

pCompany: San Diego Gas & Electric Company (U 902 M)
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Application: A.19-04-017
Exhibit: SDG&E-11

SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)
PREPARED REBUTTAL TESTIMONY OF BRUCE A. FOLKMANN
(WILDFIRE RISKS POST-AB 1054)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA



August 21, 2019

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1 **SAN DIEGO GAS AND ELECTRIC COMPANY**
2 **PREPARED REBUTTAL TESTIMONY OF BRUCE A. FOLKMANN**
3 **(WILDFIRE RISKS POST-AB 1054)**

4 **I. INTRODUCTION**

5 My supplemental rebuttal testimony on behalf of San Diego Gas & Electric Company
6 (“SDG&E” or the “Company”) addresses the testimonies submitted on August 16, 2019 from the
7 following parties: Federal Executive Agencies (“FEA”); Utility Consumers’ Action Network
8 and Protect Our Communities (collectively, “UCAN”); the County of San Diego; and the
9 Environmental Defense Fund (“EDF”), regarding the risks to SDG&E from catastrophic wildfire
10 liability following the passage of Assembly Bill (“AB”) 1054.¹

11 As credit rating agencies have recognized, although AB 1054 lessened SDG&E’s risks,
12 significant threats remain. These include uncertainty regarding AB 1054’s implementation, the
13 continued applicability of inverse condemnation, and the state’s overall political and regulatory
14 environment. This is reflected in the fact that SDG&E’s credit rating was left unchanged –
15 despite the Company’s credit rating having been repeatedly downgraded in the last year without
16 the Company being involved in a significant wildfire. As intervenors fail to recognize, SDG&E
17 is not trying to recover wildfire costs; it is requesting to set its Return on Equity (“ROE”)
18 consistent with investor expectations. If SDG&E’s ROE is set commensurate with other utilities
19 having less risks, investors will invest in those less risky utilities, harming the Company and its
20 customers. Lowering SDG&E’s current ROE to the intervenors’ below-average ROE proposals
21 would do exactly that. SDG&E’s ROE must instead be set at 12.38% to reflect its unique,
22 above-average risks.

¹ AB 1054, Stats. 2019, Ch. 79.

1 **II. RETURN ON EQUITY MUST BE SET CONSISTENT WITH INVESTOR**
2 **EXPECTATIONS**

3 In seeking their preferred outcome, intervenors ignore how an appropriate ROE must be
4 determined – by examining investor expectations to determine what return is necessary, given
5 the risks facing the company – as required by *Bluefield* and *Hope*.² Intervenors fail to
6 understand that the portion of SDG&E’s ROE proposal that reflects wildfire liability risks is not
7 an attempt to obtain wildfire insurance.³ Nor is it an attempt to compensate investors for past or
8 future wildfire costs.⁴ It is not a cost concept at all. Instead, it is a measurement of investor
9 expectations. The higher the risks faced by a company, the higher the return that is needed.
10 Otherwise, investors will go elsewhere, harming both the company and its ratepayers.

11 **A. SDG&E’s ROE Proposal Measures Investor Expectations**

12 SDG&E’s ROE proposal is thus a measurement of the return that investors require to
13 invest with SDG&E following the passage of AB 1054, given the ongoing risks that the
14 Company faces, including wildfire risks. California utilities continue to face unique threats.
15 Richard McCann on behalf of EDF attempts to argue that these risks are not “unusual.”⁵ But no
16 intervenor points to another state that combines:

² *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm’n of W. Va.*, 262 U.S. 679 (1923);
Fed. Power Comm’n v. Hope Nat’l Gas Co., 320 U.S. 591 (1944).

³ *See 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 29:4-6.

⁴ *See Prepared Reply Testimony and Direct Testimony of Karl Richard Pavlovic on Behalf of Utility
Consumers’ Action Network and Protect Our Communities Foundation* (August 16, 2019) (“UCAN
Aug. 16 Testimony (Pavlovic)”) at 9:18-10:1; *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 3; *Supplemental
Testimony of County of San Diego (AB 1054)* (August 16, 2019) (“San Diego County Testimony”) at
2.

⁵ EDF Aug. 16 Testimony (McCann) at 1.

- 1 • The high risks of wildfires in population-dense and high-value real estate areas;
2 with
- 3 • Inverse condemnation; and
- 4 • The application of a prudency review standard that investors and credit rating
5 agencies believe results in a high risk of claims being disallowed regardless of
6 how the utility acted.⁶

7 Amazingly, Dr. McCann asserts that “[o]ther than the scale of the 2017-2018 fires,
8 nothing has changed” since the Commission’s 2012 cost of capital decision.⁷ As the credit rating
9 downgrades of the last year have shown, this is the height of whistling past the graveyard. As
10 Moody’s recently underscored, the reason that wildfire liability risk is now seen as an acute
11 threat is because of two issues that arose since 2017:

- 12 • The size and severity of California wildfires in 2017-2018; and
- 13 • The Commission’s 2017 Wildfire Expense Memorandum Account decision
14 prohibiting SDG&E from recovering costs from 2007 wildfires on the same facts
15 that the Federal Energy Regulatory Commission (“FERC”) allowed recovery.

16 These two events reset stakeholder expectations by signaling that: (1) wildfires of this
17 size and magnitude could be the new normal; and (2) California utilities face a significant threat
18 of being both responsible for significant costs under inverse condemnation *and* being unable to
19 recover those costs under the Commission’s prudency review.⁸ So if the Commission’s
20 rationale in 2012 was to not increase ROE for wildfire risks because “none of the credit agencies
21 reporting on the creditworthiness of either SCE or SDG&E mentioned any risks associated with
22 wildfires”⁹ the opposite presumption applies now. SDG&E’s ROE proposal is nothing more

⁶ Moody’s, *FAQ on the credit implications of California’s new wildfire law*, dated August 6, 2019 (“Moody’s Aug. 6 Report”) at 2.

⁷ EDF Aug. 16 Testimony (McCann) at 4.

⁸ Moody’s Aug. 6 Report at 2.

⁹ Decision 12-12-034 at 30.

1 than an attempt to quantify the return required to induce investment given the risks facing the
2 Company. The quantification of the remaining wildfire liability risks to investors following AB
3 1054 is one component of that assessment.

4 **B. SDG&E Continues to Face Increased Risks Following AB 1054**

5 Some intervenors contend that AB 1054 fully eliminated all wildfire liability risks.¹⁰ But
6 they offer no evidence to support that claim. They ignore that credit rating agencies did not
7 restore SDG&E’s downgraded credit ratings. Or that the rating agencies see ongoing risks to
8 SDG&E from:

- 9 • How AB 1054 will be implemented, particularly regarding the revised prudency
10 review standard;¹¹
- 11 • Inverse condemnation, particularly if and when the wildfire fund is depleted;¹²
- 12 • Whether SDG&E will obtain credit-supportive outcomes in this and other
13 regulatory proceedings (particularly with regards to the Company’s capital
14 structure proposal);¹³ and

¹⁰ See UCAN Aug. 16 Testimony (Pavlovic) at 2:10-12; *Prepared Reply Testimony of Marlon F. Griffing, Ph.D., on Behalf of Utility Consumers’ Action Network and Protect Our Communities* (August 16, 2019) (“UCAN Aug. 16 Testimony (Griffing)”) at 5:3-4.

¹¹ 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.”).

¹² 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).

¹³ Moody’s, *Rating Action: Moody’s affirms San Diego Gas & Electric’s ratings; changes outlook to positive from negative*, dated July 29, 2019 (“Moody’s July 29 Report”) at 1-2; Moody’s, *Rating Action: Moody’s affirms San Diego Gas & Electric Company’s ratings; outlook remains negative*, dated July 12, 2019 (“Moody’s July 12 Report”) at 1-2.

- 1 • The overall political and regulatory environment.¹⁴

2 Even Mr. Pavlovic notes that any improvement in SDG&E’s credit ratings will require
3 some further mitigation of these risks.¹⁵ But instead of constructively working towards those
4 goals, Mr. Pavlovic wants to either relitigate AB 1054’s passage and/or provocatively claim that
5 credit agencies are holding SDG&E’s credit rating “hostage.”¹⁶ Both points are irrelevant.
6 Credit rating agencies are independent actors.¹⁷ Whether Mr. Pavlovic agrees with their analyses
7 is largely irrelevant – the cost of debt and equity for SDG&E is influenced, at least in part, on
8 those agencies’ determination. The only way to increase SDG&E’s credit rating – and lower
9 costs for ratepayers – is to ameliorate the risks that credit rating agencies see going forward –
10 including from this case.

11 For this reason, Dr. Griffing’s statement that a “common equity ratio of 56 percent is
12 among the highest such ratios requested in rate cases, let alone approved by a commission” is
13 equally unsupported.¹⁸ As Dr. Morin demonstrated, the average common equity ratio of his
14 proxy group is 53-54%; largely consistent with SDG&E proposal.¹⁹ Moody’s has made clear
15 that its current (downgraded) credit rating for SDG&E is based upon the Company continuing to
16 operate at its actual common equity level of 56% and that it could revise its assessment

¹⁴ Moody’s Aug. 2 Report at 6-7.

¹⁵ UCAN Aug. 16 Testimony (Pavlovic) at 12:17-20.

¹⁶ *Id.* at 11:19-21.

¹⁷ *Prepared Rebuttal Testimony of Concentric Energy Advisors, Chapter 2 (Wildfire Risks Post-AB 1054)* (August 21, 2019) (“Ex. SDG&E-12, Ch. 2 (Concentric Rebuttal)”) at 8:6-9 and n. 18.

¹⁸ UCAN Aug. 16 Testimony (Griffing) at 6:1-2.

¹⁹ *Prepared Rebuttal Testimony of Roger A. Morin, Ph.D., Return on Equity* (August 16, 2019) (“Ex. SDG&E-09 (Morin Rebuttal)”) at 26:6-7.

1 downward if SDG&E is granted a lower authorized common equity structure in this
2 proceeding.²⁰

3 Other intervenors, such as Mr. O'Donnell, concede that inverse condemnation creates
4 increased risks.²¹ But then he contradicts his own findings. Although Mr. O'Donnell reiterates
5 that he proposes a purported wildfire "adder" of .5%, as Dr. Morin has discussed, that only
6 makes his ROE proposal for SDG&E 9.5%. Such an ROE – even with the adder – would be
7 below the national average for 2018-2019.²² A below average ROE should only be set for a
8 utility facing below average risks.²³

9 And Mr. O'Donnell ignores other risks, namely those associated with AB 1054's
10 implementation. He states that it is "premature" to worry about how the revised prudence
11 standard will be applied, or when or if the wildfire fund will be depleted.²⁴ Yet these are
12 precisely the types of concerns that credit rating agencies and equity investors are concerned
13 with now. If Mr. O'Donnell's best-case scenario regarding AB 1054 comes to fruition,²⁵ then
14 investor fears will eventually dissipate, and SDG&E's ROE at that time can reflect those reset

²⁰ Moody's July 29 Report at 2; Moody's July 12 Report at 2.

²¹ FEA Aug. 16 Testimony (O'Donnell) at 29:26-27 (stating that the "stock of Sempra is still somewhat in the shadow of inverse condemnation") (citation omitted).

²² Ex. SDG&E-09 (Morin Rebuttal) at 82:18-19.

²³ Mr. O'Donnell's focus on SDG&E's parent company, the more diversified Sempra Energy, is oversimplified, as Mr. O'Donnell has previously admitted. *See 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 60:4-6 (stating that some of Sempra's "earnings growth is coming from expected earnings growth from recent acquisitions, such as the Oncor purchase, and have little to do with utility regulation in California").

²⁴ FEA Aug. 16 Testimony (O'Donnell) at 4:13-19; 25:24-33.

²⁵ *See id.* at 26:4-6.

1 expectations. But because these are the risks that credit rating agencies and other stakeholders
2 *presently* see following AB 1054, ROE must be set now with those risks in mind.²⁶

3 By contrast, it is completely speculative to state that the wildfire fund could be
4 replenished by legislative action or somehow recreated through a “CPUC rulemaking.”²⁷
5 Neither SDG&E nor other parties have control over either process. Mr. O’Donnell offers no
6 evidence to support this statement. Instead, Moody’s findings cut the other way – that SDG&E
7 faces a difficult political environment, suggesting that such a revival would be challenging.²⁸ It
8 is not realistic for the Commission to base its decisions here on Mr. O’Donnell’s speculation
9 about legislation or rulemakings that have not and may never occur.

10 Finally, as noted above, intervenors continue to argue that SDG&E and other California
11 utilities “cannot expect a higher return to compensate for the negligence of the utilities’
12 management negligence [sic] or poor management decision-making.”²⁹ But, again, the claim
13 that wildfire liability risks are simply about negligence or imprudence is laid bare by SDG&E’s
14 experience. SDG&E is widely seen as an industry leader in wildfire mitigation.³⁰ The Company
15 has not been involved in a significant wildfire event since 2007. Yet, as Mr. O’Donnell admits,

²⁶ See Ex. SDG&E-12, Ch. 2 (Concentric Rebuttal) at 10:21-11:8 (noting that S&P’s Regulatory Research Associates recently lowered California’s regulatory ranking from ‘Average/1’ to ‘Average/2,’ based upon a concern that the wildfire fund funding mechanism may not work to prevent significant liability) (citing S&P Global, *RRA Regulatory Focus: State Regulatory Evaluations*, Aug. 15, 2019 at 2).

²⁷ FEA Aug. 16 Testimony (O’Donnell) at 28:28-30.

²⁸ Moody’s Aug. 2 Report at 9.

²⁹ EDF Aug. 16 Testimony (McCann) at 1.

³⁰ Moody’s Aug. 2 Report at 5.

1 SDG&E credit rating was repeatedly downgraded following the passage of Senate Bill 901 –
2 simply because of the risks from the overall legal and regulatory environment.³¹

3 As a result, SDG&E faces an increased cost of capital through no fault of its own. It
4 defies logic to say that a higher ROE would create a “perverse incentive” to ignore wildfire
5 risk.³² California utilities’ past experience with wildfires and AB 1054 continue to underscore
6 that SDG&E’s paramount concern to effectively mitigate wildfires to the maximum extent
7 possible. SDG&E has been recognized as being a leader in doing so. Yet SDG&E faces
8 increased cost of capital and decreased credit rating despite the significant measures the
9 Company has undertaken.

10 **III. CONCLUSION**

11 It is a basic principle that ROE must reflect investors’ expectations about the risks facing
12 the company. The higher the risks, the higher the return necessary to induce investment.
13 Although AB 1054 somewhat lowered SDG&E’s risks, those risks remain elevated – reflected
14 by the Company’s depressed credit ratings. This downgraded position is not based upon any
15 actions of SDG&E, but instead reflects the increased risks from the state’s wildfire liability
16 regime. And these downgrades occurred at SDG&E’s present ROE. To engage in intervenors’
17 fiction that the credit rating agencies’ concerns are unfounded and lower the Company’s current
18 ROE to one that is below the national average would likely only further harm SDG&E and
19 stakeholders’ overall view of the state. SDG&E’s 12.38% ROE request reflects the quantified
20 risks to investors – including from wildfire liability – following AB 1054’s passage.

21 This concludes my prepared rebuttal to my supplemental direct testimony.

³¹ FEA Aug. 16 Testimony (O’Donnell) at 18:17-20.

³² EDF Aug. 16 Testimony (McCann) at 3.