SAN DIEGO GAS & ELECTRIC COMPANY (U 902 M)

PREPARED REBUTTAL TESTIMONY OF BRUCE A. FOLKMANN

(WILDFIRE RISKS POST-AB 1054)

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

SDGE

A Sempra Energy utility

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I. INTRODUCTION

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

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

¹ AB 1054, Stats. 2019, Ch. 79.
II. RETURN ON EQUITY MUST BE SET CONSISTENT WITH INVESTOR EXPECTATIONS

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

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

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

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\(^3\) See Direct Testimony of Kevin W. O’Donnell, CFA, on behalf of the Federal Executive Agencies Regarding the Applicants’ Supplemental Testimony (August 16, 2019) (“FEA Aug. 16 Testimony (O’Donnell)”) at 29:4-6.


\(^5\) EDF Aug. 16 Testimony (McCann) at 1.
The high risks of wildfires in population-dense and high-value real estate areas; with
Inverse condemnation; and
The application of a prudency review standard that investors and credit rating agencies believe results in a high risk of claims being disallowed regardless of how the utility acted.6

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

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

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

6 Moody’s, FAQ on the credit implications of California’s new wildfire law, dated August 6, 2019 (“Moody’s Aug. 6 Report”) at 2.
7 EDF Aug. 16 Testimony (McCann) at 4.
8 Moody’s Aug. 6 Report at 2.
9 Decision 12-12-034 at 30.
than an attempt to quantify the return required to induce investment given the risks facing the
Company. The quantification of the remaining wildfire liability risks to investors following AB
1054 is one component of that assessment.

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

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

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

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

\(^{11}\) Moody’s, San Diego Gas & Electric Company: Update following outlook change to positive, dated
Aug. 2, 2019 (“Moody’s Aug. 2 Report”) at 5 (“The application of this revised 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.”).

\(^{12}\) S&P July 30 Report at 1-2 (noting that, if the wildfire fund is exhausted, SDG&E “loses the credit
benefit of using the [wildfire] fund as a source of liquidity and more importantly loses the credit
protection of the liability cap,” leaving only the revised prudence standard).

\(^{13}\) Moody’s, Rating Action: Moody’s affirms San Diego Gas & Electric’s ratings; changes outlook to
positive from negative, dated July 29, 2019 (“Moody’s July 29 Report”) at 1-2; Moody’s, Rating
Action: Moody’s affirms San Diego Gas & Electric Company’s ratings; outlook remains negative,
The overall political and regulatory environment.\textsuperscript{14} Even Mr. Pavlovic notes that any improvement in SDG&E’s credit ratings will require some further mitigation of these risks.\textsuperscript{15} But instead of constructively working towards those goals, Mr. Pavlovic wants to either relitigate AB 1054’s passage and/or provocatively claim that credit agencies are holding SDG&E’s credit rating “hostage.”\textsuperscript{16} Both points are irrelevant. Credit rating agencies are independent actors.\textsuperscript{17} Whether Mr. Pavlovic agrees with their analyses is largely irrelevant – the cost of debt and equity for SDG&E is influenced, at least in part, on those agencies’ determination. The only way to increase SDG&E’s credit rating – and lower costs for ratepayers – is to ameliorate the risks that credit rating agencies see going forward – including from this case.

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

\textsuperscript{14} Moody’s Aug. 2 Report at 6-7.
\textsuperscript{15} UCAN Aug. 16 Testimony (Pavlovic) at 12:17-20.
\textsuperscript{16} Id. at 11:19-21.
\textsuperscript{17} Prepared Rebuttal Testimony of Concentric Energy Advisors, Chapter 2 (Wildfire Risks Post-AB 1054) (August 21, 2019) (“Ex. SDG&E-12, Ch. 2 (Concentric Rebuttal”) at 8:6-9 and n. 18.
\textsuperscript{18} UCAN Aug. 16 Testimony (Griffing) at 6:1-2.
\textsuperscript{19} Prepared Rebuttal Testimony of Roger A. Morin, Ph.D., Return on Equity (August 16, 2019) (“Ex. SDG&E-09 (Morin Rebuttal”) at 26:6-7.
downward if SDG&E is granted a lower authorized common equity structure in this proceeding.\(^{20}\)

Other intervenors, such as Mr. O’Donnell, concede that inverse condemnation creates increased risks.\(^{21}\) But then he contradicts his own findings. Although Mr. O’Donnell reiterates that he proposes a purported wildfire “adder” of .5%, as Dr. Morin has discussed, that only makes his ROE proposal for SDG&E 9.5%. Such an ROE – even with the adder – would be below the national average for 2018-2019.\(^ {22}\) A below average ROE should only be set for a utility facing below average risks.\(^ {23}\)

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

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\(^{20}\) Moody’s July 29 Report at 2; Moody’s July 12 Report at 2.

\(^{21}\) FEA Aug. 16 Testimony (O’Donnell) at 29:26-27 (stating that the “stock of Sempra is still somewhat in the shadow of inverse condemnation”) (citation omitted).

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

\(^{23}\) Mr. O’Donnell’s focus on SDG&E’s parent company, the more diversified Sempra Energy, is oversimplified, as Mr. O’Donnell has previously admitted. See Direct Testimony and Exhibits of Kevin W. O’Donnell, CFA, on behalf of The Federal Executive Agencies (August 1, 2019) (“FEA Aug. 1 Testimony (O’Donnell)”) at 60:4-6 (stating that some of Sempra’s “earnings growth is coming from expected earnings growth from recent acquisitions, such as the Oncor purchase, and have little to do with utility regulation in California”).

\(^{24}\) FEA Aug. 16 Testimony (O’Donnell) at 4:13-19; 25:24-33.

\(^{25}\) See id. at 26:4-6.
expectations. But because these are the risks that credit rating agencies and other stakeholders presently see following AB 1054, ROE must be set now with those risks in mind.\textsuperscript{26}

By contrast, it is completely speculative to state that the wildfire fund could be replenished by legislative action or somehow recreated through a “CPUC rulemaking.”\textsuperscript{27}

Neither SDG&E nor other parties have control over either process. Mr. O’Donnell offers no evidence to support this statement. Instead, Moody’s findings cut the other way – that SDG&E faces a difficult political environment, suggesting that such a revival would be challenging.\textsuperscript{28} It is not realistic for the Commission to base its decisions here on Mr. O’Donnell’s speculation about legislation or rulemakings that have not and may never occur.

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

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

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

\textsuperscript{28} Moody’s Aug. 2 Report at 9.

\textsuperscript{29} EDF Aug. 16 Testimony (McCann) at 1.

\textsuperscript{30} Moody’s Aug. 2 Report at 5.
SDG&E credit rating was repeatedly downgraded following the passage of Senate Bill 901—simply because of the risks from the overall legal and regulatory environment.\(^{31}\)

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

**III. CONCLUSION**

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

This concludes my prepared rebuttal to my supplemental direct testimony.

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

\(^{32}\) EDF Aug. 16 Testimony (McCann) at 3.