

Company: San Diego Gas & Electric Company (U 902 M)
Proceeding: 2020 Cost of Capital
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**SAN DIEGO GAS & ELECTRIC COMPANY
PREPARED SUPPLEMENTAL TESTIMONY OF
DON WIDJAJA
COMPANY RISK
(AB 1054)**

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



AUGUST 1, 2019

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I. INTRODUCTION

Pursuant to Administrative Law Judge (“ALJ”) Stevens’ July 18, 2019 email ruling modifying the procedural schedule,¹ my supplemental testimony addresses the impacts of Assembly Bill (“AB”) 1054² on San Diego Gas & Electric Company’s (“SDG&E” or “the Company”) risks. Specifically, it focuses on the impacts of what I will refer to as the “wildfire fund,” which was established primarily by the terms of new Section 3292 of the California Public Utilities Code (“Cal. Pub. Util. Code”), and which SDG&E opted-into on July 18, 2019.³

II. AB 1054’S WILDFIRE FUND REDUCES CERTAIN MEDIUM-TERM RISKS

As described in the supplemental testimony of SDG&E policy witness Bruce Folkmann (Exhibit SDG&E-01-S), SDG&E has opted-in to AB 1054’s wildfire fund.⁴ So this testimony will focus on the impact of that election on SDG&E’s risk profile.

SDG&E believes that the wildfire fund contains “material benefits” that “are not available in the smaller liquidity fund.”⁵ As discussed in Mr. Folkmann’s testimony, credit rating agencies Moody’s, Standard & Poor’s (“S&P”) and Fitch Ratings (“Fitch”) similarly view SDG&E’s participation in the wildfire fund as credit supportive, at least in the medium term. As reflected in those agencies’ post AB-1054 reports, the wildfire fund potentially moderates some

¹ July 18 email from ALJ Stevens to the Application 19-04-014, et al. Service List.

² AB 1054, Stats. 2019, Ch. 79.

³ See Prepared Supplemental Testimony of Bruce Folkmann (Aug. 2019), (Ex. SDG&E-01-S (Folkmann)) at 2; see also Sempra Energy and SDG&E SEC Form 8-K, filed July 19 (“July 19 Form 8-K”), available at: <http://investor.sempra.com/static-files/c182aeaf-00b8-48cb-9d48-675852d50c33>.

⁴ See Ex. SDG&E-01-S (Folkmann) at 2-4.

⁵ See July 19 Form 8-K.

1 of the most dire risks facing SDG&E from California’s catastrophic wildfire liability regime of
2 inverse condemnation strict liability and the Commission’s separate prudence review, principally
3 through:

- 4 • The availability of immediate liquidity to pay wildfire claims;
- 5 • The cap on utility liability;
- 6 • The alterations to the prudency standard; and
- 7 • The incentive to settle subrogation claims.⁶

8 For instance, S&P stated that, in the medium term, it “expect[s] that SDG&E’s credit
9 quality will benefit from the use of the [wildfire] fund as a source of liquidity, a predetermined
10 cap that limits SDG&E’s liability, and revised standards of a utility’s reasonable conduct that we
11 believe will increase the likelihood that SDG&E will recover future wildfire costs from
12 ratepayers.”⁷ Moody’s similarly added that:

- 13 • The “liability cap on cost disallowances is the most credit supportive feature of
14 the [wildfire] fund because it allows us to quantify and limit a utility’s maximum
15 exposure to a catastrophic wildfire event if the utility is not found to be prudent
16 according to the new prudency standard;”
- 17 • The wildfire fund “should be large enough to cover all but the most extreme
18 downside scenarios;” and

⁶ See, e.g., Moody’s Investor Service, *Rating Action: Moody’s affirms San Diego Gas & Electric Company’s ratings; outlook remains negative*, dated July 12, 2019, at 1 (“Moody’s July 12 Report”) (the wildfire “fund provides a much higher level of near-term risk reduction for SDG&E [compared to the liquidity-only fund] because it caps the amount of cost disallowance associated with catastrophic wildfire and applies a more credit supportive prudency standard.”).

⁷ S&P Global Ratings, *San Diego Gas & Electric Co. Ratings Affirmed, Outlook Revised to Stable from Negative*, dated July 30, 2019, at 1 (“S&P July 30 Report”).

- 1 • The actual net usage of the wildfire fund should be lower than the gross claims
2 amount because the “fund is designed to only pay subrogation claims that are
3 settled at 40 cents on the dollar or less.”⁸

4 **III. SDG&E STILL FACES HEIGHTENED RISKS FROM CATASTROPHIC**
5 **WILDFIRE LIABILITY**

6 Yet even with AB 1054’s benefits, SDG&E continues to face outstanding questions and
7 heightened risks – both in the short and long-term. This is principally reflected by the fact that
8 the credit rating agencies did not increase SDG&E’s credit rating in response to the legislation.

9 The credit ratings agencies noted several reasons for maintaining SDG&E’s credit ratings
10 at the very low levels to which they have been downgraded over the past year (levels that are
11 well below SDG&E’s historical levels).⁹ First, it is unclear how effectively AB 1054 will be
12 implemented. It will take time to determine whether the wildfire fund is working as intended;
13 perhaps until there is a catastrophic wildfire where an investor-owned utility is found to be a
14 contributing cause.

15 As noted in Mr. Folkmann’s testimony, credit rating agencies have particular concerns
16 regarding two features of the legislation that are potentially the most beneficial – namely, how
17 the new prudence standard in Section 451.1 will be applied by the Commission, and how long
18 the wildfire fund will last.¹⁰ Regarding the prudence standard, as S&P states, if “the
19 Commission does not implement AB 1054 in a credit-supportive manner then much of the new
20 law’s credit-supportive elements related to the revised standards of a utility’s reasonable conduct

⁸ Moody’s Investor Service, *Rating Action: Moody’s affirms San Diego Gas & Electric’s ratings; changes outlook to positive from negative*, dated July 29, 2019 at 1 (“Moody’s July 29 Report”).

⁹ See Prepared Direct Testimony of Don Widjaja (April 2019) (Ex. SDG&E-03 (Widjaja)) at 12.

¹⁰ Ex. SDG&E-01-S (Folkmann) at 8-9.

1 could potentially be negligible.”¹¹ The only relevant experience of how the Commission has
2 applied a prudence review is in SDG&E’s 2007 Wildfire Expense Memorandum Account
3 application where it found the Company 100% imprudent, heightening caution. Although the
4 revisions to the prudence standard seem intended to mirror the prudence standard used at the
5 Federal Energy Regulatory Commission, it is unclear if it will be applied in the same manner.
6 The Filsinger Energy Partners’ Wildfire Fund Durability Analysis conducted for Governor
7 Newsom’s ‘Strike Force’ (“Filsinger”) assumes that only 25% of wildfire costs will be found
8 prudent in 2020 – suggesting that alterations to the standard of review will not have a large
9 impact on prudency review outcomes.¹²

10 Regarding the wildfire fund’s durability, as Moody’s notes, “if and when the insurance
11 fund’s claims paying capability is exhausted, the majority of the credit friendly structures,
12 including the disallowance cap, will terminate.”¹³ How long the wildfire fund lasts (and with it,
13 the liability cap) is of particular importance because it is tied to a long-term risk that AB 1054
14 does not address – inverse condemnation. As Fitch states, the “continuation of inverse
15 condemnation remains a long-term credit issue for SDG&E as an electric utility in California.”¹⁴

¹¹ S&P July 30 Report at 2; *accord* Fitch, *Fitch Affirms San Diego Gas & Electric’s IDR at ‘BBB+’; Outlook Revised to Stable*, dated July 17, 2019 at 1 (“July 17 Report”) (“the lack of a track record of implementing the new legislation” – “especially the new prudence standard which is subject to interpretation” – is a “credit constraint[.]”).

¹² Filsinger Energy Partners, *California Wildfire Fund Durability Analysis*, dated June 26, 2019 (“Filsinger June 29, 2019 Report”); Moody’s July 12 Report at 1 (discussing Filsinger study).

¹³ Moody’s July 12 Report at 1; *accord* S&P July 30 Report at 1 (if the wildfire fund is exhausted, SDG&E “loses the [wildfire] fund as a source of liquidity and more importantly loses the credit protection of the liability cap.”).

¹⁴ Fitch July 17 Report at 1; *see also id.* at 4 (stating that “indications that a repeal of inverse condemnation doctrine is forthcoming” would be a development that may lead to a positive ratings action).

1 If the wildfire fund is exhausted, SDG&E’s investors are once again potentially exposed to
2 unmitigated downside risks from inverse condemnation.¹⁵ S&P thus sees “the lack of automatic
3 replenishing mechanism and the depleting nature” of the wildfire fund as long-term threats.¹⁶

4 Worse, the durability of the wildfire fund is largely outside of SDG&E’s control. As
5 Fitch states, the amount of funding that will be available to SDG&E from the wildfire fund
6 depends on the “frequency and severity of wildfires in other [investor-owned utilities’] service
7 territories as well as their safety conduct.”¹⁷ SDG&E faces “contagion risks associated with
8 commingling of funds in the wildfire fund, given [SDG&E’s] materially different service
9 territory and safety culture.”¹⁸ S&P echoes this, noting that “AB 1054 directly associates
10 SDG&E’s credit quality to the operations of its California electric utility peers,” meaning that
11 “even if SDG&E continues to maintain its operational excellence, its longer-term benefit of the
12 credit-supportive liquidity cap is ultimately dependent on the operations of California’s other
13 investor-owned electric utilities that are also contributing to the insurance fund.”¹⁹

14 Although Filsinger estimates that there is only a 0.9% chance of the fund being exhausted
15 by 2030, this calculation makes four assumptions, namely that:

- 16 • The wildfire experience of the past five years applies;
- 17 • Utilities maintain \$1 billion of wildfire liability insurance;

¹⁵ S&P July 30 Report at 1-2.

¹⁶ *Id.* at 1.

¹⁷ Fitch July 17 Report at 3.

¹⁸ *Id.* at 1.

¹⁹ *See* S&P July 30 Report at 2

- 1 • “[Seventy five percent] of wildfire costs are disallowed in 2020 but fall[] steadily
2 to 25% by 2030;”²⁰ and
- 3 • The subrogation incentives work as intended, inducing insurers to settle claims at
4 a 40% discount to stretch the wildfire fund’s coverage beyond its \$21 billion
5 capitalization.²¹

6 One or all of these assumptions could be incorrect. Without knowing how the revisions
7 to the prudence standard will be applied, it is impossible to know with precision what percentage
8 of catastrophic wildfire claims on the fund will be found prudent – and with it, how long the fund
9 will last. Similarly, the wildfire fund’s duration will be much shorter if the experience of the last
10 two years of catastrophic wildfire liability applies moving forward, rather than the last five years.
11 In other words, according to Filsinger, the last five years have seen an average utility-caused
12 wildfire loss of \$8.5 billion. But the average loss, for the last two years alone, is over \$12 billion
13 annually.²²

14 The provision incentivizing the settling of claims at 40% or less could also not work as
15 intended.²³ The actual experience with settling catastrophic wildfire subrogation claims has
16 resulted in average settlements that are significantly higher than 40% of the claimed amount. If
17 anything, that percentage has been increasing in recent years. It is also unclear how a future fund
18 administrator will interpret and apply the provision.²⁴

²⁰ Moody’s July 12 Report at 1.

²¹ See Filsinger June 29, 2019 Report at 2; see also Moody’s July 12 Report at 1.

²² See Cal. Dep’t of Insurance, *Wildfire insurance losses from November 2018 blazes top \$12 billion*, Released May 8, 2019, available at <http://www.insurance.ca.gov/0400-news/0100-press-releases/2019/release041-19.cfm>; Cal. Dep’t of Insurance, *California statewide wildfire insurance claims nearly \$12 billion*, Released Jan. 31, 2018, available at <http://www.insurance.ca.gov/0400-news/0100-press-releases/2018/release013-18.cfm>.

²³ Cal. Pub. Util. Code § 3292(f).

²⁴ See *id.*

1 Furthermore, AB 1054’s wildfire fund requires a substantial shareholder contribution and
2 a significant investment that is ineligible for a return. This results in a reduction in earnings,
3 potentially sets a precedent that up-front investor-owned utility shareholder contributions are a
4 prerequisite to legislative reform, and suggests an unsupportive legislative/regulatory
5 environment. In short, a poorly implemented AB 1054 could have an overall negative impact,
6 imposing significant costs on investors with little resulting benefit. As Moody’s states, the
7 “failure to successfully implement the provisions of AB 1054 associated with the [wildfire] fund
8 in a consistent and credit supportive manner” would likely put negative pressure on SDG&E’s
9 credit rating.²⁵

10 And, as noted in Mr. Folkmann’s testimony, credit ratings agencies have identified other,
11 ongoing risks facing SDG&E beyond AB 1054; namely regulatory risks from this cost of capital
12 proceeding and the Company’s pending general rate case.²⁶ Moody’s is particularly focused on
13 the need for SDG&E’s capital structure to be adopted as proposed, asserting that its current
14 rating “assumes a credit supportive outcome of SDG&E’s ongoing 2019 general rate case and
15 cost of capital proceeding where the utility requested an increase in its equity layer to 56%
16 (effective January 2020) from currently 52%.”²⁷ By contrast, the ratings agency stated that an
17 outcome in this proceeding that is not credit supportive could put downward pressure on the
18 Company’s credit rating.²⁸

²⁵ Moody’s July 12 Report at 2.

²⁶ See Moody’s July 29 Report at 1-2.

²⁷ Moody’s July 12 Report at 2.

²⁸ Moody’s July 29 Report at 2.

1 In sum, the three credit rating agencies did not conclude that AB 1054’s passage
2 warranted an increase in SDG&E’s credit rating – despite the fact that those agencies reduced the
3 Company’s credit rating by at least two notches each in the last year based upon the state’s
4 catastrophic wildfire liability regime. As S&P states, while it believes that “the credit-supportive
5 liability cap and the revised standards of a utility’s reasonable conduct will offset the rising risks
6 of its increased susceptibility to catastrophic wildfires due to climate change and California
7 courts’ interpretation of inverse condemnation over the medium term,” it sees ongoing long-term
8 threats and continues to “view SDG&E’s business risk profile as being at the higher end of the
9 range for its business risk profile category.”²⁹

10 As indicated in the supplemental testimony of Todd Shipman (Ex. SDG&E-05-S, Ch. 2),
11 it will thus likely be a long process to see any ratings improvement.³⁰ S&P indicated that any
12 ratings upgrade in the next 18 months would largely be dependent upon “California’s investor-
13 owned electric utilities participating in the insurance fund consistently improv[ing] their
14 operations such that they are not found to be the cause of a catastrophic wildfire.”³¹ In addition,
15 credit rating agencies may need to see the experience with the wildfire fund’s durability, how the
16 revised prudence standard is applied, and the outcome of this cost of capital proceeding. Even
17 then, any upgrade would leave SDG&E far below its rankings before catastrophic wildfire

²⁹ S&P July 30 Report at 2.

³⁰ See Prepared Supplemental Testimony of Concentric, Chapter 2 (Aug. 2019) (Ex. SDG&E-05-S (Concentric) Ch. 2) at 4.

³¹ S&P July 30 Report at 3; see also Fitch, *San Diego Gas & Electric Co.*, dated August 1, 2019 at 1 (“Further rating improvement for SDG&E is possible if the administration of the insurance fund and implementation of A.B. 1054 are within expectations *in the next one or two fire seasons*. A favorable general rate case (GRC) outcome would also be a positive catalyst.”) (emphasis added).

1 liability became an acute concern – indicating that it could take years for SDG&E to return to its
2 previous A-rating.

3 This lack of change in SDG&E’s credit ratings itself heightens risks and increases costs
4 for SDG&E and its ratepayers. SDG&E’s credit rating remains only multiple notches above
5 speculative grade – far from the ‘A’ rating that Dr. Roger Morin found results in the lowest cost
6 of capital.³²

7 **IV. CONCLUSION**

8 AB 1054’s wildfire fund lessens SDG&E’s risks in the medium term by capping the
9 potential amount of shareholder liability and revising the standard for reasonableness review.
10 Yet outstanding questions regarding AB 1054 – such as how the revised prudence review will be
11 implemented and how long the wildfire fund (and with it, the liability cap) will last – in addition
12 to risks outside of AB 1054 (such as a credit supportive outcome in this proceeding), leave
13 SDG&E still facing heightened risks. This is reflected in SDG&E’s unchanged credit ratings.

14 This concludes my prepared supplemental testimony.

³² See Prepared Direct Testimony of Dr. Roger Morin (April 2019) (Ex. SDG&E-04) at 62-64.