

Application No: A.07-05-003
Exhibit No: SCE-6
Witness: P. T. Hunt



(U 338-E)

***Rebuttal Testimony in Support of 2008 Cost of
Capital Application, Phase II***

Before the
Public Utilities Commission of the State of California

Rosemead, California
January 18, 2008

2008 COST OF CAPITAL REBUTTAL TESTIMONY

Table Of Contents

	Section	Page	Witness
I.	INTRODUCTION	1	P. T. Hunt
II.	INTEREST RATE INDEX.....	3	
	A. Moody’s Baa Long-Term Utility Bond Yield Should Be Used For SCE	3	
	B. The Ten-Year Treasury Rate Should Not Be Used	3	
	C. Access To Data	4	
	D. Period Over Which The Index Is Averaged And Size Of Index Deadband	5	
III.	CAPITAL STRUCTURE FLEXIBILITY	6	
IV.	INTERVENORS’ REASONS FOR OPPOSING MULTI-YEAR MECHANISMS ARE INVALID	8	
	A. Current California ROEs Are Not Too High	8	
	B. DRA’s Commentary Regarding PG&E’s Example And SDG&E’s MICAM Omits Any Discussion Of Risk Changes.....	8	
V.	RESPONSE TO DRA PROPOSALS	10	
	A. DRA’s Proposed Biennial Proceeding Is Inadequate	10	
	B. Cost of Capital Does Not Belong In The General Rate Case	10	
VI.	DRA’S PROPOSED SCHEDULE REVISION.....	11	

2008 COST OF CAPITAL REBUTTAL TESTIMONY

List Of Tables

Table	Page
Table VI-1 Proposed Cost of Capital Schedule	11

1 I.

2 INTRODUCTION

3 Phase II of this application addresses multi-year mechanisms that might replace the current
4 annual cost of capital application.¹ Testimony on this issue has been served in this proceeding by
5 applicants Southern California Edison Company (SCE),² Pacific Gas & Electric (PG&E),³ and San
6 Diego Gas & Electric (SDG&E).⁴ Testimony has also been served by the California Public Utility
7 Commission’s Division of Ratepayer Advocates (DRA)⁵ and the coalition of Aglet Consumer Alliance,
8 The Utility Reform Network and Utility Consumers’ Action Network (Aglet-TURN-UCAN)⁶
9 (collectively, Intervenors).

10 SCE’s primary recommendation in this phase remains that the current annual cost of capital
11 application should be retained; the California Public Utilities Commission (Commission) should not
12 replace it with a multi-year mechanism at this time. However, because the Commission may decide to
13 establish a multi-year mechanism in spite of SCE’s objections, SCE’s rebuttal testimony addresses the
14 following issues related to prospective multi-year mechanisms proposed by the various parties:

- 15 • Frequency of full review of cost of capital;
- 16 • Interest rate index;
- 17 • Period over which interest rate index is measured (six months, 12 months, etc.); and
- 18 • Capital structure flexibility.

¹ A.07-05-003, et al., *Assigned Commissioner’s Scoping Memo and Ruling*, issued June 21, 2007.

² Exhibit 4, Chapter VII and Southern California Edison Company, *Supplemental Testimony Regarding Multi-Year Cost of Capital Mechanisms*, dated January 4, 2008 (“SCE Supplemental Testimony”).

³ Exhibit 23, Chapter 5.

⁴ San Diego Gas & Electric, *Prepared Direct Testimony of Michael M. Schneider*, dated January 4, 2007 (“SDG&E Testimony”).

⁵ California Public Utilities Commission Division of Ratepayer Advocates, *Report on the Cost of Capital for Pacific Gas & Electric, The Southern California Edison Company, San Diego Gas & Electric Company, Test Year 2008, Phase II*, dated January 4, 2008 (“DRA Testimony”).

⁶ Aglet Consumer Alliance, The Utility Reform Network, and Utility Consumers’ Action Network submitted the testimony of James Weil: *Phase 2 Testimony of James Weil*, dated January 4, 2008 (“Weil Testimony”).

1 Although SCE continues to oppose institution of a multi-year mechanism at this time for the
2 reasons described in its prior testimony, we disagree with intervenors' descriptions of why a multi-year
3 mechanism is inappropriate. This testimony also explains why intervenors' reasons for opposing multi-
4 year mechanisms should be ignored.

1 II.

2 **INTEREST RATE INDEX**

3 **A. Moody's Baa Long-Term Utility Bond Yield Should Be Used For SCE**

4 If the Commission chooses to establish a multi-year mechanism for setting the California energy
5 utilities' returns on equity (ROE), its goal should be to create a mechanism that best tracks actual
6 changes in investors' required ROE. This will be best achieved if the indicator used to calibrate the
7 mechanism tracks both changes in the general level of interest rates and changes in each utility's risk.
8 Although individual utility risk data is not available, the bond yields for a utility's peer group provide a
9 reasonable approximation. As explained in SCE's direct testimony filed in May 2007, if a multi-year
10 mechanism is established for SCE, it should be calibrated on the 12-month average of Moody's Baa
11 long-term utility bond yield. SCE's issuer credit rating from Standard & Poor's is still BBB+. While
12 SCE's issuer credit rating from Moody's is now A3, investors who are examining SCE's riskiness will
13 focus on the lower of the two ratings. Thus, the Baa utility group is the best peer group for measuring
14 SCE-specific risk.

15 The Moody's Baa long-term utility bond yield also more accurately reflects the risk level of
16 electric utilities generally.⁷ In comparison, the Moody's Aa long-term utility bond yield preferred by
17 PG&E and embodied in SDG&E's current Market-Indexed Capital Adjustment Mechanism (MICAM)
18 is dominated by telecommunications utility bonds.⁸

19 **B. The Ten-Year Treasury Rate Should Not Be Used**

20 Aglet-TURN-UCAN proposes that the 10-year Treasury bond rate be used as the index measure.
21 Such a metric is inappropriate, since the 10-year Treasury bond rate is a risk-free rate. A risk-free rate
22 does not appropriately track changes in the cost of risky equity. Aglet-Turn-UCAN's witness himself
23 admits that "Treasury rates ... do not reflect utility-specific business risks."⁹

⁷ The Baa class on the Moody's scale is equivalent to the BBB class on the Standard & Poor's scale. The most common rating for an electric utility is in the BBB class. Standard & Poor's Ratings Direct, *Industry Report Card: U.S. Electric Utility Industry Faces Rising Costs, But Credit Quality Should Hold*, dated December 19, 2007, Chart 1.

⁸ SCE/Hunt, Tr. 367:3-13.

⁹ Weil testimony, p. 3.

1 The inappropriateness of the 10-year Treasury rate can easily be understood in the context of the
2 Capital Asset Pricing Model (CAPM). As explained in SCE’s direct testimony filed last May, the
3 CAPM can be written as:¹⁰

$$4 \qquad r = r_f + \beta(r_m - r_f) \qquad (1)$$

5 where

6 r = investors’ required return on common equity

7 r_f = the risk-free rate

8 β = the company-specific risk measure

9 r_m = the expected return on the market portfolio

10 As seen in equation (1), the risk-free rate does not account for either beta or the market risk
11 premium, $r_m - r_f$.

12 **C. Access To Data**

13 Aglet-TURN-UCAN comments that Treasury rates are readily found on the Federal Reserve
14 website that the Commission uses to find utility balancing account interest rates and intervenor
15 compensation interest rates.¹¹ Such testimony fails to point out, however, that in each case, the
16 Commission uses a three-month commercial paper rate that is not a risk-free rate.

17 Regarding the data sources proposed by the applicants, Aglet-TURN-UCAN’s testimony
18 identifies SCE’s data source as “Moody’s, reported by Bloomberg.”¹² SCE provided this information in
19 response to a data request from Aglet-TURN-UCAN. SCE has reconsidered this data source since
20 providing the response and now proposes that the Moody’s interest rate data be obtained from *Mergent*
21 *Bond Record*, and that the interest rate index be calculated as a 12-month average ending in September.

¹⁰ Exhibit 4, p. 35.

¹¹ Weil testimony, p. 3.

¹² Weil testimony, Appendix, p. 1.

1 *Mergent Bond Record* is published on a monthly basis. This source represents a publicly available
2 written record that may be verified by all parties.¹³

3 **D. Period Over Which The Index Is Averaged And Size Of Index Deadband**

4 SCE chose the period over which the Moody's Baa rate is averaged and the size of the deadband
5 so that triggering events would be relatively infrequent.¹⁴ Reducing the averaging period to six months
6 and shrinking the deadband would increase the frequency of triggering events. Whereas SCE's
7 mechanism would have triggered five times in 20 years, between 1986 and 2006, a similar mechanism
8 based on the Moody's Baa rate with a six-month average and a deadband of plus-or-minus 75 basis
9 points would have triggered nine times over the same period.

¹³ If the Commission adopts a multi-year mechanism incorporating SCE's proposed interest rate index, SCE will provide the Commission with a copy of *Mergent Bond Record* as required for the Commission to review the mechanism. This document is also available through public libraries.

¹⁴ Exhibit 4, p. 46.

1 III.

2 CAPITAL STRUCTURE FLEXIBILITY

3 Capital structure flexibility must be a feature of any cost of capital mechanism adopted for SCE.
4 Aglet-TURN-UCAN’s arguments opposing this are unavailing. While Aglet-TURN-UCAN asserts,
5 “[SCE] has not shown that changes to debt equivalence or other factors are likely during the term of the
6 adjustment mechanism that is the subject of Phase 2,”¹⁵ the group fails to recognize that if changes were
7 likely, SCE could have incorporated a capital structure change in its Phase I request. Additionally,
8 Aglet-TURN-UCAN overlooks that the rating agencies, particularly Standard & Poor’s, can change their
9 methods of assessing debt equivalence quickly.

10 For example, on November 1, 2006, Standard & Poor’s requested comments on a series of
11 substantial proposed changes to its debt equivalence methodology. The changes were implemented five
12 months later, on March 30, 2007. It is simply not feasible to wait until the conclusion of a three-year to
13 six-year cost of capital mechanism to remedy changes in debt equivalence that can occur in a period of a
14 few months.

15 Aglet-TURN-UCAN cites language from Decision No. (D.) 06-12-029 regarding the
16 requirement that SCE maintain a balanced capital structure. This language is virtually identical to
17 Ordering Paragraph 9 of D.88-01-063, which was in effect when the Commission granted SCE limited
18 capital structure flexibility in its performance-based ratemaking (PBR) mechanism. Changes from
19 D.88-01-063 to D.06-12-029 are shown in ~~strikeout~~ type and underlining:

20 ~~Edison~~ A utility shall maintain a balanced capital structure consistent with that determined to
21 be reasonable by the Commission in ~~Edison's~~ its most recent ~~general rate case~~ decision on the
22 utility's capital structure. ~~Edison's~~ The utility's equity shall be retained such that the
23 Commission's adopted capital structure ~~will~~ shall be maintained on average over the period
24 the capital structure is in effect for ratemaking purposes.

25 If D.88-01-063 did not prevent the Commission from finding limited capital structure flexibility
26 reasonable during SCE’s PBR mechanism, the corresponding language from D.06-12-029 should not
27 prevent the Commission from finding limited capital structure flexibility reasonable now.

¹⁵ Weil Testimony, p. 6.

1 Aglet-TURN-UCAN opposes SCE’s request for authority, if a multi-year mechanism is
2 established, to file one application during each cost of capital cycle to change authorized capital
3 structure for changes in debt equivalence or other factors that may harm utility credit ratings. The
4 claimed reason is that to consider capital structure changes, the Commission needs to review all factors
5 that determine overall costs of capital.¹⁶

6 This is not the case. While the ROE and other costs of capital must be known to correctly
7 calculate the financial ratios that the rating agencies use, under the multi-year mechanisms that have
8 been presented in this proceeding, they will be set by rule and will be known. The Commission will not
9 be required to consider ROE financial models during the off-cycle years, such as years two and three in
10 a three-year cycle. Alternatively, if the Commission believes it does need such information, it can
11 always order its production as additional evidence.¹⁷

¹⁶ Weil Testimony, p. 6.

¹⁷ Rule 13.10 of the Commission’s *Rules of Practice and Procedure*.

1 IV.

2 **INTERVENORS' REASONS FOR OPPOSING MULTI-YEAR MECHANISMS ARE INVALID**

3 SCE's primary recommendation in this proceeding is that the current annual mechanism be
4 retained, because there is still too much uncertainty about regulation and structure of the California
5 electric utility industry. Because of this, judgment will still be required to properly set SCE's cost of
6 capital, and quick adjustment may be required if either regulation or structure change rapidly. At the
7 same time, SCE is concerned that some of the reasons advanced by intervenors who oppose multi-year
8 mechanisms are invalid. SCE discusses those reasons here.

9 **A. Current California ROEs Are Not Too High**

10 DRA and Aglet-TURN-UCAN complain that the utilities' authorized ROEs are too high.¹⁸ This
11 assertion is baseless and has been refuted by the Commission in recent years. Specifically, the
12 Commission has examined SCE's authorized return on equity three times in the last four years (and four
13 times in the last six years), and has authorized returns on equity for SCE that have only varied by 20
14 basis points over the entire period.

15 **B. DRA's Commentary Regarding PG&E's Example And SDG&E's MICAM Omits Any**
16 **Discussion Of Risk Changes**

17 DRA's testimony focuses on PG&E's "backcast" of its proposed adjustment mechanism and the
18 historical performance of SDG&E's MICAM. In each case it asserts that "ratepayers did not receive the
19 benefit of the decrease in interest rates between 1998 and 2006 that an adjustment mechanism would
20 have provided ..." ¹⁹ DRA's testimony overlooks that the utilities' credit ratings fell between 1998 and
21 2006, that PG&E went bankrupt during this period, and that SCE narrowly escaped bankruptcy. SCE's
22 credit ratings have not returned to their 1998 levels.

23 One of the reasons why SCE's credit ratings have not returned to their 1998 levels is debt
24 equivalence. In 1999, SCE's debt equivalence was estimated to be \$537 million.²⁰ For 2008, it is

¹⁸ DRA testimony, pp. 2-3. Weil Testimony, p. 2-3.

¹⁹ DRA testimony, p. 3.

²⁰ A.04-05-021, et al., Southern California Edison, *2005 Cost of Capital*, Exhibit 3, p. 18.

1 projected to be \$1.86 billion,²¹ more than three times as much. SCE's greater risk is why its authorized
2 ROE has not fallen as much as DRA would like.

²¹ Exhibit 4, Table III-3, p. 18.

1 V.

2 **RESPONSE TO DRA PROPOSALS**

3 **A. DRA’s Proposed Biennial Proceeding Is Inadequate**

4 While SCE is sympathetic to DRA’s comments about the resource commitments that result from
5 annual cost of capital proceedings, if the Commission were to adopt a biennial cost of capital application
6 process, a trigger mechanism would still be required for the off years. While it is true that long-term
7 interest rates have not experienced dramatic change in the recent past, they have changed quite quickly
8 in earlier periods. For example, between September 1979 and March 1980, Moody’s Baa long-term
9 utility bond yield increased by 4.48 percent, while between October 1985 and April 1986, it decreased
10 by 2.89 percent. Even though changes of this magnitude have not occurred in the recent past, a multi-
11 year mechanism should allow for the possibility. In this regard, DRA’s proposed biennial proceeding is
12 inadequate. In addition, DRA’s proposal does not allow for capital structure adjustments and capital
13 structure flexibility that should be incorporated, as discussed in Chapter III above and in SCE’s
14 previously submitted testimony.²²

15 **B. Cost of Capital Does Not Belong In The General Rate Case**

16 DRA asserts that it would support merging the cost of capital proceeding into the general rate
17 case for large energy utilities.²³ This is not a feasible option and SCE opposes such a change. The
18 General Rate Case is already an extremely complex proceeding. Adding a cost of capital component to
19 it would simply make it more difficult for the Commission to resolve General Rate Case applications in
20 a timely fashion.

²² See Exhibit 4, Chapter VII.

²³ DRA testimony, p. 3.

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VI.

DRA'S PROPOSED SCHEDULE REVISION

DRA recommends that the Commission adopt a schedule whereby utilities file their cost of capital applications about one month earlier in future. SCE shares DRA's concern that the cost of capital applications need more time than the current schedule affords. Accordingly, SCE proposes the following schedule.

Utilities would file their applications on the third Tuesday of April, rather than on a specific calendar date. The following table shows how the schedule would work, using 2009 as an example.

***Table VI-1
Proposed Cost of Capital Schedule***

Line No.	Day	Date	Day of Week	Event
1.	0	4/14/2009	Tuesday	Application filed
2.	7	4/21/2009	Tuesday	ALJ, staff counsel and Commissioner assigned
3.	28	5/12/2009	Tuesday	Prehearing conference
4.	70	6/23/2009	Tuesday	DRA and intervenor testimony due; utility may file updated testimony (limited to certain issues)
5.	105	7/28/2009	Tuesday	Rebuttal testimony due
6.	118	8/10/2009	Monday	Hearings begin
7.	122	8/14/2009	Friday	Hearings end
8.	147	9/8/2009	Tuesday	Late-filed exhibit (interest rate update) filed. Opening briefs due.
9.	161	9/22/2009	Tuesday	Reply briefs due; proposed submission date
10.	196	10/27/2009	Tuesday	Proposed decision due
11.	216	11/16/2009	Monday	Opening comments on Proposed Decision due
12.	223	11/23/2009	Monday	Reply comments on Proposed Decision due
13.	233	12/3/2009	Thursday	Final decision scheduled

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 **Southern California Edison Company's (U338-E) Rebuttal Testimony in Support of 2008 Cost of Capital Application, Phase II.** 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 January 2008, 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