

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

Application of Southern California Edison)	
Company (U 338-E) for Authorized Cost of)	A.07-05-003
Capital for Utility Operations for 2008.)	
_____)	A.07-05-007
And Related Proceedings)	A.07-05-008
_____)	

**REPLY OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) TO PROTEST
OF DIVISION OF RATEPAYER ADVOCATES**

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On May 8, 2007, Southern California Edison Company (“SCE”) filed Application 07-05-003 requesting that the California Public Utilities Commission (“CPUC” or “Commission”) authorize a cost of capital for utility operations for 2008. On June 8, 2007, the CPUC’s Division of Ratepayer Advocates (“DRA”) protested SCE’s application. Pursuant to Rule 2.6 of the Commission’s Rules of Practice and Procedure, SCE files this response to DRA’s protest.

In this response, SCE addresses two elements of DRA’s protest, DRA’s comments on the Fama-French model and DRA’s comments on SCE’s recommended 11.80 percent return on equity (“ROE”).

I.

INTRODUCTION OF THE FAMA-FRENCH MODEL IS APPROPRIATE

There is a solid basis for including the Fama-French model in any evaluation of SCE’s required return on equity. While the Capital Asset Pricing Model (“CAPM”) is widely used to estimate the required return on equity for utilities, it is well-known that the CAPM does not

capture all features of observed returns.¹ In the CAPM, variations in observed returns are explained by only one factor, the excess market return. By contrast, the Fama-French model includes two additional explanatory factors, SMB (“small minus big”), which captures the size premium found in observed returns, and HML (“high book-to-market minus low book-to-market”), which captures the value premium found in observed returns.² Because of these two additional explanatory factors, the Fama-French model provides a richer explanation of observed returns.

Fama-French is not an obscure model. Its development began in 1992 and it has appeared extensively in the academic literature. The importance of the Fama-French model is that it provides another reference point for the Commission to use in calibrating SCE’s return on equity. Because the Commission has utilized the CAPM in cost of capital cases for many years, and Fama-French is a refinement of CAPM, it is appropriate for the Commission to utilize the results of the Fama-French model in this proceeding.

II.

SCE’S RECOMMENDED RETURN ON EQUITY IS BASED ON MODEL ESTIMATES AND ECONOMIC DATA

DRA’s protest expresses confusion at how SCE derived its recommended return on equity, commenting that it is not clear how SCE derived its requested ROE from its model results.³

SCE derived its recommended ROE by applying judgment to its model estimates and the information on interest rates and price inflation that it presented in its expert testimony. Indeed, contrary to what DRA’s protest appears to assume, the Commission has rejected the mechanical application of model results as the sole determinant of authorized ROEs. In D.05-12-043, the Commission stated: “In the final analysis, it is the application of informed judgment, not the

¹ Exhibit SCE-1, p. 40, ll. 7-9.

² Exhibit SCE-1, p. 40, ll. 10-20.

³ DRA Protest, p. 3.

precision of financial models, which is the key to selecting a specific ROE. ... [W]e continue to view the financial models with considerable skepticism.”⁴

III.

CONCLUSION

For the foregoing reasons, SCE requests that the Commission disregard DRA’s objections to SCE’s application.

Respectfully submitted,

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⁴ D.05-12-043, *mimeo*, p. 23. See also D.05-12-043, *mimeo*, p. 43, Finding of Fact 21.

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 OF SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) TO PROTEST OF DIVISION OF RATEPAYER ADVOCATES 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 **18th day of June, 2007**, at Rosemead, California.

/s/ Cecilia Jones
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A.07-05-003

Monday, June 18, 2007

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