Docket	:	A.12-04-015 et al
Exhibit Number	:	DRA-02
Commissioner	:	Ferron
ALJ	:	Galvin
Witness	:	Oh

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Report on The Cost of Capital for Test Year 2013

Revenue Protection

A.12-04-015 et al

San Francisco, California
August 6, 2012

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COST OF CAPITAL
REVENUE PROTECTION

I. INTRODUCTION

The Division of Ratepayer Advocates (DRA) submits its Cost of Capital exhibit in response to Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), Southern California Edison Company (SCE), and Southern California Gas Company (SoCalGas)'s Application (A.) 12-04-015 et al, for authority to increase rates.

II. SUMMARY OF RECOMMENDATIONS

DRA testifies that all four utilities have revenue and expense balancing accounts that reduce their business and regulatory risk. Additionally, the balancing accounts associated with authorized General Rate Case (GRC) revenues provide the utilities with additional revenue guarantee by eliminating risk associated with energy sales variability.

III. DISCUSSION

A Large Proportion of the Utilities Revenues are Fully Protected

In response to the Administrative Law Judge's request during the June 4, 2012 prehearing conference, the four Investor-Owned Utilities (IOUs) filed supplemental testimony to identify amounts recorded in current balancing and memorandum accounts, and the percentage of total amount in relation to authorized 2012 revenue requirement. The supplemental testimonies identified that the four IOUs have from 40% to 54.45% of their 2012 revenue requirement recoverable through balancing accounts[1]. According to the IOUs, this means 40% to 54.45% of its actual expenses do not bear the full[2] business and financial risk.

[1] PG&E reported 40%, SCE reported 45.24%, SDG&E reported 44.09%, and SoCalGas reported 54.45% of 2012 revenue requirement recoverable through balancing accounts.

[2] The utilities do bear some risk in that the Commission may disallow cost recovery.

In addition to having 40% to 54.45% of their actual expenses recoverable via a balancing account, the IOUs recover its Commission-adopted GRC base rate revenue through a balancing account[3]. As such, the percentage of revenues that are recoverable through balancing accounts is much higher than those identified by the IOUs when including the GRC authorized revenues. This elimination of sales risk for electric utilities is codified in the Public Utilities Code (PUC) Section 739.10 (added by Stats. 2001, 1st Ex. Session, Ch.8, Sec. 10) which provides that "The commission shall ensure that errors in estimates of demand elasticity or sales do not result in material over or undercollections of the electrical corporations." As such, the IOUs' business risk for any variations between actual and forecasted sales is significantly, if not completely, reduced.

Previous Commission decisions have found that revenue decoupling mechanisms[4] decrease business risk. Commission Decision (D.) 95-05-045 stated, "[t]his decoupling mechanism, called the electric revenue adjustment mechanism (ERAM), is a ratemaking mechanism that guarantees utility recovery of authorized revenue requirement, independent of actual energy sales. The utility cannot achieve higher revenues or profit by promoting higher sales relative to the sales forecast. Conversely, the utility will not lose revenues or profits if energy efficiency programs

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[3] D.05-03-023, Conclusion of Law 11 "A revenue balancing account mechanism satisfies § 739.10 to avoid material undercollections of SDG&E's authorized base margin. It is in the public interest to provide for revenue balancing for all of SoCalGas and SDG&E's base rate revenue requirement to insulate ratepayers from overcollections and shareholders from undercollections cause by errors in forecast sales/throughput.

D.02-04-055, Conclusion of Law #1, and Ordering Paragraphs #2 and #3 established a revenue balancing account mechanism that assured recovery of SCE's authorized distribution revenue requirement under the PBR mechanism.

Resolution E-3862 authorized PG&E to implement Revenue Adjustment Mechanisms for recovery of its authorized Distribution, Public Purpose Programs, Nuclear Decommissioning, and Utility Generation revenue requirements.

[4] "Decoupling sets up a mechanism to track the difference between actual and forecasted base rate revenues, whereby overcollections are refunded to ratepayers and undercolections are recovered in subsequent rate adjustments." *Interim Opinion on Phase 1 Issues : Shareholder Risk/Reward Incentive mechanism for Energy Efficiency Programs*, D.07-09-043, 2007 Cal. PUC LEXIS 451 at *105 (September 20, 2007).

produce greater savings than forecasted."[5] When initially instituting the ERAM in 1982, the Commission concluded that a "utility is afforded a better opportunity to earn its authorized rate of return."[6]

With the guaranteed recovery of authorized GRC base rate revenues and 40% to 54.45% of variable expenses recoverable via a balancing account, the utilities' risk that it will not earn its authorized rate of return is dependent on how it manages the expenses not covered in a balancing account. These expenses typically do not vary significantly.[7]

In a GRC, the revenue requirement is determined by the following formula:

RR = (RB x ROR) + E + D + T

Where RR = Revenue Requirement

RB = Rate Base

ROR = Rate of Return

E = Operating expenses and taxes other than income taxes

D = Deprecation, and

T = state and federal income taxes.

As the formula shows, the authorized revenue requirement is established by the forecasted rate base, expenses, taxes, and depreciation. Once the Commission authorizes the revenue requirement, the utility collects that amount as actual revenue.

[5] *Order Instituting Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electronic Service Industry and Reforming Regulation; Order Instituting Investigation on the Commission's Proposed Policies Governing Restructuring California's Electric Service Industry and Reforming Regulation*, D.95-05-045, 1995 Cal.PUC LEXIS 429 (Part 8 of 9) at *6fn.22, 60 Cal.PUC 2d. 18 at pp. 247-248 fn. 22 (May 24, 1995).

[6] D.82-12-055, 1982 Cal.PUC LEXIS 1209 at *28, 10 Cal. PUC 2d 155 (December 13, 1982).

[7] In PG&E's Supplemental Testimony, PG&E states that "For those types of costs that are not assumed to vary significantly over the period of a rate case – such as the costs of owning, operating and maintaining the utility's assets, revenue collection, and general and administrative costs – the utility recovers a forecast of these costs…"

A simple rearrangement of the formula shows that the utilities rate of return is dependent on revenue requirement less expenses, less depreciation, less taxes, divided by the rate base.

ROR = (RR – E – D – T)/RB

The revenue requirement is adopted in a Commission GRC decision, and protected from variability by PUC Section 739.10[8]. As such, the actual expenses, deprecation, taxes, and rate base decisions that the utility management makes will determine if the utility earns its rate of return.

These expenses are under the direct control of the utilities and afford the utilities an opportunity to earn their rate of return. And while the actual expenses, capital investment and other related costs that the utility incurs may ultimately deviate from those that were forecasted in the GRC, it is the utility management that has the discretion to fund programs as it deems appropriate in conjunction with providing safe and reliable service. Therefore, any differences between authorized GRC revenues and rate of return compared to actual revenues and rate of return is within the control of utility management.

[8] Note that PUC Section 739.10 pertains to electric utilities. Gas utilities have balancing account protection for a majority of its GRC revenues.

IV. QUALIFICATIONS OF WITNESS

Q.1 Please state your name and business address.

A.1 My name is Jerry Oh. My business address is 505 Van Ness Avenue, San Francisco, California, 94102.

Q.2 By whom are you employed and in what capacity?

A.2 I am employed by the California Public Utilities Commission as a Public Utilities Regulatory Analyst V in the Division of Ratepayer Advocates Energy Cost of Service and Natural Gas Branch.

Q.3 Briefly describe your educational background and work experience.

A.3 I received a Bachelor's of Arts degree in Business Economics from the University of California at Los Angeles in 1993. From 1995 to 2000, I was employed as a Bank Examiner conducting safety and soundness examination of commercial banks. The safety and soundness examination included analyzing the banks market risk and credit risk. From 2000 to 2007, I worked as a Regulatory Analyst and Financial Examiner in the Commission's Energy Division. Since 2007, I have worked on general rate cases of large water utilities as a member of DRA. I have been DRA's expert witness in Administrative and General expense, Operations and Maintenance expense, Cost of Capital, Affiliate Transactions, Taxes, and Results of Operations. I have supported my testimony in formal Commission hearings.

Q.4 What is the purpose of your testimony?

A.4 I am responsible for Exhibit DRA-02.

Q.5 Does that complete your prepared testimony?

A.5 Yes, it does.