond that three-year window if the risks they**
13 **identify – including the financial health of the insurance fund and the liability cap –**
14 **materialize and undermine the liquidity relief that underpins the decision not to**
15 **downgrade ratings now. Moody’s highlights the longer-term risk attendant to the**
16 **untested application of the new prudence standard, which seems to be the key element of**
17 **wildfire risk reform for their analysis.⁷ Moody’s also emphasizes risks that are broader in**
18 **scope that are not addressed in wildfire reform but are related to it. The operational**
19 **shortcomings that have long characterized California regulation, such as the uncertainties**

⁵ See Prepared Supplemental Testimony of Concentric Energy Advisors, *Wildfire Risk Premium*, Chapter 2 (Aug. 2019) (“Ex. SDG&E-05-S (Concentric) Ch. 2”) at 4-6.

⁶ S&P Global Ratings, *Research Update: San Diego Gas & Electric Co. Ratings Affirmed; Outlook Revised To Stable From Negative*, dated July 30, 2019 at 1.

⁷ Moody’s Investor Service, *Credit Opinion, San Diego Gas & Electric Company, Update following outlook change to positive*, dated August 2, 2019 (“Moody’s Aug. 2 Report”) at 5.

1 on the timing and whether there will be a credit-supportive outcome of the Company's
2 general rate case and this proceeding, are playing a role in Moody's hesitancy in deciding
3 that AB 1054 will lead to improved credit quality.⁸

4 **Q. Do you agree with Mr. Gorman that S&P's assessment of regulatory risk supports**
5 **the idea that California regulation reduces utility operating risk?**

6 **A.** No. Mr. Gorman cites two firms that publish opinions about regulatory risk, one of
7 which is S&P Global Ratings.⁹ This is not a subgroup of the ratings analysts, as he seems
8 to think. Instead, it is the ratings analysts themselves that make those assessments and
9 use them directly in the ratings analysis of SDG&E and other utilities. He notes the
10 change in the California ranking in June 2018¹⁰ but fails to understand the importance of
11 that dramatic, two-category downgrade. The drop, to a category that places California
12 among the riskiest of U.S. jurisdictions from among the most credit-supportive, was
13 instrumental in leading to the series of ratings downgrades of California electric utilities,
14 including SDG&E. Only three other jurisdictions of the other fifty-plus U.S. jurisdictions
15 are judged by S&P to harbor more innate regulatory risk than California. The move was
16 based, as Mr. Gorman correctly notes, on the recognition of the full impact of wildfire
17 risk on the state's regulatory environment and preceded the passage of wildfire reform
18 legislation. The assessments have been updated twice since then with no change in the
19 low assessment, and S&P's stable outlooks on SDG&E and the other wildfire-exposed
20 utilities is a good indication that an upward revision in the assessment is unlikely. A two-

⁸ *Id.* at 6-7

⁹ TURN Testimony (Gorman) at IV-9:3-9.

¹⁰ S&P, "U.S. And Canadian Regulatory Jurisdictions Support Utilities' Credit Quality – But Some More Than Others," dated June 25, 2018 at 6.

1 category downgrade like the one in 2018 is unusual. Changes to these assessments are
2 infrequent. The damage that wildfire risk has done to investors' regard for the
3 supportiveness of California regulation is likely to linger despite the improvement that
4 has come with the 2019 legislative actions.

5 **Q. Do you agree with Mr. Gorman's analysis of the sufficiency of SDG&E's authorized**
6 **common equity ratio based on an S&P credit analysis?**

7 **A. No. Mr. Gorman concluded that the current common equity ratio used to set rates**
8 **supports SDG&E's credit ratings and financial integrity.¹¹ He says he reached that**
9 **conclusion based on an S&P credit metric he calls an "adjusted debt ratio."¹² S&P's**
10 **rating methodology does not contain any such metric used to rate utilities or any**
11 **corporate issuer for that matter.¹³ He compares his calculation of this ratio for SDG&E to**
12 **an industry-average ratio. This step, too, is faulty, as S&P does not rate a utility by**
13 **comparing an issuer's credit metrics to an industry average in any particular country (I'm**
14 **assuming his industry averages are U.S.-based ones). S&P ratings and its methodologies**
15 **are global in scope. Metrics are assessed for ratings purposes against a set of benchmarks**
16 **that are objective (not relative to other industry participants) and that apply to issuers**
17 **across the globe. He cannot reasonably conclude from his superficial and incomplete**
18 **analysis that his recommended capital structure is sufficient to support SDG&E's credit**
19 **ratings and financial integrity.**

¹¹ TURN Testimony (Gorman) at VIII-7:11-13.

¹² *Id.* at VIII-7:16.

¹³ For a listing of the credit metrics used by S&P in its credit analysis, *see* S&P, *Criteria|Corporates|General; Corporate Methodology*, dated November 19, 2013 at 28-31.

1 **IV. RESPONSE TO MR. PAVLOVIC**

2 **Q. Please describe Mr. Pavlovic's criticism in his direct testimony of the return on**
3 **equity recommendation on the basis of credit rating agency recommendations.**

4 **A. According to Mr. Pavlovic, S&P, Moody's, and Fitch collectively recommend: "(1)**
5 **reform of regulatory procedures for recovery of wildfire costs and expenses and (2)**
6 **repeal or reform of wildfire inverse condemnation liability" to stabilize SDG&E's credit**
7 **rating a stabilize its credit outlook. On that basis, Mr. Pavlovic concludes that that an**
8 **adjustment to the return on equity is not a form of risk mitigation.¹⁴**

9 **Q. Is an ROE adjustment that recognizes the incremental risks associated with wildfire**
10 **liabilities intended to mitigate the risk and stabilize the Company's credit rating?**

11 **A. No. As discussed by my colleagues Reed and Coyne in rebuttal,¹⁵ debt investors and**
12 **equity investors are exposed to different risks, and therefore require different returns.**
13 **The authorized ROE incorporated into a utility's revenue requirement is often noted**
14 **when a rating agency is assessing the utility's regulatory risk. And, as noted, Moody's is**
15 **focused on whether SDG&E will have a positive outcome in this proceeding. But it is**
16 **not a direct or significant input into the ratings analysis. Credit analysts are much more**
17 **focused on the actual returns that a utility achieves, and that is subject to many more**
18 **factors than the authorized ROE.¹⁶ They also take note of the equity ratio in the capital**

¹⁴ UCAN Aug. 1 Testimony (Pavlovic) at 9:17-11:21.

¹⁵ *See Prepared Rebuttal Testimony of Concentric Energy Advisors, Wildfire Risks Post AB-1054, Chapter 1* (Aug. 2019) at 22:14-23:11.

¹⁶ *See, for instance, S&P Ratings Services, Assessing U.S. Investor-Owned Utility Regulatory Environments*, dated May 18, 2015 at 3.

1 structure, as they recognize that it governs how much leverage a utility will employ. That
2 has a direct effect on credit metrics and, therefore, financial risk and ultimately ratings.¹⁷

3 **Q. Mr. Pavlovic relies in part on the absence of rating agency advocacy for higher**
4 **authorized ROEs when claiming that a wildfire adjustment to ROE would not**
5 **mitigate catastrophic wildfire risk. Is this accurate?**

6 **A. No. He errs in two ways. First, he misunderstands the role of the rating agencies. They**
7 **are independent arbiters of credit quality and do not perceive their roles as recommending**
8 **any course of action to the CPUC, the utilities, or any other party. In fact, they are**
9 **prohibited by their codes of conduct from doing so.¹⁸ Secondly, he claims the agencies**
10 **do not mention wildfire risk impact on equity return as a reason for the ratings**
11 **downgrades.¹⁹ That is wildly inaccurate. The downgrades were a direct result of the**
12 **agencies' determinations that wildfire liability risk raised regulatory risk to California**
13 **electric utilities. A central focus of their assessment of regulatory risk is a utility's ability**
14 **to fully and timely recover costs through the regulatory process.²⁰ A fair and reasonable**
15 **return on equity that fully recovers a utility's cost of equity is one of those costs.²¹**
16 **Everything that Mr. Pavlovic lists in his ensuing recitation of rating agency concerns on**

¹⁷ Moody's, *Rating Methodology, Regulated Electric and Gas Utilities*, dated June 23, 2017 at 21.

¹⁸ See Moody's Code of Professional Conduct (Feb. 2019) at 10, §1.17, and S&P Code of Conduct (Mar. 1, 2019) at 8, §7.2.

¹⁹ UCAN Aug. 1 Testimony (Pavlovic) at 9:17-19.

²⁰ Moody's, *Rating Methodology, Regulated Electric and Gas Utilities*, dated June 23, 2017 at 12 (*"Factor 2: Ability To Recover Costs And Earn Returns"*).

²¹ See Moody's Aug. 2 Report at 9 (only rating SDG&E's "Timeliness of Recovery of Operating and Capital Costs" at 'Baa').

1 wildfire risk relate precisely to the utilities' ability to earn a compensatory return and
2 contradict his premise that the agencies are indifferent to a utility's equity return.

3 **Q. Do you agree with Mr. Pavlovic's characterization in his reply testimony of the**
4 **ratings agencies' communications to investors about the outlook for SDG&E's**
5 **ratings?**

6 **A. No. He melodramatically describes the rating agencies as holding SDG&E's ratings**
7 **"hostage"²² as he reviews what is a typical example of the regular and common manner**
8 **that the agencies communicate to investors on the circumstances that would lead them to**
9 **raise or lower an issuer's ratings. In my time at S&P, we were constantly admonished to**
10 **be transparent with investors on that point, as they are acutely sensitive to ratings changes**
11 **and desire as much information as possible to gauge the probability of a change to assist**
12 **their risk management in holding a security, especially when the outlook is not stable.**
13 **Every credit report contains such guidance to stakeholders, and the Moody's language on**
14 **its positive outlook is unremarkable.²³**

15 Putting aside Mr. Pavlovic's attempt to paint the rating agencies as an interested
16 party to neutralize their independent opinions on the impact of AB 1054, which
17 misconception I covered above, he reinforces our argument that the legislation did not
18 fully reinstate the risk profile of SDG&E with regard to wildfire risk:

²² UCAN Aug. 16 Testimony (Pavlovic) at 6:12 and 11:19-21.

²³ For recent examples, see Moody's, *Rating Action: Moody's affirms ACEA's Baa2 rating; stable outlook*, dated Aug. 8, 2019 at 2 ("Negative pressure on ACEA's ratings could arise following ... (3) any adverse regulatory development...and/or adverse political interference from the government..."), and S&P, *Research Update: DPL Inc. and Subsidiary Dayton Power & Light Outlooks Revised TO Negative On Elevated Regulatory Risk, Ratings Affirmed*, dated June 21, 2019 at 2 ("We could lower our ratings on DPL and DP&L over the next 12 months by one or more notches if its use of the DMR is modified, indicative of a significant shift to the company's regulatory construct.")

1 In other words, having initially characterized SDG&E's credit downgrades
2 as a response to a perceived increase in wildfire risk, SDG&E and the
3 rating agencies now say that restoration of SDG&E's former credit ratings
4 will require not only AB 1054's mitigation of wildfire risk, but also credit
5 supportive outcomes in SDG&E's cost of capital proceeding, general rate
6 case proceeding, and other unspecified proceedings.²⁴
7

8 I could hardly express the situation better myself. Mr. Pavlovic has correctly
9 identified the risk equation, although it's only Moody's and not the rating agencies in
10 general that believe a rating upgrade is conceivable in the ratings horizon. If AB 1054
11 were sufficient, other risk-reducing measures would not be necessary to return ratings to
12 former levels. Regardless of Mr. Pavlovic's view, SDG&E's credit ratings are subject to
13 the credit rating agencies' assessments of the Company's relative risks – and with it, the
14 resulting costs of debt and equity.

15 Mr. Pavlovic also misunderstands S&P's Regulatory Research Associates'
16 ("RRA") assessment.²⁵ It is not "two-dimensional." It is simple ranking, like a credit
17 rating, except that the RRA rankings are relative, not absolute. Mr. Pavlovic's quotes
18 from the February RRA reporting are misleading. The '1' that he says means "more
19 constructive" simply means that it is a little lower risk than other states in the Average
20 category – not lower risk overall.

21 And on August 15, 2019, RRA issued new state rankings, where they lowered the
22 ranking of California from Average/1 to Average/2, meaning that it is now considered of
23 higher risk than before.²⁶ RRA stated that it was lowering California's regulatory ranking
24 based on ongoing uncertainty for:

²⁴ UCAN Aug. 16 Testimony (Pavlovic) at 12:16-20.

²⁵ *Id.* at 13:3-7.

²⁶ S&P Global, *RRA Regulatory Focus: State Regulatory Evaluations*, Aug. 15, 2019 at 2.

1 investor-owned utilities in the state resulting from the reliance on
2 interpretation of “inverse condemnation,” under which a utility may be
3 held liable for damage associated with force majeure events even if it has
4 adhered to prevailing safety guidelines. While recently enacted legislation
5 mitigates some of the utilities’ exposure, it is unclear whether the funding
6 mechanisms outlined in the law will avert similar situations in the future.
7 The frequency at which severe weather-related events are occurring argues
8 for a more comprehensive approach in RRA’s view.²⁷

9 Mr. Pavlovic’s point is therefore no longer applicable.

10 **V. CONCLUSION**

11 **Q. What is your conclusion with regard to your recommendation?**

12 **A. The rating agency reactions to AB 1054 support the conclusion that the legislation did not**
13 **fully restore the risk profile of SDG&E with regard to wildfire risk. Therefore, the**
14 **recommended risk adjustment presented in the Supplemental Direct Testimony of Reed**
15 **and Coyne, reflecting the impacts of AB 1054, in combination with Dr. Morin’s ROE**
16 **recommendations in direct testimony, provides a fair and reasonable return on equity for**
17 **SDG&E.**

18 **Q. Does this complete your Supplemental Direct Testimony?**

19 **A. Yes.**

²⁷ *Id.* at 2-3.