BEFORE THE PUBLIC UTILITIES COMMISSION OF THE

STATE OF CALIFORNIA

Order Instituting Rulemaking to Implement Public Utilities Code Section 451.2 Regarding Criteria and Methodology for Wildfire Cost Recovery Pursuant to Senate Bill 901 (2018).	Rulemaking 19-01-006

SOUTHERN CALIFORNIA EDISON COMPANY'S (U 338-E) OPENING COMMENTS ON ORDER INSTITUTING RULEMAKING

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TABLE OF CONTENTS

Section	Title	Page
I.	INTRODUCTION AND EXECUTIVE SUMMARY	1
II.	THE COMMISSION MUST ADDRESS THE DEEPENING CRISIS BY ESTABLISHING AN APPROPRIATE COST RECOVERY FRAMEWORK FOR REGULATED UTILITIES' WILDFIRE-RELATED COSTS AND EXPENSES	4
	A. The State and IOU Customers Benefit from Stable Access to Investor Capital	4
	B. Confidence in the State's Regulatory Construct Is Critical to Continued Investment in California's IOUs	5
	1. IOUs' Continuous Access to Equity Capital Markets Depends on a Stable Investment Risk Profile	6
	2. IOUs Must Have Investment Grade Credit Ratings to Maintain Continuous, Low-Cost Access to Debt Capital Markets, Benefiting Customers	7
	C. Investors and Credit Rating Agencies Are Rapidly Losing Confidence in California's Regulatory Construct; Suppliers Continue Doing Business but Also Have Concerns	8
	D. The Energy Crisis Provides Important Context for Understanding the Implications of Limited Capital Market Access and the Need for an Appropriate Cost Recovery Framework to Restore Investor and Supplier Confidence	11
	E. The Commission Must Re-Focus Its Efforts to Implement SB 901 by Establishing a Durable Framework Similar to the One Put in Place Following the Energy Crisis	13
III.	SCE'S COMMENTS ON PRELIMINARY OIR QUESTIONS	16
IV.	THE COMMISSION SHOULD AUTHORIZE IOUS TO EFFICIENTLY FINANCE WILDFIRE LIABILITIES INDEPENDENT OF PRUDENCY REVIEW TIMING	23
V.	SCE'S PROPOSED PHASED SCHEDULE	24
VI.	CONCLUSION	25

SOUTHERN CALIFORNIA EDISON COMPANY'S (U 338-E)
OPENING COMMENTS ON ORDER INSTITUTING RULEMAKING

TABLE OF AUTHORITIES

Page

Statutes

Cal. Pub. Util. Code § 451 .... 3, 16, 19
Cal. Pub. Util. Code § 451.1 .... 4, 13, 19
Cal. Pub. Util. Code § 451.2 .... 4, 16
Cal. Pub. Util. Code § 701 .... 3, 16
Cal. Pub. Util. Code § 8386 13

Legislation

Cal. Assembly Bill (AB) 57 3
Cal. Senate Bill (SB) 901 .... 1, 2, 3
SB 350 4

CPUC Decisions

D.03-12-035 .... 7, 18
D.04-07-022 6
D.09-05-019 5
D.10-10-035 5
D.10-12-057 5
D.17-11-003 8
D.17-11-033 21

CPUC Rulemakings

R.15-02-020 5
R.19-01-006 .... *passim*

Other

Answer of Repondent to Petition for Writ of Review, SDG&E v. Public Utilities Commission, 2018 WL 4386757, Case No. D074417 (Cal. App. 4 Dist., Sept. 7, 2018) 15
EIX Business Update Presentation (Oct. 31, 2017) 5
Morgan Stanley Research Survey (Jan. 7, 2019) 9, 10, 20
Press Release, Moody's Investor Service, Moody's places Edison and Southern California Edison Under Review for Downgrade, (Jan. 24, 2019) 8
Press Release, Standard & Poor's, Edison International and Subsidiary Southern California Edison Downgraded to 'BBB'; Ratings Placed On Watch Negative (Jan. 21, 2019) 8, 18
Standard & Poor's *Key Credit Factors for the Regulated Utilities Industry* (Nov. 19, 2013) 7, 17
Value Line Investment Survey (Jan. 25, 2019) 10

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Pursuant to the *January 10, 2019 Order Instituting Rulemaking* (OIR), Rulemaking 19-01-006, Southern California Edison Company (SCE) provides its opening comments as a respondent.

I. INTRODUCTION AND EXECUTIVE SUMMARY

SCE appreciates the Commission's urgently needed efforts to implement Senate Bill (SB) 901 in a timely manner, including the evaluation of a framework for determining the maximum amount of disallowed wildfire costs and expenses before harming customers. Recent events, however, have overtaken the Commission's original SB 901 path and threaten further and even greater harm to California and its economic vitality. Investor confidence in the State's regulatory construct is rapidly deteriorating: the State's largest investor-owned utility (IOU) has declared bankruptcy, and its other large IOUs have been downgraded and placed on negative watch with the potential for downgrades to sub-investment grade, or "junk" credit ratings.[1] The Commission must take prompt action now by expanding this OIR's scope to include

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[1] Negative watch is a status that the credit-rating agencies (Standard and Poor's, Moody's, and Fitch) give a company while they are deciding whether to lower that company's credit rating. Once a ratings agency places a company on negative watch, there is a 50 percent chance that the company's rating will officially decline in the next three months. *See* the definition *available on* https://www.investopedia.com/terms/n/negative-watch.asp

establishing a clear, durable, and repeatable process for assessing the prudency of IOU wildfire operations and enabling timely recovery of prudently incurred wildfire expenses.[2] Swiftly resetting the regulatory construct between the Commission, the IOUs, customers, and the financial community will enable the State's IOUs to attract the capital needed to safely deliver reliable, clean, and affordable electric power to customers.

It is beyond dispute that California's wildfire risk has dramatically increased, resulting in a "new abnormal" of year-round and potentially catastrophic wildfires.[3] In this challenging environment, SCE is enhancing its electrical system to mitigate wildfire risk and continuing to implement leading clean energy policies in order to meet its core objective of safely delivering reliable, affordable, and clean electricity to customers. Critical to these efforts—and the State's regulated IOU framework—is the ability to access low-cost debt and equity capital for operating needs and infrastructure investments.[4] That access is threatened by the State's increasingly negative investment risk profile due to recent catastrophic wildfires, the application of inverse condemnation with a strict liability standard, and the Commission's unclear and prolonged cost recovery process. Unfortunately, the Commission's current implementation path of SB 901 has not adequately addressed this highly concerning issue because it does not include a critical feature: establishing an upfront and objective process for assessing prudent wildfire operations and determining cost recoverability.

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[2] This includes incremental, unreimbursed wildfire-liability related expenses included in SCE's Wildfire Expense Memorandum Account (WEMA) such as: (1) payments to satisfy wildfire claims, including any co-insurance, deductibles and other insurance expense paid by SCE, (2) outside legal expenses incurred in the defense of wildfire claims, (3) payments made for wildfire insurance and related risk-transfer mechanisms, including associated fees and taxes, and (4) the cost of financing these amounts.

[3] The OIR notes that devastating wildfires have become a regular occurrence in California. OIR, p. 1. This is due to a number of factors, including climate change effects and the growing wildland-urban interface, among others.

[4] As discussed in III.1, the rating agencies view a utility's ability to access equity capital as critical to managing financial risk. Without access, a utility would not have an investment grade credit rating, restricting its access to low-cost debt capital.

This approach to restore investor confidence has been successfully done before. California's own history proves that cost recovery frameworks based on clear, upfront standards and timely, after-the-fact compliance reviews restore investor confidence and enable IOU access to low-cost debt and equity markets. Specifically, the Commission's implementation of the Assembly Bill (AB) 57 energy procurement process successfully restored confidence in the regulatory construct that was fractured during the Energy Crisis, by providing for Commission-approved plans with upfront, achievable standards and timely, robust reviews to ensure compliance with those approved plans. This clear and predictable framework helped stabilize the State's energy landscape and transform its energy markets—California's IOUs have been investment grade in the decades since the Commission implemented the procurement framework. AB 57 also helped propel key State climate initiatives, doubling the percentage of SCE's retail sales served by renewable power to 32 percent over the last decade, and advancing others like transportation electrification and grid modernization. In many respects, AB 57 provided the basis for California to be a national leader in clean energy and ensured utility actions are clearly aligned with customers' needs.

Like AB 57, SB 901 provides a process for Commission approval of wildfire mitigation plans with upfront, achievable metrics and assessing IOUs' compliance with their approved plans. This worsening crisis, however, illustrates the immediate need to clearly link a finding of substantial compliance with those approved plans to an overall determination that the utility acted prudently and may timely recover wildfire-related costs and expenses. The Commission has the authority[5] to take this important step by determining in this proceeding that substantial compliance with a utility's wildfire mitigation plan is *per se* evidence of prudent conduct by the utility for purposes of wildfire mitigation operations. Establishing this clear process will have

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[5] The Commission has broad authority under Public Utilities Code (PUC) Sections 451 and 701 to effectuate the changes required to directly align the SB 901 cost recovery framework with the more complete one established under AB 57. Under this framework, the Commission retains authority to penalize IOUs should they fail to substantially comply with their respective wildfire mitigation plans, and to investigate and penalize the IOUs for misconduct associated with specific wildfires.

the benefit of stabilizing the energy landscape while the SB 901 Commission on Catastrophic Wildfire Cost and Recovery and the Legislature consider potential additional and complementary longer-term solutions for the current crisis this year.

SCE believes that the Commission must take this action now and in this proceeding because, at present, SB 901 implementation is perceived as slow and uncertain and financial markets are reacting negatively due to the bankruptcy of the State's biggest utility. SCE understands this OIR was originally focused on developing a methodology to determine how much a regulated utility can pay in potential disallowances without harming customers. While SCE agrees this is an important issue and has answered the Commission's preliminary questions in the OIR, it is secondary to the more pressing and fundamental question of how the Commission will first review the prudency of an IOU's wildfire operations to determine if a cost recovery disallowance is even warranted. SCE therefore proposes a phased approach to address both objectives, plus one other: Phase 1 to create an appropriate cost recovery framework based on PUC Section 451.1 to restore investor confidence; Phase 2 to establish the maximum amount for PUC Section 451.2; and Phase 3 to reduce potential customer rate impacts and address financing risk by establishing ways for IOUs to finance wildfire costs.

II. THE COMMISSION MUST ADDRESS THE DEEPENING CRISIS BY ESTABLISHING AN APPROPRIATE COST RECOVERY FRAMEWORK FOR REGULATED UTILITIES' WILDFIRE-RELATED COSTS AND EXPENSES

A. The State and IOU Customers Benefit from Stable Access to Investor Capital

California's regulated IOUs provide substantial benefits to the State and their customers. They deliver over 70 percent of the State's electric power and are on track to obtain 50 percent of their power from renewables ten years earlier than SB 350's 2030 target date. IOUs are also lead implementers of clean energy policies and are investing in modernizing the electric grid to enable customer adoption of technologies, increase solar deployment, integrate energy storage, and electrify the transportation and building sectors. Over the last decade,[6] SCE has doubled the percentage of SCE retail sales supplied by eligible renewable resources to almost 32 percent in 2017 and invested over $36 billion in infrastructure to support the State's policies, while increasing system average rates by just 1.2 percent per year, approximately 0.5 percent less than Los Angeles-area inflation. SCE is also pursuing enhanced measures to further address wildfire safety and plans to spend almost $600 million during the 2018-2020 period on this effort. Beyond this, SCE is planning on accelerating and expanding its wildfire mitigation activities in 2019 as part of its proposed wildfire mitigation plan, and anticipates incurring additional incremental costs as part of this effort. Key to funding these and other objectives is SCE's ability to attract low-cost capital from equity and debt investors, helping keep rates affordable and avoiding the need for the state to invest directly in electric utility infrastructure and support electric utility operations. In addition, for SCE to perform its day-to-day operations, SCE's suppliers must have confidence that SCE will be a reliable counterparty and honor its contractual obligations.

B. Confidence in the State's Regulatory Construct Is Critical to Continued Investment in California's IOUs

Investors and suppliers rely upon the regulatory construct to establish a predictable, comparable risk business environment for SCE, providing the utility with ready access to relatively low-cost capital and establishing it as a reliable counterparty that will honor its contractual obligations to suppliers. The Commission has repeatedly recognized its role in maintaining this construct and the benefits it provides to customers:

> We know that ***California depends on having financially viable public utilities,*** and therefore all of our decisions must ensure that these regulated entities have a

[6] References period ending with the last reported calendar year (2017), based on annual 10-K filings with the SEC for 2008 to 2017, the 10/31/2017 EIX Business Update presentation *available at* https://www.edison.com/content/dam/eix/documents/investors/events-presentations/eix-october-2017-business-update.pdf, and SCE's 2007 and 2017 RPS Compliance Reports, R.15-02-020.

> reliable process to recover just and reasonable costs and an opportunity to earn a fair return. (Emphasis added.)[7]

> We understand that the investment community is vitally interested in the decisions of this Commission. ***We also recognize that an investor-owned utility's credit rating and its access to capital are of critical importance to its ability to provide the infrastructure it needs to meet its customer service obligations.*** (Emphasis added.)[8]

By maintaining a stable regulatory construct, the Commission ensures investors have confidence they will have the opportunity to earn a reasonable, risk-adjusted rate of return on their invested capital. This confidence is essential to IOUs' continued access to capital markets—without it, IOU investments and operations may be affected, which will harm customers.

1. IOUs' Continuous Access to Equity Capital Markets Depends on a Stable Investment Risk Profile

Equity investments have significantly greater risk than debt investments as earned equity returns are based on the residual cash flows after operating expenses and capital-related costs are paid, absorbing any cost increases relative to authorized levels. As a result, the returns that equity investors earn are much more volatile than the interest payments that bondholders receive. The Commission has traditionally addressed this by setting the authorized cost of equity at a rate substantially higher than the cost of debt and tracking macroeconomic fluctuations by a mechanism that tracks utility bond rate changes. That approach, however, is becoming insufficient in the current environment: the shift in California's risk profile as compared to its utility peers due to the heightened and increasing wildfire risk, the application of inverse condemnation with a strict liability standard, and the Commission's unclear and prolonged cost recovery process have resulted in market disruption. Investors, however, expect regulatory implementation of SB 901, and potential future legislation as necessary, to mitigate this risk to California's IOUs. If this risk goes unaddressed or is not addressed with a sense of urgency in

[7] Decision (D.) 09-05-019, p. 4; D.10-10-035, p. 6; and D.10-12-057, p. 5.
[8] D.04-07-022, p. 11.

recognition of the interdependency between investors and the IOUs' customers, market access could become limited or cease altogether due to an unstable view of the investment risk profile. This outcome must be avoided as utilities rely on equity investors to reinvest a substantial portion of their return on capital and the entirety of their return of capital each year.[9]

2. IOUs Must Have Investment Grade Credit Ratings to Maintain Continuous, Low-Cost Access to Debt Capital Markets, Benefiting Customers

Debt investor views are reflected in the credit ratings established by the credit rating agencies. Cost of debt increases and access to debt capital becomes more difficult as ratings decline, with the greatest impact occurring as credit ratings drop below investment grade. The Commission has recognized the importance of investment grade credit ratings. In its decision approving the Modified Settlement Agreement that allowed Pacific Gas & Electric Company (PG&E) to exit its prior bankruptcy in 2003, the Commission stated the following:[10]

> In setting just and reasonable rates, in addition to protecting the consumers, we also must consider the financial health of the public utility. Indeed, we view this commitment to act to facilitate and maintain investment grade credit ratings as essentially doing what we have always done under cost-of-service regulation: provide just and reasonable rates and authorize a reasonable capital structure that maintains the fiscal integrity of the utility. As already discussed, our traditional regulation resulted in high investment grade ratings of our energy utilities.… ***as part of our regulatory responsibilities, that it is in the public interest to restore [the IOU's] investment grade credit ratings.*** (Emphasis added.)

When determining a utility's credit rating, the rating agencies assess risk in two primary categories: financial risk and business risk.[11] The financial risk profile is largely tied to capitalization and return parameters set as part of the cost of capital proceeding and the ability to recover costs. The business risk profile is largely set by the regulatory environment, including

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9 For SCE, like many other utilities, the primary sources of equity capital are retained earnings (return on capital that is reinvested in the business and not paid out as dividends) and depreciation expense (return of capital that it reinvested in the business).

10 D. 03-12-035, pp. 32-33.

11 Standard & Poor's *Key Credit Factors for the Regulated Utilities Industry,* published November 19, 2013.

how predictable and timely the commission is in providing cost recovery, and the resulting impact on equity and debt capital market access. Additional detail is provided below in response to the Commission's question regarding the assessment of a utility's financial status, in Section IV.1.

C. Investors and Credit Rating Agencies Are Rapidly Losing Confidence in California's Regulatory Construct; Suppliers Continue Doing Business but Also Have Concerns

The Commission's 2017 Decision (D.) 17-11-003 denying SDG&E cost recovery for its 2007 wildfire-liability related expenditures, followed by the devastating 2017 and 2018 wildfires and the "new abnormal" of year-round wildfire risk, have negatively affected the way investors view California's regulated IOUs. This view contributed to PG&E's bankruptcy filing, and Standard and Poor's (S&P), Moody's, and Fitch have downgraded SCE and San Diego Gas & Electric Company (SDG&E) and placed them on negative watch or negative outlook. Although SCE's issuer and debt issuance credit ratings are at the low end of investment grade, SCE's preferred and preference stock are now non-investment grade. Troublingly, S&P stated a review is forthcoming, and additional downgrades may be imminent due to the current wildfire cost recovery framework, not potential liability from the 2017 or 2018 wildfire seasons:[12]

> The downgrade reflects S&P Global Ratings' continuing reassessment of California's regulatory construct for electric utilities… While the 2018 passage of Senate Bill 901 was, in our view, a first step designed to protect the credit quality of—and modestly limit the wildfire risks to—California's electric utilities, further reform is necessary to preserve the credit quality of California's electric utilities… ***The CreditWatch negative placement reflects the increased likelihood that [SCE] will continue to experience catastrophic wildfires because of climate change and without sufficient regulatory protections …. We could lower our ratings on the company by one or more notches if regulators and or politicians do not take concrete steps to explicitly address these growing risks in the next few months.*** (Emphasis added.)

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[12] Press Release, Standard & Poor's, Edison International and Subsidiary Southern California Edison Downgraded to 'BBB'; Ratings Placed On Watch Negative (Jan. 21, 2019) *available at* https://www.standardandpoors.com/en_US/web/guest/article/-/view/type/HTML/id/2155495. (Registration required for access.)

Moody's echoed similar sentiment when placing SCE on review for downgrade:[13]

> The review will also consider the California Public Utility Commission's (CPUC) prudency review process for passing on wildfire costs to ratepayers and the likelihood that the CPUC will allow utilities to recover costs associated with both past and future wildfires.

SCE has observed significant changes in the interest rates required by debt investors in secondary market trading and its 2018 long-term bond offerings. It is estimated that recent trades in the secondary market imply that SCE must offer at least 75 basis points or ¾ of a percent more than its historical peers to issue 30-year first mortgage bonds. This interest rate premium relative to peers may further increase if wildfire risk is not addressed within the next few months as investors' expectations of a favorable outcome declines. This would cause at least $7.5 million per year of additional interest expense for the next 30 years (or $225 million over the life of the bonds) for each $1 billion of bonds issued. For reference, SCE issued $2.75 billion of long-term bonds in 2018. Based on this annual rate of long-term debt issuance, customers will have to pay more than $600 million in additional interest expense over the life of the bonds issued each year, and potentially significantly more if wildfire risk is not addressed. Besides the impacts on the cost of long-term debt, SCE's commercial paper costs, a key source of funding of day-to-day operations, have increased by more than 25 basis points recently. SCE commercial paper is dependent on credit ratings, and if SCE is downgraded further, SCE may no longer be able to issue commercial paper, increasing the cost to customers of short-term financing requirements.

Credit rating agencies such as S&P and Moody's generally focus on debt instruments; risks to debt and equity are different, but their concerns have been similarly echoed by equity analysts and investors. To better understand equity investor views, Morgan Stanley recently

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[13] Press Release, Moody's Investor Service, Moody's places Edison and Southern California Edison Under Review for Downgrade, (Jan. 24, 2019) *available at* https://www.moodys.com/research/Moodys-places-Edison-and-Southern-California-Edison-under-review-for--PR_394211 . (Registration required for access.)

surveyed 40 equity investors:[14] 90 percent of the investors viewed this proceeding's outcome as important to determine whether California utilities are investable. As of the survey's issuance, 88 percent of investors viewed PG&E as uninvestable even if the customer harm threshold applies to 2018; 43 percent of investors viewed SCE as uninvestable if the customer harm threshold applies to 2017 and 2018; and 23 percent of investors viewed SDG&E's holding company, Sempra Energy, the same way.[15] In the case of SDG&E, a significant number of investors view Sempra Energy as uninvestable despite the fact that SDG&E is a minority component of Sempra's portfolio, which includes significant operations outside of California. Meanwhile, all respondents indicated that investments in PG&E and SCE, if investable, would require a higher-than-peer cost of capital, and over 50 percent indicated the same for SDG&E.[16] This indicates a need to address more than just the historical customer harm threshold.

Investors are looking for greater clarity on the framework for cost recovery than the proposed scope of this proceeding. Currently, investors believe there is significant risk of disallowance even when an IOU operates according to regulations and approved plans. In fact, equity market prices have reflected investor expectations of non-recovery for fires before any facts are known linking a utility to a wildfire. This results from additional cost recovery risk not viewed as typical of other jurisdictions and has already resulted in investors targeting a higher return on capital. By establishing a clear and durable cost recovery framework, the CPUC can help restore investor confidence, and customers will pay a lower net present value of rates as the cost of equity reverts to normal levels. This investor sentiment is captured by Value Line in a report dated January 25, 2019:[17]

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14 Based on question 4 of Morgan Stanley Research's survey as shown in exhibit 6 of Morgan Stanley Research's report on PG&E Corp as published on 1/7/19.

15 Based on question 3 of Morgan Stanley Research's survey as shown in exhibit 5 of Morgan Stanley Research's report on PG&E Corp as published on 1/7/19.

16 *Id.*

17 Value Line Investment Survey is only available by subscription, but many public libraries subscribe to it, including Los Angeles Public Library, Sacramento Public Library (multiple locations), San Diego Public Library (multiple locations), and San Francisco Public Library (multiple locations).

> Investors remain concerned about the wildfire-related liabilities of Edison International's utility subsidiary [SCE]. ... Under California's inverse condemnation law, utilities may be held liable for damage if their equipment contributed to the fires, even if the companies followed established safety and inspection procedures. This makes this situation even more problematic for SCE. ***And there is no assurance that the California Public Utilities Commission (CPUC) will allow the utility to pass all of these costs through to its customers. ... We advise investors to avoid this stock.*** (Emphasis added.)

While SCE continues to have access to debt and equity capital markets today, S&P, Moody's, and Morgan Stanley have noted that investors do not have confidence in the Commission's cost recovery framework for wildfire risk and are seeking clarification on predictable and reasonable standards of behavior for cost recovery and an acceleration of the determination. Investors are still evaluating the actions of the Commission and State Legislature to determine whether the regulatory construct will be supportive of continued capital investments in the State's utilities. But patience is waning, and the situation can further deteriorate dramatically and quickly; therefore, the Commission must address the cost recovery framework as soon as possible and before capital market access ceases altogether and causes significant and potentially long-term harm to the State's economic health.

SCE further notes that concerns about the State's regulatory construct extend beyond investors to the supplier community as well. Although SCE's larger, longer-term suppliers continue to do business with the utility, there are growing concerns about the crisis and what it means for continuing to do business in the State. The crisis is also a significant topic of discussion and concern among potential new suppliers.

D. The Energy Crisis Provides Important Context for Understanding the Implications of Limited Capital Market Access and the Need for an Appropriate Cost Recovery Framework to Restore Investor and Supplier Confidence

During the Energy Crisis of 2000-2001, SCE could not obtain financing on reasonable terms and defaulted on payments in early 2001, triggering rating agencies to assign SCE a sub-investment grade rating. The impact on SCE's ability to fund capital expenditures was substantial, and its capital expenditures fell from $1,096 million ($1.096 billion) in 2000 to

$688 million in 2001, a decrease of approximately 37 percent. Besides the adverse impact on capital expenditures, SCE could not purchase power for its customers, and the State had to assume that role.[18] To regain capital market and supplier confidence and ongoing access following the Energy Crisis, the state Legislature passed AB 57 (2002)[19] to establish a framework for the California electric utilities to resume power procurement and instill investor confidence of recoverability of procurement costs.

AB 57 was a key element in restoring SCE to investment grade status in 2003. The essence of the AB 57 framework was that if the utility procured power under a Commission-approved procurement plan that included upfront, achievable standards, its procurement was deemed reasonable if it complied with the plan. The compliance review takes place annually and is robust. The importance of this approach, which continues today, is that the utility knows before procuring power that its actions will be reasonable and associated costs recoverable if it proceeds according to the approved plan. As discussed below, under its existing authority, the Commission can implement a similar approach for assessing the prudency of utility actions to mitigate wildfire risk and provide for more certainty regarding cost recovery. This will be an important step to increase investor confidence in California's wildfire liability/cost recovery framework. Unless the Commission acts quickly and credibly, legislation may be needed to give investors stronger confidence in a more explicit linkage between IOUs' substantial compliance with SB 901 wildfire mitigation plans and cost recovery. Quick action by the Commission will stabilize the current deteriorating situation while the SB 901 Commission on Catastrophic Wildfire Cost and Recovery and the Legislature consider potential additional and complementary long-term solutions. As the State's history with AB 57 illustrates, this is an important step towards restoring SCE's credit ratings to their previous levels and avoiding serious financial

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18 During the Energy Crisis the state issued over $10 billion in bonds to finance new long-term power contracts at above market prices.

19 AB 57 *available at* http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=200120020AB57.

consequences that could cause significant customer harm by disrupting SCE's ability to invest in the safe and adequate operation of its system while advancing public policy objectives.

E. The Commission Must Re-Focus Its Efforts to Implement SB 901 by Establishing a Durable Framework Similar to the One Put in Place Following the Energy Crisis

SB 901 is a good start towards establishing an appropriate cost recovery framework for assessing the prudency of IOU wildfire mitigation activities. In many ways, SB 901 is like the framework for energy procurement set out by AB 57 in that SB 901 requires Commission-approved plans with upfront, achievable metrics and regular reviews to determine compliance with the approved plans. Specifically, SB 901 amended Section 8386 of the Public Utilities Code (PUC) and requires the state's electric IOUs to prepare and submit wildfire mitigation plans to the Commission for review and approval. The wildfire mitigation plans prescribed by SB 901 are comprehensive, incorporating numerous performance metrics based on statutory criteria, plus any other criteria required by the Commission. Once approved by the Commission, the IOUs must subsequently demonstrate compliance with the objective metrics set forth in the WMP.

Another key feature of SB 901 is the addition of Section 451.1 to the PUC, which enumerates twelve factors that the Commission may consider when evaluating an IOU's application for recovering costs and expenses related to catastrophic wildfires. Importantly, these cost recovery factors substantially overlap with the metrics that will be part of the IOUs' wildfire mitigation plans and subject to compliance reviews. For comparison, below is a table highlighting some overlapping areas.

Section 451.1 (Cost Recovery Factors)	**Section 8386 (Compliance Factors)**
Whether the IOU disregarded indicators of wildfire risk	• Description of how plan accounts for wildfire risk • Methodology for identifying wildfire risk • Risks and risk drivers associated with the design, construction, operations and

Section 451.1 (Cost Recovery Factors)	Section 8386 (Compliance Factors)
	maintenance of IOU equipment and facilities • Risks and risk drivers associated with topographic and climatological risk factors throughout different parts of an IOU's service area
Whether the IOU failed to operate its assets in a reasonable manner	• Preventive strategies and programs to minimize risk of electrical lines and equipment causing wildfires • Protocols for disabling reclosers and de-energizing portions of electrical system • Plans to prepare for, and restore service after, a wildfire
Whether the IOU failed to maintain its assets in a reasonable manner	• Plans for vegetation management • Plans for infrastructure inspections • Monitoring and auditing of the effectiveness of electrical line and equipment inspections
Whether the IOU's practices to monitor, predict, and anticipate wildfires, and to operate its facilities in a reasonable manner based on information gained from its monitoring and predicting of wildfires, were reasonable	• See above criteria regarding accounting for wildfire risk and developing appropriate preventive strategies

As the Commission exercises its responsibility to implement SB 901, it must restore investors' and ratings agencies' confidence in the State's support of investment-grade regulated electric utilities and ensure that the IOUs can operate with investment grade status if they are prudent utility managers. The deepening financial crisis at all of California's electric IOUs highlights the need for a clear, durable, and repeatable process for assessing the prudency of IOU wildfire operations that enables timely cost recovery of prudently incurred, wildfire-related expenses. This includes payments to settle claims where utility facilities are alleged to be a significant cause of a wildfire ignition when those payments exceed the limits of the utility's insurance.

The Commission has the authority to address the continuing crisis by implementing a cost recovery framework that is more aligned with the proven model adopted in AB 57, i.e., one that provides upfront certainty regarding the standards that will apply when a wildfire event occurs. A key feature of the AB 57 procurement model discussed above was directly tying compliance reviews to cost recovery, facilitating the prompt review of utility procurement operations and associated recovery of procurement costs (or imposition of disallowances in instances of non-compliance that were also subsequently found to be imprudent through an accelerated reasonableness review). Here, the Commission can make substantial progress towards restoring investor confidence to stabilize the energy landscape to benefit all stakeholders by implementing these additional measures for assessing IOU wildfire-related costs:

- **The Commission should deem an IOU prudent for cost recovery purposes if the IOU is found to have substantially complied with its Commission-approved wildfire mitigation plan.** As shown above, many of the prudency factors in Section 451.1 can be linked to substantial compliance with a utility's approved wildfire mitigation plan. Substantial compliance is an appropriate standard by which to judge an IOU's wildfire mitigation operations, since prudency cannot equate to perfect operations regardless of the industry in question. If an IOU is found not to have substantially complied with its approved plan, the Commission can exercise its existing authority to penalize the IOU.
- **The Commission should deny cost recovery for wildfire claims payments only to the extent that an IOU's non-compliance with its wildfire management plan is found to be a substantial cause of a wildfire and its damages.** Cost recovery should not be an "all or nothing" proposition during prudency reviews.[20]

  When considering the extent to which an IOU's non-compliance with its wildfire management plan may have contributed to a wildfire and associated damages, the

[20] The Commission acknowledged its ability to "apportion costs between ratepayers and shareholders where warranted" in its Answer to the Petition for Review filed by SDG&E requesting appellate review of the Commission decisions on its WEMA. Answer of Repondent to Petition for Writ of Review at 36, SDG&E v. Public Utilities Commission, 2018 WL 4386757, Case No. D074417 (Cal. App. 4 Dist., Sept. 7, 2018).

Commission should consider all other causes of a wildfire ignition and factors contributing to wildfire size and damages from the wildfire, and disallow only costs proportional to the IOU's misconduct. Specifically, Section 451.1 lists these factors, among others, for consideration by the Commission: circumstances beyond the utility's control, whether extreme climate conditions contributed to the fire's ignition or exacerbated damages, and/or whether any actors outside the utility contributed to the extent of the damages. The Commission should use these factors to create a cost recovery methodology that accounts for external factors beyond the utility's control, such as wind, fuel stock, duration, and low humidity and limits disallowance risk accordingly.

The Commission has the requisite authority under PUC Sections 451 and 701 to implement these measures, which are necessary to prevent further harm to customers and will serve to stabilize the current crisis while the Legislature continues to explore additional, long-term solutions. Utilities and financial markets cannot operate efficiently under extended periods of uncertainty related to the recovery of billions of dollars of potential wildfire claims. Further, the Commission retains the authority to impose penalties on the IOUs should they fail to substantially comply with their respective wildfire mitigation plans, and to investigate and penalize the IOUs for misconduct associated with specific wildfires.

III. SCE'S COMMENTS ON PRELIMINARY OIR QUESTIONS

Below, SCE responds to the Commission's preliminary questions in the OIR and offers its proposed methodology for implementing Section 451.2.

1. What factors or financial metrics should the Commission consider when examining an electrical corporation's "financial status"? Specifically, comment on whether these factors should include:

- **a. Debt/Equity ratios and changes to capital structure;**
- **b. Net income;**
- **c. Retained earnings;**
- **d. Credit ratings;**

e. Changes to the ability of the electrical corporation to pay dividends;

f. Equity issuances by the electrical corporation;

g. Current outstanding debt and terms of debt issuances;

h. Current insurance costs and coverage amounts;

i. Outstanding liabilities and assets;

j. Accounting requirements under GAAP;

k. Borrowing ability and ability to raise equity; and

l. Other factors (please describe).

To assess the "financial status" of each utility, the Commission should follow a methodology similar to the one used by the rating agencies. To access low-cost capital to the benefit of customers, the Commission should support the maintenance of strong investment grade ratings for each utility. As previously referenced, the rating agencies, in determining the assignment of a credit rating, assess the financial risk profile and business risk profile of each utility and apply a few additional modifiers.

The financial risk profile is based on a select set of cash flow metrics (e.g., Funds From Operations / Debt, Debt to EBITDA) and balance sheet metrics (e.g., Debt / Total Capitalization, Debt / Equity).[21] These metrics include various adjustments for debt equivalence of power purchase agreements, operating leases and other differences from Generally Accepted Accounting Principles (GAAP) accounting to reflect suppliers' reliance on the utility's balance sheet. For regulated utilities, these metrics are primarily driven by the authorized capital structure and the ability of the utility to earn a fair return and recover costs.

To assess business risk, S&P views "the regulatory framework/regime's influence [to be] of critical importance when assessing regulated utilities' credit risk." S&P's methodology for evaluating regulated utilities' credit ratings lays out these four pillars for assessing the regulatory framework[22]:

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[21] Standard & Poor's *Key Credit Factors for the Regulated Utilities Industry,* published November 19, 2013.

[22] *Id.*

i. Regulatory Stability

- "Predictability that lowers uncertainty for the utility"

ii. Tariff-setting Procedures and Design

- "Recoverability of all operating and capital costs in full"

iii. Financial Stability

- "Timeliness of cost recovery to avoid cash flow volatility"
- "Flexibility to allow for recovery of unexpected costs if they arise"
- "Attractiveness of the framework to attract long-term capital"

iv. Regulatory Independence and Insulation

- "Market framework and energy policies that support long-term financeability of the utilities and that is clearly enshrined in law and separates the regulator's powers"

Recent activity initially resulted in a downgrade of SCE's "competitive position" component of business risk by S&P from "Strong" to "Satisfactory" with further downgrades potentially imminent as S&P "is reexamining its assessment of California's regulatory construct for electric utilities."[23]

As S&P notes in its third pillar to assessing the regulatory environment, the ability to attract long-term capital is a key element of their rating. Besides the factors previously discussed regarding the opportunity to earn a reasonable risk-adjusted return, the Commission has also recognized the role dividends play in attracting public shareholders.[24]

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[23] Press Release, Standard & Poor's, Edison International and Subsidiary Southern California Edison Downgraded to 'BBB'; Ratings Placed On Watch Negative (Jan. 21, 2019) *available at* https://www.standardandpoors.com/en_US/web/guest/article/-/view/type/HTML/id/2155495. (Registration required for access.)

[24] D.03-12-035, p. 30: "Historically, under traditional cost-of-service ratemaking, regulated utilities are provided the opportunity to earn a return on their investment, and have traditionally issued dividends or repurchased common stock under authorized capital structures approved by their regulators. Assuming that a utility is responsibly meeting its obligation to serve, the Commission does not micromanage the utility in its carrying out of its obligations and responsibilities and financial management practices."

2. **How should the Commission define a "material impact" on a utility's ability to provide safe and adequate service under Section 451.2(b)? For example, should a material impact be defined by a change to debt costs or cost of capital paid by ratepayers, by reference to a company's ability to finance its operations (including capital outlay for infrastructure improvements, and procurement of electricity and gas) or in another way?**

When ensuring that the maximum amount of disallowed costs allocated to shareholders does not have a "material impact" on a utility's ability to provide safe and adequate service, the Commission should consider the ability to access low-cost capital to make necessary investments and fund operations, the ability to attract needed employees to execute on the plan and the cost of providing safe and adequate service. Since the lack of safe and adequate service would cause harm to customers, SCE has included the relevant Commission considerations in the response to Question 3, below.

3. **How should the Commission define harm to ratepayers under Section 451.2(b)? What measures or metrics should be used in determining whether ratepayers are harmed?**

Section 451.2 seeks to ensure that utility customers are not harmed when allocating costs and expenses to utility shareholders based on Section 451 or Section 451.1 review. Currently, California IOUs are bearing a risk that is inconsistent with the risks borne by peer utilities outside of California. This non-comparable risk results in two ways that customers may be harmed under this analysis: (a) the utility no longer has access to the capital markets to fund investments and operations benefiting customers, including required investments to provide safe and adequate service, and (b) the utility has higher rates for the same level of service. Both are centered on the availability and cost of capital required to fund the utility's capital and operating plans.

Each utility's authorized general rate case (GRC) is based on capital investment and operating plans that undergo extensive review, as do any capital investments or operating expenses authorized by the Commission outside of the GRC proceeding. Utility capital and O&M provide for safe and adequate service and the necessary infrastructure and resources to enable achievement of public policies. As such, it would cause customer harm to reduce any planned capital spend or operating expenses that the Commission has previously determined provide customer net benefits. While implementing the plans, events sometimes occur that cause a utility to re-allocate expenditures or even increase them to address opportunities/risks with greater customer benefits. This does not, however, invalidate the fact that a reduction in the overall level of planned spend would cause customer harm.

The utility's ability to fund its approved capital and operating plans depends on access to low-cost debt and equity markets to fund operations. That access depends on the utility's ability to recover its costs under a sound regulatory construct that only imposes disallowances in circumstances typical to the industry. As a general matter, even large disallowances imposed for imprudent utility conduct associated with typical utility operations, such as procuring power or operating electrical facilities, generally will not result in harm to customers because the financial markets have already priced this risk in the required rate of return and will not increase the utility's cost of capital because of it. Although the Commission might impose a disallowance so substantial that it results in harm to customers, such instances should be rare.

The potential for customer harm increases substantially if the regulatory construct is unsound and fails to account for non-comparable risks to the utility.[25] Even modest disallowances imposed for atypical risks have serious ramifications for a utility's overall financial health and ability to fund operations. These disallowances are not within the scope of standard utility risks considered by financial markets and inject substantial uncertainty into the cost recovery process. Utility equity and debt investors are not accustomed to taking on these atypical risks for the sector and will increase their required debt[26] and equity[27] returns to account for them. If unaddressed, the utility's continued exposure to future uncertain and potentially significant disallowances that are largely outside the utility's control will become

25 Non-comparable risks are risks not found in other regulatory jurisdictions.

26 SCE's 30-year first mortgage bonds currently trade ~75 bps wider than selected peer companies.

27 *See* Morgan Stanley's equity research survey referenced in section II.C above.

unsustainable—as the increasing risk of defaults and higher cost of capital eventually leads to downgrades by rating agencies and the eventual loss of access to capital markets entirely.

It is this latter scenario that the Commission must consider when defining customer harm for this OIR. As discussed above, the State's wildfire risk landscape for its utilities is clearly unique within the industry sector given the unfortunate combination of increasing risk of catastrophic wildfires coupled with the application of inverse condemnation and an unclear cost recovery process.

4. SCE's proposed methodology for calculating maximum amount a utility can pay without harming customers

Regarding an appropriate long-term methodology for determining the maximum amount that can be allocated to investors without harming customers, SCE recommends the Commission focus on the ability to access capital markets to fund capital and operating plans and the maximum disallowance amount. When evaluating an IOU's risk, investors will consider whether they view the underlying risk as recurring or one-time. At present, investors view the risk of disallowances as recurring due to a range of factors including, but not limited to, climate change effects, the growing wildland-urban interface, and the current cost recovery process as exemplified by the SDG&E WEMA Decision, D.17-11-033. Because the potential impact on cost of capital largely depends on whether a sound cost recovery framework is in place, the Commission should develop the framework recommended above in Section II before establishing a long-term methodology that determines the maximum allocation to investors of imprudently incurred disallowed costs in 2017, 2018, and future years, although both should occur in a timely manner in order to provide immediate reassurance to the capital markets. With investors presently viewing this as a recurring risk, the Commission must consider the cumulative impact over time rather than evaluate each wildfire event separately.

To evaluate this approach across the State's IOUs, the Commission must consider a hypothetical investment grade electric utility company with no investments in other lines of business and a public investor base to derive the appropriate capital market metrics. Because shareholders bear the ultimate burden of disallowances and prudent utility finance requires an adequate equity base, the metric to be applied to determine each electric utility's maximum amount should be based entirely on the ability to raise capital in the equity markets. This will also support strong investment grade credit rating as debt investors and rating agencies look to maintain continuous equity capital market access for credit support.

To define an appropriate hypothetical utility for each IOU, the parties should identify a set of comparable publicly traded, investment grade utility companies whose primary investments are electric utilities and are of similar size. SCE believes that the maximum cumulative amount that a utility can pay without harming customers over a ten-year period can be sized based on the average amount of equity raised in the five largest public equity offerings by electric utility holding companies in the last five years. These transactions must be scaled for equity value of the electric utility being assessed.

After identifying comparable companies, the Commission should use this methodology to determine an appropriate disallowance:

1. Determine the percent of equity value that can be issued by a hypothetical electric utility based on current electric utility equity market conditions. The percent of equity value that can be issued would be calculated as:
   - The average percentage of total shares outstanding issued in the five largest public equity offerings by regulated electric utilities closed in the last five years[28]

2. Determine the hypothetical equity value based on the scale of the evaluated California electric utility. The equity value would be calculated as:
   - The authorized electric rate base effective at the time of the wildfire event, **times**
   - The authorized equity layer percentage effective at the time of the wildfire event, **times**

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[28] To exclude equity offerings completed to finance the acquisition of the equity of another company.

- The authorized return on equity effective at the time of the wildfire, **times**
- The average share price to next calendar year earnings per share ratio (P/E ratio) of the comparable companies at the time of the wildfire event
  - To maintain comparability of underlying business risk, if a durable wildfire cost recovery framework has not been put into effect, the P/E ratio applied would need to be adjusted downward to account for the unique California wildfire risk
  - If a durable wildfire cost recovery framework is in effect, the P/E ratio of the comparable companies can be used unadjusted

3. Calculate the amount of disallowed cost recovery from wildfire events for the prior ten years

4. The maximum amount would be equal to: (the percent of equity value as calculated in step 1 times the hypothetical equity value as calculated in step 2 less the amount disallowed over the prior ten years as calculated in step 3.

IV. THE COMMISSION SHOULD AUTHORIZE IOUS TO EFFICIENTLY FINANCE WILDFIRE LIABILITIES INDEPENDENT OF PRUDENCY REVIEW TIMING

The state's "new abnormal" of potentially catastrophic wildfires can result in multibillion dollar potential liabilities for the state's large IOUs—a risk carried for many years as the litigation, claims payments, and regulatory cost recovery processes play out. This leads to significant uncertainty regarding the IOUs' ability to pay claims as they come due that, if unaddressed, can cause credit rating downgrades, negative investor outlooks, and ultimately a higher cost of capital. Without an established and durable cost recovery framework for wildfire risk, and given the length of time between a wildfire event and the resolution of cost recovery under the existing process, equity investors will require a higher risk-adjusted return regardless of the ultimate recovery decision due to the extended period of uncertainty. Early authorization to finance such liabilities, as needed, would give the markets the certainty they need to enable financing of the liability at a lower cost to customers without stressing credit metrics.

Importantly, if the IOU is later found to have acted imprudently, the Commission has the authority to issue a disallowance in proportion to the IOU's imprudent conduct that led to the damages caused by the fire without affecting the repayment of any debt that had been issued.[29]

Specifically, as it evaluates cost recovery for each wildfire under its current standard, the Commission should authorize IOUs to exclude impacts on authorized equity and debt capitalization due to financing of wildfire claims before a cost recovery decision is issued. The Commission should further issue financing orders as requested and necessary before claims payments to finance those payments. In the financing order, the Commission should authorize the issuance of securities with the lowest present value cost to customers (e.g., securitization bonds if permitted) to mitigate bill impacts. Additionally, the Commission should authorize the recovery of the resulting debt service in current rates pending determination of cost recoverability. In its cost recovery decision, the Commission should determine the non-recoverable portion of the remaining debt service and prior debt service payments based on the percentage of wildfire liabilities disallowed, if any.[30]

V. SCE'S PROPOSED PHASED SCHEDULE

SCE proposes the below phased schedule for this OIR. SCE realizes its proposed Phase 1 is aggressive; however, it is imperative the Commission act swiftly and decisively to prevent the ongoing crisis from worsening. SCE is prepared to discuss a detailed schedule at the February 20, 2019 prehearing conference and does not believe hearings are necessary to resolve these issues.

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[29] One way for the Commission to do this would be to issue an offsetting rate credit to customers matching the debt service cost of the disallowed amount over the life of the securitization.

[30] In the case of a securitization bond with a dedicated rate component, the Commission would require a rate credit equal to the portion of debt service determined to be non-recoverable.

Phase	**Scope**	**Commission Decision (Target Date)**
Phase 1	Address current crisis and customer harm by establishing cost recovery framework, incorporating the WMPs and the 12 factors of Section 451.1	May-June 2019 (to align with approval of IOUs' WMPs)
Phase 2	Address future potential harm to customers by developing customer harm threshold methodology	December 2019
Phase 3	Reduce potential customer rate impacts by developing plan for IOUs to issue securitization bonds to finance future wildfire claims	June 2020

VI. CONCLUSION

SCE appreciates the Commission initiating this crucial proceeding and strongly encourages it to adopt this expanded scope on a timely basis to immediately address the state's deepening wildfire crisis and its impact on the IOUs and their customers and address other SB 901 implementation issues promptly.

Respectfully submitted,

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