UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Inquiry Regarding the Commission's Policy for Determining Return on Equity	))	Docket No. PL19-4-000

COMMENTS OF
SAN DIEGO GAS & ELECTRIC COMPANY

I. INTRODUCTION

San Diego Gas & Electric Company ("SDG&E") respectfully submits the following comments in response to the Notice of Inquiry ("NOI") issued by the Federal Energy Regulatory Commission ("FERC" or "Commission") on March 21, 2019.[1] SDG&E is a California public utility engaged in the transmission, distribution, and sale of energy services in San Diego and Orange Counties, California, and is a participating transmission owner in the California Independent System Operator. The Commission seeks stakeholder views following the Commission's proposal for a new composite methodology to determine whether a utility's return on equity ("ROE") is just and reasonable.[2]

The proposed methodology establishes a two-prong, rebuttable presumption to apply to challenges to an existing ROE under section 206 of the Federal Power Act. Under the first prong, FERC will average three financial models to determine if a utility's existing ROE falls within the applicable quartile of the resulting zone of reasonableness. If it does, the ROE will be presumed just and reasonable.

[1] *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (March 21, 2019) ("NOI").
[2] *See Martha Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018) ("Coakley"); *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc. [MISO]*, 165 FERC ¶ 61,118 (2018) ("MISO Briefing Order") (together, the "Briefing Orders").

If the ROE does not fall within that quartile, the Commission moves to the second prong. There, the agency will average four financial models to set a just and reasonable utility ROE. A utility's ROE will be placed at one of three locations – the averaged midpoint/medians of the zones of reasonableness for average risk utilities, or the midpoint/medians of the resulting lower or upper halves of the zones of reasonableness for below or above average utilities.[3]

SDG&E's comments focus solely on the "second prong" of the Commission's proposed method – namely how the Commission proposes to set a new just and reasonable ROE – whether applied to a section 205 or 206 proceeding.[4] SDG&E generally supports the Commission's proposal to apply multiple financial models to establish an ROE.[5]

Yet SDG&E is concerned that the second prong, as proposed, provides for insufficient consideration of specific utility risks; particularly those that would not be shared by the proxy group. The unparalleled, asymmetric risks facing SDG&E (and other California investor-owned utilities) from California's wildfire liability construct are an apt example. Although SDG&E has a widely renowned wildfire mitigation program,[6] it cannot entirely eliminate the risk that its equipment will be involved in the ignition of a catastrophic wildfire. Under California law,

[3] *See Coakley*, 165 FERC ¶ 61,030 P 32. As discussed below in II.C, SDG&E respectfully suggests that FERC should consistently apply the midpoint to both group and individual filers.

[4] Although SDG&E notes that neither the Briefing Orders nor the NOI specify whether and how the proposed second prong will apply to section 205 filings, the Company supports the Commission applying the same test to utility applications. SDG&E respectfully requests that the Commission clarify the applicability of prong two to initial section 205 filings.

[5] *See* Roger A. Morin, *New Regulatory Finance*, Public Utilities Reports, Inc., p. 28 (2006) ("When measuring equity costs, which essentially deals with the measurement of investor expectations, no one single methodology provides a foolproof panacea . . . It follows that more than one methodology should be employed in arriving at a judgment on the cost of equity and that these methodologies should be applied across a series of comparable risk companies.").

[6] *See* A Report from Governor Newsom's Strike Force, *Wildfires and Climate Change: California's Energy Future* (April 12, 2019) ("Strike Force Report") at 11 ("SDG&E engaged in a robust fire mitigation and safety program after experiencing devastating fires in its service territory in 2007 and has become a recognized leader in wildfire safety"), *available at* https://www.gov.ca.gov/wp-content/uploads/2019/04/Wildfires-and-Climate-Change-California%E2%80%99s-Energy-Future.pdf.

utilities are held strictly liable under inverse condemnation for such wildfire property damage, regardless of fault; even if the utility was only one of several concurrent causes.[7] The state's legal "regime – strict liability for wildfire damage coupled with uncertain ability to recover those damages in rates – thus increases the risk of bankrupt utilities."[8] Indeed, the state's largest investor-owned utility, Pacific Gas and Electric Company, is currently in Chapter 11 reorganization proceedings due to wildfire liabilities and uncertain cost recovery. This unlimited downside risk has resulted in a decline in SDG&E (and other California utilities') credit ratings and an increase in the cost of capital. To ensure an ROE that is commensurate with risks, as required by the Supreme Court's capital attraction standard,[9] the Commission must modify its proposal to take unique threats like these into account and adjust ROE accordingly – even if it results in an ROE above the upper midpoint of the zone of reasonableness generated by the mechanics of the proxy group approach.

II. COMMENTS

SDG&E believes that the Commission's proposed second prong must be altered to adequately account for utility-specific threats that are not shared by the proxy group – for example, SDG&E's unique risks from California's wildfire regulatory regime. To that end, the Commission should:

- Specify that the Commission will consider utility-specific risk factors outside of proxy group selection when setting a utility ROE;
- Consider utility-specific risk factors after establishing the zone of reasonableness to set ROE wherever those risk factors indicate are appropriate – even if it is above the

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[7] *See, e.g., San Diego Gas & Elec. Co.*, 146 FERC ¶ 63,017, P 60 (2014) (this initial decision became the final decision of the Commission by operation of law because no exceptions were taken to it).
[8] Strike Force Report at p. 27.
[9] *See* NOI at P 4 (citing *Bluefield Water Works Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923), *Fed. Power Comm'n v. Hope Nat'l Gas Co*., 320 U.S. 591 (1944), and *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307-312 (1989)).

midpoint of the upper half of the zone of reasonableness – rather than automatically limiting a utility's ROE to one of three points; and

- Apply the midpoint (rather than median) to single-utility filings to give weight to the entire range of the proxy group.

A. The Commission Must Consider Utility-Specific Risks Outside of Proxy Group Selection

Although SDG&E agrees that utility-specific risks should be considered both in proxy group selection **and** in placing a utility's ROE within the zone of reasonableness,[10] the current proposal insufficiently provides for the latter. As the Commission stated in the Briefing Orders, "we continue to find that a utility's risk profile remains the 'particular circumstance' most relevant to determining whether a point within a zone of reasonableness is a just and reasonable ROE for that utility."[11] Yet the proposed second prong only takes unique, utility-specific risks into account to place the utility at one of three midpoints within the zone of reasonableness. That is, the zone of reasonableness results from the choice of who is in the proxy group. The utility's specific risk profile is then used to determine whether the midpoint of the upper, middle, or lower halves of the zone of reasonableness should apply based on whether the utility is of above-average, average, or below-average risk.[12]

Limiting a utility to one of three mechanistically determined locations within the model means that the Commission is relying too heavily on the proxy group to establish an appropriate risk range. Although this dependence on the peer group is presumably based on proxies being limited to companies "with credit ratings no more than one notch above or below the utility or

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[10] *See* NOI Q. D2 at P 34 ("Should risk be considered both in the proxy group selection and in the placement within the zone of reasonableness?").
[11] *See Coakley*, 165 FERC ¶ 61,030 P 24; *see also id.* at P 21 ("chief" among the factors that are relevant to determining whether an ROE is just and reasonable "is the company's risk profile, with a riskier profile indicating that a higher ROE may be appropriate") (citing *NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327, 1344 (D.C. Cir. 1981)).
[12] *See Coakley*, 165 FERC ¶ 61,030 P 32

utilities whose ROE is at issue,"[13] relying solely on credit ratings to differentiate risks is problematic for several reasons. Credit ratings, standing alone, do not provide an adequate indication that two companies with the same credit profile have the same risks.[14] Bond rating categories are broad.[15] Two utilities can have the same bond rating but have very different risk profiles to investors – including divergent credit costs – with different betas, Value Line ratings, investor surveys, state regulatory environments, and stock returns. Nor is there a direct relationship between credit ratings and the cost of equity.[16] Credit ratings are based on risks to bond holders, not equity investors.[17]

Relying so heavily on a proxy group of similar credit ratings to differentiate risk is particularly problematic when a utility faces risks that it does not share with the proxy group – for instance, the unprecedented threats facing SDG&E from California's wildfire liability regime. Although SDG&E is recognized as "a global leader on utility wildfire practices,"[18] California's current process for determining wildfire liability – strict liability for the utility with the uncertainty of cost recovery under the California Public Utility Commission's prudence standard – results in California's investor-owned utilities facing a much "higher cost of capital and the risk of bankruptcy."[19] As Standard & Poor's ("S&P") observed, "California's

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[13] *Id.* at P 49.
[14] *See* Morin, *New Regulatory Finance*, p. 93.
[15] *Id.* ("Four investment-grade ratings categories do not make for a very discriminating classification system when 90% of all rated bonds are included in that system.").
[16] *See id.* ("Equity investors in companies with the same bond rating do not necessarily require the same expected return.").
[17] *See* NOI Q. D7 at P 34 ("To what extent do credit ratings correspond to the ROE required by investors?").
[18] California Senate Bill ("SB") 901 Commission on Catastrophic Wildfire Cost and Recovery (Wildfire Commission), Wildfire Fund and/or Other Funding Mechanism(s) Workgroup Report, Appendix II at 7, *available at* http://opr.ca.gov/meetings/wildfire-commission/2019-06-07/docs/20190607-Item_7_Appendix_II_Fund_Workgroup_Report_Draft.pdf.
[19] *Id.*, Appendix I at 4, *available at* http://opr.ca.gov/meetings/wildfire-commission/2019-06-07/docs/20190607-Item_7_Appendix_I_Utility_Liability_Workgroup_Report_Draft_for_Discussion.pdf.

interpretation of the legal doctrine of inverse condemnation effectively makes California's electric utilities the state's reinsurer, which creates new risks that were never envisioned when investor-owned utilities were established."[20]

This asymmetric threat separates SDG&E from its non-California peers. As Moody's recently stated:

> California's changing climate conditions, housing development plans and legal structures create a wildfire risk profile that is unique when compared to other regulated utilities across North America. As it stands today, we do not think these risks are characteristic of comparable, investment-grade peers . . . .[21]

S&P likewise notes that California's wildfire liability framework "significantly raises the risk for California's electric utilities to a level inconsistent with any other North American utility."[22]

Moreover, because of these wildfire liability risks, SDG&E and other California utilities face an ongoing deterioration in credit ratings. In the last year, SDG&E has been downgraded two notches and faces a negative outlook from both S&P and Moody's. S&P recently noted that it could again downgrade the California utilities if the California legislature does not address wildfire liability by July 12, 2019.[23] The more that SDG&E's credit rating is downgraded, the fewer utilities will remain within one-credit rating of the Company. This could result in a peer group that is statistically unreliable.[24]

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[20] S&P Global Ratings Credit FAQ: Will California Still Have an Investment-Grade Investor-Owned Electric Utility? (Feb. 19, 2019), *available at* https://www.capitaliq.com/CIQDotNet/CreditResearch/RenderArticle.aspx?articleId=2168627&SctArtId=467165&from=CM&nsl_code=LIME&sourceObjectId=10866063&sourceRevId=14&fee_ind=N&exp_date=20290218-21:25:39.

[21] Moody's Investors Service, Sector Comment: Limiting utility liabilities looms large after release of SB 901 Commission draft report (June 4, 2019).

[22] S&P Global Ratings Credit FAQ: Will California Still Have an Investment-Grade Investor-Owned Electric Utility?, *supra* n.20.

[23] S&P Global Ratings Credit FAQ: The Looming California Wildfire Season Prompts An Examination of Investor-Owned Utilities' Risk (June 7, 2019).

[24] *See, e.g.*, Morin, *New Regulatory Finance*, p. 399 ("it is important to select relatively large sample sizes as opposed to small sample sizes consisting of a handful of companies in applying the CAPM [Capital Asset Pricing Model], Risk Premium, and DCF [Discounted Cash Flow] methods").

In short, relying primarily on the proxy group to differentiate risks with a mechanical application of ROE could lead to a return that is not commensurate with a utility's risks, contrary to Supreme Court precedent. The Commission should leave open the possibility that the "zone of reasonableness" generated by its methodology may not in fact be reasonable in particular circumstances, such as those discussed above.

B. The Commission's Proposed Second Prong Should Allow for Placing a Utility's ROE Based on its Particular Circumstances

A better approach is to apply a large, statistically significant proxy sample group, with the Commission then making utility-specific risk adjustments based on the agency's reasoned judgment to set a just and reasonable ROE that reflects a utility's particular circumstances.[25] The NOI's suggestion of including all investment grade utilities in the proxy group is one method to accomplish that goal.[26] Or the Commission could include non-regulated, capital intensive industries with similar levels of investor risk.[27]

Either way, instead of limiting a utility's ROE to one of three modeled midpoints, the Commission should modify its proposal to retain the authority (after establishing a zone of reasonableness) to place a utility's ROE wherever a utility's specific risk-profile indicates is appropriate – even if that results in an ROE above the upper midpoint generated by the mechanistic application of the proposal's formula to the proxy group.[28] Those specific

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[25] *See, e.g.*, *id.* at p. 401 ("Under circumstances of instability, a superior approach [is] to apply cost of capital estimation techniques to a large group of electric utilities representative of the electric utility industry and then make adjustments to account for any difference in investment risk between the subject utility and the industry average.").

[26] *See* NOI Q. D6 at P 34 ("What would be the impact of the Commission modifying the credit rating screen to include all investment-grade utilities in the proxy group?").

[27] *Id.* at Q. D1 at P 34 ("Should proxy groups for electric utilities, as well as natural gas and oil pipelines, consist only of companies with corresponding regulated businesses?").

[28] *See id.* at Q. D9 at P 34 ("What circumstances or factors, if any, warrant an adjustment from the midpoint/median to other points within the zone of reasonableness (e.g., lower or upper midpoint/median)?").

considerations can include regulatory climate, beta, bond rating, capital structure, and unique risks like California wildfire liability regime.

Risk exists on a spectrum. While the *Emera Maine* Court held that the midpoint of the upper half of the zone of reasonableness was the "'obvious place to begin'" when assessing a just and reasonable ROE for risky utilities,[29] that does not mean it should end there.[30] Merely because two utilities are of "above average risk" does not mean they both face the same level of threats. The current proposed approach of simply placing a utility at one of three midpoints is too formulaic, will cluster too many utilities together at the same ROE despite having different levels of risks, and may not allow for the setting of an ROE that is warranted by a utility's risk profile. This could perversely harm a utility like SDG&E that is considered riskier than its peers by "capping" its ROE at the upper midpoint of the zone of reasonableness derived from the proxy group – despite widespread acknowledgement that SDG&E faces unique and unparalleled threats from California's wildfire liability regime. If a utility is riskier than its peers, its ROE should reflect that.[31]

C. The Commission Should Use the Midpoint for Single Utility Filers

Finally, the Commission should apply the midpoint (rather than the median) for all utilities; whether filing individually or as a group. Because the median is the single number in a series that divides the highest half of the numbers from the lowest half, applying the median fails

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[29] *See Coakley*, 165 FERC ¶ 61,030 at P 25 (citing *Emera Maine v. FERC*, 854 F.3d 9, 29-30 (D.C. Cir. 2017)).
[30] *Coakley*, 165 FERC ¶ 61,030 at P 25 ("recognizing that, nevertheless, the particular circumstances facing a utility may differ from some or all of the proxy group companies, the Commission has adjusted the ROE within the zone of reasonableness derived from the proxy group, increasing the ROE for a riskier utility and decreasing it for one that is less risky").
[31] *See id.* at P 44 ("a key consideration in determining just and reasonable utility ROEs is determining what ROE a utility must offer in order to attract capital, *i.e.*, induce investors to invest in the utility in light of its risk profile").

to adequately account for variations in risk among the proxy group.[32] Different groups can have the same median – even though they have significantly different midpoints. For example, the median of the series 8, 9, 10, 11, 12, would be 10. But so would the median of 8, 9, 10, 13, 15 – despite the fact that top-end values in the second sample are significantly higher.

The median thus fails to adequately account for risk differential. It eliminates comparisons to other high-risk utilities and skews distribution. Like over-reliance on the proxy group, it penalizes high-risk utilities such as SDG&E by prioritizing the ROE of the middle utility in the proxy group. This, again, could result in failing to set ROE commensurate with risks.

The Commission itself seems to recognize that using the median pushes all ROEs towards the center of the zone of reasonableness – regardless of risk profile. FERC questions whether it would "be reasonable to determine the central tendencies of the upper and lower halves of the zone of reasonableness for single utilities based on a midpoint analysis, so as to produce approximately equal ranges of presumptively just and reasonable ROEs for below average, average, and above average risk utilities?"[33] Rather than reverse-engineer portions of the methodology, FERC should consistently apply the midpoint to create an equal distribution that adequately reflects the entire range of risks indicated by the proxy group. To the extent that the Commission continues using the median for individual utilities, it becomes even more important that FERC consider utility-specific risks and set ROE commensurate with those risks.

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[32] *See* NOI Q. G4 at P 37 ("In single utility rate cases, the Commission determines the central tendency of the zone of reasonableness based on the median of the proxy group ROEs. Is the approach outlined in the *Coakley* and MISO briefing orders appropriate in single utility rate cases given that the proxy company ROEs tend to cluster near the center of the zone of reasonableness, making the middle quartile relatively narrow?").

[33] *Id.* Q. G4a at P 37.

III. CONCLUSION

The Commission should modify the second prong of its proposed method to more fully consider utility-specific risks. The proposal should enable the Commission to set ROE wherever those risks indicate are appropriate; particularly in cases where the zone of reasonableness will result from a proxy group that does not share the unique threats facing a utility. This is the only way to ensure that the chosen ROE is commensurate with risks, such as the asymmetric threat that SDG&E faces from California's wildfire liability regime.

Respectfully submitted,

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