

**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)	
_____)	
)	
)	A.07-05-007
And Related Proceedings.)	A.07-05-008
_____)	

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

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Dated: **September 27, 2007**

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

Pursuant to Rule 13.44 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”) submits its Opening Brief and request for oral argument in this proceeding. Consistent with applicable law and its current financial condition, SCE recommends that the CPUC adopt the following cost of capital amount and capital structure to take effect on January 1, 2008 and the Findings of Fact and Conclusions of Law set forth at Appendix A:

***Table I-1
2008 Recommended Cost of Capital***

Component	Percentage	Cost	Weighted Cost
Long-Term Debt	43.00%	6.22%	2.67%
Preferred Equity	9.00%	5.01%	0.54%
Common Equity	<u>48.00%</u>	11.80%	<u>5.66%</u>
Total	100.00%		8.87%

I.

INTRODUCTION

The CPUC has historically set the authorized return on equity (“ROE”) for energy utilities by looking to a variety of factors, including applicable law, interest rates, company-specific risks, credit rating ratios, and the results of financial models based on subjective inputs. “In the final analysis,” the CPUC has concluded, “it is the application of informed judgment, not the precision of financial models, which is the key to selecting a specific ROE estimate.”¹ In this proceeding, the CPUC should once again utilize its judgment, informed by the benefit of the valid evidence in this proceeding. SCE has presented valid financial models and model results which result in an average required ROE result of 12.1%, an increase of 50 basis points from the current authorized ROE of 11.6%. SCE did not rely solely on its financial model results and is only requesting an authorized ROE of 11.8% based on its judgment that the increase indicated by the modeling results can be tempered by a variety of factors.² SCE’s judgment is that an increase in ROE is necessary at this time and that a 20 basis point increase is sufficient.

The record demonstrates the need for financial results that produce credit ratios supportive of an “A” credit rating. The record also highlights the importance of this cost of capital decision in setting a compensatory return to permit continued capital attraction capability given the historically high level of capital investment requirements facing SCE. As SCE sets forth below, the recommended 11.8% return on equity and 2008 capital structure fully meets the relevant standards the CPUC must achieve in granting a decision in SCE’s 2008 cost of capital application.

First, the record amply reflects that adoption of SCE’s recommendations will offer investors rates of returns in the range of comparable investments of similar risk, maintaining SCE’s current credit recovery path, allowing SCE the ability to attract the capital necessary to

¹ D.05-12-043, *mimeo*, p. 23.

² These factors include credit market conditions, forecasted interest rate changes, and the need for SCE to improve its credit rating.

provide proper electric service to its customers, and ensuring sufficient continuing confidence in the financial soundness of the utility.³

Second, the recommendation provides for SCE-specific risk-adjusted return requirements and the specific risks investors take into account when deciding whether to supply capital to SCE. Investors in electric utilities operating in California bear substantial risks including direct access, community choice aggregation and municipalization, customer bypass, and risks associated with power procurement contracting and power supply requirements including renewable portfolio standards and potential carbon offset requirements when providing capital dedicated to SCE's electrical service procurement and delivery obligation.⁴

Third, the results of SCE's financial models provide the CPUC an accurate and credible analysis of various quantitative factors required to assure that these models appropriately estimate the required ROE for SCE's utility investments. As SCE demonstrates, various intervenors have misconstrued, miscalculated, and biased the models so as to incorrectly reduce their ROE recommendations and encourage the CPUC to grossly reduce SCE's authorized ROE to levels insufficient to compensate SCE's investors.

Fourth, SCE notes that there is no dispute in this proceeding over its requested capital structure or its requested embedded costs of long-term debt and preferred equity.

SCE's evidence on financial model results, the adequacy of resulting credit ratios, target credit ratings goals, changes in forecasted interest rates, SCE's financial performance while operating under the current authorized return on equity, when taken together, demonstrate what is required by the investment community and the law. This record leads to the conclusion that 11.8% is the appropriate level at which to set the 2008 authorized return on equity for SCE. The CPUC should find the same.

³ SCE/Boada, Ex. 4, pp. 2-4.

⁴ SCE/Hunt, Ex. 4, pp. 12-15.

II.

SCE'S RECOMMENDED CAPITAL STRUCTURE AND ROE ARE CONSISTENT WITH APPLICABLE LAW AND REQUIRED STANDARDS

SCE's opening testimony discusses the well-established legal principles that should continue to guide the CPUC's decision setting SCE's 2008 authorized capital structure and rate of return on invested capital.⁵ These four principles are:

- The return must be comparable to returns on investments of similar risk;
- The return should maintain the utility's credit;
- The return should allow the utility to attract the capital necessary to provide proper service to customers; and
- The return must be sufficient to ensure confidence in the financial soundness of the utility.⁶

These standards accurately frame the relevant issues the CPUC must consider when establishing an adequate and compensatory level of return on invested capital. No party has disputed the applicability of these four principles to the CPUC's consideration of SCE's request in this proceeding.⁷ In fact, the parties recognize that for a cost of capital decision to be lawful, it must meet the mandates set forth in the "seminal" Supreme Court cases from which these principles were born.⁸

As set out below, SCE's recommended ROE and capital structure fulfill the legal requirements of the *Hope* and *Bluefield* decisions. With an authorized ROE of 11.8% and the capital structure set out above, SCE will be able to offer investors a comparable risk adjusted rate

⁵ SCE/Boada, Ex. 4, pp. 2-3.

⁶ SCE/Boada, Ex. 4, pp. 2-3.

⁷ See e.g., Federal Executive Agencies ("FEA")/Hill, Ex. 44, pp. 3-4; Pacific Gas and Electric Company ("PG&E")/Avera Tr. 311:3-21.

⁸ *Id.*; 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).

of return that will ensure confidence in the credit quality and financial soundness of the utility.⁹ No party to this proceeding has offered credible evidence demonstrating that a different capital structure or ROE level will satisfy the four principles for a company with the specific profile of SCE.

A. SCE's Recommended ROE Appropriately Compensates for Risks

SCE's recommended ROE reflects the fact that in addition to traditional utility risks, California utilities like SCE are subject to ongoing risks from continuing efforts to accomplish wholesale and retail deregulation. In addition, as SCE's credit rating indicates, the company has not returned to the financial condition it enjoyed prior to the financial crisis that began in late 2000.¹⁰ While SCE fully appreciates the policies the CPUC has adopted to restore SCE's financial health, SCE's recommendation here recognizes that utility risks, including procurement-related risks, are substantial and the financial recovery of SCE is not yet complete in the eyes of investors.¹¹ Adopting SCE's recommendations will continue to send the investment community the message that SCE's risks will be compensated and that California's regulators continue to focus on the goal of returning SCE to a full "A" rating.

Additionally, the CPUC should take notice that evidence submitted by intervenors in this proceeding assesses the regulatory climate faced by California's utilities as "below average."¹² This finding, published in *Value Line*, a publication which one expert has called "influential," and whose information is relied upon by several parties to this proceeding, confirms the statements made by SCE, PG&E, and SDG&E regarding the continued perception of California's utility regulatory risk.¹³ Further evidence of investors' wariness with regard to

⁹ SCE/Boada, Ex. 4, p. 3.

¹⁰ SCE/Boada, Ex. 4, p. 4.

¹¹ SCE/Boada Tr. 109:9-110:22.

¹² See Aglet Consumer Alliance ("Aglet")/Weil, Ex. 55, pp.18-20; San Diego Gas & Electric Company ("SDG&E")/Hayes Tr. 563:21-564:1; Aglet/Weil Tr. 618:4-21; PG&E/Patterson 563:21-564:1.

¹³ FEA/Hill Tr. 494:25-495:2 ("I use Value Line in my testimony. I think we all do. It is one of many sources available to investors. I think it is influential."); Aglet/Weil Tr. 610:14-19, 612:11-20, 618:22-26 (elements of Continued on the next page

California's utilities is found in various articles published by Standard & Poor's ("S&P") *RatingsDirect*. These articles note that the uncertain regulatory environment in California related to retail choice, renewables, resource adequacy and greenhouse gas emissions regulation is considered a "weakness" for California's utilities.¹⁴ California regulatory risks are widely noted, and the CPUC must take this high risk factor into account when setting an authorized ROE and capital structure for SCE as a regulated California utility.¹⁵ Setting an authorized ROE of 11.8% appropriately recognizes and compensates SCE for these risks.

B. SCE's Recommended ROE and Capital Structure Will Enable SCE to Maintain its Capacity for Credit Quality Improvement

In establishing the appropriate authorized ROE and capital structure for SCE, the CPUC also should recognize how SCE has improved its credit quality under the current authorized capital structure and authorized return on equity of 11.6%. The cash flow afforded by the CPUC's current return authorizations has been critical to providing the credit ratios needed for ratings improvements. In particular, in September and October 2006, SCE received meaningful credit rating upgrades from two of the three rating agencies. In addition, during this same timeframe, SCE received a business profile improvement from the third rating agency, S&P, buoyed by improvements in SCE's credit statistics and perceptions of improvements in operating risks and environment.¹⁶

Additionally, the CPUC should bear in mind the significance to the credit rating agencies of supportive CPUC decisions regarding credit quality to the credit rating agencies. As Standard & Poor's notes, California has a "fairly supportive credit environment."¹⁷ That supportive

Continued from the previous page

analysis are based on Value Line information); PG&E/Avera 283:12-22 ("I think the information that Value Line publishes is information that they believe that investors use.")

¹⁴ Ex. 15, p. 13.

¹⁵ PG&E/Avera Tr. 318:20-28; SCE/Boada Tr. 129:5-13.

¹⁶ SCE/Boada Tr. 96:27-97:18, 149:14-150:12.

¹⁷ Ex. 15, p. 13

environment has returned SCE from the brink of financial disaster to a company with the following credit ratings:

Table II-2
SCE's Current Credit Ratings¹⁸

Rating	Moody's	Standard & Poor's	Fitch
Corporate Credit Rating	A3	BBB+	A-
Senior Secured Debt Senior	A2	A	A+
Unsecured Debt	A3	BBB	A
Preferred Equity	Baa2	BBB-	A-
Short-Term Debt	P-2	A-2	F1

While the CPUC's efforts to bring SCE this far are laudable, these credit ratings do not assure access to capital under times of financial market stress. As SCE recently discovered, in times of financial crisis (as recently caused by events in the subprime mortgage market), SCE's current credit rating does not provide the access to capital that is available to entities of higher credit quality. As SCE explained, during the recent subprime mortgage crisis, SCE was unable to issue short term debt in the form of commercial paper in August and portions of September 2007 because of its current short term debt credit ratings of A-2/P-2.¹⁹ This effect was also felt by PG&E, which was also unable to issue commercial paper during this time.²⁰

CPUC decisions which help support SCE's return to a full "A" corporate credit rating from all three credit rating agencies should allow SCE to attract capital in both the long-term and short term markets and avoid potential dislocations like those seen this summer.²¹ Similarly, CPUC decisions which help return SCE to a full "A" rating would "be again further evidence of a positive CPUC support for both maintaining access to capital and providing soundness to the utility."²² Such a change could also allow SCE to improve its business profile score in a manner which makes it easier for SCE to adjust to future situations of financial stress.²³ As discussed,

¹⁸ SCE/Boada, Ex. 4, p. 16; SCE/Boada Tr. 54 :19-55:6.

¹⁹ SCE/Boada Tr. 109:17-110:22, 111:23-112:12.

²⁰ PG&E/Avera Tr. 279:20-280:9.

²¹ SCE/Boada Tr. 147:21-148:3; PG&E/Avera Tr. 319:1-26.

²² SCE/Boada Tr. 150:20-151:7.

²³ SCE/Boada Tr. 149:14-150:12.

the current authorized capital structure and ROE were valuable in securing credit rating upgrades in 2006 from Fitch Ratings and Moody's Investor services. Additionally, the current cost of capital authorization period allowed for the change in current business profile for SCE from a "6" to a "5".²⁴ The Commission should take particular note of this positive trend and take appropriate actions that build upon and advance it.

Conversely, any CPUC decision that significantly lowers SCE's ROE is likely to negatively affect how investors and rating agencies perceive SCE, its risks, and its credit rating framework.²⁵ Although SCE's business profile has improved, its profile is still not equal to that which it held before the crisis. While SCE, in the past year, returned to a Standard & Poor's business profile score of "5", that score does not reflect the same business risk framework of the score of "5" that SCE held before the energy crisis. The scores are not equivalent because in the years since the energy crisis, Standard & Poor's has revised business profile framework score. Accordingly, any comparison of like numbered then and now business profiles does not yield "an apples-to-apples" comparison.²⁶ No party disputes that the manner in which Standard & Poor's business profiles are determined has changed. Nevertheless, intervenors claim that SCE's business profile is "the same rating as before the crisis."²⁷

Approving SCE's 11.8% ROE request was shown to produce adequate financial credit ratio measures for an "A" rated utility and is an essential means of helping SCE continue on its path to the full single-A rating it once held. Approving this ROE request and its related credit

²⁴ SCE/Boada Tr. 96:27-97:18, 149:14-150:12.

²⁵ See SDG&E/Arriola Tr. 46:17-22; PG&E/Avera Tr. 281:25-282:13 (Regarding possible CPUC announcement of a return less than what was ordered a few years ago, "when interest rates were lower, when almost every indicia of risk was less. think that would interpreted by the investment community as an alarming sign . . ."), 317:4-21, 324:12-325:3 ("I think it's important for this Commission not to send a negative signal with the outcome of this case. And I believe a signal such as a return significantly lower than was, or even the same as was allowed at the end of 2005 when interest rates were lower would be a very negative signal.")

²⁶ SCE/Boada Tr. 111:3-13, 150:13-19; SDG&E/Arriola Tr. 33:23-26.

²⁷ See Aglet/Weil, Ex. 55, p. 2.

implications would be wholly consistent with the CPUC’s pre-crisis history of supporting credit ratings of electric and gas utilities at single-A levels.²⁸

C. SCE’s Recommended ROE and Capital Structure Will Support a Continued Capability to Attract Capital and Ensure Confidence in SCE’s Financial Soundness

In addition to helping SCE maintain an improving credit rating path, adoption of SCE’s recommended ROE and capital structure will further support SCE’s continuing ability to attract debt and equity capital on reasonable terms.²⁹ It will also bolster balance sheet strength need to engage in the necessary power purchase agreements for meeting customer energy needs and fulfilling SCE’s obligations for policy programs such as meeting the 20% renewable energy supply standards that have increased debt equivalents in SCE’s financial metrics from \$885 million to a projected \$1.9 billion in 2008.³⁰

As SCE explained to Administrative Law Judge Michael Galvin during questioning, CPUC policies which help SCE move toward an “A” credit rating will likely allow SCE to attract capital in the long-term and short-term markets and avoid potential dislocations like those experienced this summer.³¹ As SCE and others explained, during this summer’s crisis in the mortgage industry, investors flocked to lower risk investments.³² This meant that for higher risk companies, including those with “BBB” credit ratings like SCE, access to capital was cutoff for several days.³³ For SCE, this meant that it was unable to issue commercial paper with a term of over seven days and that the borrowing rate on the paper it was able to issue increased by 60 to

²⁸ See SCE/Boada, Ex. 4, p. 5 (Notably, no party disputes that until 2001, SCE, SDG&E, PG&E, and So Cal Gas all had a long record of credit ratings of single-A or better); SCE/Boada Tr. 114:8-15 (“I think it would be a sign that there’s continued support of the Commission to a restoration of the credit quality of Southern California Edison Company. Be another positive step.”)

²⁹ SCE/Boada Tr. 147:21-148:3.

³⁰ SCE/Boada, Ex. 4, p. 18.

³¹ SCE/Boada Tr. 147:21-148:3

³² SCE/Boada, Ex. 5, p. 4; PG&E/Avera Tr. 319 :6-15.

³³ PG&E/Avera 279:20-280:9, 319:27-320:10.

80 basis points.³⁴ As long as Standard & Poor’s continues to rate SCE in the BBB category, it falls into a higher risk spectrum than higher rated companies, which would not have been deprived of reasonably priced capital during this summer’s financial crisis.³⁵ For example, while SDG&E testified of just a 15 basis point lower spread than SCE in longer-term bond yields because of its higher credit rating in the longer term market, SCE experienced Tier-2 (A-2/P-2 rated) short-term commercial paper spreads of over 80 basis points as compared to Tier-1 (A-1/P-1 rated) commercial paper issuers like SDG&E during the recent sub-prime market crisis.³⁶

No intervenor in this proceeding has disputed the effect of SCE’s credit rating during this summer’s financial crisis. More notably, no intervenor has attempted to quantify the effect any ROE reduction would have on the utilities’ credit ratings or their access to capital.³⁷ This is an important issue. SCE’s testimony provided evidence of its credit rating both with and without debt equivalence showing adequacy of financial metrics in targeting an “A” credit rating.³⁸ Conversely, there was a lack of evidence from intervenors regarding the effect of their lower recommended ROEs on credit quality, and therefore, on access to capital, especially in times of crisis.

Accordingly, the CPUC should act based on the uncontroverted evidence in the record, and not take any speculative action that could harm SCE’s credit quality and its financial recovery or, most importantly, its access to capital on reasonable terms. The CPUC must recognize that supporting a strong credit quality for SCE is critical to capital attraction and meeting investor return requirements and thereby, their interest in providing capital to SCE.³⁹ Adoption of SCE’s 11.8% ROE and capital structure recommendations herein will provide

³⁴ SCE/Boada, Ex. 5, p. 4, SCE/Boada Tr. 129:26-130:19 (“Edison is effectively—is still today unable to issue this paper with prices or terms comparable to what it used to before this current market dislocation started occurring.”)

³⁵ See SDG&E/Arriola Tr. 33:11-16; SDG&E/Schneider 186:11-20; SDG&E/Schneider 227:10-13 (“SDG&E currently has a higher credit rating than the other two utilities.”)

³⁶ SDG&E/Arriola Tr. 40:15-18; SCE/Hunt Tr. 411:26-412:1.

³⁷ See e.g., Division of Ratepayer Advocates (“DRA”)/Woolridge Tr. 482:26-483:3.

³⁸ SCE/Boada, Ex. 6, pp. 2-4.

³⁹ SCE/Boada, Ex. 5, p. 4; PG&E/Avera 331:12-20 (“[R]eal world investors will look to the authorized return in this case as a signal of whether California is continuing its program of recovery or there’s a problem here.”)

further evidence of the CPUC’s support for maintaining access to capital and providing financial soundness to SCE.⁴⁰

III.

THE CPUC SHOULD CONTINUE TO ACCOUNT FOR DEBT EQUIVALENCE IN SETTING SCE’S ADOPTED CAPITAL STRUCTURE AND MEASURING CREDIT RISK EXPOSURE

DRA asserts that it “does not accept that DE [debt equivalence] needs to be part of the determination of the appropriate capital structure for ratemaking purposes.”⁴¹ DRA’s position ignores prior CPUC policy⁴² as well as the fact that debt equivalence is a significant factor considered by credit rating agencies and regulatory commissions nationwide.⁴³ Approval of continuation of the existing capital structure, which was last adjusted in recognition of debt equivalence for the 2005 test year, would appropriately continue the CPUC’s policy of recognizing the impact of debt equivalence on SCE’s financial metrics.

The CPUC has previously adopted a protocol for the inclusion of the debt equivalence impacts of power purchased agreements.⁴⁴ In that decision the CPUC authorized the use of a 20% debt equivalence factor. In cost of capital cases, specifically, the CPUC has affirmatively stated that debt equivalence impacts are to be considered and in this proceeding the CPUC should adopt an updated 25% risk factor for evaluating SCE’s power purchase agreement debt equivalence in the context of considering capital structure.

Other states have also taken action with regard to recognizing debt equivalence. Florida, for example, “allows a debt equivalence adjustment in the resource procurement process with a

⁴⁰ SCE/Boada Tr. 150:15-28.

⁴¹ DRA/Woolridge Ex. 34, pp. 3-4.

⁴² See Decision 05-12-043, *mimeo*, p. 9 (The CPUC’s goal in affirming that debt equivalence impacts would be assessed when setting a balanced capital structure and fair return on equity. Was to maintain and support investment-grade credit ratings and provide utilities the ability to raise necessary capital.)

⁴³ SDG&E/Arriola Tr. 15:15-22.

⁴⁴ D.04-12-047, *mimeo*, pp. 51-52.

risk factor adjustment of 30%.”⁴⁵ Washington uses “a risk factor that ranges from 15%-40%.”⁴⁶ Wisconsin “will allow an adjustment for PPA debt equivalency when it is demonstrated that the PPA degrades the utility’s credit rating.”⁴⁷ Lastly, Connecticut allows “electric distribution companies to request debt equivalence adjustments within the context of a rate case based on financial impacts that can be proven attributable to capacity contracts, ‘if needed for electric distribution companies to attract needed capital and maintain their financial integrity.’”⁴⁸

There is no factual or policy basis in this proceeding for changing the CPUC’s policy with regard to debt equivalence. Accordingly, SCE urges the CPUC to continue its policy of setting a balanced capital structure and ROE in a manner which includes consideration of debt equivalence and its impact on credit ratios and metrics.

IV.

THE CPUC SHOULD CONSIDER SCE’S FINANCIAL MODEL RESULTS AND CHANGES IN INTEREST RATE FORECASTS AND OTHER FACTORS WHEN DETERMINING AN APPROPRIATE AUTHORIZED ROE

As virtually all parties to this proceeding recognize, modeling is not an objective exercise.⁴⁹ Instead, modeling the estimated level of required ROE involves making subjective judgments about which inputs to use. As Commissioner John Bohn has noted, “the underlying input information and methods of using the models can make a significant difference in the results that are produced.”⁵⁰ In this proceeding alone, intervenors have all reached different

⁴⁵ SCE/Woolridge, Ex. 41, p. 8; DRA/Woolridge Tr. 476:9-15.

⁴⁶ SCE/Woolridge, Ex. 41, p. 8. DRA/Woolridge Tr. 477:11-17.

⁴⁷ SCE/Woolridge, Ex. 41, pp. 8-9; DRA/Woolridge Tr. 476:25-477:9.

⁴⁸ SCE/Woolridge, Ex. 41, p. 8; DRA/Woolridge Tr. 475:12-476:4.

⁴⁹ PG&E/Avera Tr. 286:10-287:3; FEA/Hill Tr. 493:11-494:14 (DCF analysis requires use of judgment), 501:17-502:26 (“[J]udgment comes into play in every faced of cost-of-capital analysis . . . [w]hen it comes to determining a cost-of-equity capital, it is a subjective process. It can’t be reduced effectively to a simple mechanical calculation.”); Aglet/Weil Tr. 612:11-613 (“It’s based on judgment, like so many other variables in this proceeding”).

⁵⁰ SCE/Hunt, Ex. 5, pp. 24-25; *see e.g.*, PG&E/Avera 286:10-287:3.

conclusions about what the appropriate return on equity is for SCE.⁵¹ For the reasons set out below, the CPUC should once again reject a fully mechanistic application of any of the models set forth by parties to this proceeding and only accept the results of those models once their inputs and biases are studied and assessed.

In addition, as a precursor to undertaking this task and establishing a basis for informing their judgment, the CPUC should first look at the current SCE authorized ROE of 11.6%, the market reaction to that level of return, and the changes in forecasted interest rates since that latest authorizing decision. As a next step, the CPUC must determine the appropriate data inputs to the financial return estimation models and the related credit statistics as the appropriate factors to consider in setting the 2008 authorized ROE.

A. The Results of SCE’s Financial Modeling and Changes in Forecasted Interest Rates Justify a 20 Basis Point Increase in SCE’s Authorized ROE

Pursuant to previous CPUC decisions, SCE submitted for the CPUC’s consideration the properly calculated results of three standard financial models used in the most recent authorized cost of capital proceeding to estimate SCE’s required 2008 authorized return on equity. In addition to the Discounted Cash Flow (“DCF”) model, the Historical Risk Premium (“HRP”) model, and the Capital Asset Pricing Model (“CAPM”),⁵² SCE submitted a return on equity estimate derived from the Fama-French model. These models yielded the following results:

⁵¹ DRA/Woolridge, Ex. 34, p. 1-I; FEA/Hill, Ex. 44, p. 3; Aglet/Weil, Ex. 55, p. 1.

⁵² “Each year we expect the three models to be submitted in the bare-bones forms of a nominal yield compound growth version of the DCF model without other adjustments and one version each of the RP and CAPM models. . .” D.92-11-047, *mimeo*, p. 78.

Table IV-3
SCE Cost of Equity Estimates

Model	Low	Midpoint	Average	High
DCF	7.31%	12.25%	10.96%	17.20%
CAPM	8.52%	11.46%	11.59%	14.40%
FF	7.42%	18.21%	15.04%	29.00%
HRP	--	--	10.87%	--

The simple average of the four averages of these models, as pointed out by DRA, is 12.1%, 50 basis points higher than SCE’s current authorized ROE of 11.6%.⁵³ Notably, the DCF estimates of SCE’s required ROE are not reliable at this time.⁵⁴ They are unreliable indicators of the cost of equity for SCE because the stable market-to-book and price earnings ratios required by the constant growth DCF model are not currently available.⁵⁵ As SCE demonstrated, over the past several years, price-to-earnings ratios for electric utilities have not been stable.⁵⁶ Similarly, the average market/book ratio for comparable utilities has been unstable. The result of this instability is that the DCF model understates the required return on equity.⁵⁷ The CPUC has, in the past, recognized and discounted the DCF model because of issues with its accuracy.⁵⁸ It should recognize such flaws and again reject the estimates resulting from it.

The HRP model, additionally, is flawed because it assumes an unchanging risk premium for the utility industry. Assuming an unchanging risk premium will understate required equity returns for utilities.⁵⁹ An understating of equity returns will generally make a utility’s funds from operations drop, which could lead to a decline in credit rating.⁶⁰

To better improve the estimating capability and supplement the models the CPUC has traditionally used to inform its judgment on the issue of the appropriate authorized return on

⁵³ SCE/Boada, Tr. 143:307.
⁵⁴ SCE/Hunt, Ex. 4, p. 29; SCE/Hunt Tr. 389:1-26.
⁵⁵ SCE/Hunt, Ex. 4, p. 29.
⁵⁶ SCE/Hunt, Ex. 4, p. 31-32.
⁵⁷ SCE/Hunt, Ex. 4, p. 33.
⁵⁸ See Decision 04-09-063, *mimeo*, pp. 159, 170
⁵⁹ SCE/Hunt, Ex. 4, p. 29.
⁶⁰ DRA/Woolridge Tr. 482:26-484:17.

equity for SCE, SCE has again in this proceeding included the Fama-French model. This model has for over 15 years been “promising” in its attempts to revisit modern portfolio theory.⁶¹ In addition to including the market factor of the CAPM, the Fama-French captures a size premium and value premium, two of the factors not captured by the traditional models.⁶²

Importantly, the Fama-French model, in addition to bearing market risk, compensates investors for exposure to size risk and value risk. This theory is routinely taught in finance courses throughout the nation.⁶³ SCE’s use of the Fama-French model is significant here because it is the one model in the proceeding that addresses risks not evaluated by the other three models, but which are relevant to the setting of a rate of return.⁶⁴

Specifically, the Fama-French model picks up factors like a pricing factor for market-to-book ratios.⁶⁵ Accordingly, the Fama-French model has greater explanatory power than the CAPM model and should also be incorporated into the CPUC’s framework for judgment in this proceeding.⁶⁶ The increased explanatory factor is why the Fama-French model has been described as the model used in the real world by people who have money at stake.⁶⁷ In light of the issues with the DCF and HRP models, only the CAPM and Fama-French models provide “correct” estimates of equity returns at this time. Looking at only these model results, the average CAPM estimate of SCE’s required return on common equity is only slightly lower than SCE’s request in this proceeding, while the Fama-French result is above SCE’s request.⁶⁸

⁶¹ DRA/Woolridge, Ex. 43, p. 5; SDG&E/Hayes 522:10-23 (“[A]cademics have debated and tested the three-factor model over the course of more than 10 years. And they haven’t repudiated it. Hence, it is not a model that has been resigned to the financial history, so to speak.”)

⁶² SCE/Hunt, Ex. 4, p. 40.

⁶³ DRA/Woolridge, Ex. 42, p. 6.

⁶⁴ SCE/Boada Tr. at 139:10-26.

⁶⁵ SCE/Boada Tr. 139:10-26

⁶⁶ SCE/Hunt Tr. 406:8-407:12; SDG&E/Hayes Tr. 516:9-517:2, 531:18-28 (Nevada has accepted the Fama-French model as a data point in cost of capital proceedings).

⁶⁷ SDG&E/Hayes Tr. 516:9-22.

⁶⁸ SCE/Hunt, Ex. 4, p. 29.

In addition to these model results, another rate of return factor to consider is the current SCE authorized ROE of 11.6%, which has served SCE well in attracting capital and receiving favorable action from the rating agencies during in 2006.⁶⁹

Finally, as presented in SCE's testimony, forecasted interest rates for the test year for Moody's Aa utility bond rate and long-term Treasury rates increased from 4 to 17 basis points.⁷⁰ This level of interest rate forecast increase, taken with the actual performance of SCE with an 11.6% ROE, moderated SCE's judgment on the usage of the straight average of the model results and informed a decision to request only a 20 basis point increase for its 2008 ROE. Although the Global Insight forecasts have been updated to September 2007⁷¹ and the forecasted interest rates for the test year are now somewhat lower than they were in April, it is SCE's judgment that instability in credit markets and increased volatility in observed interest rates, along with the heightened need to support improvement in SCE's credit metrics at this time, more than offset the forecast improvement and support continuation of SCE's request for a 20 basis point increase in its authorized ROE.

There is one overriding theme from all these results. The cost of equity for SCE is increasing and while the current 11.6% base was fair, reasonable, and compensatory for its period of authorization, a higher level is needed for 2008.

SCE is requesting a 20 basis point increase in ROE which is in the range and supported by several combinations of the financial model results including the CAPM and Fama French-models. An 11.8% return is an appropriate authorized 2008 ROE for SCE. This level of ROE meets the comparability standard requirement needed for the legal requirements of *Hope* and *Bluefield* and also, as demonstrated by SCE, meets the requirements of the other three standards.

⁶⁹ See e.g., SCE/Boada Tr. 96:27-97:18, 149:14-150:12.

⁷⁰ SCE/Hunt, Ex. 4, Table IV-5, p. 24. This table contains September 2005 and April 2007 Global Insight projections.

⁷¹ SCE, Ex. 64, Table 2.

B. The Intervenors' Financial Models Contain Fundamental Errors Which Should Lead The CPUC To Reject Their Recommendations

The intervenor's various model results purport to present to the CPUC accurate estimates of what SCE's return on equity should be. However, for the reasons set forth briefly below, those models do not accurately determine the required ROE. SCE needs to fairly compensate investors, attract capital and inspire investor confidence in SCE's overall financial soundness and credit quality. Application of the intervenor return estimates in a mechanistic manner leads to a return on equity less than what SCE has most recently authorized and will likely undermine investor confidence in SCE and the CPUC's commitment to maintaining and improving SCE's credit quality and financial soundness. It would be inappropriate and financially reckless to proceed on such a path at a time when CPUC policy and market conditions require utilities with strong balance sheets and sufficient financial strength to anchor California's electric utility regulatory framework.⁷²

1. Intervenor DCF Estimate Errors

- DRA's Woolridge here urges the CPUC to accept DCF as a valuation tool.⁷³ This is not the same as using the model to value cost of capital. DRA's Woolridge gives conflicting information regarding the importance of DCF estimates. In his publications, Dr. Woolridge advises investors to use the CAPM model, not the DCF model.⁷⁴ The CPUC should thus disregard his recommendations here because they "give primary weight to the DCF results."⁷⁵

⁷² PG&E/Avera Tr. 281:25-282:13.

⁷³ DRA/Woolridge, Ex. 34, pp. 4-1-4-2.

⁷⁴ SCE/Hunt, Ex. 5, p. 28.

⁷⁵ SCE/Hunt, Ex. 5, p. 28.

- FEA’s DCF growth rates do not seem to follow any clear and consistent pattern.⁷⁶
The introduction of such growth rates into the DCF model produces “illogical costs of equity by any objective measure.”⁷⁷ Such inputs also result in understated recommendations.⁷⁸
- DRA and FEA incorrectly multiply the current dividend by one-half of the growth rate in the DCF calculation, resulting in an understatement of the dividend yield and the resulting DCF ROE estimates.⁷⁹
- Aglet/TURN/UCAN rely solely on dividend growth rates to provide the growth rate in the DCF model. Dividend growth rates are inferior rates to use in the DCF model because they are only reported by a limited group of entities, and only for the long-term. Earnings growth rates, on the other hand, are widely available from the investment community. Accordingly, it is clear that that earnings growth rates are more important to the investment community, and thus a superior metric to dividend growth rates for use in the DCF model.⁸⁰
- FEA’s statistical screening of utility DCF estimates is flawed. By inexplicably adjusting utility DCF estimates to exclude individual company estimates that are more than one standard deviation away from the average, and then reaveraging the estimates, FEA deliberately skews the results of this model downward.⁸¹

2. Intervenor CAPM Estimate Errors

- DRA and FEA incorrectly cite Morningstar when estimating the market risk premium. Both DRA and FEA cite it as estimating 6.5%, when in fact that arithmetic

⁷⁶ SCE/Hunt, Ex. 5, p. 29; PG&E/Avera 282:14-24 (“[Messrs. Hill and Woolridge] gave weight . . . to growth estimates that were illogical.”)

⁷⁷ PG&E/Avera 287:26-288:6.

⁷⁸ PG&E/Avera 289:11-16.

⁷⁹ SCE/Hunt, Ex. 5, p. 30.

⁸⁰ SCE/Hunt, Ex. 5, p. 30; *see also* PG&E/Avera 303:16-18.

⁸¹ SCE/Hunt Ex. 5, p. 31.

average derived from Morningstar is 7.1%. DRA and FEA come to this conclusion by subtracting the average total return on long-term government bonds from the average total return on large company stocks. Morningstar does not calculate the market risk premium in this way.⁸² The effect of this error is to understate CAPM estimates of the ROE.

- DRA’s witness uses an inconsistent methodology for calculating the market risk premium. When advising private investors, Dr. Woolridge recommends a market risk premium of 3% when valuing stock, in this proceeding however, when attempting to value utility stock, he uses a market risk premium of 4.14%.⁸³ Using a 4.14% market risk premium in place of a 3% market risk premium increases the CAPM ROE estimate, but neither market risk premium is correct because they are so low. Perhaps more important, this is another instance where Dr. Woolridge’s investing publications contradict his testimony in this docket.
- DRA and FEA cite market risk premium analyses based on less reliable data, and DRA omits findings from more recent research, while FEA does not provide complete information from an article that it cites.⁸⁴ In each case, the result is a failure to recognize evidence that contradicts intervenors’ understated market risk premium.
- Aglet/TURN/UCAN incorrectly use the estimated market risk premium. In the CAPM analysis, a market risk premium of 5.71% is utilized.⁸⁵ This amount is incorrect because the survey of 28 estimates upon which it is based is dominated by market risk premium estimates measured relative to the 20-year Treasury bond rate. It is incorrect to estimate the market risk premium with respect to the 20-year Treasury bond rate and then use it without modification in a CAPM equation with a

⁸² Notably, FEA’s own testimony references an article which supports SCE’s method of calculating the market risk premium. See FEA/Hill, Ex. 44, p. 71 (citing “*Risk and Return in the 20th and 21st Centuries*”).

⁸³ SCE/Hunt, Ex. 5, p. 33.

⁸⁴ SCE/Hunt, Ex. 5, pp. 32-35.

⁸⁵ Aglet/Weil, Ex. 55, p. 22.

risk-free rate of different duration.⁸⁶ This incorrect estimation renders void the groups' CAPM estimates. While cross-examining an SCE witness, Aglet/TURN/UCAN tried to rehabilitate its CAPM estimate, but that effort failed because Aglet/TURN/UCAN's adjustment was based on interest rates outside of the measurement period and was based on an interest rate relationship that was observed for only a single day.⁸⁷

- In addition, many of the market risk premium estimates included in Aglet/TURN/UCAN's survey are based on geometric mean calculations, which are incorrect for the purpose of estimating cost of capital.⁸⁸

3. Intervenor HRP Errors

- Aglet/TURN/UCAN estimate an HRP over a time interval that is too short to effectively use the HRP. The group's use of the 1991 to 2006 time period is contrary to the fundamental HRP practice of using the longest period for which data is available when constructing an HRP model. Even the Aglet/TURN/UCAN witness acknowledges that "more numbers would be better to the extent they measure historical risk premiums."⁸⁹ However, the value of data for those additional years is not reflected in the Aglet/TURN/UCAN testimony. The misleading information mean that Aglet/TURN/UCAN did not correctly capture the full extent of returns anticipated by investors.⁹⁰ SCE's HRP model, on the other hand, was constructed using the complete available data from 1946 through 2006.⁹¹

⁸⁶ SCE/Hunt, Ex. 5, p. 36.

⁸⁷ SCE/Hunt Tr. 425:3-8. Aglet/Reid, Tr. 602:16 - 603:25.

⁸⁸ SCE/Hunt, Ex. 5, p. 31. PG&E/Avera, Ex. 24, pp. 1-58 to 1-59. PG&E/Avera Tr. 338 :15-27.

⁸⁹ Aglet/Weil Tr. 612:11-613:1.

⁹⁰ SCE/Hunt, Ex. 5, p. 38.

⁹¹ SCE/Hunt, Ex. 5, p. 38; PG&E/Avera Tr. 338:28-339:25 (Notably, PG&E's witness also conducted the HRP modeling using data from 1946 to the present.)

- Aglet/TURN/UCAN’s HRP estimates rely on earned returns on book value, which do not represent the returns actually earned by investors, which are the true returns on which a historical risk premium should be based.⁹² This is a second reason why Aglet/TURN/UCAN’s HRP estimates should not be used.

4. Intervenor Errors In Selection of Comparable Companies

- FEA devised an additional screening criterion on electric utility revenues that is incorrect because it does not account for regulated gas utility revenues. FEA’s resulting comparable group is invalid.⁹³
- Aglet/TURN/UCAN employed no screening criteria beyond choosing to use the entire set of Value Line electric and gas utilities.⁹⁴ This results in ROE estimates for the average utility across the entire 82 companies, regardless of whether the applicant utilities in this docket are more or less risky than that average utility.⁹⁵ Cross-examination revealed that Aglet/TURN/UCAN performed no study to evaluate the appropriateness of its 82 company sample for evaluating the cost of capital for California utilities,⁹⁶ and that the 82 company sample included seven companies that were below investment grade.⁹⁷

5. Intervenor Errors In Selection of Base Interest Rates

- DRA and FEA utilize current interest rates in their CAPM and HRP analyses and criticize the use of forecasted interest rates. SCE demonstrated that forecast interest rates are better measures of future interest rates than current (spot) interest rates.⁹⁸

⁹² PG&E/Avera, Ex. 24, p. 1-56.

⁹³ SCE/Hunt, Ex. 5, pp. 40-41.

⁹⁴ Aglet/Weil Tr. 626:22-627:8, 634:12-20.

⁹⁵ SCE/Hunt, Ex. 5, p. 41; Aglet/Weil Tr. 627:26-628:3, 629:13-17.

⁹⁶ Aglet/Weil Tr. 630:9-15.

⁹⁷ Aglet/Weil Tr. 629:13-630:1.

⁹⁸ SCE/Hunt, Ex. 5, pp. 7-8.

V.

**SCE’S PROPOSALS REGARDING RECOMMENDED 2008 CAPITAL STRUCTURE
AND COSTS OF LONG-TERM DEBT AND PREFERRED EQUITY ARE
UNCONTESTED AND SHOULD BE ADOPTED**

DRA and FEA accept SCE’s recommendations regarding its 2008 cost of long-term debt and preferred equity, and SCE’s proposed capital structure.⁹⁹ Because no party to this proceeding has contested these issues, the CPUC should adopt them as set forth at Table I-1 above.

VI.

**SDG&E’S PROPOSAL REGARDING ITS AUTHORIZED RETURN ON SAN ONOFRE
GENERATING STATION ASSETS SHOULD BE ADOPTED**

SDG&E’s testimony explains why its current ROE is inadequate to compensate it for the risks associated with its San Onofre Nuclear Generating Station (“SONGS”) investment. Thus, SDG&E requests SCE’s authorized ROE be applied to SDG&E’s investment in SONGS.¹⁰⁰ SCE supports this proposal.

VII.

REQUEST FOR ORAL ARGUMENT

SCE hereby requests the opportunity for oral argument in this proceeding.

⁹⁹ DRA/Woolridge, Ex. 34, pp. 1-17; FEA/Hill, Ex. 44, pp. 5-7. Aglet/TURN/UCAN make no recommendation against SCE’s capital structure and do not discuss SCE’s 2008 costs of long-term debt and preferred equity. Aglet/Weil, Ex. 55, p. 24.

¹⁰⁰ SDG&E/Schneider, Ex. 12, pp. MMS-6-MMS-7.

VIII.

CONCLUSION

For all of the foregoing reasons, as well as others contained in SCE's testimony in this proceeding, the CPUC should grant SCE's request for an authorized return on equity of 11.8% as well as SCE's request to continue its presently authorized capital structure.

Respectfully submitted,

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Appendix A

Proposed Findings of Fact and

Conclusions of Law

Findings of Fact

1. SCE filed its application on May 8, 2007 requesting that the CPUC authorize its ratemaking capital structure and costs of long-term debt, preferred equity, and common equity for 2008.
2. SCE's recommended cost of capital will result in an estimated revenue requirement increase of \$16.9 million.
3. SCE requested an authorized return on common equity of 11.80 percent for 2008.
4. SCE proposed an embedded cost of long-term debt of 6.22 percent and an embedded cost of preferred equity of 6.01 percent for 2008.
5. SCE requested a 2008 ratemaking capital structure consisting of 43.00% long-term debt, 9.00% preferred equity, and 48.00% common equity.
6. No party opposed SCE's requested costs of long-term and preferred equity, or SCE's requested ratemaking capital structure. The evidence in this case fully supports them.
7. While negative effects of the energy crisis are fading, the future structure of California's electric industry remains uncertain.
8. Risks associated direct access, customer bypass, and purchased power are among the key risks that affect SCE's required return on common equity. Many of these risks are unique to California.
9. The United State Supreme Court established the legal standard for setting the fair return on equity in the *Bluefield* and *Hope* cases.
10. *Bluefield* and *Hope* establish four fundamental principles for setting rate of return: (1) the return must be comparable to returns on investments of similar risk; (2) the return should maintain the utility's credit; (3) it must allow the utility to attract capital; and (4) it must be sufficient to ensure confidence in the financial soundness of the utility.
11. Although SCE's credit ratings have improved dramatically since the energy crisis, SCE has not returned to the credit standing it enjoyed before the energy crisis. SCE's recovery from its financial crisis that began in late 2000 is not complete.
12. The CPUC has had a long history of supporting credit ratings of electric and gas utilities at single-A levels.

13. The improved access to funds that results from a single-A rating becomes crucial in times of financial stress. Recent events in financial markets have emphasized this point.
14. SCE's financial models correctly estimate SCE's cost of common equity.
15. SCE's proposed return on equity is well within the range of its financial model results and is below the average of its financial model estimates.
16. The financial models of DRA, Aglet/TURN/UCAN, and FEA contain numerous flaws and they do not correctly estimate SCE's cost of common equity.
17. SCE has demonstrated that the Fama-French model explains observed returns better than the CAPM, which we have relied upon for many years to estimate the cost of common equity.
18. SCE's Fama-French model estimates provide important information to the CPUC for setting SCE's authorized return on equity.
19. The wide range of Fama-French estimates for individual companies does not invalidate SCE's Fama-French estimate of its required return on equity.
20. SCE's debt equivalence has increased since SCE's last cost of capital application.
21. It is unwise to adopt hard and fast rules regarding debt equivalence in cost of capital proceedings. It is reasonable to devise strategies to mitigate debt equivalence on a utility-specific basis, with reference to each utility's financial situation.
22. SDG&E proposes that SCE's authorized return on equity be applied to SDG&E's equity investment in San Onofre Nuclear Generating Station to reflect the risks associated with that investment.

Conclusions of Law

1. SCE's proposed cost of capital and capital structure satisfy the requirements of the *Bluefield* and *Hope* cases.
2. We should adopt SCE's proposed costs of long-term debt, preferred equity, and common equity, and SCE's proposed capital structure.
3. Annual cost of capital applications are the appropriate place to evaluate the financial effects of debt equivalence. Incorporation of debt equivalence in power purchase contract evaluations should be done in the appropriate resource procurement proceeding.
4. We should apply SCE's authorized return on equity to SDG&E's equity investment in San Onofre Nuclear Generating Station.

CERTIFICATE OF SERVICE

I hereby certify that, pursuant to the Commissioner's Rules of Practice and Procedure, I have this day served a true copy of Opening Brief of Southern California Edison Company (U 338-E) on all parties identified in the attached service list(s).

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 **27th day of September, 2007**, at Rosemead, California.

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