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

August 21, 2019
SAN DIEGO GAS & ELECTRIC COMPANY

PREPARED REPUTTAL TESTIMONY OF JOHN J. REED
AND JAMES M. COYNE

(WILDFIRE RISK POST-AB 1054)

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OF THE STATE OF CALIFORNIA

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INTRODUCTION

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

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

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

Q. On whose behalf are you testifying?

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

Q. Have you previously provided testimony in this proceeding?

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

PURPOSE AND OVERVIEW

Q. What is the purpose of your Rebuttal Testimony?

A. Our rebuttal testimony addresses the evidence presented by the intervening parties regarding our supplemental testimony and the risks associated with wildfire liabilities and the effect of Assembly Bill 1054 (“AB 1054”) on the risk profile of SDG&E and the appropriate adjustment to its authorized return on equity (“ROE”). We respond to the direct testimonies of Mr. Michael P. Gorman on behalf of Energy Producers & Users Coalition (“EPUC”), Indicated Shippers, and The Utility Reform Network (“TURN”), Mr. Karl Richard Pavlovic on behalf of Utility Consumers’ Action Network (“UCAN”)
and Protect Our Communities ("POC"), Dr. Richard McCann on behalf of the Environmental Defense Fund ("EDF"), Mr. Kevin W. O'Donnell on behalf of the Federal Executive Agencies ("FEA"), and the County of San Diego (collectively "intervening witnesses") submitted on August 1, 2019 and August 16, 2019, with respect to the risks associated with wildfire liabilities and proposed allowed ROE for SDG&E following the passage of AB 1054.

Q. What are your key conclusions and recommendations?

A. Our key conclusions are as follows:

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

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

• In deriving our estimate of the appropriate risk adjustment, we place most weight on the Estimated Loss Approach, the Insurance Approach, and the CAT Bond Approach. None of the intervening witnesses provided an alternative view to these market-based analyses of the risk borne by shareholders.
Some of the intervening witnesses suggest that AB 1054 has eliminated the shareholder risks associated with wildfire liabilities. With the enactment of AB 1054, the shareholder risks we identified in our Direct Testimony have been reduced, but not eliminated. There remain significant uncertainties as to the degree to which shareholders will be responsible for any future wildfire-related liabilities, and we have taken this into account in our updated recommendation.

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

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

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

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


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.
his calculation of a 65 basis point ROE adjustment is based on incremental debt costs, and therefore, an incomplete measure of the risks borne by equity investors. Nonetheless, Mr. Gorman includes an ROE adjustment for the risks associated with wildfire liabilities, subsequent to the passage of AB 1054, in his final recommendation.

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

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

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

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.
In Section III, we respond to the testimony of EPUC, Indicated Shippers, and

TURN witness, Mr. Gorman;

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

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

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

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

In Section VIII, we summarize our conclusions and recommendations.

III. RESPONSE TO MR. GORMAN

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

A. Mr. Gorman concludes that legislative actions, including Senate Bill 901 (“SB 901”) and
AB 1054, as well as “policy signals” from Governor Newsom and California Public
Utilities Commission (“Commission” or “CPUC”) actions have fully mitigated
shareholder risk from liabilities associated with California wildfires.⁵ Mr. Gorman also

disagrees with the relevance of CAT Bond pricing as a measure of shareholder risk to
wildfire liabilities.⁶ Further, Mr. Gorman proposes an alternative proposal to adjust the
Base ROE if the Commission recognizes “any wildfire risk unique to California,” based

on an analysis of credit spreads.⁷ Mr. Gorman’s analysis suggests an incremental
adjustment of 0.65 percent (65 basis points) is the maximum incremental ROE

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

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

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

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

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

A. Mr. Gorman points to the ACR issued July 2, 2019, and to the determination that “[t]he
Commission will not consider a separate wildfire adder in the scope of this proceeding”
to conclude that the Commission will reject any proposal to address this risk through a
separate risk premium. However, the ACR clearly states that “[a]dditional risk factors,
including financial, business, and regulatory risks, that should be considered in setting the
utilities’ authorized return on equity” are within the scope of this proceeding. 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.
8, 2019, Administrative Law Judge ("ALJ") Stevens found as "reasonable" SCE’s interpretation of the scoping memo as establishing “that while the Commission will not consider a separate, stand-alone return on equity (ROE) adder for wildfire risk, it will consider wildfire risk among the many risks when determining an authorized ROE. We [SCE] also understand the utilities’ overall ROE requests—which reflected all risks including wildfire risk—to remain pending before this Commission."\[12\]

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

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\[12\] 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.
recommendation, and an adjustment for financial, business, and regulatory risks incremental to the risk profile of the proxy companies contained in Dr. Morin’s analysis.

Our approach to measurement of incremental risk and the Company’s overall ROE recommendation is entirely consistent with the scope of this proceeding.

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

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

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

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

A. It is not clear how the Commission will apply the new prudence standard in future cost recovery proceedings. The CPUC denied SDG&E recovery of all the costs associated with the 2007 wildfires in the Company’s Wildfire Expense Memorandum Account ("WEMA") application, but the Federal Energy Regulatory Commission ("FERC") approved SDG&E’s recovery of all FERC-jurisdictional costs associated with the same fires. This demonstrates that a prudence standard is subject to interpretation, and the CPUC standard has been materially different from other jurisdictions.\(^{15}\) AB 1054 revises the prudence standard. But even the Filsinger Wildfire Fund Durability Analysis ("Filsinger Report"), produced by an expert retained by Governor’s Newsom’s office, suggests that the effect of the new prudence standard will change over the course of ten years with a 75 percent likelihood of an imprudence finding in the first year, and a 25 percent likelihood of an imprudence finding in the tenth year – indicating that the revised prudence standard may be applied in a different manner than at FERC. Mr. Gorman contends that “[t]he state, including this Commission, has given very strong indications 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.
result from imprudent management.” However, he provides no basis for this “strong indication,” and we see no evidence that credit or equity analysts agree that risk to shareholders has been eliminated. While we would agree that there is an increased likelihood that the prudence standard will be applied in a manner more consistent with other jurisdictions, we revised our analyses in our Supplemental Direct Testimony to reflect the remaining risk that still exists.

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

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

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

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

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

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

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

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

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

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²¹ *Id.* at V-5:8 to V-6:23.
distinction is whether investors in CAT Bonds are required to pay wildfire damage claims, or investors in the Company’s equity are required to pay wildfire damage claims. Mr. Gorman suggests it is appropriate to include the debt interest on CAT Bonds in the Company’s cost of service to compensate investors in CAT Bonds for their exposure to wildfire liabilities. This is of course true, since the CAT bonds are essentially a supplemental form of insurance. However, he fails to explain why it is not appropriate to include an adjustment to the ROE for shareholders for the same exposure to wildfire liabilities above the level covered by the combination of CAT bonds and insurance.

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

Q. Does an ROE adjustment create “the potential for shareholder windfalls” that Mr. Gorman describes?22

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

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22 Id. at V-6:3-23.
"prefund financial liabilities that might or might not occur." Instead, the ROE adjustment is intended to compensate investors for the real risks they are required to bear.

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

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

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

\[\text{id. at V-6:7.}\]

\[\text{id. at V-8:19-20.}\]
provide protections that leave shareholders with a lower level of risk than they had immediately before its enactment, there remains a considerable level of risk above what investors experienced prior to: 1) the increased prevalence of wildfires; 2) the application of the doctrine of inverse condemnation applied to investor-owned utilities; and 3) the CPUC’s divergence from FERC in its prudence finding in SDG&E’s WEMA application.

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

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

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

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

A. No, we do not. To the extent the Company’s debt costs have increased over the last three years as a result of increased risks to debt investors, those are appropriate to reflect in the 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.
equity investors, and therefore have limited relevance in measuring the incremental cost of equity to shareholders. In part, this is because the credit rating agencies clearly anticipated that some form of wildfire liability relief would be enacted and held off on further downgrades of California utility debt until the degree of relief was known.\(^{26}\)

In addition, the risks faced by debt-investors and equity-investors are fundamentally different. While wildfire liabilities may cause a change in a company’s credit rating, and its cost of debt, this does not capture that risk borne by shareholders. Credit ratings are intended to measure the likelihood that a company will meet its debt-payment obligations, and debt investors require a return commensurate with the risk that the company will fail to meet that obligation. However, equity investors bear the residual risk associated with ownership, and have a claim on cash flows only after debt holders are paid. As such, debt and equity securities are exposed to different risks, and therefore require different returns. Virtually all shareholder equity can be eroded prior to any losses to debt holders due to their respective seniority. Equity financing carries no repayment obligation and is therefore much riskier than a debt investor’s position. In the case of wildfire liability claims, it is shareholders who are ultimately responsible for liabilities in excess of the company’s insurance coverage or any insurance funds made 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/CQDotNet/CreditResearch/RenderArticle.aspx?articleId=2168627&SetArtId=467165&from=CM&nsl_code=LIME&sourceObjectld=10866063&sourceRevId=14&fee_ind=N&exp_date=20290218-21:25:39.
IV. RESPONSE TO MR. PAVLOVIC

Q. Please summarize Mr. Pavlovic’s testimony and his conclusions related to the risks associated with wildfire liabilities.

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

(1) there is no quantifiable cost-causative nexus between SDG&E’s capital costs and operating expenses incurred due to catastrophic wildfires and SDG&E’s equity return on rate base that supports such an adjustment;

(2) a wildfire adjustment to SDG&E’s equity return would violate the fundamental ratemaking principle that costs and expenses are only recovered through rates after the costs and expenses have been prudently incurred; and

(3) an adjustment to return on equity is not the form of mitigation recommended by the rating agencies that have recently downgraded SDG&E’s credit ratings due to the perceived increase in SDG&E’s risk of catastrophic wildfires. 27

We respond to each of these points below.

A. Catastrophic Events and Ratemaking Principles

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

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

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

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

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28 UCAN Aug. 1 Testimony (Pavlovic) at 5:6-8.
29 See Moody’s Aug. 6 Report at 2.
30 Id. at 2.
32 UCAN Aug. 1 Testimony (Pavlovic) at 5:12-15.
Q. Are utilities generally permitted to recover the costs associated with catastrophic events through rates?

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

33 Id. at 7:7-9.
34 Id. at 7:14-15.
35 Id. at 3:14-15.
Q. How does the principle of cost causation apply to the ROE as it relates to wildfire liabilities?

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

Mr. Pavlovic concludes that “a wildfire adjustment to equity return would allow SDG&E to recover through rates wildfire costs and expenses that SDG&E has not yet and may never incur.” However, this is not what we have proposed in our Direct Testimony or our Supplemental Direct Testimony. The adjustment to the Company’s ROE is not intended to recover wildfire costs and expenses, but rather, it is intended to offer a reasonable return to investors for the risk that they will be subject to unrecoverable costs associated with wildfire liabilities. The same is true for the equity return in general - it is an estimate of the appropriate return to investors for bearing the 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.
measured against other investments of comparable risk. In effect, shareholders are self-insuring for all wildfire liabilities that are not recoverable through insurance, the Wildfire Fund, or rates. For this risk, utilities are entitled to a fair rate of return sufficient to attract capital under the basic tenets of the landmark decisions by the United States Supreme Court, notably *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923) ("Bluefield"), and *Fed. Power Comm'n v. Hope Nat'l Gas Co.*, 320 U.S. 591 (1944) ("Hope"). And we have quantified the return required for this risk based on the analytical approaches initially provided in our Direct Testimony and updated in our Supplemental Direct Testimony.

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

Q. Please describe Mr. Pavlovic’s criticism of the ROE recommendation on the basis of credit rating agency recommendations.

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

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

39 *Id.* at 9:15-10:1.
Q. Is an ROE adjustment that recognizes the incremental risks associated with wildfire liabilities intended to mitigate the risk and stabilize the Company's credit rating?

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

\(^{40}\) *Id.* at 8:3-4.
Q. **Does AB 1054 eliminate risks to shareholders?**

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

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

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41 *Id.* at 10:4-6.

42 *Id.* at 11:15-16.

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

V. RESPONSE TO DR. MCCANN
Q. Please summarize Dr. McCann’s testimony and his conclusions related to the risks
associated with wildfire liabilities.
A. While Dr. McCann does not make an ROE recommendation, he is critical of the utility
witnesses’ recommendations, and suggests that there is no market evidence that an
adjustment to the ROE is appropriate despite our several market-based analyses
introduced in our Direct Testimony and updated in our Supplemental Direct Testimony.
Dr. McCann is also critical of certain elements of the proposed calculations of the ROE
adjustments. In addition, Dr. McCann takes issue with the fact that there is no proposed
mechanism to make funds available to pay for future wildfire liabilities.

Q. Do you agree with Dr. McCann’s conclusions?
A. No, we do not. Dr. McCann ignores our application of market data in our analytical
approaches and claims to be the sole witness relying on market prices. Yet his analyses
are deeply flawed. Given that his analysis provides little relevant information as to the
effect of wildfire liabilities on the risk profile of the California utilities, his conclusions
cannot be supported. Further, Dr. McCann’s suggestion that an adjustment to the ROE
constitutes the Commission “simply awarding free money to shareholders”\(^{44}\)
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.
ROE adjustment. Shareholders remain exposed to potential wildfire liabilities that are not recoverable through insurance, the Wildfire Fund, or rates. This represents a risk that is not reflected in Dr. Morin’s proxy group companies. Therefore, utilities are entitled a fair rate of return that reflects this incremental risk.

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

Q. Please summarize Dr. McCann’s analyses of market prices of the California utilities.

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

1) California utility shares have significantly outpaced industry average returns since January 2000, and since March 2009;

2) California share prices only decreased significantly after the wildfire events that have been tied to specific market-perceived negligence on the part of the electric utilities in 2017 and 2018; and

3) Other events and state policy actions do not appear to have a measurable sustained impact on utilities’ valuations.45

Dr. McCann also claims that there is no other analysis of market prices in the proceeding and that “[a]t no point did any witness present an analysis of market prices or behavior that would indicate that investors priced a risk premium into the utilities’ share 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.
Q. Do you agree with Dr. McCann’s analytical approach?

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

Dr. McCann presents his analysis of Edison International, PG&E Corp., and Sempra as an analysis of “California Utilities,” but this is not true. All three companies are holding companies that own California utilities. But over the period studied by Dr. McCann, these holding companies have also owned (and some continue to own) significant assets that are either unregulated or have operations outside of California. As we noted in our Direct Testimony, Sempra recently acquired Energy Future Holdings Corp., for $9.45 billion, which includes a majority stake in Oncor Electric Delivery Company LLC. However, Dr. McCann’s analysis does not adjust, or even acknowledge, the fact that only a portion of Sempra’s total holdings are CPUC-jurisdictional assets.47 As described by Dr. Morin, “Sempra Energy is a diversified multi-activity company, and 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.
given its extraordinarily high relative risks.\textsuperscript{48} As such, it is not possible to discern from Dr. McCann's analysis to what degree Sempra's stock price performance has been influenced by CPUC-jurisdictional operations, or other unregulated or non-California business segments.

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

Q. Are there other flaws in Dr. McCann's analysis?

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

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

\textsuperscript{48} Prepared Direct Testimony of Roger A. Morin, Ph.D. (April 2019) ("Ex. SDG&E-04" (Morin)) at 55:17-20.
adjusted for both stock splits and dividends, but the Dow Jones Utilities Index does not adjust index values for dividends (stock splits are accounted for). An adjustment for dividends applied only to the stock prices, but not the benchmark index, distorts his analysis.\(^4^9\) As such, Dr. McCann’s conclusion that “California utility shares have significantly outpaced industry average” is due in part to the effect of overstating the performance of the “California utility shares.”

Q. Do you agree with Dr. McCann’s conclusions from his analysis?

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

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

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

\(^{4^9}\) 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.
PG&E Corp. in our Direct Testimony, we limited our conclusions to what we could
observe in the data. Based on that analysis, we can conclude that investors increased
their return requirements for California utilities at that time. However, without offering
any evidence to support Dr. McCann’s claim that this was due to “market-perceived
negligence,” it is unclear how he can make this claim. Dr. McCann does not even
acknowledge the discrepancy between the CPUC and FERC with regard to the cost
recovery standard for wildfire liabilities, so it is unclear how he is able to make a clear
determination as to the perception of negligence.

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

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

A. Yes, Dr. McCann calculates an “implied market ROE” for Edison International, PG&E
Corp., and Sempra, and compares that to an average of other investor-owned utilities and
CPUC authorized ROEs. To determine the “implied market” ROE for the California
utilities’ holding companies, Dr. McCann assumes that each company is able to earn its
CPUC-authorized ROE for the holding company’s entire equity base. For example, Dr.
McCann assumes Sempra’s first quarter 2019 income can be derived by multiplying its
10.3 percent authorized ROE by Sempra’s book value per share of $71.06. He then
divides this assumed income by Sempra's stock price of $125.86 to derive an "implied market ROE" of 5.8 percent.\textsuperscript{50}

\textbf{Q. What can you conclude from this analysis?}

\textbf{A.} There is little meaningful information that can be derived from this analysis because it contains flaws that are similar to Dr. McCann's analysis of share prices of Edison International, PG&E Corp., and Sempra relative to the Dow Jones Utilities Index. Once again, Dr. McCann has conflated the holding companies of the California utilities and California utilities themselves. In the example discussed above regarding Sempra, Dr. McCann is applying the CPUC-jurisdiction ROE of 10.3 percent to Sempra's entire book value, despite the fact that SDG&E and Southern California Gas Company comprise 57 percent of Sempra's total assets as of 2018.\textsuperscript{51} Sempra Energy's remaining assets include either non-regulated companies or non-California regulated entities. Both the book value per share and the stock price for Sempra take into account Sempra's other business segments, but Dr. McCann has assumed that all segments will earn equivalent to a CPUC-authorized return. Given that Dr. McCann's implied ROE analysis includes a return based on CPUC-regulated income, but an equity base that includes both CPUC-regulated and non-CPUC-regulated assets, the analysis has little bearing on the appropriate regulated return for SDG&E.

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

\textsuperscript{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.
B. Dr. McCann’s Response to the Utilities’ Direct Testimony

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

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

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

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52 EDF Aug. 1 Testimony (McCann) at 18-19.
53 Id. at 19.
ROE premium added for wildfire liabilities appropriately in adjusting the overall ROE is misplaced, as we have effectively attributed no incremental risk to the gas assets in our calculation, which has the effect of reducing the overall ROE adjustment. All else equal, if we applied this adjustment solely to the electric assets, it would have the effect of increasing the ROE adjustment by a larger amount on the electric side, as offset by no adjustment on the gas side of SDG&E. Overall, the results would have been the same.

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

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

1) Guess at the likely average annual liability from future wildfires (note that only five large fires have been caused by utility equipment since 2007 according to evidence available in this case).

2) Determine the likely payouts covered by the state fund established by AB 1054 and additional insurance coverage purchased by the utility and expensed to ratepayers, after adjusting for payouts likely being less than the initial requests.

3) Guess at the likely amount of the remaining liability cost that will be disallowed by the Commission, without determining the reason for the disallowance, including ranges up to 75%. None of the utilities have provided evidence supporting their estimates of disallowances, unless they are admitting that their negligence accounts for roughly that amount of the remaining liabilities.

4) Roll the disallowed amount back as an addition to the base ratebase and calculate the increase in the ROE to cover the disallowed funds that will instead by [sic] recovered from ratepayers indirectly through a higher ROE.55

54 Id.

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

- wildfire behavior (i.e., the utilization of vegetation, topography, and weather patterns to estimate fire growth);
- housing prices;
- climate change; and
- risk-reducing effects of SDG&E’s existing wildfire mitigation activities.\(^{56}\)

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

In addition, we did not “guess at the likely amount of the remaining liability cost that will be disallowed by the Commission.”\(^{57}\) We instead relied on the assumptions used by the energy advisory firm retained by Governor Newsom’s Strike Force. As described in our Supplemental Direct Testimony, based on the Filsinger Report, there is an 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.
over the first three years of the Wildfire Fund, and that the average likelihood of being
found to be imprudent over the 2020 to 2030 period is 50 percent.

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

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

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

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

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

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

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

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


\textsuperscript{62} EDF Aug. 1 Testimony (McCann) at 19.

\textsuperscript{63} Id.
shareholders, and as such, the most relevant approaches are based on the incremental
effects on the ROE, with market-based inputs to the analysis. In prior ratings analyses,
S&P has applied an adjustment methodology that imputes debt to the balance sheets of
utilities with significant PPA obligations because those PPAs are fixed-cost obligations
with known terms for a fixed number of years, like debt. The wildfire risk borne by
SDG&E’s shareholder is not similar in any manner. Further, if the level of imputed debt
for PPAs becomes significant, the utility faces the need to rebalance its equity level to
maintain a capital structure that does not threaten its credit rating. Dr. McCann does not
take this into consideration either, which has the effect of understating the true cost
imposed on investors for bearing wildfire risks.

C. Reserve Funds for Wildfire Liabilities

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

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

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

64 Id. at 19-20.
of the costs."\textsuperscript{65} Dr. McCann’s characterization of this situation defies market principles and logic. Under these circumstances, an investor cannot simply “walk away” from the realization of this risk and sell their shares, since the liability associated with this outcome will certainly depress the trading price of the utility’s common stock. Also, as described in our response to Mr. Gorman, the ROE adjustment is not intended to fund future wildfire liabilities, but instead to provide shareholders an appropriate return to bear the risk of potential future wildfire liability.

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

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

\textsuperscript{65} \textit{Id.} at 20.

\textsuperscript{66} \textit{Id.} at 9 [clarification added].
Q. Has Dr. McCann accurately described your CAT Bond Approach?

A. No, he has not. Dr. McCann suggests that the closest example presented to creating a
reserve fund "is of SDG&E issuing a catastrophic event bond, but then Concentric dilutes
that option by combining it with two others that do not involve setting aside any funds."\(^{67}\)

Our CAT Bond Approach looks at transactions on CAT Bonds to derive a market-based
indication of an appropriate ROE adjustment for shareholders. The Company has issued
a CAT Bond, and it limits the Company’s exposure to wildfire liabilities in the same
manner as traditional liability insurance. We apply the CAT Bond investors’ return
requirements as an estimate for the compensation required for any investor to accept the
risk of wildfire liabilities that are not covered through other means. We have not
proposed any assurances to set aside funds “to pay out wildfire victims or for other
costs.”\(^{68}\) As stated above, we are using this market-based information to estimate an
appropriate return for shareholders, not to fund future wildfire liabilities.

VI. RESPONSE TO MR. O’DONNELL

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

A. Mr. O’Donnell provides an analysis of each of the applicants’ cost of equity, with a
primary focus on the methodologies that are used to derive the Base ROE. Overall, he
characterizes the requested ROEs as “excessive and punitive in that the requested ROEs,
unless updated and lowered by the IOUs, do not take into account the lower risk
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.
recommendation in our Supplemental Direct Testimony to explicitly take into account the
effect of AB 1054 on the Company’s risk profile.

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

A. Yes, he does. Mr. O’Donnell suggests that a 50 basis point adjustment is appropriate
unless the State of California implements a plan to reverse inverse condemnation.
Specifically, he states “The stock of SEMPRA is still somewhat in the shadow of inverse
condemnation and, for that reason, I believe a 9.5% ROE is warranted. Again, however,
if the State of California implements a plan to reverse inverse condemnation, the ROE
should be set no higher than 9.0%.” 70 Since AB 1054 did not address the issue of inverse
condemnation, and there has been no subsequent legislation, this risk remains. It is not
clear how Mr. O’Donnell derives a 50 basis point ROE adjustment, but he recognizes the
incremental risks to shareholders associated with wildfire liabilities. However, 50 basis
points is an inadequate adjustment to provide shareholders an adequate return for the
residual risk that they bear for wildfire liabilities. Mr. O’Donnell claims that he arrived
at his 50 basis point recommendation based on “market estimates of the required return
and not, as Concentric did, various mathematical formulations that omit obvious risk
mitigation measures.” 71 However, Mr. O’Donnell’s proxy group does not include any
other companies that are subject to the same level of business risk associated with
catastrophic wildfire liabilities as the Company, and his analysis of Sempra’s stock price,
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.
Sempra’s total holdings are CPUC-jurisdictional assets. By comparison, all of our “mathematical formulations” are based on market-data, specific to the Company’s risk profile, and have been adjusted for the risk mitigation measures contained in AB 1054.

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

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

Q. Do you have additional concerns with Mr. O’Donnell’s analysis of Sempra’s stock price?

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

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72 Id. at 22:16-18.
assets. Consistent with Dr. Morin’s observation, due to Sempra’s diversified
operations, measures of its stock price performance likely understate the risks borne by
SDG&E. As noted in the Forbes article cited by Mr. O’Donnell, “The new utility law
also benefits Sempra though less so: Its California electric utility is less than a quarter of
overall earnings versus 100 percent for Edison and PG&E,” reflecting Sempra’s
operations after its acquisition of Energy Future Holdings Corp. As such, it is not
possible to discern from Mr. O’Donnell’s observation of Sempra’s stock price on two
days how Sempra’s stock price performance has been influenced by risks related to
wildfire liabilities, the effect of AB 1054, or other unregulated or non-California business
segments. Mr. O’Donnell’s conclusion that “the investment community clearly disagrees
with the Concentric analysis, as evidenced by the tremendous jump in the SEMPRA
stock,” is unfounded because he only analyzes the performance of SDG&E’s holding
company and presents no evidence as to how the other business segments have changed
over his limited analytical period. Even if the stock price of Sempra could be considered
representative of SDG&E, Mr. O’Donnell provides no benchmark comparison for
Sempra’s performance. Mr. O’Donnell asserts, “If consumers were truly frightened by

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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-9tba-4782-bf8e-a96cceed78d25. 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.
the alleged risks cited by Concentric, the stock of SEMPRA would not have jumped by nearly 30% in the past year alone. However, he provides no analysis as to how the broader equity market has performed, or other changes in capital market conditions that could have an effect on Sempra’s stock price performance.

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

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

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77 Id. at 29:14-16.

78 Guggenheim, SRE: Simplicity is the Ultimate Sophistication..., dated March 27, 2019 at 1 (emphases in original).
As such, Mr. O’Donnell’s analysis has little relevance in assessing the relative
risk profile of SDG&E and provides little information that can be used to conclude how
AB 1054 may have affected investors’ perception of risks related to wildfire liabilities.
Most importantly, we are not proposing to apply a risk premium to all of Sempra, or even
all of Sempra’s California utilities; we are attempting to determine the appropriate ROE
for SDG&E, reflecting the risks that are unique to this business.

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

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

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80 Id.
81 Id.
nuanced, but apt. In effect, AB 1054 places bounds on shareholders’ exposure to wildfire liabilities such that they are no longer “bottomless.” However, this does not fully mitigate the risks to shareholders. The article cites several uncertainties as described in the following excerpts:

1) AB 1054 does not “end the doctrine of ‘inverse condemnation,’ under which utilities are ultimately liable for the cost of wildfires in which power lines are involved.”

2) “That means power companies will continue to be under scrutiny during the state’s increasingly long dry season.”

3) “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.”

4) “These decisions will have a major impact on how quickly the wildfire fund utilities choose is exhausted.”

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

1) “The legal standard known as inverse condemnation was unchanged by AB 1054, and utilities remain legally liable when their equipment is a cause of a wildfire ignition.”

2) “The impact on the CPUC’s determination of prudence is uncharted water with significant impact on shareholders.”

3) “The risk reducing effect of the adoption of the ‘industry norm’ for prudence depends on how the CPUC implements the standard for utilities operating under the Wildfire Fund.”

4) “There are ongoing concerns about the Wildfire Fund’s durability.”

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82 Id.

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

Q. Has the Company’s prior precedent for recovery of wildfire liabilities “been rendered obsolete”,\textsuperscript{84} as described by Mr. O’Donnell?  

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

\textsuperscript{84} FEA Aug. 16 Testimony (O’Donnell) at 25:27-28.

\textsuperscript{85} Id. at 25:27-30.

\textsuperscript{86} Forbes, \textit{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 prudence standard.”), available at: https://www.forbes.com/sites/greatspeculations/2019/07/24/californias-wildfire-reset-unequal-benefits/#826095d81974.

\textsuperscript{87} Id.
Direct Testimony, we observed, "[t]here is no precedent for the CPUC operating under the revised prudence standard articulated in AB 1054". As such, it remains unclear as to how the CPUC will apply the directive it has received from the California Legislature and what constitutes "an appropriate manner" to implement the measures contained in AB 1054. In our Supplemental Direct Testimony, we have modified our assumption that the only relevant precedent of a CPUC prudence review is the WEMA decision, and modified our analysis to reflect the uncertainties acknowledged in the article cited by Mr. O'Donnell.

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

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

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

Mr. O'Donnell also calls into question the uncertainty that the Wildfire Fund Administrator ("Administrator") may recommend a lower insurance level. In Mr. O'Donnell’s view, the only scenario he envisions "in which the Wildfire Fund 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.
over-funded.93 While we agree that the Administrator recommending a lower insurance level is unlikely and likely inappropriate given the current risks posed to the Company, AB 1054 enables the Administrator to do so, and it is therefore an uncertainty in light of the legislation. However, given that this is an unlikely scenario, our updated analysis provided in our Supplemental Direct Testimony makes no change to the Company’s assumed insurance level as a result of this uncertainty. Therefore, Mr. O’Donnell’s disagreement on this point has no direct bearing on our analysis.

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

A. Mr. O’Donnell characterizes our analysis as a “mathematical smokescreen” and describes the uncertainties associated with AB 1054 (and recognized by an article he cites) as “hypothetical risks.”94 However, his criticisms are either without merit or based on flawed analyses of SDG&E’s holding company – rather than direct market-based evidence of the return required for SDG&E’s shareholders to bear the risk associated with wildfire liabilities. In addition, Mr. O’Donnell’s characterization of our recommended ROE adjustment as “higher dividend payouts to stockholders that cannot be used in the future to replenish the Wildfire Fund,”95 demonstrates a misunderstanding our proposal. Our recommendation is to provide a reasonable return to investors for the risks they currently bear and does not preclude any efforts to replenish the Wildfire Fund, 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.
or regulatory reforms change that risk profile, that would be the appropriate time to reconsider the risk adjustment.

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

VII. RESPONSE TO COUNTY OF SAN DIEGO

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

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

1) The request for an ROE adjustment due to wildfire risk is outside the scope of this proceeding;

2) AB 1054 reinforces the impropriety of including an ROE adder that shifts liability to ratepayers without regard to whether SDG&E acted reasonably and show that it has been a prudent manager of its facilities;

3) For rates to be just and reasonable, SDG&E must have acted reasonably. SDG&E seeks via its requested rate increase to shift the risk to ratepayers even in cases where it is later determined that SDG&E acted unreasonably.96

96 Supplemental Testimony of County of San Diego (AB 1054) (August 16, 2019) at 1-3.
Q. How do you respond to the Supplemental Testimony of County of San Diego?

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

1) The Scoping Ruling issued July 2, 2019 clearly states that “additional risk factors, including financial, business, and regulatory risks, that should be considered in setting the utilities’ authorized return on equity” are within the scope of this proceeding.\(^\text{97}\) The risks associated with wildfire risks are not a separate and distinct risk that fall outside the scope of traditional regulatory finance, and wildfire liabilities distinguish the Company’s financial, business and regulatory risks relative to Dr. Morin’s proxy group. Our approach to measurement of incremental risk and the Company’s overall ROE recommendation is entirely consistent with the scope of this proceeding, as confirmed in ALJ Stevens’ July 8, 2019 email to the parties.

2) The revised prudence standard in AB 1054 is expected to reduce the incremental risk relative to precedent, but the application remains uncertain, and therefore investors still require a higher return to invest in California utility companies. Under the basic tenets of *Hope* and *Bluefield*, SDG&E must be awarded a fair and reasonable return for the actual risks it bears.

3) The CPUC denied SDG&E recovery of all the costs associated with the 2007 fires in the Company’s WEMA application, but FERC approved SDG&E’s recovery of all FERC-jurisdictional costs associated with the same fire, demonstrating that a prudence standard is subject to interpretation. As such, the CPUC standard has been materially different from other jurisdictions and represents a risk that distinguishes the Company’s financial, business, and regulatory risks relative to Dr. Morin’s proxy group.

\(^{97}\) Scoping Ruling at 3.
and other utilities and should be recognized in the determination of a fair and reasonable return.

VIII. CONCLUSION

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

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

Q. Does this complete your Rebuttal Testimony?

A. Yes.
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

August 21, 2019
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SAN DIEGO GAS AND ELECTRIC COMPANY
PREPARED REBUTTAL TESTIMONY TODD A. SHIPMAN

I. INTRODUCTION

Q. Please state your name, affiliation, and business address.
A. My name is Todd A. Shipman. I am an Executive Advisor with Concentric Energy Advisors, Inc. ("Concentric"), which has its headquarters at 293 Boston Post Road West, Suite 500, Marlborough, Massachusetts 01752.

Q. On whose behalf are you testifying?
A. I am submitting this Rebuttal Testimony regarding wildfire risks post-AB 1054\(^1\) on behalf of San Diego Gas & Electric Company ("SDG&E" or the "Company"), a subsidiary of Sempra Energy, Inc. ("Sempra"), a publicly traded holding company.

Q. Have you previously provided testimony in this proceeding?
A. Yes. I provided Direct Testimony on April 22, 2019 and Supplemental Direct Testimony on August 1, 2019.

II. PURPOSE AND OVERVIEW

Q. What is the purpose of your Rebuttal Testimony?
A. My rebuttal testimony addresses the direct testimony of Mr. Michael P. Gorman on behalf of Energy Producers & Users Coalition ("EPUC"), Indicated Shippers, and The Utility Reform Network ("TURN"),\(^2\) and the direct and rebuttal testimonies of Mr. Karl Richard Pavlovic on behalf of Utility Consumers’ Action Network ("UCAN") and

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

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

A. My key conclusions are as follows:

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

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

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

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

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

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

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

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

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

In Section VII, I summarize my conclusions and recommendations.

III. RESPONSE TO MR. GORMAN

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

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

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4 TURN Testimony (Gorman) at IV-14:15.
credit quality. There is nothing profound about it. While the positive aspects of AB 1054 were recognized and acknowledged in the change in ratings outlooks, the overhang of uncertainties about the implementation of the legislation and elevated risk that remains due to a lack of reform of the application of inverse condemnation to utilities continues to hinder credit quality. The lower ratings caused by wildfire risk are still in place.

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

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

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

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

A. No. Mr. Gorman cites two firms that publish opinions about regulatory risk, one of
which is S&P Global Ratings. This is not a subgroup of the ratings analysts, as he seems
to think. Instead, it is the ratings analysts themselves that make those assessments and
use them directly in the ratings analysis of SDG&E and other utilities. He notes the
change in the California ranking in June 2018 but fails to understand the importance of
that dramatic, two-category downgrade. The drop, to a category that places California
among the riskiest of U.S. jurisdictions from among the most credit-supportive, was
instrumental in leading to the series of ratings downgrades of California electric utilities,
including SDG&E. Only three other jurisdictions of the other fifty-plus U.S. jurisdictions
are judged by S&P to harbor more innate regulatory risk than California. The move was
based, as Mr. Gorman correctly notes, on the recognition of the full impact of wildfire
risk on the state’s regulatory environment and preceded the passage of wildfire reform
legislation. The assessments have been updated twice since then with no change in the
low assessment, and S&P’s stable outlooks on SDG&E and the other wildfire-exposed
utilities is a good indication that an upward revision in the assessment is unlikely. A two-

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8 Id. at 6-7
9 TURN Testimony (Gorman) at IV-9:3-9.
category downgrade like the one in 2018 is unusual. Changes to these assessments are infrequent. The damage that wildfire risk has done to investors’ regard for the supportiveness of California regulation is likely to linger despite the improvement that has come with the 2019 legislative actions.

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

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

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

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

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

A. No. As discussed by my colleagues Reed and Coyne in rebuttal,\(^ {15}\) debt investors and equity investors are exposed to different risks, and therefore require different returns. The authorized ROE incorporated into a utility's revenue requirement is often noted when a rating agency is assessing the utility's regulatory risk. And, as noted, Moody's is focused on whether SDG&E will have a positive outcome in this proceeding. But it is not a direct or significant input into the ratings analysis. Credit analysts are much more focused on the actual returns that a utility achieves, and that is subject to many more 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.


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

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

A. No. He errs in two ways. First, he misunderstands the role of the rating agencies. They are independent arbiters of credit quality and do not perceive their roles as recommending any course of action to the CPUC, the utilities, or any other party. In fact, they are prohibited by their codes of conduct from doing so.\(^2\) Secondly, he claims the agencies do not mention wildfire risk impact on equity return as a reason for the ratings downgrades.\(^3\) That is wildly inaccurate. The downgrades were a direct result of the agencies’ determinations that wildfire liability risk raised regulatory risk to California electric utilities. A central focus of their assessment of regulatory risk is a utility’s ability to fully and timely recover costs through the regulatory process.\(^4\) A fair and reasonable return on equity that fully recovers a utility’s cost of equity is one of those costs.\(^5\)

Everything that Mr. Pavlovic lists in his ensuing recitation of rating agency concerns on


\(^{19}\) UCAN Aug. 1 Testimony (Pavlovic) at 9:17-19.


\(^{21}\) See Moody’s Aug. 2 Report at 9 (only rating SDG&E’s “Timeliness of Recovery of Operating and Capital Costs” at ‘Baa’).
wildfire risk relate precisely to the utilities’ ability to earn a compensatory return and contradict his premise that the agencies are indifferent to a utility’s equity return.

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

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

Putting aside Mr. Pavlovic’s attempt to paint the rating agencies as an interested party to neutralize their independent opinions on the impact of AB 1054, which misconception I covered above, he reinforces our argument that the legislation did not 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.”)
In other words, having initially characterized SDG&E’s credit downgrades as a response to a perceived increase in wildfire risk, SDG&E and the rating agencies now say that restoration of SDG&E’s former credit ratings will require not only AB 1054’s mitigation of wildfire risk, but also credit supportive outcomes in SDG&E’s cost of capital proceeding, general rate case proceeding, and other unspecified proceedings.

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

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

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

24 UCAN Aug. 16 Testimony (Pavlovic) at 12:16-20.
25 Id. at 13:3-7.
investor-owned utilities in the state resulting from the reliance on interpretation of “inverse condemnation,” under which a utility may be held liable for damage associated with force majeure events even if it has adhered to prevailing safety guidelines. While recently enacted legislation mitigates some of the utilities’ exposure, it is unclear whether the funding mechanisms outlined in the law will avert similar situations in the future. The frequency at which severe weather-related events are occurring argues for a more comprehensive approach in RRA’s view.27

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

V. CONCLUSION

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

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

Q. Does this complete your Supplemental Direct Testimony?

A. Yes.

27 Id. at 2-3.