

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE  
STATE OF CALIFORNIA**

Application of Southern California Edison	)	
Company or Authorized Cost of Capital for	)	A.07-05-003
Utility Operations for 2008	)	
<hr/>	)	
	)	A.07-05-007
And Related Proceedings.	)	A.07-05-008
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**REPLY BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E)**

MICHAEL D. MONTOYA  
LAURA I. GENAO

Attorneys for  
SOUTHERN CALIFORNIA EDISON COMPANY

2244 Walnut Grove Avenue  
Post Office Box 800  
Rosemead, California 91770  
Telephone: (626) 302-6842  
Facsimile: (626) 302-1935  
E-mail: [laura.genao@sce.com](mailto:laura.genao@sce.com)

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# REPLY BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E)

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**REPLY BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E)**

Pursuant to Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission (“CPUC”) and the Assigned Commissioner’s Scoping Memo and Ruling, issued June 21, 2007, Southern California Edison Company (“SCE”) responds to the opening briefs of the Division of Ratepayer Advocates (“DRA”), Federal Executive Agencies (“FEA”), and the combined opening brief of the coalition comprised of Aglet Consumer Alliance, The Utility Reform Network, and the Utility Consumers’ Action Network (“Aglet/TURN/UCAN”).

As no party opposes SCE’s recommended ratemaking capital structure and recommended cost of long-term debt and preferred equity for 2008, SCE replies herein to various comments regarding SCE’s recommended authorized return on equity (“ROE”) of 11.8%. Specifically, SCE addresses intervenor misrepresentations regarding the risks facing California’s electric utilities and how those should factor into the determination of SCE’s authorized ROE; the superiority of SCE’s models, inputs, and results; the effect of lowering SCE’s ROE on its creditworthiness and ability to attract necessary capital; the irrelevance of comparisons of authorized utility ROEs to pension fund returns; and the need for maintaining current debt equivalence policies. To the extent SCE does not reiterate arguments articulated previously in its

Opening Brief, filed September 27, 2007 (“SCE Opening Brief”), it incorporates those by reference herein.

## I.

### INTRODUCTION

California’s electric utilities face higher risks when compared to utilities in other states. This unique risk profile is a result of the State’s failed attempt to deregulate the electricity market and the ongoing need to implement a stable and durable market for electricity. Notwithstanding this situation, California is moving forward with additional efforts to advance major policy initiatives in the areas of renewable power development, energy efficiency implementation, and greenhouse gas emission controls, while simultaneously continuing to remedy market structure shortfalls that remain from the deregulation effort. Successful implementation of all of these policy initiatives relies heavily on California’s electric utilities and their balance sheets. As a result, SCE has a greater than average need for financial strength sufficient to allow it to perform its integral role in the implementation of the State’s policies. As such, SCE faces higher risks than utilities in other states.<sup>1</sup>

Since California’s energy crisis, which began in 2000, the CPUC has acknowledged the reality of California’s electric utility market structure and SCE’s risk-return requirements by consistently authorizing lawful ROEs that are higher than the national average. Such actions have been appropriate given the risk-adjusted returns required by SCE’s investors, the need to reestablish SCE’s financial health, and the legal requirements for cost of capital decisions. As SCE’s financial risks, recovery, and role in policy implementation continue today, CPUC policies supportive of SCE’s financial health are appropriate.<sup>2</sup>

As SCE demonstrates below, intervenors’ arguments in this proceeding fail to recognize California’s unique and continuing risks and that the State’s utilities require adequate

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<sup>1</sup> SCE/Boada, Ex. 4, pp. 6-7; SCE/Hunt, Ex. 4, p. 10

<sup>2</sup> SCE/Boada, Ex. 4, pp. 4-6.

compensation to maintain creditworthiness and attract capital. Recognizing the evidence of factors affecting risk and the implementation of additional policies within the State, as well as the need for financially healthy utilities as a cornerstone of such policy implementation, will help guide the CPUC to an appropriate ROE for SCE that complies with applicable laws, previous CPUC decisions, and which adequately compensates SCE investors. By setting an ROE that maintains creditworthiness and financial soundness, the CPUC will also enable the capital attraction necessary to support SCE's infrastructure and the State's policy goals.

## II.

### **SCE'S REQUESTED 11.8% ROE IS APPROPRIATE AND FAIR**

In this proceeding, SCE has provided credible evidence that its recommended ROE will appropriately compensate it for risk, enable it to maintain its capacity for credit quality improvement, and support SCE's continued capability to attract capital and ensure confidence in SCE's financial soundness. Various intervenors, however, dispute the recommended ROE of 11.8%. Below, SCE demonstrates the evidence intervenors have ignored or miscalculated when making their assertions. When correctly considered, this evidence undermines intervenors' conclusions.

#### **A. The CPUC Should Recognize The Assessment of California's Regulatory Environment Provided By Well-Established Financial Authorities Relied Upon By All Parties To This Proceeding**

Aglet/TURN/UCAN asserts that "[t]he evidence clearly shows that California regulatory risks, which are an important part of the business risk for which investors are compensated, are declining and under control."<sup>3</sup> Aglet/TURN/UCAN relies solely on the statements of Regulatory

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<sup>3</sup> Opening Brief of Aglet Consumer Alliance, The Utility Reform Network and Utility Consumers' Action Network ("Aglet/TURN/UCAN Opening Brief"), served September 27, 2007, p. 6.

Research Associates for this assessment.<sup>4</sup> The record provides significant evidence contrary to such statements.

As Aglet/TURN/UCAN's own evidence demonstrates, California's regulatory climate is rated "below average" by *Value Line*.<sup>5</sup> Data from *Value Line* publications is well-regarded and used by several parties to this proceeding.<sup>6</sup> Neither Aglet/TURN/UCAN, nor any other participant in this proceeding has provided any grounds for rejecting the *Value Line* information on the regulatory climate in California in favor of the evidence provided by Regulatory Research Associates.

More importantly, *Value Line*'s assessment of California's regulatory uncertainty is echoed by other investment community publications and financial authorities. Standard & Poor's *RatingsDirect* notes that the investment community considers "[u]ncertainty in California with regard to retail choice, resource adequacy, and renewables, including greenhouse gas restrictions" a "weakness[]" of California's utilities.<sup>7</sup> Contrary to Aglet/TURN/UCAN's evidence, sources that *all* parties consider credible enough to use in their cases here, clearly note that the regulatory environment in California is considered riskier for investors than other states and that such risk makes investors wary of California utilities like SCE.<sup>8</sup> No party has provided any credible evidence that such risks have disappeared.

Additionally, Aglet/TURN/UCAN's own data, cited from *Value Line*, is further compelling evidence that California's electric utilities are riskier than the average U.S. utility. Aglet/TURN/UCAN's presentation of PG&E Corporation's Capital Assets Pricing Model beta

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<sup>4</sup> Aglet/TURN/UCAN Opening Brief, p. 4.

<sup>5</sup> Aglet/Weil, Ex. 55, pp. 18-20.

<sup>6</sup> FEA/Hill Tr. 494:25-495:2; Aglet/Weil Tr. 610:14-191 612:11-20, 618:22-26; Pacific Gas and Electric Company ("PG&E")/Avera Tr. 238:12-22.

<sup>7</sup> Ex. 15, p. 3.

<sup>8</sup> SCE does not disagree that the regulatory environment in California has "vastly improved" compared to late 2000 into 2001, however, improvement does not mean that SCE should not continue to have an ROE that allows it to maintain its credit, continue to attract capital on reasonable terms, and ensure its financial soundness. The CPUC must recognize that the improved regulatory conditions which currently exist must be maintained in order to convince investors that California's regulatory environment is not a risk. Until such times, the law requires that SCE investors be compensated for such risk.

shows a value of 1.2,<sup>9</sup> as compared to the industry average beta of .9.<sup>10</sup> This is notable as PG&E Corporation, though a holding company, has only one operating subsidiary – its utility. It is, therefore, a proxy “pure play” electric utility in California. This factor is market evidence that California’s utility risk is 33% higher than the industry average. This translates to a California risk premium of 2.1%.<sup>11</sup> If a calculation was done beginning with an authorized ROE of 10.2% in 2007,<sup>12</sup> adding a California risk premium would yield a California-specific ROE of 12.3%.

Alternatively, in order to compensate SCE on a risk-adjusted basis and encourage capital attraction and confidence in terms of the investment community’s perception of California regulation, the CPUC should adopt SCE’s recommended 11.8% ROE. The record does not provide any evidence supporting the view that regulatory risk in California has declined to the point where an ROE of less than 11.8% will maintain SCE’s financial health and adequately compensate investors or that utilizing the industry average authorized return is a benchmark for setting SCE’s authorized ROE.

**B. The CPUC Should Not Rely on Intervenors’ Flawed Analysis of Authorized ROEs in Other Jurisdictions**

Aglet/TURN/UCAN requests that the CPUC adopt a substantially lower ROE for SCE than currently authorized because “current returns are out of touch with industry norms.”<sup>13</sup> Aglet/TURN/UCAN relies on a self-described “quantitative analysis” for this “solid fact” in its findings. This analysis is necessarily incomplete because it does not capture companies whose return has not been recently reset.

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<sup>9</sup> Aglet/Weil, Ex. 55, p. 20.

<sup>10</sup> Aglet/Weil, Ex. 55, p. 31.

<sup>11</sup> Using a Capital Asset Pricing Model-based calculation, 2.1% equals the 0.3% higher beta multiplied by the market risk premium of 7.1%. SCE provided this market risk premium in its testimony. SCE/Hunt, Ex. 4, p. D-1, Appendix D. The market risk premium is labeled “equity risk premium” in the documentation.

<sup>12</sup> Ex. 27, p. 2.

<sup>13</sup> Aglet/TURN/UCAN Opening Brief, p. 19.

There are currently approximately 70 shareholder-owned electric utilities in the United States.<sup>14</sup> Since some of these companies have multiple subsidiaries in different jurisdictions, it is clear that the number of subsidiary operating companies is much higher than the 70 used in Aglet/TURN/UCAN's analysis. Review of the evidence in this proceeding also makes clear that there are not 70 rate cases filed in the United States during a typical year.<sup>15</sup> Accordingly, it seems to be quite common for utility operating companies to operate for several years without filing new rate cases. This allows those companies to maintain higher ROEs than those set in recent proceedings. Differences in regulatory structures, including other utilities' abilities to benefit from sales growth, may also allow utilities to reap gains from sales growth over time and consistently earn above their authorized ROE. These regulatory realities mean that while Aglet/TURN/UCAN's analysis may show the level of recently granted ROEs, it cannot and does not show what legacy ROEs still prevail for utilities that have not recently participated in rate cases. For these reasons, Aglet/TURN/UCAN's analysis cannot and does not depict the true range of average authorized ROEs currently in effect.

**C. The CPUC Should Reject Efforts To Set SCE's ROE By Focusing Solely On Unanticipated Business and Financial Risks**

After setting forth the relevant CPUC process for setting a cost of capital, Aglet/TURN/UCAN requests that the CPUC fundamentally alter the manner in which it sets SCE's ROE by requesting that the CPUC focus only on new and previously unanticipated business and financial risks when setting SCE's 2008 cost of capital.<sup>16</sup> There is no legal or factual basis for supporting such a change to the CPUC's policies.

As SCE has explained, and all parties accept, the CPUC's decision here should be guided by, among other things, the four principles set out in *Hope* and *Bluefield*. Among those four

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<sup>14</sup> Ex. 28, p. 4.

<sup>15</sup> Ex. 28, pp. 3-4, Table VI.

<sup>16</sup> Aglet/TURN/UCAN Opening Brief, p. 2.

principles is the tenet that the authorized return should be comparable to returns on investments of similar risk.<sup>17</sup> When investors evaluate the risks of competing investments, they do not need to know whether associated risks are old or new, but simply whether they exist and the likelihood that they will continue to exist. Because investors act in such a manner with regard to other investments, the CPUC cannot lawfully consider setting SCE's ROE without considering all risks that attach to an investment in SCE, whether or not they are new. Accordingly, the CPUC should reject Aglet/TURN/UCAN's meritless proposal.

**D. The CPUC Should Consider Risks Created By Decoupling When Setting The Authorized ROE**

DRA and Aglet/TURN/UCAN assert that, because of ratemaking mechanisms, which ensure a utility's recovery of authorized revenue requirements independent of actual sales, SCE's ROE should be lowered to reflect the decreased risk created by such accounts.<sup>18</sup> This suggestion must be rejected, as it does not consider factors relevant to the discussion of revenue decoupling.

The intervenors ignore that while decoupling can reduce the variability of revenues, it does nothing to reduce the cost variability, and in some circumstances, it can produce an adverse effect on utility earnings. For example, if sales are higher than forecast, utility costs likely will be higher than forecast, but the utility will be unable to retain such increased revenue.<sup>19</sup> Because decoupling breaks the link between revenues and utility sales, a utility under a decoupling regime cannot profit from increased sales, which is, of course, the point of such a regime.

Additionally, the CPUC should note that only three states currently have revenue decoupling mechanisms and that, on average, states with authorized returns that comprise the 2007 average of 10.2% do not have revenue decoupling. Decoupling mechanisms allow those

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<sup>17</sup> See *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia et al.*, 262 U.S. 679, 692-693 (1923); *Federal Power Commission, et al. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

<sup>18</sup> Aglet/TURN/UCAN Opening Brief, pp. 29-30 ; Opening Brief of DRA, served September 27, 2007 ("DRA Opening Brief"), pp. 26-27.

<sup>19</sup> SCE/Hunt, Ex.5, p. 46; Aglet/Weil, Ex. 55, pp. 10-11.

utilities to retain revenues from higher than forecast sales to enhance earned ROEs. SCE’s balancing account does not allow this. SCE must refund such revenues to customers. An example of this mechanism’s impact is that a mere .2% increase in sales above forecast would produce enough revenues to offset the \$17 million rate increase SCE has requested in this application.

Having revenue decoupling also means that a utility may need to seek more and greater rate increases as allowed revenues have not grown with sales. The increased frequency and higher amounts in such requests subject the utility to increased regulatory risk.

**E. DRA’s Own Evidence Demonstrates That SCE’s Proposed ROE Is Reasonable**

Although intervenors argue that SCE’s recommended ROE of 11.8% should be rejected and its current authorized ROE of 11.6% dramatically lowered, it is again notable that intervenors’ own evidence in this proceeding supports an ROE that exceeds what SCE has requested in this application.

DRA’s testimony presents the average earned ROE for the sample companies used by DRA and the utilities in their model estimates.<sup>20</sup> SCE has reproduced that table below.<sup>21</sup>

**Table 4-18**  
**Return on Equity and Market-to-Book Ratios**  
**SCE, PG&E, and SDG&E Electric Utility Groups**

	<b>Return on Equity</b>	<b>Market-to-Book Ratio</b>
<b>SCE</b>	<b>11.9%</b>	<b>210</b>
<b>PG&amp;E</b>	<b>11.4%</b>	<b>190</b>
<b>SDG&amp;E</b>	<b>11.6%</b>	<b>196</b>
<b>Average</b>	<b>11.7%</b>	<b>199</b>

Source: Tables 3-3a, 3-3b, and 3-3c.

This table shows that the companies against which SCE must compete for capital earn an 11.9% return on common equity. Since the companies assessed in this analysis were selected because they are generally of comparable risk, SCE is at least as risky as the firms typical of this

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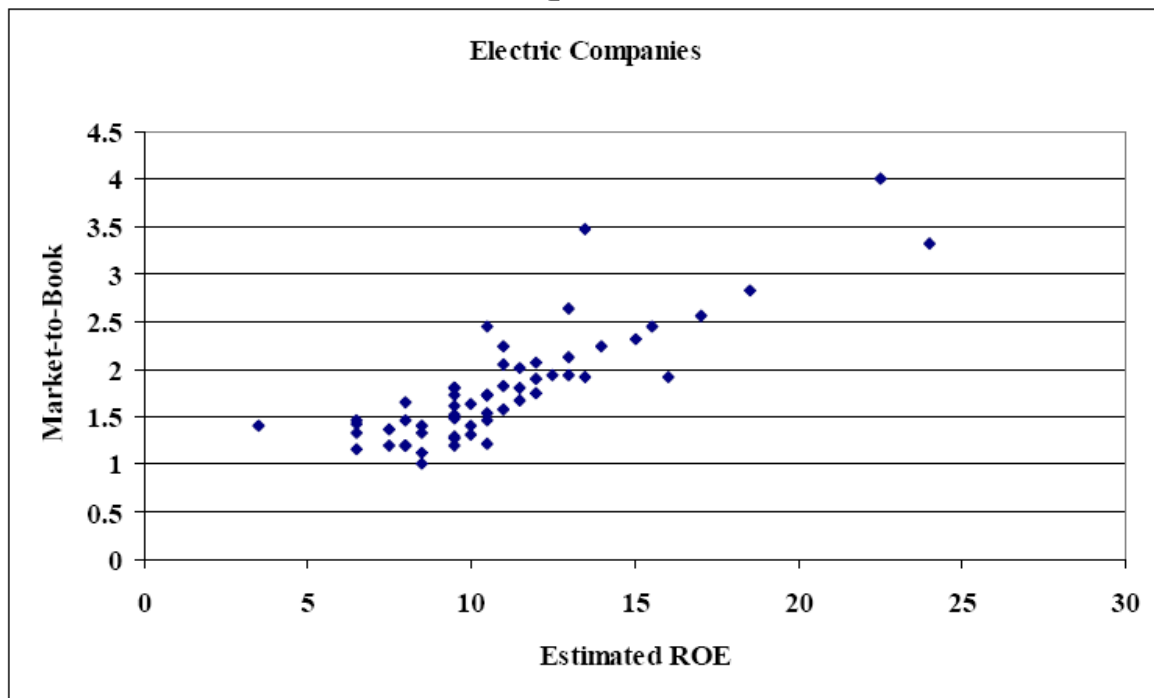
<sup>20</sup> DRA/Woolridge, Ex. 34, p. 4-52 (*see* Table 4-18).

<sup>21</sup> Tables 3-3a, 3-3b, and 3-3c are found in DRA’s testimony. DRA/Woolridge, Ex. 34, pp. 3-14 to 3-16. Those tables contain the source data for Table 4-18.

sample. Nevertheless, such companies earn an ROE greater than the 11.8% requested by SCE in this application. For SCE to attract capital, it must earn a return comparable to that earned by the companies against which it competes for that capital. Authorizing an ROE for SCE less than 11.8% is unreasonable and will put SCE at a disadvantage when it attempts to attract competitive capital on reasonable terms.

DRA’s testimony also contains charts depicting the relationship between “Estimated ROE” and the market-to-book ratio.<sup>22</sup> One of these charts for electric utilities is reproduced below.<sup>23</sup> As DRA explains, this chart “demonstrates the strong positive relationship between ROEs and market-to-book ratios for public utilities.”<sup>24</sup>

**Graph 2-6**  
**The Relationship Between Estimated ROE and Market-to-Book Ratios**  
**Value Line Electrics Companies,**  
**Gas Distribution Companies, and Water Utilities**



R-Square = .70  
N=58

<sup>22</sup> DRA/Woolridge, Ex. 34, pp. 2-12 to 2-13.

<sup>23</sup> DRA/Woolridge, Ex. 34, pp. 2-12 to 2-13.

<sup>24</sup> DRA/Woolridge, Ex. 34, p. 2-13.

During cross-examination, San Diego Gas & Electric (“SDG&E”) demonstrated that it is possible to estimate a linear regression from the data in the preceding chart that shows the relationship between the market-to-book ratio and estimated ROE that is implied by the data.<sup>25</sup>

SDG&E estimated the following linear regression equation:

$$\text{Market-to-book} = 0.279593 + (0.138651 \times \text{Estimated ROE})^{26}$$

If the comparable sample average market-to-book ratio of 2.10<sup>27</sup> is inserted into this equation, the estimated ROE implied by the equation is 13.13 percent.<sup>28</sup> Yet again, DRA’s own evidence shows that ROEs for DRA’s comparable group exceed the ROE requested in SCE’s application.

Based on DRA’s own evidence, it is clear that its recommended ROE again fails to meet the comparability and soundness criterion of the *Bluefield* and *Hope* decisions and that SCE’s recommended ROE should be adopted.<sup>29</sup>

#### **F. Reducing SCE’s ROE May Have A Negative Effect on SCE’s Credit and Borrowing Costs**

Aglet/TURN/UCAN asserts that the CPUC should reduce SCE’s authorized ROE to 9.8% because “[t]here is little risk that current, investment grade ratings will deteriorate in test year 2008” and because there is no evidence that policies supportive of a single-A credit rating for SCE is an appropriate target.<sup>30</sup> Such propositions lack evidentiary support and should be soundly rejected.

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<sup>25</sup> DRA/Woolridge Tr. 459:28-461:21.

<sup>26</sup> See Ex. 39, pp. 1-3.

<sup>27</sup> Although shown in the preceding table as 210, it is really 210 percent or 2.10.

<sup>28</sup> During cross-examination, DRA witness Dr. Woolridge objected to this calculation when SDG&E used it to solve for the implied ROE at a market-to-book ratio of one, stating that “when you go outside the range of the data you run into problems.” DRA/Woolridge Tr. 463:7-8. However, a market-to-book ratio of 2.10 is well within the range of the data, which can be seen by inspection.

<sup>29</sup> See SCE Opening Brief, p. 4. The authorized return must be comparable to returns on investments of similar risk. See also *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia et al.*, 262 U.S. 679, 692-693 (1923); *Federal Power Commission, et al. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

<sup>30</sup> Aglet/TURN/UCAN Opening Brief, p. 13.

The evidence cited by Aglet/TURN/UCAN does not support the assertion that there is “little risk” that credit ratings will decrease in 2008.<sup>31</sup> Neither Aglet/TURN/UCAN, nor any other party to this proceeding has done an assessment of the impact on SCE’s credit ratings of a CPUC decision awarding it a 9.8% ROE. On the other hand, recent history does provide evidence that an ROE of at least 11.6% will allow SCE to achieve the credit ratios needed for meaningful improvement of its credit ratings.<sup>32</sup>

Aglet/TURN/UCAN’s assertion also demonstrates an extremely shortsighted view of credit management policy. By only considering the effect of the authorized return on SCE in 2008, intervenors ignore the signaling effect such a decision has on credit agencies. That effect is important to SCE’s maintenance and improvement of its credit quality. As the rating agencies extrapolate long-term credit policy from short-term credit decisions, lowering the authorized ROE to 9.8%, at a minimum, derails SCE’s recent credit recovery trajectory.

Additionally, Aglet/TURN/UCAN attacks the appropriateness of any attempt to return SCE to a single-A rating. It fails to provide any support for that proposition. In making its baseless assertion, Aglet/TURN/UCAN fails to acknowledge two issues. First, it fails to acknowledge the CPUC’s pre-crisis history of supporting policies that helped utilities obtain credit ratings of single-A or better.<sup>33</sup> Second, it fails to recognize the cost and financing impacts of SCE’s Tier 2 short-term credit rating on its need for and ability to attract commercial paper investors on reasonable terms. As SCE has explained, this summer its Tier 2 credit rating prevented it from obtaining access, for its business purposes (including support for collateral needs), to short-term capital for several days as investors migrated toward lower risk investments in the face of the sub-prime mortgage industry’s financial crisis.<sup>34</sup>

Because the intervenors fail to take into account the very real and costly effects of a less than single-A/Tier 1 credit rating, and provide no support for the proposition that credit ratings

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<sup>31</sup> See e.g., Ex. 59; Ex. D.

<sup>32</sup> See SCE/Boada Tr. 96:27-97:19, 149:14-150:12.

<sup>33</sup> SCE/Boada, Ex. 4, p. 5.

<sup>34</sup> SCE/Boada Tr. 147:21-148:3, SCE/Boada, Ex. 5, p. 4; PG&E/Avera Tr. 319:6-15.

will be unchanged in the face of a dramatic reduction in SCE's ROE, the CPUC should authorize SCE's requested 11.8% ROE. Such a return will provide continued evidence of the CPUC's commitment to improving SCE's credit quality and maintaining SCE's access to capital and its financial soundness.

**G. SCE's Financial Models Collectively Provide An Accurate Basis For Setting SCE's Authorized ROE**

**1. The Fama-French Model Provides An Appropriate Data Point To Consider In this Proceeding**

Intervenors assert that the use of Fama-French model estimates of the ROE by SCE and SDG&E is unreasonable and/or that those results are upwardly biased.<sup>35</sup> The intervenors are mistaken on both counts.

The Fama-French model is an extrapolation of the Capital Assets Pricing Model ("CAPM"). The Fama-French model expands on the CAPM model by adding size premium and value premium factors.<sup>36</sup> Such expansion on CAPM is necessary because it is well known among cost of capital experts that the CAPM does not fully explain actual returns for companies such as utilities.<sup>37</sup> DRA witness, Dr. Woolridge, has co-authored a finance textbook that teaches the anomalies of the CAPM.<sup>38</sup> That textbook also explains some of the research behind the development of the Fama-French model.<sup>39</sup> What intervenors label an upward bias is in reality a recognized correction to CAPM estimates that underestimate true ROE.

As SCE demonstrated, the Fama-French model does a much better job of explaining observed returns than the CAPM does.<sup>40</sup> It does so because it incorporates explicit

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<sup>35</sup> Aglet/TURN/UCAN Brief, pp. 20-21; DRA Opening Brief, pp. 23-24; Opening Brief of FEA, served September 27, 2007 ("FEA Opening Brief"), pp. 18-21.

<sup>36</sup> SCE/Hunt, Ex. 4, pp. 40-41; SDG&E/Hayes, Ex. 45, pp. GHH-12-GHH-15.

<sup>37</sup> SCE/Hunt, Ex. 4, p. 40.

<sup>38</sup> Ex. 43, pp. 429-431.

<sup>39</sup> See Ex. 43, p. 1; DRA/Woolridge Tr. 478:14-21.

<sup>40</sup> SCE/Hunt, Ex. 5, p. 43.

pricing factors based on the market-to-book ratio and size of the company.<sup>41</sup> No party disputes this fact. Additionally, since the ROE being set in this proceeding is on a book value-based regulatory framework, it is reasonable to include the Fama-French model as it is the only pricing model with a book value pricing factor presented by the parties to this proceeding.<sup>42</sup>

Notably, SCE does not claim that its ROE should be determined on the basis of the results of any single financial model. Contrary to DRA's desire to eliminate models it does not like, SCE believes the CPUC's decision should be informed by all models assessing relevant factors. As DRA states, reliance on multiple models "tempers the impact of any supposed illogical results ...."<sup>43</sup>

Finally, there has been much debate in this proceeding about the inputs, appropriateness, accuracy, and estimation powers of all of the models in this proceeding as well as their relevance to setting SCE's and the other California utilities' estimated cost of equity. Given the range of model outcomes in this proceeding, intervenors' theory of informing judgment using average results is better served in this context by including, and not excluding, the Fama-French model in informing the judgment of the CPUC in setting the authorized ROE for SCE. Fama-French is a valid predictive model and ignoring its results could interfere with the CPUC's duty to set a fair and reasonable ROE.

## **2. SCE's CAPM Model Uses An Appropriate Market Risk Premium**

The principal issue of contention regarding the CAPM is the appropriate value for the market risk premium. SCE's market risk premium is within the reasonable range found by Aglet/TURN/UCAN. In addition, there is a wealth of evidence in this application supporting the use of a market risk premium based on an arithmetic average (not a geometric average) of historical excess returns.<sup>44</sup>

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<sup>41</sup> SCE/Hunt, Ex. 5, p. 43.

<sup>42</sup> SCE/Boada Tr. 80:25-82:5.

<sup>43</sup> DRA Opening Brief, Ex. 5, p. 19.

<sup>44</sup> SCE/Hunt, Ex. 5, p. 31.

**3. Aglet/TURN/UCAN’s Evidence Demonstrates That SCE’s Market Risk Premium Is Reasonable and Intervenor’s Averaging Approach Should be Rejected**

The magnitude of the market risk premium used in the CAPM was the subject of considerable discussion. Intervenor’s assert various theories for why their market risk premium amounts should be used when calculating SCE’s ROE, however, analysis of such testimony demonstrates the reasonableness of SCE’s approach with regard to the market risk premium.

In its testimony, SCE advocated the use of the historical risk premium used by Morningstar – currently 7.1%.<sup>45</sup> This market risk premium is within the range found acceptable by Aglet/TURN/UCAN witness Mr. Reid, whose acceptable range extended from 4.55% to 7.52%.<sup>46</sup>

If, however, the CPUC chooses to rely on a forward-looking market risk premium, SCE urges the CPUC to use the forward-looking market risk premium of 7.4% calculated by PG&E’s witness, Dr. Avera. This forward-looking market risk premium is also within the reasonable range of 4.55% to 7.52% found by Aglet/TURN/UCAN.<sup>47</sup> The CPUC can also refer to the *ex ante* market risk premium of 8.88 percent estimated by the California State Board of Equalization in its 2007 capitalization rate study that is used in the assessment of utility property taxes.<sup>48</sup> SCE’s Opening Brief provides additional detail regarding intervenor errors associated with the market risk premium.<sup>49</sup>

Additionally, Aglet/TURN/UCAN and FEA both argue for adoption of an averaging approach. There is no precedent for adopting such an approach. The resulting

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<sup>45</sup> SCE/Hunt, Ex. 4, p. 37.

<sup>46</sup> Aglet/Reid, Ex. 54, p. 11.

<sup>47</sup> Aglet/Reid, Ex. 54, p. 11.

<sup>48</sup> SCE/Hunt, Ex. 5, p. 34. The Board also estimates an overall ROE for SCE of 12.25%.

<sup>49</sup> See SCE Opening Brief, pp. 18-20.

decrease in risk premium is also unprecedented. Accordingly, such a methodology should be rejected.<sup>50</sup>

#### **4. SCE's Discounted Cash Flow Model Assesses Appropriate Factors**

Intervenors seek to have the CPUC ignore the results of SCE's Discounted Cash Flow ("DCF") results by criticizing SCE's use of analyst growth rates and methodologies.<sup>51</sup> As shown below, the intervenors variously support SCE's rates and methodologies or fail to credibly attack them.

For example, considerable academic literature demonstrates that analyst's earnings forecasts are superior to forecasts based solely on historical growth.<sup>52</sup> FEA's witness seems to agree by stating, "[S]tudies do show that projected growth rates are superior to simple, mechanical averages of historical growth rates."<sup>53</sup> Nevertheless, DRA attempts to support its claims by purporting to demonstrate that analysts' three-to-five year forecasts have been in excess of actual earnings per share growth rates.<sup>54</sup> DRA's evidence is flawed. Graph 5-1 ends in 1999, shortly before the dot-com boom came to an end.<sup>55</sup> That analysis also says nothing about the time period between 2000 and 2007. Further, Graph 5-3 purports to show forecasted and actual earnings growth rates through 2006.<sup>56</sup> What is not clear, is whether the chart's time periods are synchronized. SCE cannot know what an actual three-year earnings growth rate is for 2006 unless it calculates one beginning in 2003 and it cannot know an actual five-year earnings growth rate for 2006 unless it calculates one beginning in 2001. To add to the confusion, DRA's testimony states, "The projected EPS growth rates, which were in the four

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<sup>50</sup> Notably, while FEA argues for the averaging approach, an article cited in its testimony supports SCE's method of calculating the market risk premiums. *See* FEA/Hill, Ex. 44, p. 71 (*citing "Risk and Return in the 20<sup>th</sup> and 21<sup>st</sup> Centuries"*).

<sup>51</sup> DRA Opening Brief, p. 17; FEA Opening Brief, p. 5.

<sup>52</sup> SCE/Hunt, Ex. 4, p. 31. SCE/Hunt, Ex. 5, pp. 28-29. SDG&E/Hayes, Ex. 46, pp. GHH-7 to GHH-8, Appendix B.

<sup>53</sup> FEA/Hill, Ex. 44, p. 14.

<sup>54</sup> DRA Opening Brief, p. 17.

<sup>55</sup> DRA/Woolridge, Ex. 34, p. 5-4.

<sup>56</sup> DRA/Woolridge, Ex. 34, p. 5-8.

percent range in the 1990s, have increased over the past five years to the six percent range today.”<sup>57</sup> This raises the question of whether “the six percent range today” refers to projections from 2006 through 2009 or to 2006 through 2011. Neither the chart nor DRA’s testimony provides an explanation.<sup>58</sup> Such incomplete assessments fail to provide sufficient evidence to credibly deny the accuracy of SCE’s DCF model results.

DRA also claims that the DCF model is the sole model used by the Federal Energy Regulatory Commission (“FERC”).<sup>59</sup> DRA’s claim is somewhat overstated. While DCF is the *preferred* model at FERC at this time, FERC and Congress have been grappling with the problem that ROEs authorized or approved by the FERC have been insufficient to spur reasonable levels of transmission investment.<sup>60</sup>

FEA claims that “the Companies’ claims of DCF inaccuracy were grounded primarily on a theoretical example contained in the published work of Dr. Roger Morin” and that its witness, Mr. Hill, exposed “logical shortcomings” in this analysis.<sup>61</sup> FEA errs when suggesting that SCE’s criticisms of DCF are solely based on that example. The example, which FEA reproduces in its testimony, compares the DCF return to the market return for three hypothetical situations.<sup>62</sup> While SCE does reference the text where that example appears, SCE’s explanation of the problems with the DCF model refers to a larger section of the text which sets out four reasons why caution must be used when applying the DCF model to utility stocks.<sup>63</sup>

SCE’s direct testimony cited two broad problems with the DCF model at this time: that price/earnings ratios and market-to-book ratios for electric utilities have not been stable during the past several years.<sup>64</sup> FEA witness, Dr. Hill, himself recognizes that the DCF model assumes stability in these ratios, “The [DCF] model also assumes that the company whose

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<sup>57</sup> DRA/Woolridge, Ex. 34, p. 5-7.

<sup>58</sup> At the very least, DRA’s testimony is incomplete on this issue, and possibly incorrect.

<sup>59</sup> DRA Opening Brief, p. 14.

<sup>60</sup> SCE/Hunt Tr. 389:5.

<sup>61</sup> FEA Opening Brief, p. 5.

<sup>62</sup> FEA/Hill, Ex. 44, p. 24.

<sup>63</sup> SCE actually references pages 431-436 of Dr. Morin’s book. See SCE/Hunt, Ex. 4, p. 31, fn. 44.

<sup>64</sup> SCE/Hunt, Ex. 4, pp. 31-34.

equity cost is to be measured exists in a steady state environment, i.e., the payout ratio and the expected return are constant and the earnings, dividends, book value, and stock price all grow at the same rate, forever.”<sup>65</sup> If stock price and earnings grow at the same rate, then the price/earnings ratio will be stable, and if stock price and book value grow at the same rate, then the market-to-book ratio will be stable. Accordingly, even Dr. Hill realizes that the DCF model assumes the stability of these ratios. SCE has demonstrated that these ratios are not stable at the present time, hence the DCF estimates are unreliable.<sup>66</sup> For these reasons, the CPUC should ignore intervenors’ recommendations that the DCF estimates be given primary weight in this proceeding. If anything, the errors the intervenors ignore show DCF results should be given the least weight.

FEA claims that its testimony supports the proposition that dividends, earnings and book value of stock grow at the same rate.<sup>67</sup> However, that proposition is insufficient to impair SCE’s analysis, because SCE’s analysis is based on the behavior of the price/earnings ratio and the market-to-book ratio, both of which depend on the stock price. FEA fails to address the growth rate of utility stock prices. Instead, FEA refers to average growth rates for dividends, earnings, and book value for the Dow Jones Industrial Average. Such information is irrelevant, as this cost of capital proceeding is about utility cost of capital and DCF estimates of the same. FEA should instead have referred to the average long-run growth rates of dividends, earnings, and book value which range from 3.2% to 4.5%, depending on the variable of interest and the method of calculation. Examination of the growth rates over the most recent period in Schedule 7, from 1994 to 1999, shows substantial volatility over this period. Finally, Schedule 7 gives no information about 2000 and later years. In summary, FEA’s cited evidence does not support its conclusions and does not impair SCE’s analysis of the value of DCF estimates.<sup>68</sup>

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<sup>65</sup> FEA/Hill, Ex. 44, p. 24.

<sup>66</sup> SCE/Hunt, Ex. 4, pp. 31-34.

<sup>67</sup> FEA Opening Brief, p. 5.

<sup>68</sup> FEA/Hill, Ex. 44, Schedule 7.

Lastly, intervenors criticize SCE's calculation of the dividend yield in the DCF model. The intervenors claim that this is erroneous is unsubstantiated. It is correct to multiply the current dividend by one plus the growth rate.<sup>69</sup>

**5. The CPUC Should Correctly Incorporate the Use of Interest Rates When Evaluating Financial Models**

DRA continues to incorrectly argue for the use of spot interest rates over forecast interest rates in the financial models.<sup>70</sup> Confronted with SCE's study showing forecast interest rates to be more accurate predictors of test year interest rates than spot rates,<sup>71</sup> DRA offered the meritless argument that SCE should have somehow anticipated DRA's use of spot interest rates and conducted its study before filing SCE's application in this docket.<sup>72</sup> Previous CPUC decisions have relied on interest rate projections to help determine ROE.<sup>73</sup> The CPUC's policy is logical because the subject of this application is the cost of capital for the 2008 test year.

**6. Equal Weight Should Be Given To Each of SCE's Model Results to Derive an Appropriate ROE**

Intervenors do not have a consistent view of how much weight the different model estimates should be accorded when reaching a final recommendation. Aglet/TURN/UCAN weighs DCF and risk premium results equally, but within the class of risk premium estimates, gives "two-thirds weight to the simple risk premium model and one-third weight to the CAPM."<sup>74</sup> It provides no analysis supporting its proposal. FEA recommends that equal weight be given to DCF and risk premium estimates, but fails to support this recommendation with any details.<sup>75</sup> DRA's view appears to be the most muddled of the three.

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<sup>69</sup> SCE/Hunt, Ex. 5, p. 30.

<sup>70</sup> DRA Opening Brief, p. 22.

<sup>71</sup> SCE/Hunt, Ex. 5, pp. 7-8.

<sup>72</sup> DRA Opening Brief, p. 22.

<sup>73</sup> SCE/Hunt, Ex. 4, pp. 23-24.

<sup>74</sup> Aglet/TURN/UCAN Opening Brief, p. 29.

<sup>75</sup> FEA Opening Brief, p. 4.

In testimony, DRA witness Dr. Woolridge gave “primary weight to the DCF results ...”<sup>76</sup> However, as pointed out in SCE’s rebuttal testimony, when advising investors on stock selection, Dr. Woolridge (with his co-authors) champion the CAPM model to determine the cost of equity capital and give no weight to DCF results.<sup>77</sup> DRA’s brief continues to advocate a conflicted position. For the reasons set forth throughout this brief, the CPUC should reject the intervenors’ suggestions regarding the appropriate weight to give to model results and consider equally each of the four models SCE has presented when determining SCE’s ROE. Doing so results in an average ROE of 12.1%.

### III.

#### **RETURNS ON PENSION FUNDS ARE NOT RELEVANT TO THE CPUC’S CONSIDERATION OF AN APPROPRIATE ROE FOR SCE**

Both Aglet/TURN/UCAN and FEA assert that the CPUC should compare SCE’s ROE request against its pension fund returns.<sup>78</sup> Neither intervenor, however, disputes SCE’s evidence demonstrating that their comparisons are flawed.

The intervenors ignore significant differences when making this classic “apple and oranges” comparison. Most significantly, they ignore financial theory noting differences in the return requirements of a portfolio of assets, like a pension fund, as opposed to a single-asset enterprise-like a utility. The argument presented by the intervenors simply confounds issues in this proceeding. Returns on pension funds are irrelevant to the issue of the appropriate authorized ROE for SCE.

Additionally, the intervenors’ comparison fails to recognize the inherent differences of market returns on assets, such as in a pension fund, and the authorized return on the historical book value rate of return framework. Following intervenors’ arguments that SCE’s market-

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<sup>76</sup> DRA/Woolridge, Ex. 34, pp. 4-1, 4-51.

<sup>77</sup> SCE/Hunt, Ex. 5, p. 28.

<sup>78</sup> Aglet/TURN/UCAN Brief at 15; FEA/Hill Ex. 44, pp. 62-66.

to-book value is 2.1, in order to fairly compensate the utility assets on a market value basis (which is the value basis of pension fund assets), the equivalent return necessary to apply to SCE's regulatory asset base is substantially higher. For example, FEA's DCF estimate for SCE is 9.23%. Adjusting this estimate to calculate the required return on book equity yields a figure of 13.30%.<sup>79</sup> If this adjustment is applied to the DCF estimates provided by FEA or other parties, similar upward adjustments would occur.<sup>80</sup>

Finally, in their discussion of pension fund return assumptions for SCE and other utilities, the intervenors fail to acknowledge that the return assumptions for pension fund returns are net of investment expenses, whereas SCE's requested ROE includes investment expenses. The difference between the gross and net pension returns is about 30 basis points.<sup>81</sup> This difference in methodology partly explains some of what the intervenors characterize as a "large disparity between returns requested in this proceeding and estimates of pension fund returns."<sup>82</sup> Neither Aglet/TURN/UCAN, nor FEA, dispute that this error explains a portion of why pension fund returns seem to be different than requested ROE levels.<sup>83</sup>

#### IV.

### **THE CPUC SHOULD CONTINUE TO CONSIDER DEBT EQUIVALENCE IN COST OF CAPITAL PROCEEDING**

Intervenors make several statements regarding debt equivalence that are incorrect or misleading. The CPUC should reject the numerous intervenor attempts to alter current CPUC policies on debt equivalence.

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<sup>79</sup> SCE/Hunt, Ex. 5, pp. 25-26.

<sup>80</sup> SCE/Hunt, Ex. 5, p. 26.

<sup>81</sup> SCE/Boada, Ex. 5, p. 23.

<sup>82</sup> Aglet/TURN/UCAN Brief, p. 15.

<sup>83</sup> Additionally, the intervenors do not dispute SCE's assertion that assumed pension fund returns are an estimate of longer term expected returns, and therefore include an allowance for the risk of adverse outcomes. This situation tends to bias the assumed return downward in order to avoid underfunding contributions and creating volatility. SCE/Boada, Ex. 5, p. 23. Such an assumption is absent when forecasting the appropriate ROE for SCE.

First, Aglet/TURN/UCAN argues that debt equivalence creates economic costs but not accounting costs, therefore when a utility signs a power purchase agreement (“PPA”), there is no new cost created.<sup>84</sup> On its face, this argument is nonsensical. Economic costs are costs. It is perhaps more accurate to say that debt equivalence does not create accounting costs by itself, but that compensating utility credit ratios after an increase in debt equivalence creates both economic costs and accounting costs. Either way, debt equivalence creates costs that must be evaluated in determining recoverable costs from utility customers.

Second, FEA argues that utility customers are “shouldering the responsibility for 100% of the actual costs related to purchased power because those anticipated costs are being included in rates and through an after-the-fact true-up of those expenses.”<sup>85</sup> This is not true, PPAs impose additional costs. Customers must bear the responsibility for the debt equivalence costs associated with such PPAs. To the extent the CPUC recognizes such costs, they will further be recovered in utility rates.<sup>86</sup>

Third, FEA claims that Standard & Poor’s debt equivalence methodology is somehow anomalous when a utility increases its dependence on purchased power.<sup>87</sup> As SCE explained in its rebuttal testimony, there is nothing anomalous about the situation.<sup>88</sup>

Fourth, FEA claims that the rating agencies “assume that PPAs are financed only with debt.”<sup>89</sup> That assumption is starting to change. Standard & Poor’s now imputes a depreciation stream to a PPA, which is a partial recognition that PPAs have equity characteristics.<sup>90</sup>

Lastly, it is important to note that regulatory agencies across the country are considering debt equivalence. DRA’s witness provided information about how other states recognize debt

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<sup>84</sup> Aglet/TURN/UCAN Opening Brief, p. 36.

<sup>85</sup> FEA Opening Brief, p. 26.

<sup>86</sup> If the CPUC does not recognize the costs of mitigating debt equivalence and restoring utility credit ratios, the utility may choose to forgo such mitigation, in which case customers will likely bear the burden of increased costs of capital. There is no “free lunch.”

<sup>87</sup> FEA Opening Brief, pp. 27.

<sup>88</sup> SCE/Boada, Ex. 5, pp. 19-20.

<sup>89</sup> FEA Opening Brief, p. 28.

<sup>90</sup> SCE, Ex. 4, Appendix B. Standard & Poor’s states that this change “align[s] the analytical treatment of PPAs with the concept of purchased power as a substitute for self-build.” (See page B-3 of the appendix.)

equivalence. Connecticut allows electric distribution companies to request debt equivalence adjustments in a general rate case if needed to attract needed capital and maintain financial integrity.<sup>91</sup> Florida allows a debt equivalence adjustment in the resource procurement process, with a risk factor of 30 percent.<sup>92</sup> Washington also allows a debt equivalence adjustment in the resource procurement process, with a risk factor that ranges from 15 percent to 40 percent.<sup>93</sup> Finally, Wisconsin authorizes compensation in cost of capital proceedings as part of a general rate review, when it is demonstrated that a PPA degrades the utility's credit rating.<sup>94</sup>

The CPUC should also continue to recognize the impacts of debt equivalence and reject intervenor arguments to the contrary.

## V.

### **CONCLUSION**

California's electricity policies and future plans for the electric utility industry rely on financially strong, creditworthy, and adequately compensated utilities for enactment and advancement of far-reaching goals for new power resources, new infrastructure, new renewable power supply and greenhouse gas emission controls. SCE's customers will only enjoy the benefits of such policies, at the best and most reasonable prices, if SCE is adequately compensated and has an appropriate credit structure supportive of its role in implementing such policies. For all these reasons, as well as those set forth in SCE's testimony and briefs submitted in this proceeding, the CPUC should authorized SCE's recommended 11.8% ROE and the recommended capital structure for 2008.

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<sup>91</sup> Ex. 41, p. 2; DRA/Woolridge, Tr. 475:19-476:8.

<sup>92</sup> Ex. 41, p. 2; DRA/Woolridge, Tr. 476:9-24.

<sup>93</sup> Ex. 41, p. 3; DRA/Woolridge, Tr. 477:11-20.

<sup>94</sup> Ex. 41, p. 4-5; DRA/Woolridge, Tr. 476:25-477:10.

Respectfully submitted,

MICHAEL D. MONTOYA  
LAURA I. GENAO

/S/ LAURA I. GENAO

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By: Laura I. Genao

Attorneys for  
SOUTHERN CALIFORNIA EDISON COMPANY

2244 Walnut Grove Avenue  
Post Office Box 800  
Rosemead, California 91770  
Telephone: (626) 302-6842  
Facsimile: (626) 302-1935  
E-mail: [laura.genao@sce.com](mailto:laura.genao@sce.com)

October 5, 2007

**CERTIFICATE OF SERVICE**

I hereby certify that, pursuant to the Commission's Rules of Practice and Procedure, I have this day served a true copy of REPLY BRIEF OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) on all parties identified on the attached service list(s). Service was effected by one or more means indicated below:

Transmitting the copies via e-mail to all parties who have provided an e-mail address. First class mail will be used if electronic service cannot be effectuated.

Executed this **5th day of October, 2007**, at Rosemead, California.

/S/ CECILIA R. JONES

Cecilia R. Jones

Project Analyst

SOUTHERN CALIFORNIA EDISON COMPANY

2244 Walnut Grove Avenue  
Post Office Box 800  
Rosemead, California 91770

**A.07-05-003**

Friday, October 5, 2007

CASE ADMINISTRATION  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003

STEPHEN D. BAKER  
SENIOR REGULATORY ANALYST  
FELLON-MCCORD AND ASSOCIATES  
9960 CORPORATE CAMPUS DRIVE, STE.  
2000  
LOUISVILLE, KY 40223  
A.07-05-003

John Bohn  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5200  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

JONATHAN BROMSON  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4107  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

LISA BROWY  
SAN DIEGO GAS & ELECTRIC  
8330 CENTURY PARK COURT, CP 32D  
SAN DIEGO, CA 92123  
A.07-05-003

FRANK J. COOLEY  
ATTORNEY AT LAW  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003

KATHE HUNTER CORDOVA  
SAN DIEGO GAS & ELECTRIC COMPANY  
8330 CENTURY PART CT. - CP32D  
SAN DIEGO, CA 92123  
A.07-05-003

KAY DAVOODI  
NAVY UTILITY RATES AND STUDIES OFFICE  
1322 PATTERSON AVE, SE - BLDG 33  
WASHINGTON NAVY YARD, DC 20374-5018  
A.07-05-003

THOMAS A. DOUB  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

KEVIN DUGGAN  
CALPINE COPORATION  
3875 HOPYARD ROAD, SUITE 345  
PLEASANTON, CA 94588  
A.07-05-003

CENTRAL FILES  
SAN DIEGO GAS & ELECTRIC  
8330 CENTURY PARK COURT, CP31E  
SAN DIEGO, CA 92123  
A.07-05-003

NORMAN J. FURUTA  
ATTORNEY AT LAW  
FEDERAL EXECUTIVE AGENCIES  
1455 MARKET ST., SUITE 1744  
SAN FRANCISCO, CA 94103-1399  
A.07-05-003

Michael J. Galvin  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5015  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

LAURA GENAO  
ATTORNEY AT LAW  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003

HAYLEY GOODSON  
ATTORNEY AT LAW  
THE UTILITY REFORM NETWORK  
711 VAN NESS AVENUE, SUITE 350  
SAN FRANCISCO, CA 94102  
A.07-05-003

KIM F. HASSAN  
ATTORNEY AT LAW  
SAN DIEGO GAS & ELECTRIC COMPANY  
101 ASH STREET, HQ-12  
SAN DIEGO, CA 92101  
A.07-05-003

STEPHEN G. HILL  
HILL ASSOCIATES  
PO BOX 587  
HURRICANE, WV 25526  
A.07-05-003

EDWARD HOWARD  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5110  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

**A.07-05-003**

Friday, October 5, 2007

PAUL T. HUNT  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WLANUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003

Donald J. Lafrenz  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
AREA 4-A  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

CARLOS F. PENA  
SEMPRA ENERGY LAW DEPARTMENT  
101 ASH STREET HQ12  
SAN DIEGO, CA 92101  
A.07-05-003

Robert M. Pocta  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

Thomas M. Renaghan  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

FELIX ROBLES  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
AREA 4-A  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

FILE ROOM  
PACIFIC GAS AND ELECTRIC COMPANY  
PO BOX 7442  
SAN FRANCISCO, CA 94120-7442  
A.07-05-003

MICHAEL SHAMES  
ATTORNEY AT LAW  
UTILITY CONSUMERS' ACTION NETWORK  
3100 FIFTH AVENUE, SUITE B  
SAN DIEGO, CA 92103  
A.07-05-003

JAMES SIMMONS  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4108  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

STEPHEN ST. MARIE  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5202  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

NINA SUETAKE  
THE UTILITY REFORM NETWORK  
711 VAN NESS AVE., STE 350  
SAN FRANCISCO, CA 94102  
A.07-05-003

PETER VAN MIEGHEM  
PACIFIC GAS & ELECTRIC COMPANY  
PO BOX 7442  
SAN FRANCISCO, CA 94120  
A.07-05-003

JAMES WEIL  
AGLET CONSUMER ALLIANCE  
PO BOX 37  
COOL, CA 95614  
A.07-05-003

DON WOOD  
PACIFIC ENERGY POLICY CENTER  
4539 LEE AVENUE  
LA MESA, CA 91941  
A.07-05-003

J. RANDALL WOOLRIDGE  
THE PENNSYLVANIA STATE UNIVERSITY  
302 BUSINESS BUILDING  
UNIVERSITY PARK, PA 16802  
A.07-05-003

SHIRLEY A. WOO  
ATTORNEY AT LAW  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MC B30A  
SAN FRANCISCO, CA 94105  
A.07-05-003

James R. Wuehler  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4208  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003

STELLA ZAHARIUDAKIS  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MCB10A  
SAN FRANCISCO, CA 94105  
A.07-05-003

**A.07-05-003**

Friday, October 5, 2007

ADAR ZANGO  
ASSOCIATE ANALYST  
ZIMMER LUCAS PARTNERS  
45 BROADWAY, 28TH FLOOR  
NEW YORK, NY 10006  
A.07-05-003

STELLA ZHARIUDAKIS  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MCB10A  
SAN FRANCISCO, CA 94105  
A.07-05-003

MRW AND ASSOCIATES, INC.  
1814 FRANKLIN STREET, SUITE 720  
OAKLAND, CA 94612  
A.07-05-003

**A.07-05-003, A.07-05-007, A.07-05-008**

Friday, October 5, 2007

CASE ADMINISTRATION  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003, A.07-05-007, A.07-05-008

STEPHEN D. BAKER  
SENIOR REGULATORY ANALYST  
FELLON-MCCORD AND ASSOCIATES  
9960 CORPORATE CAMPUS DRIVE, STE.  
2000  
LOUISVILLE, KY 40223  
A.07-05-003, A.07-05-007, A.07-05-008

John Bohn  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5200  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

JONATHAN BROMSON  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4107  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

LISA BROWY  
SAN DIEGO GAS & ELECTRIC  
8330 CENTURY PARK COURT, CP 32D  
SAN DIEGO, CA 92123  
A.07-05-003, A.07-05-007, A.07-05-008

FRANK J. COOLEY  
ATTORNEY AT LAW  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003, A.07-05-007, A.07-05-008

KATHE HUNTER CORDOVA  
SAN DIEGO GAS & ELECTRIC COMPANY  
8330 CENTURY PART CT. - CP32D  
SAN DIEGO, CA 92123  
A.07-05-003, A.07-05-007, A.07-05-008

KAY DAVOODI  
NAVY UTILITY RATES AND STUDIES OFFICE  
1322 PATTERSON AVE., SE - BLDG. 33  
WASHINGTON NAVY YARD, DC 20374-5018  
A.07-05-003, A.07-05-007, A.07-05-008

THOMAS A. DOUB  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

KEVIN DUGGAN  
CALPINE COPORATION  
3875 HOPYARD ROAD, SUITE 345  
PLEASANTON, CA 94588  
A.07-05-003, A.07-05-007, A.07-05-008

Michael J. Galvin  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5015  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

LAURA GENAO  
ATTORNEY AT LAW  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WALNUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003, A.07-05-007, A.07-05-008

HAYLEY GOODSON  
ATTORNEY AT LAW  
THE UTILITY REFORM NETWORK  
711 VAN NESS AVENUE, SUITE 350  
SAN FRANCISCO, CA 94102  
A.07-05-003, A.07-05-007, A.07-05-008

KIM F. HASSAN  
ATTORNEY AT LAW  
SAN DIEGO GAS & ELECTRIC COMPANY  
101 ASH STREET, HQ-12  
SAN DIEGO, CA 92101  
A.07-05-003, A.07-05-007, A.07-05-008

STEPHEN G. HILL  
HILL ASSOCIATES  
PO BOX 587  
HURRICANE, WV 25526  
A.07-05-003, A.07-05-007, A.07-05-008

EDWARD HOWARD  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5110  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

PAUL T. HUNT  
SOUTHERN CALIFORNIA EDISON COMPANY  
2244 WLANUT GROVE AVENUE  
ROSEMEAD, CA 91770  
A.07-05-003, A.07-05-007, A.07-05-008

Donald J. Lafrenz  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
AREA 4-A  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

**A.07-05-003, A.07-05-007, A.07-05-008**

Friday, October 5, 2007

CARLOS F. PENA  
SEMPRA ENERGY LAW DEPARTMENT  
101 ASH STREET  
SAN DIEGO, CA 92101  
A.07-05-003, A.07-05-007, A.07-05-008

Robert M. Pocta  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

Thomas M. Renaghan  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4205  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

FELIX ROBLES  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
AREA 4-A  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

FILE ROOM  
PACIFIC GAS AND ELECTRIC COMPANY  
PO BOX 7442  
SAN FRANCISCO, CA 94120-7442  
A.07-05-003, A.07-05-007, A.07-05-008

MICHAEL SHAMES  
ATTORNEY AT LAW  
UTILITY CONSUMERS' ACTION NETWORK  
3100 FIFTH AVENUE, SUITE B  
SAN DIEGO, CA 92103  
A.07-05-003, A.07-05-007, A.07-05-008

JAMES SIMMONS  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4108  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

STEPHEN ST. MARIE  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 5202  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

NINA SUETAKE  
ATTORNEY AT LAW  
THE UTILITY REFORM NETWORK  
711 VAN NESS AVE., STE. 350  
SAN FRANCISCO, CA 94102  
A.07-05-003, A.07-05-007, A.07-05-008

PETER VAN MIEGHEM  
PACIFIC GAS & ELECTRIC COMPANY  
PO BOX 7442  
SAN FRANCISCO, CA 94120  
A.07-05-003, A.07-05-007, A.07-05-008

JAMES WEIL  
AGLET CONSUMER ALLIANCE  
PO BOX 37  
COOL, CA 95614  
A.07-05-003, A.07-05-007, A.07-05-008

DON WOOD  
PACIFIC ENERGY POLICY CENTER  
4539 LEE AVENUE  
LA MESA, CA 91941  
A.07-05-003, A.07-05-007, A.07-05-008

J. RANDALL WOOLRIDGE  
THE PENNSYLVANIA STATE UNIVERSITY  
302 BUSINESS BUILDING  
UNIVERSITY PARK, PA 16802  
A.07-05-003, A.07-05-007, A.07-05-008

SHIRLEY A. WOO  
ATTORNEY AT LAW  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MC B30A  
SAN FRANCISCO, CA 94105  
A.07-05-003, A.07-05-007, A.07-05-008

James R. Wuehler  
CALIF PUBLIC UTILITIES COMMISSION  
505 VAN NESS AVENUE  
ROOM 4208  
SAN FRANCISCO, CA 94102-3214  
A.07-05-003, A.07-05-007, A.07-05-008

STELLA ZAHARIUDAKIS  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MCB10A  
SAN FRANCISCO, CA 94105  
A.07-05-003, A.07-05-007, A.07-05-008

ADAR ZANGO  
ASSOCIATE ANALYST  
ZIMMER LUCAS PARTNERS  
45 BROADWAY, 28TH FLOOR  
NEW YORK, NY 10006  
A.07-05-003, A.07-05-007, A.07-05-008

STELLA ZHARIUDAKIS  
PACIFIC GAS AND ELECTRIC COMPANY  
77 BEALE STREET, MCB10A  
SAN FRANCISCO, CA 94105  
A.07-05-003, A.07-05-007, A.07-05-008

**A.07-05-003, A.07-05-007, A.07-05-008**  
Friday, October 5, 2007

CENTRAL FILES  
SAN DIEGO GAS AND ELECTRIC COMPANY  
8330 CENTURY PARK COURT-CP31E  
SAN DIEGO, CA 92123-1530  
A.07-05-003, A.07-05-007, A.07-05-008

SAN DIEGO GAS & ELECTRIC COMPANY  
8330 CENTURY PART CT. - CP31E  
SAN DIEGO, CA 92123  
A.07-05-003, A.07-05-007, A.07-05-008

MRW AND ASSOCIATES, INC.  
1814 FRANKLIN STREET, SUITE 720  
OAKLAND, CA 94612  
A.07-05-003, A.07-05-007, A.07-05-008