COM/GFB/eam **Mailed 3/22/05**

Decision 05-03-023 March 17, 2005

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

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| Application of Southern California Gas Company for Authority to Update its Gas Revenue Requirement and Base Rates. (U 904 G) | Application 02-12-027<br>(Filed December 20, 2002) |
| Application of San Diego Gas & Electric Company for Authority to Update its Gas and Electric Revenue Requirement and Base Rates. (U 902-M) | Application 02-12-028<br>(Filed December 20, 2002) |
| Investigation on the Commission's Own Motion into the Rates, Operations, Practices, Service and Facilities of Southern California Gas Company and San Diego Gas & Electric Company. | Investigation 03-03-016<br>(Filed March 13, 2003) |

(See Appendix B for a list of appearances.)

# DECISION ON SOUTHERN CALIFORNIA GAS COMPANY AND SAN DIEGO GAS & ELECTRIC COMPANY'S PHASE 2 POST-TEST YEAR 2004 RATEMAKING, EARNINGS SHARING, INCENTIVE PROPOSALS, AND 2004 INCENTIVE PROPOSALS

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# DECISION ON SOCALGAS AND SDG&E'S PHASE 2 POST-TEST YEAR 2004 RATEMAKING, EARNINGS SHARING, INCENTIVE PROPOSALS, AND 2004 INCENTIVE PROPOSALS

## 1. Summary

In this decision, we approve post-test year ratemaking mechanisms for Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E) that will remain in effect until their next general rate case for Test Year 2008.

Pursuant to Rule 51 *et seq*. of the Commission's Rules of Practice and Procedure, we adopt, with some minor modifications, a partial settlement agreement supported by SoCalGas, SDG&E, the Office of Ratepayer Advocates (ORA), The Utility Reform Network (TURN), Aglet Consumer Alliance (Aglet), Natural Resources Defense Council (NRDC), and Southern California Generation Coalition (SCGC). The Settlement resolves or otherwise disposes of all issues in Phase II for both SoCalGas and SDG&E, with the exception of matters related to performance incentives and performance indicators. The Settlement is joined by all active parties who made recommendations in the proceeding on the issues resolved by the Settlement Agreement.

We find the Settlement generally reasonable in light of the whole record, consistent with the law, and in the public interest. With respect to the performance incentives and indicators, we adopt modified electric reliability incentives for SDG&E that set reasonable targets and include appropriate rewards and penalties. We adopt a modified safety incentive for both companies that sets reasonable targets and includes appropriate rewards and penalties. Finally, we adopt monitor-only customer satisfaction measurements in addition

to four specific customer satisfaction incentives that set reasonable targets and include appropriate rewards and penalties.

This decision adopts proposals for a SoCalGas service guarantee and continues the existing guarantee for SDG&E. Finally, this decision determines that earnings sharing and all of the incentive mechanisms do not apply to 2004 operations and will be effective from 2005 onwards until modified or terminated by further action of the Commission.

As discussed in Phase I, SoCalGas and SDG&E have the sole obligation to provide a convincing and sufficient showing to meet the burden of proof, and any active participation of other parties can never change that obligation.

## 2. Procedural History

SoCalGas and SDG&E filed individual applications to revise their base rate revenue requirements effective January 1, 2004, and for authority to establish a method to adjust the revenue requirement for 2005 through 2008.[1] The applications did not propose joint rates or a single common revenue requirement. Pursuant to Rules 45 and 55 of the Commission's Rules of Practice and Procedure,[2] a joint motion for consolidation of the separate applications was filed concurrently with SoCalGas' A.02-12-027 and SDG&E's A.02-12-028 on December 20, 2002 respectively, for authority to update their gas and electric revenue requirements and base rates. In addition, both companies sought

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[1] In Resolution ALJ-176-XXXX, the Commission categorized the matters as Ratesetting and preliminarily determined that hearings were required. This was affirmed in the Scoping Memo.

[2] Unless otherwise noted all subsequent references to Commission Rules are to the Commission's Rules of Practice and Procedure.

authority for margin-per-customer (MPC) indexing mechanisms and certain other incentive reward and penalty mechanisms.

By Ruling the applications were consolidated on January 22, 2003. On March 13, 2003 the Commission issued Order Instituting Investigation (I.) 03-03-016 to allow the Commission to hear proposals other than the applicants', and to enable the Commission to be able to enter orders on matters for which the utilities may not be the proponent.

In D.97-07-054 (73 CPUC 2d, 469), the Commission first adopted an incentive ratemaking mechanism for SoCalGas and suspended the requirement to file a general rate case for the life of the mechanism.
(73 CPUC 2d, at 535). D.01-10-030 extended for a year the five-year rate period that was to expire on December 31, 2002. For SDG&E the requirement to file a general rate case for test year 1999 was suspended by D.97-12-041 (77 CPUC 2d, 139) and the company was ordered to file a "cost-of-service showing" as a part of the performance-based ratemaking (PBR) form of incentive ratemaking mechanism in a proceeding ordered by D.94-08-023. This latter decision adopted an "experimental" mechanism as an alternative to the traditional proceeding. SDG&E's last-adopted incentive ratemaking mechanism was to remain in effect through 2002 and was also extended through 2003 by D.01-10-030.

In Decision 97-04-085, the Commission found that the typical requirements to process a general rate case were a burden on the limited resources of staff and parties because of the workload imposed by the
in-progress implementation of electric restructuring.[3] In Phase 1 of this

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[3] Reference to D.97-04-085 within D.97-12-041, (77 CPUC 2d 138, 142.)

proceeding we addressed just and reasonable rates[4] for SoCalGas and SDG&E for Test Year 2004.[5]

Our legal obligation to the residents of California is to ensure that SoCalGas and SDG&E provide adequate service at just and reasonable rates. As we use the term here, adequate[6] service encompasses all aspects of the utilities' service offering, including but not limited to safety, reliability, emergency response, public information services, new customer connections, and customer service. In addition, a utility that provides adequate service must be in compliance with laws, regulations, and public policies that govern public utility facilities and operations. In carrying out this statutory obligation, we assess whether SoCalGas and SDG&E have justified the ratemaking proposals in their applications for post-test year 2004 and for earnings sharing and other incentive mechanisms. These questions were deferred by the May 22, 2003 *Ruling Clarifying the Scoping Memo and Modifying the Schedule.* D.03-12-057 granted interim rate relief to SoCalGas and SDG&E[7] by establishing memorandum

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4 The Commission generally adopts as an annual amount, a revenue requirement, which is necessary to provide safe and reliable service. This amount is then converted to an authorized unit price, or a rate based on a sales forecast. Therefore the term “rates” can be used interchangeably to refer to either the total revenue requirement or to the unit price.

5 Cite decision as adopted.

6 Webster’s Third International Dictionary, (1976) defines adequate as equal in size or scope, or fully sufficient for a specified or implied requirement.

7 April 18, 2003, SoCalGas and SDG&E filed a Motion seeking reconsideration of the April 2, 2003 Scoping Memo. The May 22, 2003 Ruling clarified the Scoping memo as appropriate and D.03-12-057 was necessary to grant the interim relief request.

accounts to track any eventual difference in current rates and any increase or decrease adopted for Test Year 2004.

Active parties in Phase 2 were: the Office of Ratepayer Advocates (ORA), The Utility Reform Network (TURN), Aglet Consumer Alliance (Aglet) and the California Coalition of Utility Employees (CCUE) all of whom sponsored testimony and witnesses of their own and actively cross-examined the SoCalGas and SDG&E witnesses. In addition, the Natural Resources Defense Council (NRDC), and the Southern California Generation Coalition (SCGC) each sponsored testimony and a witness. Evidentiary hearings were held on June 1 through June 10, 2004.

A Comparison Exhibit, Ex. 168, was served on June 18, 2004. This exhibit provided a jointly prepared summary of the parties' litigation positions in Phase 2. Opening Briefs were filed on July 16, 2004[8] and Phase 2 was submitted following the Replies that were filed on August 6, 2004.[9]

### a. Late-Filed Partial Settlement

On July 21, 2004 SoCalGas and SDG&E filed a motion to adopt (Motion to Adopt) a proposed partial settlement[10] jointly with Aglet, NRDC, ORA, SCGC,

8 Opening Briefs were filed by SoCalGas and SDG&E, ORA, TURN, Aglet, SCGC, CCUE, and City of Chula Vista.

9 Reply Briefs were filed by SoCalGas and SDG&E, ORA, TURN and Aglet.

10 Motion of Joint Parties Southern California Gas Company, San Diego Gas & Electric Company, Office of Ratepayer Advocates, The Utility Reform Network, Aglet Consumer Alliance, Natural Resources Defense Council, and Southern California Generation Coalition for Adoption of Settlement Agreement Regarding Specified Issues in Phase 2 for Southern California Gas Company and San Diego Gas & Electric Company.

TURN that would settle certain issues in Phase 2. The motion was filed more than the thirty days after the end of evidentiary hearings allowed by Rule 51.2. The parties to the proposed settlement also filed a motion[11] for leave to late-file the motion (Late-File Motion) to adopt the settlement. Finally, they also filed a *Settlement Agreement Regarding Phase 2 Base Margin Issues* (Base Margin Settlement). We grant the Motion for Leave to File and we will, as discussed, adopt the Base Margin Settlement in this decision. The City of Chula Vista (Chula Vista) filed comments on August 20, 2004. Chula Vista argued in its comments that the Commission should not adopt the Phase 2 settlement because it was premised on, and required the adoption of, the Phase 1 revenue requirements settlement proposed for SDG&E's cost of service, and that the Phase 2 settlement was not in the public interest.[12]

The Base Margin Settlement is a not a complete settlement under Rule 51(c), because it fails to reach a "mutually acceptable outcome to the proceedings" which implies, and we take to mean, all litigated issues. It is however a partial settlement.[13] We are not bound to accept the settlement, but as

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[11] Motion of Joint Parties Southern California Gas Company (U 904-G), San Diego Gas & Electric Company (U 902-M), Office of Ratepayer Advocates, The Utility Reform Network, Aglet Consumer Alliance, Natural Resources Defense Council, and Southern California Generation Coalition for Leave to File Motion for Adoption of Settlement Agreement More Than 30 Days After Close of Hearings.

[12] Comments, pp. 2 ff.

[13] Certain Phase II matters are not resolved by this Settlement Agreement, and are left to be resolved by the Commission on a litigated basis unless resolved by subsequent settlement agreement. The unresolved matters are in the area of performance indicators and performance incentives, which for SDG&E currently include electric reliability, customer service, and employee safety and for SoCalGas currently include customer service and employee safety.

discussed in the decision, we do find the settlement "reasonable in light of the whole record, consistent with the law, and in the public interest"[14] when compared to the careful consideration of the litigated positions of the parties.

The Base Margin Settlement also contained an automatic reopening of negotiations[15] if the proposed settlements for SoCalGas and SDG&E in Phase 1 were not adopted. The Phase 1 decision was adopted by the Commission and therefore this provision is moot.

## 3. Compliance with Rule 51

SoCalGas and SDG&E did not make a timely filing of the partial settlements in Phase II in compliance with Rule 51.2, but our policy interest in considering all reasonable settlements leads us to grant the motion to allow for late filing as discussed above. Generally we will defer to the parties where they are able to demonstrate to us that they knowingly, and with adequate information available to all parties, entered into a settlement where they accept compromises to their litigated positions. This settlement was offered after evidentiary hearings in Phase II of the proceeding and therefore offered no saving in time or effort to the parties or the Commission. It would be perfectly reasonable for the Commission to decide the affected portion of the proceeding on the litigated record, but we will defer to the partial settlements because they

[14] Rule 51.1.(e).

[15] P. 8: "If the Commission does not approve both of the Phase 1 settlements or if the Commission orders substantive modifications to either or both of them, then the Joint Parties agree to continue good faith efforts to negotiate mutually acceptable outcomes for all issues covered by this Settlement Agreement."

are reasonable outcomes within the very wide range of outcomes available to us on the record.

Pursuant to Rule 51.1(e), we reach this conclusion after finding that the Base Margin Settlement is reasonable in light of the whole record, consistent with the law, and in the public interest. The Settlement is supported by all active parties who made recommendations in this phase of the proceeding and therefore complies with the Commission guidelines and relevant precedents for all-party settlements. When opposing parties agree to a settlement, it may be one indication of the reasonableness of the settlement.

The parties assert that the Base Margin Settlement is fully consistent with law and prior Commission decisions. We agree. We are not aware of any policy rule or order that would be contravened by the Settlement.

We find the Settlement is in the public interest. Like many settlements, this is the result of compromises to accommodate and balance the interests of all the parties and the public. We find that the parties have compromised their litigation positions and have arrived at a reasonable result in light of the extensive record.

This Settlement, as with all settlements, is not binding precedent for any future proceeding.

## 4. Overview of the Issues

In the comparison exhibit, the parties identified specific issues for both SoCalGas and SDG&E and provided references into their exhibits in support of their litigation positions. Using that as an outline, in addition to the briefs and the record as a whole, this decision resolves the issues necessary to adopt the Base Margin Settlement for just and reasonable rates and resolves all other issues outside the settlement for the post-test year periods until the next rate cases for SoCalGas and SDG&E.

1. Starting Conditions for Indexing
2. Indexing Method
3. Productivity Factor
4. Sharing Mechanism
5. Adjustment to Cost of Capital
6. Z-Factor – Allowance for Unique Events
7. Term of the Mechanisms
8. Electric Reliability Incentives - SDG&E
9. Safety Incentives
10. Service Quality Indicators
11. 2004 Incentives
12. Nuclear-related Cost Recovery - SDG&E

The first seven issues are included in the Base Margin Settlement submitted by the parties which we discuss below.

### a. Program Features and Descriptions

It is important to note that this decision will try not to adopt and use ratemaking program features,[16] presumptive naming conventions, and common ratemaking language without description or attribution; a specific example is the phrase "performance-based ratemaking" – PBR – which is used by SoCalGas and

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[16] By program features we mean for example that the ratemaking proposals for productivity factors can be separately considered and adopted or rejected without regard to whether we also adopt or reject other program features such as a sharing mechanism all of which are included as parts of "PBR" by SoCalGas and SDG&E.

SDG&E to mean their specific ratemaking program that encompasses a bundle of specific ratemaking features. The term "PBR" may also mean a different ratemaking program with a different mix of features to other parties. In adopting a complete ratemaking package, this decision will consider the various proposals of SoCalGas and SDG&E and intervenors. A hybrid outcome can be reasonable in light of the whole record, and in consideration of a particular combination of features which may more fully serve the public interest.

## 5. Starting Conditions for Indexing

SoCalGas and SDG&E, and the parties, assume that some form of post-test year adjustment to rates will be adopted. The Commission has a clear history of allowing for some form of attrition; i.e., adjusting rates in a simplified fashion between major reviews of rates in a General Rate Case (GRC) to allow for the detrimental effects of inflation that would reduce the utility's opportunity to earn a reasonable rate of return. We agree that this was a reasonable presumption and that attrition is a reasonable approach to ratemaking. We will authorize a mechanism to adjust SoCalGas and SDG&E' rates on an annual basis until their next major GRC. This is consistent with the Base Margin Settlement.

The adopted revenue requirements in Phase 1 for the Test Year 2004 should be the beginning base for setting rates in 2005 and beyond. For SDG&E's electric operations the process starts with the Phase I settlement base margin and then excludes generation, transmission, San Onofre Nuclear Generation Station (SONGS), Catastrophic Event Memorandum Account (CEMA), California Alternative Rate for Energy (CARE), Demand-Side Management (DSM), Pension, Commission-imposed and Post Retirement Benefits Other than Pensions (PBOPs) costs.[17]

For gas operations, SoCalGas and SDG&E propose to start with the Phase I settlement base margin and exclude CEMA, Hazardous Substance Cost Recovery Memo Account (HSCRA), Self-Generation Program Memo Account (SGPMA), CARE, Direct Assistance Program (DAP), DSM, Public Goods and Other Research Design & Development (RD&D), Pension, Commission-imposed and PBOPs costs. ORA agrees with the applicants' proposal.[18]

As defined by SoCalGas and SDG&E and used in Phase 1, the revenue requirement includes miscellaneous revenues. Base Margin is total revenue requirement less miscellaneous revenues. This decision accepts all parties' use of the residual amount, Base Margin, as the appropriate starting point for indexed adjustments to post-test years.

We adopt as a starting point for post-test year indexing of Base Margin the revenue requirement as adopted in Phase 1.

We also adopt the otherwise uncontested adjustments or exclusions to the Base Margin as requested by SoCalGas and SDG&E. These are consistent with prior attrition mechanisms for SoCalGas and SDG&E.

## 6. Indexing Method

### a. Margin, Revenue or Rate Indexing

SoCalGas and SDG&E propose an indexing method that converts the revenue requirements for the whole company to a dollar-amount per customer.

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[17] Comparison Ex. 168, SDG&E p. 1, citing Ex. 152, p. JVL-6 and p. JVL-8.

[18] Comparison Ex. 168, SDG&E p. 1, citing Ex. 334, p. 1-9 and p. 1-11.

For SoCalGas, a Margin Per Customer (MPC) method was adopted in D.97-07-054. Applicants proposed adjustment formulae to calculate the post-test year's base margin:

i. ***$MPC_t = MPC_{t-1}$ (1 + $Inflation_t$ – $X\text{-}Factor_t$)***[19]

ii. ***Total Base $Margin_t$ = ($MPC_t$ * Customer $Forecast_t$) ± any Z-factor Adjustments***

Test Year 2004 is the initial start-point in time and the subsequent post-test years, 2005 forward, are the target years. Thus, in the first formula, "t" is the next forecast year, 2005, and "t-1" is Test Year 2004.[20] For example, for 2005 if we start with Test Year 2004 as the first base year, and we assume that the revenue requirement is $1.0 billion for 5 million customers, it would equal a 2004 MPC of $200 per customer per year.[21] For 2005, using formula (i) above: if inflation is 4%, and the X-factor is 1%, the 2005 MPC would be $206.[22] If we further forecast that there will be 5.2 million customers and an allowable Z-factor of $10 million, the

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[19] Note: "t" = the <u>target</u> or current post-test year, e.g., 2005 is the first post-test year; "t-1" is the previous year; the "X-Factor" is the productivity offset factor for year-t; and "Z-Factors" are defined as events unanticipated when the base rates were adopted but recoverable from customers (both X and Z factors are discussed in detail later in the decision). See Ex. 151, p. JVL-14.

[20] SoCalGas and SDG&E used an unfortunate labeling convention. The formula ratchets forward every year so that 2006 will become the next "t" year, etc., until the next GRC but the labeling in the formula counts backward rather than forward from the test year, thus "t" and "t-1" change each year. Labeling "t" as 2004 and counting forward as "t+1", etc., would have shown the progression in time from the test year.

[21] $1,000,000,000 / 5,000,000 = $200.

[22] $200(1 + 0.04 – 0.01) = $206. (Note that SoCalGas and SDG&E request X-factors of 1.16% for gas and 0.47% for electric. Using 1.0% here is a simplifying illustration of the formula.)

final 2005 Base Margin using formula (ii) would be $1.081 billion, an $81 million increase over the prior year.[23]

The NRDC supported the SoCalGas and SDG&E use of the MPC.[24]

By contrast, a revenue method would annually adjust the base margin by some factor without a separate direct consideration of customer growth. Any change in customers would be subsumed in the total revenue change so that revenues could rise (due to the index employed) even if there was a quantifiable loss of customers. This is effectively ORA's and Aglet's position because they opposed the MPC approach, discussed further, below.

### b. Standard Indices

The most important issue for the indexing method is to correctly identify the most appropriate index to reasonably adjust the post-test year revenue requirements. There are two different options posed by applicants and the intervenors. SoCalGas and SDG&E propose the use of utility-specific indices, a Gas Utility Input Price Index (Gas Index) and Electric Distribution Price Index (Electric Index) that the companies assert are based on the last-adopted indexing plan for SDG&E.[25] In fact, the details become complicated for there are separate index components for labor and non-labor and three parts to the capital expenditures component, as well as a weighing of the individual components for the overall Gas Index. The Electric Index is even more complicated with five separate non-labor components, a labor component, and a similar three-part

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23 ($206 * 5.2 million) + $10 million = $1.071 billion + 0.010 billion = $1.081 billion.

24 Ex. 950, p. 9.

25 See Ex. 155, p. DTB-3, ff, and Ex 156, p. DTB-3, ff.

capital expenditure component. Both companies propose that the final weighting should be based on the Phase 1 decision's adopted labor, non-labor and capital expenditures. This would ensure that the three cost components are escalated at an appropriate rate. SDG&E has a further series of indices for SONGS costs separate from electric distribution. SoCalGas and SDG&E demonstrated that these indices are constructed using costs that are appropriate to consider when adjusting rates for gas and electric utility operations.

ORA, TURN and Aglet (with some differences among themselves) generally oppose the Gas Index and Electric Index (collectively, Indices) and propose that the post-test year adjustment should be based on the Consumers Price Index (CPI).[26]

ORA proposes a "straight" CPI adjustment without allowing for productivity or change in number of customers, which would result in applying a relatively straightforward formula:

$$R_{t.} = R_{t-1} * (CPI \pm Z\text{-}factor)$$[27]

TURN proposes no indexing if the next test year is 2006, or a CPI method without indexing an adjustment for miscellaneous revenues.[28]

Aglet argues strongly against both the Gas and Electric Indices and contends that the CPI is preferable. Aglet acknowledges ORA's simplicity theme and makes five other points: first, consumers understand the CPI; it is easily

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[26] Ex. 333, pp. 1-4 to 1-6; Ex. 561, pp. 2-4; and Ex. 800, pp. 4-9.

[27] Note: $R_{t.}$ = the Base margin in the current or target year, and $R_{t-1}$ = the prior year. See Ex., p. 1-4.

[28] Ex. 561, pp. 2-4.

verified; it is not revised; it is less volatile than the Gas and Electric Indices; and, finally, that the CPI shows no bias.

### c. Discussion

The Base Margin Settlement would ask the Commission to adopt the CPI instead of the Gas and Electric Indices, but it also introduces a limitation. The parties would include a floor and ceiling in the index by setting maximum and minimum adjustments[29] that change annually, differ between SoCalGas and SDG&E, and treat the SoCalGas gas department and the SDG&E gas department differently. We recognize that in order to reach a settlement, parties sometimes compromise a litigated position. We find that the parties have reached a reasonable compromise in light of the record.

Under reasonably foreseeable levels of inflation, the Settlement Agreement will reproduce a level of authorized revenue for each of SoCalGas and SDG&E in each of the three post-test years that is between the level that would have been produced given Applicants' litigation position and the lowest levels produced by the position of any interested party. We find this feature, limits on the adjustment, to be a reasonable outcome in the best interests of the ratepayers. Our objective is to ensure that SoCalGas and SDG&E have adequate revenues to provide safe and reliable service and, in return, that ratepayers can expect those revenues to be used for the safe and reliable operations of SoCalGas and SDG&E.

There seemed to be some confusion about the meaning of a "revision" to an index and when or if a revision should be used. We must understand whether or not indices are revised from forecast to actual values for calculating a

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[29] Base Margin Settlement, p. 10.

specific year's rate impacts, and then how subsequent years' rate impacts are calculated using an appropriate index value. For example, 2005 is the first post-test year for SoCalGas and SDG&E. It is clear from the record that to adjust the test year 2004 to set new rates[30] for 2005, applicants propose that we use the most recent 2005 forecast indices available at the time we adopt rates for 2005. Applicants do not propose that 2005 rates would be 'trued-up" at the end of 2005 by substituting actual 2005 indices for the 2005 forecast. Once adopted, 2005 rates should be final.

When the forecast is made for the second post-test year – 2006 – the issue to clarify is whether the new base for 2006 begins with the authorized 2005 values as calculated on forecast indices, or whether the base is the test year (2004) first adjusted by the actual 2005 indices and then adjusted by the 2006 forecast indices. Based on the transcript regarding the Market Index Capital Adjustment Mechanism (MICAM), SoCalGas and SDG&E propose the latter method, i.e., 2006 would be calculated by using actual 2005 indices instead of the 2005 forecast indices applied to the 2004 starting point. The 2005 starting point for calculating and adopting 2006 rates is therefore different than the authorized 2005 base margin.

If the base year is not adjusted to the actual indices' values before calculating the next period's rates, we would subject both the ratepayers and the utilities to a compounding of any forecast error for the base year. Assume that inflation for 2005 is forecast to be 4% but proves to be either 2% or 6%. Fairness dictates that the actual inflation rate should be applied to recalculate the correct

[30] Transcript, p. 2696, lines 1 – 15.

2005 base margin before forecasting 2006 base margin. Over time, we drive retail rates away from the reality of SoCalGas and SDG&E's actual costs unless we correct the index to actual values before forecasting the next year's base margin. Therefore the only revision we will adopt is to recalibrate each base year to actual index values in order to calculate the next year's base margin. The Base Margin Settlement builds in a permanent forecasting error by explicitly not adjusting the index to actual for subsequent years. We do not adopt this approach because rates are divorced from costs and there is no stated or apparent tradeoff in benefits.

There are several differences from the litigated positions and the final positions in the settlement: the proposal of minimum floors and maximum ceilings to the base margin adjustment, the use of the CPI, and not adjusting the base, $MPC_{t-1}$ when setting MPC.

#### d. Conclusion

We recognize that settlements represent a compromise between parties' litigated positions rather than an agreement to any party's specific position. This Settlement is supported by parties representing all various affected interests in this proceeding and represents a fair and reasonable compromise of the issues. We find that the settlements' use of the CPI are reasonable indicators of inflation for SoCalGas and SDG&E for the post-test year period until the next GRC.

### 7. Productivity Factor

An X-factor reduction to the post-test year rate adjustment has been included in the past ratemaking for SoCalGas and SDG&E as an incentive for management to improve corporate performance over time. The companies describe it as a "mandated" offset to inflation and customer growth.[31] An additional "stretch" factor in prior ratesetting has provided a boost to the incentive by pushing SoCalGas and SDG&E to outperform the industry's X-factor by some increment.

### a. X-Factor

Ex. 153 and 154 demonstrate the survey results that derive a Total Factor Productivity index for the gas and electric distribution companies studied, and the 1992-2002 average annual growth rates, as determined by these studies, are 1.16% for gas and 0.47% for electric distribution operations.[32] An X-factor reduces the increase otherwise made to rates to reflect changes in productivity.

No party opposes the econometric derivation of the 1.16% and 0.47% gas and electric X-factors, although they did not always explicitly support their inclusion. ORA replicated the survey results and has determined that the productivity rates are reasonable if the Commission adopts the MPC method proposed by SoCalGas and SDG&E.[33] In order to adopt the settlements, we understand the necessity to forego some of the litigated positions in order to reach a reasonable compromise. Although we do not adopt an X-factor at this time, we will order SoCalGas and SDG&E to include the necessary studies for an X-factor as part of the next GRC.

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[31] Ex. 151, p. JVL-22, line 1.

[32] See Ex. 153, Table 2 *X factor Calibration for Southern California Gas Company - Productivity Results: Gas Distribution*, and Ex. 154, Table 2, *X factor Calibration for San Diego Gas & Electric Company - Productivity Results: Power Distribution*.

[33] Ex. 333, p. 3-1.

### b. Stretch Factor

From 1998 through 2002 SoCalGas had stretch factors of 0.6% increasing to 1.0% in 2002 and 2003[34] and SDG&E had stretch factors of 0.55% adopted in D.99-05-030.[35] In this proceeding, SoCalGas and SDG&E oppose inclusion of any stretch factors. Essentially SoCalGas and SDG&E argue that after the prior years' obligations to achieve the stretch factors they have captured all efficiencies to meet the requirement. The companies state that after the merger to form the holding company they were required to pass through the merger's savings to customers. Merger savings are avoided costs that were already captured in the development of the test year. These savings are not relevant to the improvement of efficiency of the ongoing operations of the companies.

Inherent in the use of any X-factor is the collective effect of the differences in the population of the index and the target(s) SoCalGas and SDG&E. A stretch factor removes some element of the worse-performers' impact on the index; otherwise we target average performance rather than best performance. If the productivity study had removed the worse performers, or weighted the better performers, or could more specifically identify the companies most like SoCalGas and SDG&E, then the study results alone could be a reasonable target. It was clear on the record that the studies did not exclude the worst or find the best matches; they relied on the largest population with sufficient data. TURN describes the SoCalGas and SDG&E proposal as one that would "reward

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[34] Ex. 151, p. JVL-22, lines 8 & 9.

[35] Ex. 152, p. JVL-17, line 8.

mediocrity by setting productivity on an average basis with no stretch factor and to ignore the actual performance of the utilities that are being regulated."[36]

### c. Revenue Balancing

SoCalGas and SDG&E request "balancing", i.e., balancing account treatment, to ensure there is no unintended over- or undercollection of the adopted base margin revenues. The revenue is subject to risk caused primarily by differences between the forecast and actual sales/throughput volumes in kilowatt-hours or therms. Without a balancing account process overcollections are a risk to ratepayers and undercollections are a risk to the applicants. SDG&E argues balancing would satisfy the requirements of § 739.10[37] for the electric department, and would be consistent with D. 97-07-054, which protected SoCalGas from sales/throughput risk. SDG&E asks that this balancing process be extended to its gas department, notwithstanding that the Commission declined this protection in D. 99-05-030. No one opposed these requests. As noted in this decision, there are many similarities in the operations of SoCalGas and SDG&E, especially in the development of these rate cases and the daily management of the companies that would support aligning the revenue balancing protection for both gas departments and the electric department. We will continue revenue balancing for SoCalGas' gas operations and extend the process to both SDG&E's electric and gas operations.

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[36] Ex. 561, p. 13.

[37] "The commission shall ensure that errors in estimates of demand elasticity or sales do not result in material over or undercollections of the electrical corporations." Pub. Util. Code, §739.10.

### d. Conclusion

As discussed above, we do not adopt the proposed X-factors for SoCalGas and SDG&E, and for SDG&E nor will we adopt a stretch factor for SoCalGas and SDG&E. We recognize that the adoption of a minimum floor and maximum ceiling displace the use of a productivity factor and a stretch factor and find it to be a reasonable compromise of their litigated positions.

## 8. Sharing Mechanism

SoCalGas and SDG&E propose a symmetrical sharing mechanism whereby the companies and the customers would share either the excess earnings or losses on an annual basis. This is a change to the mechanism last adopted for SoCalGas in D.97-07-054[38] and SDG&E also requested the identical mechanism.[39]

In the companies' proposal, they get significant relief at the first recoverable levels of losses; 75% of anything between 25 and 50 points below authorized is reimbursed by ratepayers, but ratepayers also receive 75% of the first band of higher earnings. Based on the proposed approach to be reimbursed by ratepayers, the applicants appear to be highly adverse to losses. As we have demonstrated, it is difficult to determine that the deferral of expenses that would avert the losses otherwise absorbed by shareholders is imprudent.

SoCalGas and SDG&E argue that sharing was a product of the adoption of PBR packages. They argue if the ratemaking mechanisms proposed by Aglet,

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[38] Ex. 151, pp. JVL-34 ff.

[39] Ex. 152, pp. JVL-34 ff. (Ex. 151 and 152 are sequential exhibits sponsored by the same witness that differ only to the particular history or circumstances of the two companies.)

ORA and TURN are adopted, there would be no sharing. SoCalGas and SDG&E consider the intervenors' proposals to be similar to the proposals made for PG&E and Edison in the recent GRCs.[40]

No party challenges the concept of a sharing mechanism; ORA and TURN propose different mechanisms. ORA proposed that earnings sharing should apply only to earnings in excess of authorized rate of return (ROR). It proposed to apply to SoCalGas and SDG&E the sharing bands currently effective for SDG&E, except that shareholder shares would be capped at 75% for all bands above 175 basis points above authorized ROR.[41]

TURN recommended an earnings sharing mechanism of 50/50 ratepayer/shareholder for earned ROR in excess of 100 basis points above authorized ROR. If an indexing formula like that proposed by SoCalGas and SDG&E were adopted, TURN recommended application to SoCalGas and SDG&E of the earnings sharing mechanism currently applicable to SDG&E.[42]

#### a. Sharing in the Base Margin Settlement

The Base Margin Settlement proposal would adopt sharing above the authorized rate of return for up to 300 basis points (3%). There would be no sharing in the event of earned ROR falling below authorized ROR for either of the two utilities individually. After a 300 point spread, SoCalGas and SDG&E would trigger an automatic suspension and "a formal review by the Commission

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[40] Sempra Opening Litigation Brief, p. 57.

[41] Ex. 333, pp 2-2 to 2-7 as cited in the Comparison Exhibit.

[42] Ex. 561, pp. 14 and 15 as cited in the Comparison Exhibit.

of that utility's PBR mechanism." At 175 points, the utility has the "option" to suspend the mechanism and file an application.[43]

However, the utility can always file an application (without regard to the outcome) and we believe this approach is one-sided; for example, ORA could not – within the limits of the settlement – obtain an automatic review if, after 2 years, both companies earned 175 points above the authorized return. With the sole modification of clarifying that ORA (or any other party) may also petition the Commission for an automatic formal review, we will adopt the sharing mechanism as otherwise proposed in the partial settlements.

| Base Margin Settlement Proposal | | | |
|---|---|---|---|
| **Bands** | **Sharing Band (Basis Points) Above Authorized Rate of Return** | **Company** | **Customer** |
| Inner | 0-50 | 100% | 0% |
| 1 | 51-100 | 25% | 75% |
| 2 | 101-125 | 35% | 65% |
| 3 | 126-150 | 45% | 55% |
| 4 | 151-175 | 55% | 45% |
| 5 | 176-200 | 65% | 35% |
| 6 | 201-300 | 75% | 25% |
| Outer | More than 300 | Suspend | |

### b. Sharing in 2004

One of the Phase 2 issues is whether the incentives and sharing apply to 2004. The proposed Base Margin Settlement said no.[44] The parties in their

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[43] Base Margin Settlement p. 12. We note that this approach assumes the presumption that the adopted rate setting mechanisms would be the SoCalGas and SDG&E "PBR" bundle of mechanisms, as settled.

litigation positions focused on the nature of the mechanism and did not address 2004 explicitly. Although the adopted revenue requirement is lawful,[45] the legality of a 2004 sharing mechanism has not been addressed.

We find that sharing is not reasonable for 2004. SoCalGas and SDG&E asked for 2004 Sharing in their applications and argued at the time it was a continuation of the existing PBRs. In the opening brief, they expressed a concern that adopting only upside sharing would be retroactive ratemaking and that it would be unlawful to require them to share 2004 earnings based on a decision adopted after the start of the test year.[46] We need not resolve the first issue because we adopt both upside and downside sharing. We also need not find whether it would be retroactive to adopt 2004 sharing after the start of the test year. We earlier found the Phase 1 adoption of the final test year revenue requirement was not retroactive ratemaking when it was made subject to refund in the interim Phase 1 decision, D.03-12-057. Here, we determine that applying sharing to 2004 would not be reasonable because of the uncertainty that was

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44 Base Margin Settlement, p. 12.

45 D.03-12-057 granted interim rate relief to SoCalGas and SDG&E by establishing memorandum accounts to track any eventual difference in current rates and any increase or decrease adopted for Test Year 2004.

46 "SoCalGas and SDG&E have not agreed to be subject to upside earnings sharing for 2004, which would be required under the holding of the Pacific Telephone decision cited above. Given that the Commission did not create a balancing account for costs or otherwise provide notice of the application of an earnings sharing mechanism applicable to 2004 before the start of that year, it would clearly constitute unlawful retroactive ratemaking for a decision in Phase 2 to require SoCalGas and SDG&E to refund any above-authorized returns they might earn in 2004." Sempra Opening Litigation Brief, pp. 57-58.

inherent in adopting a final revenue requirement significantly after the start of the test year. We are not comfortable with the reverse incentives that could result from this delay. If actual expenses in 2004 are higher than adopted, SoCalGas or SDG&E could incur a loss. But if the companies were exceptionally cautious, perhaps avoiding necessary expenditures because of the uncertainty, there could be a windfall gain. Sharing up to 300 basis points may not exactly offset the actual differences between 2004 expenditures and the adopted revenue requirement, nor would it be reasonable to share a chance gain or loss by SoCalGas and SDG&E when they were not in a position to exercise management discretion that would affect whether 2004 earnings were above or below the authorized rate of return. In this case the final decision on 2004 revenue requirements was adopted extremely late in the year. The practical fact is that SoCalGas and SDG&E could not react and manage to a final revenue requirement. We will not authorize a sharing mechanism for 2004.

## 9. Cost of Capital

SoCalGas and SDG&E propose the continuation, with certain modifications, of the MICAM, which is described[47] as:

> "a mechanism composed of three distinct components: a trigger that indicates when a change is necessary because market conditions for the cost of capital have changed significantly, a margin adjustment to reflect the change in the cost of capital, and a change to the authorized rate of return used in the earnings sharing calculation to reflect the change in the cost of capital."

[47] Ex. 155, p. DTB-10 and Ex. 156, p. DTB-13, with identical language.

In other words, the MICAM is a process to adjust rates in a predetermined fashion if or when certain conditions are met. By definition, the MICAM does not reflect the actual cost of capital for SoCalGas and SDG&E.

### a. Traditional Cost of Capital

In a traditional ratesetting environment, the cost of capital would be determined by calculating and weighting the actual reasonable costs of existing long-term debt and preferred stock, the forecast cost of new securities expected to be issued in the forecast period, and a reasonable return on expected level equity (common stock and retained earnings).

| Illustration of Traditional Cost of Capital | | | | |
|---|---|---|---|---|
| | Amount | Cost | Weight | Weighted Cost |
| Debt | $500,000,000 | 6% | 50% | 3.0% |
| Preferred | 100,000,000 | 8% | 10% | 0.8% |
| Equity | 400,000,000 | 12% | 40% | 4.8% |
| **Total** | $1,000,000,000 | | 100% | 8.6% |

In the traditional cost of capital proceeding, as maturing debt is retired and refinanced, the embedded cost changes to reflect the impacts of the retirement and the forecast for new debt. The only other discretionary element is the Commission's judgment to adopt a fair and reasonable return on equity (which is also required to start the MICAM). Regardless of how current capital market prices vary, the debt and preferred cost components change in the traditional mechanism only because of new issues or retirements. If the above illustration were the applicants' forecast of capital structure and costs, then the adopted rate of return would be the weighted cost of 8.6% and the authorized return on equity would be 12%.

The traditional cost of capital mechanism recalibrates annually to reflect actual reasonable costs plus any forecast changes, and the Commission authorizes a reasonable return on equity. Both ratepayers and utilities are protected from long-term harm if actual costs are out of line with the forecast because the rate of return is adjusted annually.

#### b. Applicants' MICAM

As proposed by SoCalGas and SDG&E, the MICAM is a mechanism that, subject to triggering events, adjusts the cost of capital in post-test year rates. They further assert that this is essentially the same mechanism as last adopted for SDG&E. None of the trigger features described above are directly attributable to specific changes in the operating conditions, financial condition or operating risks of SoCalGas and SDG&E. The cost of outstanding debt issued by SoCalGas and SDG&E does not change regardless of how the market rates change for new debt.

SoCalGas and SDG&E argue that the capital expenditure-related cost index within the proposed Gas and Electric Indices "implicitly adjust for changes in the cost of capital through the rental price of capital" feature of the index. The Base Margin Settlement does not use these indices.

Aglet opposes the use of the MICAM mechanism.[48] First, Aglet argues that the MICAM relies on the published Moody's Aa Utility Bond rates[49] that may not reflect the risks actually experienced by SoCalGas and SDG&E.[50] SoCalGas had previously used 30-year U.S. Treasury bonds in its MICAM that were traditionally viewed as a long-term risk-free benchmark. The Treasury no longer

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[48] See Ex. 800, pp. 11-13.

[49] Ex. 155, p. DTB-10 and Ex. 156, p. DTB-13.

[50] Ex. 800, p. 12.

issues 30-year bonds but does issue 10-year treasury notes, which Aglet states are now viewed as the financial market standard benchmark for risk-free investments. Aglet argues for a return to the conventional cost of capital applications for SoCalGas and SDG&E but, as an alternate, would benchmark a MICAM to the 10-year notes instead of Aa utility bonds. According to Aglet, there is no reason to link the return of SoCalGas and SDG&E to the "investor perceptions of risks" indicated by the Aa bonds and the Commission should allow ORA and other intervenors to address the facts and present evidence on the costs of capital and diversification of risks as actually faced by the applicants.

SDG&E did participate in two recent cost of capital proceedings in 1999 and 2002 when the current MICAMs were supposed to be operative.[51] The Base Margin Settlement continues the use of the MICAM mechanism. We will adopt the proposed MICAM for SoCalGas and SDG&E as described in the settlement. We will order SoCalGas and SDG&E to include in the next GRC a detailed analysis comparing the actual results of the MICAM to an imputed cost of capital based on the adopted cost of capital for Pacific Gas & Electric Company and Southern California Edison Company to illustrate the differences between the MICAM and more traditional cost of capital ratemaking.

## 10. Z-Factor

In post-test year ratemaking the Commission has recognized the need to protect both the utility and the customers and allow a way to adjust for unexpected and uncontrollable events. SoCalGas and SDG&E propose that the

[51] Transcript, p. 2,695.

previously adopted mechanism,[52] a Z-factor, should be continued. The nine criteria[53] for a Z-factor's occurrence are:

1. The event must be exogenous to the utility;
2. The event must occur after implementation of rates;
3. The costs are beyond the control of the utility management;
4. The costs are a normal part of doing business;
5. The costs must have a disproportionate impact on the utility;
6. The costs and event are not reflected in the rate update mechanism;
7. The costs must have a major impact on overall costs;
8. The cost impact must be measurable; and
9. The utility must incur the cost reasonably.

No one opposes the continued use of a Z-factor. Aglet has a different post-test year ratemaking proposal, but alternatively supports ORA who would maintain a $5 million "deductible" for all events before applying a Z-factor. SoCalGas and SDG&E would exclude the deducible for government mandates. ORA cites the SoCalGas example of a change in carbon monoxide inspection services.[54] We need not tinker with the

[52] Ex. 155 cites to D.96-09-092 in A. 93-12-029 filed by Southern California Edison. It in turn cited and did not modify the Z-factors as adopted in D.94-06-011 and originally recognized in D.89-10-031. See Findings of Facts 24 and 25, D.96-09-092 (68 CPUC 2d, 275, 311).

[53] The restatement here is a further paraphrasing of SoCalGas and SDG&E's paraphrasing of prior decisions. The intention here is to avoid the specific jargon of PBR proposals by the applicants. The underlying analysis and the Commission's prior adoption of these criteria are found in the appropriate portions of D.89-10-031, D.94-06-011, and D.96-09-092.

[54] Ex. 333, p. 2-15, lines 1-13.

Z-factor: SoCalGas and SDG&E are as randomly likely to have mandates change in their favor, as they are to incur unexpected increases. We will apply the deductible to all Z-factors.

SoCalGas and SDG&E propose, "providing sufficient detail for the Commission to conduct an examination"[55] of the event. Instead, we remind SoCalGas and SDG&E, that the ninth criterion, the reasonableness of the costs as incurred by the applicants,[56] clearly and squarely puts the full burden of proof on SoCalGas and SDG&E to show that they competently responded to the event in a reasonable and efficient manner before they can recover any costs in a Z-factor Memorandum Account.[57] There is no presumption of recovery of an identified event.

### 11. Term

We resolved the term of post-test year ratemaking in Phase 1, when we directed SoCalGas and SDG&E to file a Notice of Intent for an application with a Test Year 2008. SoCalGas and SDG&E propose that the term should be through 2008 with a Test Year 2009.[58] ORA agrees with a possible extension beyond 2008.[59] TURN proposes a Test Year 2006 with no adjustment in 2005.[60] Aglet

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[55] Ex. 155 and 156 at p. 19 and 20, respectively.

[56] Or on an intervenor for any proposed rate decreasing Z-factor event noticed by ORA or others.

[57] See for example, D.02-08-064, dated August 22, 2002, mimeo, pp. 5-8, for a discussion on the standards for a reasonableness review.

[58] Ex. 151, JVL-2.

[59] Ex. 333, p. 1-6.

proposes a 2008 Test Year with the adopted post-year ratemaking running through 2007.[61]

Nothing in this phase of the proceeding has assuaged our concerns that the underlying base margin in Phase 1 for Test Year 2004 is not sufficiently robust to be an appropriate base for five years' of rates (2004 through 2008).  Nothing in the post-test year ratemaking process can improve on the 2004 foundation to make it a reasonable component of rates for five years.  The adjustments we make in the post-test years are at best broad-stroke approximations designed to prevent a major disconnect to the actual cost of service and the operating conditions faced by SoCalGas and SDG&E between major rate cases.

### 12. Electric Reliability Incentives for SDG&E

Decision 04-01-007 dated January 8, 2004 granted a petition to modify D.01-10-030[62] to extend the existing 2003 performance indicators for 2004 but specifically deferred to this proceeding the question of any financial incentives for 2004.  This decision addresses whether or not any incentives should apply to 2004.

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[60] Ex. 561, p.2.

[61] Ex. 800, p.2.

[62] Application 98-01-014 of San Diego Gas & Electric Company ("SDG&E") for Authority to Implement a Distribution Performance-Based Ratemaking Mechanism, Application 95-06-002 of Southern California Gas Company To Adopt PBR for Base Rates to be Effective January 1, 1997, and
Application 96-10-038 of Pacific Enterprises, Enova Corporation, Mineral Energy Company, B Mineral Energy Sub and G Mineral Energy Sub for Approval of a Plan of Merger of Pacific Enterprises and Enova Corporation with and into B Energy Sub and G Energy Sub, the Wholly-Owned Subsidiaries of a Newly Created Holding Company, Mineral Energy Company.

*Footnote continued on next page*

The parties identify eleven issues for electric reliability. We must determine whether or not to adopt the various mechanisms, and the right measurement targets, as performance incentives for SDG&E's electric distribution operations. The only reason to adopt the incentives would be to achieve better service over time than would occur without the incentives. We will resolve the following issues:

1. System Average Interruption Duration Index (SAIDI) target;
2. System Average Interruption Frequency Index (SAIFI) target;
3. Momentary Average Interruption Frequency Index (MAIFI) target;
4. Updating targets;
5. Maximum reliability reward or penalty;
6. Adoption of a Reliability Policy;
7. New indicators;
8. Cost reporting for electric reliability projects;
9. Adoption of a Reliability Standard Practice;
10. Benchmarking; and
11. Additions to electric reliability reporting requirements.

The intervenors propose higher standards for the previously existing incentives, SAIDI, SAIFI and MAFI (collectively, Electric Reliability Incentives) than requested by SDG&E, and Aglet opposes all reward and penalty mechanisms. In addition to the target, parties disagree on whether to have a deadband (a range of no penalty/reward) and how large a liveband (upper and lower limit to penalty/reward) to have. We also assume that the parties to the partial settlements in Phase 1 consistently litigated Phase 2 on the assumption of the Commission adopting the settlements. To the extent necessary, this decision will consider the outcome adopted in Phase 1 when adopting performance incentives. For example, the rate of cable outages was a significant factual dispute – a fundamental premise – in SDG&E's rebuttal exhibit 165. As a result, the adopted forecasts for capital expenditures in Phase 1 related to cable maintenance and replacement, and other reliability-related expenditures, has a direct bearing on identifying the appropriate targets for the Electric Reliability Incentives.[63] No party proposes to separate the measurements for underground cable and non-cable performance.

Some of the issues will be discussed separately but they are inter-related; for example, whether we update SAIDI and others annually, or only once for the test year and post-test year period, may well affect the appropriate target for 2004 and 2005.

**a. System Average Interruption Duration Index (SAIDI)**

Parties propose an array of SAIDI goals and Aglet opposes the adoption of any incentive mechanism.

[63] See Ex. 165, pp. CW-7 through CW-11, amongst other instances.

| SAIDI Proposals | SDG&E | ORA | CCUE | TURN | Aglet |
|---|---|---|---|---|---|
| Target | 71 | 64 | 69 | 63 | None |
| Deadband | none | 7.7 | none | None | |
| Liveband | +/- 15 | +/- 15 | +/- 15 | None | |
| Reward/Penalty | $250,000 | $125,000 | $250,000 | None | |
| | | No Reward | | | |
| Range - Millions | +/- $3.75 | -$1.875 | +/- $3.75 | | |

### b. System Average Interruption Frequency Index (SAIFI)

| SAIFI Proposals | SDG&E | ORA | CCUE | TURN | Aglet |
|---|---|---|---|---|---|
| Target | 0.80 | 0.68 | 0.68 | 0.66 | none |
| Deadband | none | 0.07 | none | none | |
| Liveband | +/- 0.15 | +/- 0.15 | +/- 0.15 | none | |
| Reward/Penalty | $250,000 | $125,000 | $250,000 | none | |
| | | No Reward | | | |
| Range – Millions | +/- $3.75 | -$1.875 | +/- $3.75 | | |

### c. Momentary Average Interruption Frequency Index (MAIFI)

| MAIFI Proposals | SDG&E | ORA | CCUE | TURN | Aglet |
|---|---|---|---|---|---|
| Target | 0.97 | 0.77 | 0.77 | 0.77 | none |
| Deadband | none | 0.07 | none | none | |
| Liveband | +/- 0.30 | +/- 0.30 | +/- 0.15 | none | |
| Reward/Penalty | $50,000 | $25,000 | $50,000 | none | |
| | | No Reward | | | |
| Range - Millions | +/- $1.0 | -$0.5 | +/- $1.0 | | |

### d. Deadbands

Only ORA proposes a deadband for the three Electric Reliability Incentives. A deadband is a range around the target where no incentive penalty or reward is assessed. It is attractive because the targets are only a reasonable estimate – it is highly unlikely that SDG&E could directly influence the precise outcome and so it could see a penalty or reward as a matter of chance. The ORA deadband narrows the range of penalties or rewards because ORA did not widen the overall liveband.  One benefit of a deadband is that minor random variances in performance do not trigger an undeserved penalty or reward – undeserved in the sense that SDG&E's actions were not the likely cause of the variance from the target.  ORA's deadbands are too large, in that there is no evidence in the record that would support the proposed range as likely to encompass the random influences compared to SDG&E's deliberate actions that affect the final result. Therefore we will adopt a deadband, but smaller than proposed by ORA, to eliminate the more random effect on penalties or rewards.  ORA also structured its deadband for a penalty-only recommendation and did not expect that it would be exceeded on a regular basis.  A narrower deadband will be more likely to invoke penalties or rewards and act as an incentive to SoGalGas and SDG&E.

#### e.  Livebands

ORA and CCUE agree with SDG&E on two of the liveband sizes, CCUE would halve the MAIFI liveband.  The justification for a liveband is to put an outer limit on both a penalty or a reward in the event of extraordinary results, because, again, SDG&E has little direct control on specific outages.  The purpose of an incentive is to ensure proper attention, including expenditures on maintenance and capital improvements, is paid to electric reliability.  We will adopt the liveband ranges as proposed:

+/-15 minutes for SAIDI,

+/-0.15 for SAIFI, and

+/-0.30 for MAIFI.

We agree with applicants that these livebands are large enough to provide an incentive without providing excessive rewards or penalties.

### f. Reward and Penalty Targets

SDG&E proposes that the SAIDI, for example, would accrue a reward/penalty of $250,000 for every one-minute increment from the proposed target, up to a maximum +/- $3.750 million. With a proposed target of 71 minutes, the reward/penalty range would be from 56 minutes (good) to 86 minutes (bad). SDG&E proposes the ten most recent years' annual average of 71 minutes, rounded from 71.19.[64] The problem with a ten-year average, especially when there have been incentives in place, is that any progress achieved over that time is diluted by earlier years' results. A fundamental principle underlying the utilization of incentives is that they lead to improvements, otherwise we would not impose the cost of the incentives on consumers.

ORA proposes using the most recent five-year average and a "rolling" average adjusted each year. The mechanical details would be dealt with in an advice letter.[65] We do not expect this rate cycle to be a long one, with the next rate case for both SoCalGas and SDG&E to have a Test Year 2008. We will not require an annual target adjustment, but we will use the most current five-year average as a part of the correct base for setting the targets.

ORA also proposes a penalty-only approach, and we find this to be inappropriate. The concept of an incentive mechanism, based only on a penalty, is not an incentive. ORA provides its perspective on "value of service"[66] that essentially concludes commercial customers face significant financial hardships

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[64] Ex. 159, p. CW-13, and ORA Opening Litigation Brief, pp. 24-25.

[65] Ex. 333, pp. 6-19 and 6-20.

[66] Ex. 333, pp. 6-25 to 6-27.

from any outage and place a high value on avoiding outages. ORA argues that a "penalty-only structure will protect ratepayers from paying twice for the same performance, and protect the company from paying for outages beyond its control."[67] However, a reward or penalty cannot compensate or penalize SDG&E for the full cost expended or avoided for achieving the goals. The payments are rewards or penalties for a level of special performance, *not* the sole reimbursement for improving service reliability. In fact, if SDG&E were to consistently fail to spend the revenues provided in rates on the reliability projects adopted in the test year forecast, and implicit in the post-test years, then we can pursue other sanctions for its failure to meet its obligation to serve customers safely and reliably.

### g. Reliability Policy

ORA proposes that the "Commission should adopt a policy to consistently value reliability which applies both to the determination of cost of service / revenue requirement and to penalties or rewards associated with reliability."[68] ORA does not make a specific policy proposal, although it does argue the allocation of the incentives is skewed between residential and commercial ratepayers. ORA concludes from its analysis that the incentive mechanism should be a penalty-only mechanism and the penalty amount should be half the size proposed by SDG&E.[69] If we accept ORA's analysis that

[67] ORA Opening brief, p. 23.

[68] Ex. 333, p. 6-6, lines 7-10.

[69] "Given the difficulty of determining any value that would be equitable to all classes, ORA recommends that the Commission adopt the revealed preference penalties of

*Footnote continued on next page*

commercial and industrial customers receive 97% of the benefit of a reduction in service interruptions, but only 46% of the costs, then we should consider a reallocation of the costs rather than a reduction in the penalty and an elimination of the reward.

Aglet argues that SDG&E has not met its burden of proof to show that the electric reliability incentives are necessary or reasonable: "Despite approximately ten years of utility experience with PBR mechanisms in California, the applicants present no study on the causality between performance and financial incentives."[70] Aglet states[71] that SDG&E's proposed settlement in Phase 1 would allow the utility to meet its goal to maintain current levels of reliability; incentives are not necessary for safe and reliable service, and SDG&E has never studied the effectiveness of existing incentives. Aglet also argues that the value of service studies are out of date; that Phase 1 was SDG&E's opportunity to request ratepayer funding of cost-effective service quality improvements; and that management have salary incentives that ensure they are attentive to reliability.

Aglet also argues that SDG&E failed to prove that reliability is affected by the incentives. In fact, SDG&E argues that cable failures are rising and are the nature of the beast, at least the early underground cable installations, so Aglet raises a credible argument that the proposed incentives are not appropriate, and

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$125,000 per SAIDI and SAIFI unit and $25,000 per MAIFI unit as the most reasonably balanced on this record." ORA Opening Litigation Brief, p. 32.

[70] Aglet Opening Litigation Brief, p. 19 ff.

[71] Aglet cites Geier, 27 RT 2404:4, 2406:3-7, 2411:6; Geier, 27 RT 2455:11-17; and Petersilia, 30 RT 2726:10-12; Little, 30 RT 2809:2-7; Geier, 27 RT 2455:25-27, respectively.

the "results" are as likely to be coincidental, citing the safety improvement at SoCalGas before a safety incentive was adopted.[72]

Aglet concludes:

> "Aglet believes that rewards gained through performance incentives like those proposed by SoCalGas and SDG&E depend more on the design of incentive formulas than incremental improvements in performance attributable to the incentives. The testimony in this proceeding focuses on the details of complex formulas, while giving little attention to more important issues of causality and overall company efficiency. The scorecard for SDG&E during the period from 1997 through 2002 shows 24 wins, 4 losses and 2 no-decisions. (Citations omitted.) SDG&E earned incentive rewards in 24 of 30 opportunities, and suffered penalties in only four. Based on review of recorded performance, Aglet cannot tell whether the incentives worked as promised or the financial outcomes merely reflect success in gaming the formulas."[73]

We are keenly aware of the SDG&E's record and we are not prepared to terminate the Electric Reliability Indicators without a more thorough analysis, because reliability has generally improved while incentives have been in effect. We do intend to adopt reasonable but challenging targets and not the 10-year status quo proposed by the applicant.

#### h. Adopted Electric Reliability Incentives.

We believe that ORA's proposed use of a five-year average, without the burden of annual adjustments, is the most reasonable base to set the Electric Reliability Incentives, but we are concerned that the use of averages does not sufficiently drive SDG&E to improve performance. Thus we believe that a small

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72 Aglet Opening Litigation brief, p. 22.

73 Aglet Opening Litigation brief, p. 23.

stretch factor, similar in concept to the stretch factor in the base margin escalation process, would be beneficial. It is also clear that SDG&E's control over reliability is not perfect and is not total; we believe that deadbands protect against unwarranted rewards or penalties.

A further ratepayer protection could be to lengthen the measurement period to two years – for example, if the measured SAIDI for 2005 and 2006 were 64 and 60 minutes respectively, the average would be 62. If the annual average target was set at 63, the effect would be that SDG&E beat the target by one minute. Any reward would need to be twice the annual level too. Ignoring any deadband, this example would allow the good year to partially offset the bad one, for a net incentive over a longer period of time. The record is clear that reliability improvement is a long-term exercise, dependent upon consistent maintenance and timely capital expenditures. Annual measurement artificially distorts the long-term commitment necessary for reliability improvements. We will not adopt a multi-year evaluation now without allowing the parties to consider its effects. We direct SDG&E to address this proposal in the next performance incentive proceeding. We also direct SDG&E to provide a detailed analysis that responds to Aglet's concerns. SDG&E must demonstrate that the incentives contribute to improving performance.

CUE points out that during the most recent five years the SAIDI average is skewed by two years with abnormal weather. There is a 5.72 minute per year difference in weather-related SAIDI between the ten-year and five-year rates, which accounts for most of the 6.51 minute overall difference between the five-and ten-year averages.[74] Thus CUE argues we should use 69 minutes as the SAIDI target. Using the five-year average, without adjusting for weather, would be an extreme target; therefore, we will adopt the CUE proposal for a base year SAIDI of 69 minutes before the stretch factor.

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[74] CUE Opening Brief, pp. 9-11.

| Adopted Reliability Incentives | SAIDI | SAIFI | MAIFI |
|---|---|---|---|
| 5 Year Base | 69 | 0.68 | 0.77 |
| Stretch Factor | 1 | 0.01 | 0.01 |
| Target | 68 | 0.67 | 0.76 |
| Deadband | +/-2 | +/-0.02 | +/-0.02 |
| Increment | 1 | 0.01 | 0.015 |
| Liveband | +/-15 | +/- 0.15 | +/- 0.30 |
| Reward/Penalty | $250,000 | $250,000 | $50,000 |
| Range – Millions | $3.75 | $3.75 | $1.00 |

## 13. Safety Incentives

SoCalGas and SDG&E both have a safety incentive mechanism in-place, and no party objects to some form of incentive continuing into the test year and post-test years. All parties agree on the use of reportable or recordable events as defined by the California Occupational Safety & Health Agency (OSHA). Applicants propose the following employee safety penalty/reward performance indicators:

**SDG&E EMPLOYEE SAFETY (OSHA Recordable Rate)**

| Penalty Liveband | Deadband | Reward Liveband | Change Increment | Reward/Penalty Per Change Increment | Maximum Reward/ Penalty |
|---|---|---|---|---|---|
| 7.52 – 6.33 | 6.32 – 5.30 | 5.29 – 4.10 | 0.01 | $25,000 | $3,000,000 |

**SOCALGAS EMPLOYEE SAFETY (OSHA Recordable Rate)**

| Penalty Liveband | Deadband | Reward Liveband | Change Increment | Reward/Penalty Per Change Increment | Maximum Reward/ Penalty |
|---|---|---|---|---|---|
| 6.53 – 7.72 | 5.85 – 6.52 | 5.84 – 4.64 | 0.01 | $50,000 | $6,000,000 |

Both utilities propose that the lower limit of the deadband should be the average of the two best performance years over the past five years, and the upper limit of the deadband should be the average performance over the past 5 years. Thus, to receive a reward, SoCalGas or SDG&E must exceed the average performance of its two best years ever, and to receive a penalty, SoCalGas' or SDG&E's performance would have to decline below the five-year average from 1999 through 2003.

ORA proposes to sub-divide the mechanism into four broad categories of jobs that it argues face different degrees and types of risks. In addition, ORA would eliminate any reward possibility, creating a penalty-only environment. ORA argues that SoCalGas and SDG&E did not prove the incentive was reasonable from a ratepayer perspective because current rates are supposed to be sufficient to ensure a safe working environment.

**ORA Proposal for SDG&E**
**Employee Safety Penalty Criteria**

| WORK CATEGORY | DEADBAND | LIVEBAND | INCREMENT | PENALTY PER INCREMENT |
|---|---|---|---|---|
| Meter Reading | 18.90 – 22.64 | 22.66 – 24.66 | .02 | $2,500 |
| Customer Field Service | 9.40 – 11.20 | 11.22 – 13.22 | .02 | $2,500 |
| Distribution Transmission & Storage | 7.70 – 11.20 | 11.22 – 13.22 | .02 | $5,000 |
| Office | 1.95 – 2.79 | 2.80 – 3.80 | .01 | $5,000 |

**ORA Proposal for SoCalGas**
**Employee Safety Penalty Criteria**

| WORK CATEGORY | DEADBAND | LIVEBAND | INCREMENT | PENALTY PER INCREMENT |
|---|---|---|---|---|
| Meter Reading | 9.60-12.04 | 12.06-14.06 | .02 | $5,000 |
| Customer Field Service | 7.42-8.24 | 8.28-10.28 | .02 | $5,000 |
| Distribution Transmission / Storage | 5.70-8.24 | 8.26-10.28 | .02 | $10,000 |
| Office | 3.96-4.71 | 4.72-5.72 | .01 | $10,000 |

An interesting feature of ORA's penalty structure is there are disparate impacts depending on which category of worker is injured: CCUE testified that using ORA's proposal, a single recordable accident or injury would cost the company over $68,000 if it happens to a meter reader, but less than $23,000 if it happens to a lawyer.[75]  In its opening litigation brief, ORA proposes to raise the penalty recommendation as a solution to CCUE's objection.  TURN recommends that the safety indicators should be subject to either monitoring or penalty only, and points out that SoCalGas has earned a reward annually but did not consistently improve safety.  TURN also suggests that we need only monitor injuries by worker category.[76]

While we agree with CCUE, that a sprained ankle hurts just as much whether it happens to a meter reader or an attorney, no party has addressed whether the same injury affects service reliability or the safety of other workers

[75] Ex. 1100 p. 44; 32 RT 2997-3000, Marcus / CCUE.

[76] TURN Opening Litigation Brief, p. 60.

differently depending on the circumstances of the injury or the nature of the job. That is, is the incentive mechanism solely intended to reduce all injuries, or does it also serve to directly or indirectly affect reliability and the safety of others? We can speculate that a worker's injury in a distribution or transmission environment could directly delay service restoration or lead to a second injury. SoCalGas, SDG&E, and CCUE use a moral argument that there should be no differentiation.

**CCUE Proposal for SDG&E**
**Employee Safety**

| | |
|---|---|
| Benchmark | 5.21 |
| Deadband | 0.0 |
| Reward liveband | 2.0 |
| Penalty liveband | 2.0 |
| Incentive rate | $8000 / .01 |
| Max. reward | $1.6 million |
| Max. penalty | $1.6 million |

CCUE's constituency is the most likely to be injured on the job and so the CCUE estimate for reward / penalty per measured increment speaks most clearly for the workers' interests. SoCalGas and SDG&E as corporate entities have financial, operational efficiency and corporate image incentives to reduce injuries and improve safety. ORA and TURN share the ratepayers' financial interest in safety issues, as well as the operational and humane concerns.

CCUE points out that SDG&E had an unenviable safety record between 1988 and 1993, the OSHA rate rose from 5.07 to almost 11 in 1991 and was above 9 in 1993 before the first incentive was adopted in 1994. Over the next four years

(1994-98), SDG&E's OSHA rate fell slightly from its 1993 level, to 8.65 in 1998.[77] CCUE argues that only after the incentives were matched to OSHA recordable events did SDG&E's rates fall significantly and improve every year after 1998.[78] In contrast, of the four major California energy utilities, only PG&E, which has no employee safety incentive mechanism, failed to make a statistically significant improvement.[79] According to CCUE, the SDG&E and ORA mechanisms suffer from their use of deadbands – intervals over which there would be no incentive mechanism in effect. The result is that each would allow considerable backsliding to occur. CCUE argues for no deadband and a lower benchmark (better performance).[80]

CCUE argues that the SDG&E benchmark should be an OSHA recordable rate of 5.21. This is the 2003 performance by SDG&E[81] compared to SDG&E's proposal of a benchmark of 5.81 which is the midpoint of its proposed deadband of 5.30 to 6.32.[82] CCUE acknowledges that this rate exceeded the projected trend for 2003 of 4.87. CCUE also argues against any deadband, but as we discussed with the performance incentives, some results are unavoidable and not attributable to the action or inaction of SDG&E. We believe, as discussed with other mechanisms, a small deadband eliminates unfair rewards or penalties due

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77 CCUE Opening Litigation Brief, pp. 4-5, and Ex. 1100, p. 40.

78 Ex. 160, p. LL-4, Table LL-2.

79 Ex. 166, pp. LL-13 – LL-14, and Table LL.2; Tr. 32:3002, 3015-16, CUE / Marcus.

80 CCUE Opening Litigation Brief, p. 23.

81 Ex. 1100, p. 42.

82 Ex. 160, p. LL-34.

to random chance, especially in a short one-year measurement cycle. SDG&E proposed a deadband range of 1.02 and ORA's were varied but generally larger for a penalty-only mechanism. CCUE did not address SoCalGas but we can infer a CCUE-like target of 2003 actual, with no deadband.

We generally reject setting rates on one point of data measures because they can so often mislead compared to the trend, or even random events that significantly affect the single data point outcome. We will not adopt the CCUE benchmark with no deadband proposal because it demands perfection. We will also not adopt ORA's penalty-only mechanism because it offers no positive inducement to improve safety. A balance of reward and penalty around a reasonable target is a reasonable tool to enhance service and provide a safer environment.

### a. Adopted Safety Incentives

We will halve the deadbands[83] proposed by both companies, there is no evidence that supports the width of the applicant's proposals as necessary and this approach mitigates CCUE's valid concern about backsliding. While every accident is not a failure of the incentive mechanism, chance still plays a role in the outcome. The financial incentives proposed by SoCalGas and SDG&E are too high, especially given recent consistent annual rewards to both companies. We will not adopt CCUE's reward / penalty of $8,000 per 0.1 change in the rates for both companies because it has offered no basis to suggest it would be effective. We will halve applicants' rates to $12,500 and $25,000 per 0.1 change in the rates,

[83] SoCalGas proposed a deadband range 0.34 above and below the target 6.19; one-half is 0.17. SDG&E proposed 0.52 above and below the target 5.81; one-half is 0.26.

because the companies have not convinced us that the incentives need to be at that level. The adopted rates are a reasonable compromise between the applicants' proposals and CCUE's proposal. We expect SoCalGas and SDG&E to focus on safety because it is the right thing to do; the rewards and penalties should be a secondary factor but still an incentive, and as ORA has correctly said, we adopt test year rates that are designed from the start to be sufficient for safe and reliable service.

**Adopted for SDG&E**
**Employee Safety**

Benchmark........................5.81
Deadband .........................5.55 – 6.07
Reward liveband.............1.75
Penalty liveband .............1.75
Incentive rate....................$12,500 / .01
Max. reward .....................$2.18 million
Max. penalty.....................$2.18 million

**Adopted for SoCalGas**
**Employee Safety**

Benchmark........................6.19
Deadband .........................6.02 – 6.36
Reward liveband.............2.0
Penalty liveband .............2.0
Incentive rate....................$25,000 / .01
Max. reward .....................$5.0 million
Max. penalty.....................$5.0 million

We will also direct SoCalGas and SDG&E to track the reportable incidents in the four categories proposed by ORA; meter reading, customer field service, distribution, transmission and storage, and office. ORA proposes that this data should be submitted to the Commission annually.[84] We modify this proposal to require the utilities to submit a report in the next rate proceeding. SoCalGas and SDG&E should follow the uniform system of accounts and any personnel not in the first three categories should be in the office category. We welcome parties to propose any sub-division of the mechanism by work category that is fact-based and directly considers the likely costs and means of reducing injuries based on sub-categorizing the employees of SoCalGas and SDG&E.

### 14. Service Quality indicators

SoCalGas and SDG&E propose to standardize the service quality indicators and reward mechanisms for the two companies; this stance is consistent with many other facets of these applications where past differences are now aligned. Since the adoption of service quality indicators in 1997, SoCalGas has met or exceeded benchmarks for most incentive-related indicators in each year, though performance did fall below the benchmarks (but within the deadband) for a few indicators in 1997 and 1998. SoCalGas did not incur any penalties.[85] In the period 1999 through 2002, SDG&E earned rewards of $2.960 million and has paid out less than $28,000 to customers for missed appointments.[86]

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[84] ORA Opening Litigation Brief, p. 77.

[85] Ex. 333, p. 8-5.

[86] Ex. 333, p. 9-17.

SoCalGas's proposed 2005 penalty/reward service quality indicators[87] are summarized below:

[87] Sempra Opening Litigation Brief, p.67.

| SoCalGas Indicators | Target | Deadband | Maximum Reward/Penalty |
|---|---|---|---|
| Phone/Office Contact Satisfaction | 83.4% | +/- 1.0% | +/- $1,500,000 |
| Field Visit Satisfaction | 94.1% | +/- 1.0% | +/- $1,500,000 |
| Field Service Orders Appointments Provided/Percent Made | Varies | 50-55% provided 98% Met | +/- $4,500,000 |
| Call Center Responsiveness | 80% within 60 Seconds | +/- 2% | +/- $2,000,000 |

SDG&E's proposed 2005 penalty/reward service quality indicators[88] are summarized below:

| SDG&E Indicators | Target | Deadband | Maximum Reward/Penalty |
|---|---|---|---|
| Phone/Office Contact Satisfaction | 78.1% | +/- 1.0% | +/- $500,000 |
| Field Visit Satisfaction | 92.4% | +/- 1.0% | +/- $500,000 |
| Field Service Orders Appointments Provided/Percent Made | Varies | 35-40% provided 99% Met | +/- $600,000 |
| Call Center Responsiveness | 80% within 60 Seconds | 80.0% – 85.6% | +/- $1,500,000 |

In addition, SoCalGas and SDG&E propose different lists of monitor-only indicators.[89]

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88 Sempra Opening Litigation Brief, p.68.

89 Sempra Opening Litigation Brief, pp.67-69.

| Proposed Indicators | SoCalGas | SDG&E |
|---|---|---|
| Level of busy signal | √ | √ |
| Estimated meter reads | √ | √ |
| Leak response time | √ | |
| Missed appointments | √ | |
| Problem resolved on first visit | √ | |
| Elapsed time | √ | √ |
| Percentage of abandoned calls | | √ |
| Shortest time to CSR | | √ |
| Gas emergency response time | | √ |
| Electric emergency response time | | √ |
| Complaints | | √ |

For SoCalGas, ORA proposes a set of revised performance indicators that are monitor-only with a remediation trigger. No rewards or penalties would be included. ORA also recommends that the Commission adopt a service guarantee similar to one in place for SDG&E customers. ORA recommends that the Commission adopt specific SDG&E performance standards of Phone/Office Contact Satisfaction, Field Service Order Satisfaction, Field Service Order Elapsed Time, and Call Center Responsiveness. ORA also argues these indicators should change from penalty/incentive mechanisms to a monitor only framework. ORA argues that SDG&E has not shown that ratepayer funded financial rewards are warranted to ensure that SDG&E provides safe, reliable and adequate service to its customers.[90]

According to TURN, the existing system of incentives were successful in focusing management attention on service quality through monitoring the

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[90] ORA Opening Litigation Brief p. 79.

indicators, avoiding penalties, and earning rewards. But TURN argues there is no definitive indication that rewards have provided any better incentive to maintain appropriate service quality as compared to reasonable base margin funding, monitoring requirements, or penalty-only indicators. Thus TURN recommends either a monitor only or penalty only mechanism.[91]

Aglet provides a thorough theoretical summary of incentives generally as adopted by this Commission in the past, and specifically opposes incentives as applied to SoCalGas and SDG&E:

> "Aglet opposes approval of performance incentives that would allow financial rewards and penalties for SoCalGas or SDG&E. Aglet supports monitoring of utility performance, to remind utility managers of the Commission's interest in specific areas of their operations.
>
> Narrow, targeted incentives might be justified in order to correct specific utility problems, but the showings in this proceeding have not identified any such problem. Even then, targeted incentives should be limited in scope and duration.
>
> Aglet opposes approval of performance incentives that would allow financial rewards and penalties for SoCalGas or SDG&E. Aglet supports monitoring of utility performance, to remind utility managers of the Commission's interest in specific areas of their operations." (Aglet Opening Brief, p.22.)

We are not convinced like Aglet or ORA that financial incentives are not effective for improving performance by SoCalGas and SDG&E. Monitoring alone is not likely to lead to improvement and it lacks any enforcement teeth if there is no penalty.

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[91] TURN Opening Litigation Brief, p. 46.

### a. Service Guarantee

ORA recommended that the Commission order SDG&E to retain its current service guarantee program and that a similar service guarantee be added for SoCalGas. The Service Guarantee concept centers on compensating ratepayers who are inconvenienced by a missed appointment. ORA's proposal keeps in effect the current Service Guarantee program in place for SDG&E that tracks missed appointments and pays $50 to the affected ratepayer. ORA proposes that the service guarantee be shareholder funded as ratepayers should not be asked to compensate themselves for the utility's service errors.

Both companies argue the mechanism is ineffective, and is a disincentive to offering appointments. They contend that the mechanism "unduly micro-manages utility operations, and by focusing only on the dimension of timeliness, provides incentives to prioritize utility services improperly."[92] SoCalGas argues that it would cost $1.0 million to implement a guarantee and points to the low payout by SDG&E as proof that it would not be cost-effective. Based on current tracking systems, SoCalGas has improved its on-time arrival percentage from 93.9% in 1999 to 98.5% in 2003. (Ex. 164, p. 26).

The Commission recently ordered Southern California Edison (Edison) to provide a service guarantee to its ratepayers that is identical to that proposed here by ORA. As the Commission noted in the Edison decision, "we feel that customer service is a core element of utility service and thus wish to ensure there is no degradation to SCE's current level of customer service."[93]

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[92] Sempra Opening Litigation Brief, p. 89.

[93] Application of Southern California Edison Company for Authority to, Among Other Things, Increase its Authorized Revenues for Electric Service (2004) D.04-07-022, p. 159.

We find it reasonable to adopt a similar mechanism here as proposed by ORA.  As TURN states in its comments, for a customer who has had to miss work (often at an hourly wage) only to have the utility employee not appear within a reasonable window of time, the service guarantee is at least partial compensation and better than nothing.  While the goal may be to improve overall service when individual customers are harmed, as with missed appointments, it is fully appropriate to have the compensation go to the individual.  That SDG&E has a low payout is evidence that the program is working and not eliminated.  We therefore will continue the service guarantee mechanism for SDG&E and adopt a service guarantee for SoCalGas.

### b.  Adopted Service Quality Mechanism

What is not at all clear is why we should set different levels of performance as targets and different rewards for SoCalGas and SDG&E.  This is an open question for all incentives, but operational incentives such as safety measures would have unique risks for the two companies.  Customer satisfaction, especially for the four highly generic measures proposed by SoCalGas and SDG&E, ought to be more closely aligned considering the companies have essentially one management structure.

We recognize the two companies are of different size, but as ORA points out, we already adopt just and reasonable rates that are sufficient to fund safe and reliable service; therefore any reward or penalty is solely an incentive to improve (or not backslide).  There is no convincing argument that the rewards and penalties need be of different sizes for SoCalGas and SDG&E.  The incentives are for achieving a certain level of service.  SoCalGas and SDG&E did not justify the differential in the penalty or reward and we will allow the same amount as sufficient to focus attention on improving service and avoiding any penalty.

| Adopted Indicators SoCalGas and SDG&E | Target | Deadband | Maximum Reward/Penalty Each Company |
|---|---|---|---|
| Phone/Office Contact Satisfaction | 83.4% | +/- 1.0% | +/- $500,000 |
| Field Visit Satisfaction | 94.1% | +/- 1.0% | +/- $500,000 |
| Field Service Orders Appointments Provided/Percent Made | Varies | 35-40% provided 99% Met | +/- $600,000 |
| Call Center Responsiveness | 80% within 60 Seconds | +/- 2% | +/- $1,500,000 |

In addition we will adopt the monitor-only measures, but we see no reason to excuse either SoCalGas or SDG&E from the full set, except for the unique electric measure, and two similar measures for gas leaks.  The existing data records for SoCalGas' leak response time and SDG&E's gas emergency response time are not monitored in the same fashion – we will not duplicate similar measures - so we adopt the following list applicable to both companies:

| Adopted Indicators | SoCalGas | SDG&E |
|---|---|---|
| Level of busy signal | √ | √ |
| Estimated meter reads | √ | √ |
| Leak response time | √ | N/A |
| Missed appointments | √ | √ |
| Problem resolved on first visit | √ | √ |
| Elapsed time | √ | √ |
| Percentage of abandoned calls | √ | √ |
| Shortest time to CSR | √ | √ |
| Gas emergency response time | N/A | √ |
| Electric emergency response time | N/A | √ |
| Complaints | √ | √ |

In the next proceeding applicants and interested parties may draw any appropriate conclusions based on the data.  Absent a good reason at that time to continue the tracking, we will consider dropping the reporting requirements as unnecessarily burdensome.

## 15. 2004 Incentives

The year is so advanced that enforcing the adopted incentives in 2004 would be unfair to applicants and ratepayers. SoCalGas and SDG&E would have, we expect, cautiously managed the operations of the companies in anticipation of adoption of the proposed settlements in Phase 1 and Phase 2 as a best case apart from the litigation positions. As discussed already with sharing, the incentives adopted herein should begin in 2005.

## 16. SONGS Cost Recovery

Aglet proposes to adjust SDG&E's attrition year revenue requirements to reflect scheduled refueling outages at SONGS 2 and 3 based on the adopted estimate in Edison's recent rate case. In D.04-07-022, we:

> "approved (Edison's) proposed flexible outage schedule ratemaking mechanism for SONGS 2 & 3 and a per-outage O&M estimate of $52.462 million (2000 dollars, 100% share). A component of that mechanism is (Edison's) proposal to forecast outage O&M costs in annual (post-test year) filings based upon the adopted outage cost estimate and a forecast of the number of outages expected to occur in the next year." (Mimeo, p. 276.)

Aglet recommends that the Commission should adopt the same method and dollar amount found reasonable in Edison's rate case, adjusted for SDG&E's 20% ownership share.

We further required that:

> "in any (post-test year) filing in which it includes costs for SONGS outages that it forecasts will occur in the following year, (Edison) shall include a proposal for refunding to ratepayers the costs of any outage that was forecast and included in rates but did not occur in that year.

O&M costs were specifically excluded from our procurement proceedings,[94] and we will be consistent here, as we were by adopting SONGS O&M expenses in Phase 1. We will adopt a comparable requirement for SDG&E, so that it may include its proportional share of O&M costs in its post-test year ratemaking filings and it shall also refund any costs that were not incurred.

Many of the SONG's non-fuel O&M costs are billed by Edison including the impact of post-test year escalation factors: they are therefore beyond SDG&E's direct control. SDG&E proposes that post-test year ratemaking for its SONGS costs be consistent with the escalation rates adopted for Edison in D. 04-07-022, and as may be authorized for subsequent years in Edison's current A. 04-12-014, for a test year 2006, and later. Similarly, certain SONGS-related capital costs for 2005 and beyond have been or will be determined in Edison's rate applications, not SDG&E's. SDG&E again proposes to use the capital expenses authorized in D. 04-07-022, and subsequently in an applicable decision for A. 04-12-014, to derive its post-test year capital expenses. This proposal was not opposed and is consistent with the deference shown in phase 1 to D. 04-07-022 for adopting SDG&E's test year 2004 SONGS costs.

## 17. Comments on the Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) and the alternate proposed decision of the Assigned Commissioner in this matter was mailed to the parties simultaneously in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure.

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[94] D.02-10-062, mimeo p. 61, in Rulemaking 01-10-024.

Timely comments were filed by CUE, ORA, SCGC, TURN, SoCalGas and SDG&E on March 7, 2005 and by Aglet on March 4, 2005. Reply comments wer filed by ORA, TURN, SoCalGas and SDG&E on March 14, 2005. As parties to the proposed settlements on post-test year ratemaking, they reiterated their support for the settlement without modifications. Parties oppose any revision of the all party settlement and argue that any tinkering of the settlement would undo the delicate balance of the agreement. We understand the give-and-take in settlement discussions, but we also must consider our role in reviewing these settlements and our determination on whether these settlements are reasonable. As discussed in this decision, if the base year is not adjusted to the actual indices' values, both the ratepayers and the utilities would be subjected to a compounding of any forecast error for the base year. However, as noted in SoCalGas' and SDG&E's comments, given the negotiated provision of a floor and a ceiling in the settlement, the decision has been clarified to limit the true up within the bounds of the floor and the ceiling as adopted in the settlement.

Other arguments offered by parties also address the reasonableness of the sharing and incentive mechanisms. We have considered all of the comments and, where appropriate, the decision has been changed to reflect those comments. The SAIDI base target has been corrected to reflect the weather effects on a five-year and ten-year average as indicated in comments by both CUE and the applicants. ORA and TURN argue for the continuation of SDG&E's service guarantee program and propose a similar service guarantee be added for SoCalGas. We find their arguments reasonable and adopt ORA's proposal for a service guarantee program for both SDG&E and SoCalGas.

The decision has been clarified to indicate that the post-test year escalation factors for SONGS costs billed to SDG&E by Edison are to be consistent with the escalation rates adopted for Edison in D.04-07-022, and as may be authorized for subsequent years, in Edison's current A.04-12-014, for test year 2006.[95]

The decision has been clarified to indicate that the base margin per customer is subject to balancing account treatment consistent with § 739.10 for SDG&E's electric operations and as proposed for SoCalGas and SDG&E's gas operations.[96]

## 18. Assignment of Proceeding

Geoffrey F. Brown is the Assigned Commissioner and Douglas M. Long is the assigned ALJ in this proceeding.

## Findings of Fact

1. In Phase 1 of this proceeding we adopted just and reasonable rates for SoCalGas and SDG&E for Test Year 2004.

2. In providing adequate service, each utility must be in compliance with laws, regulations, and public policies that govern public utility facilities and operations.

3. In carrying out its statutory obligation, the Commission assesses whether SoCalGas and SDG&E have justified the ratemaking proposals in their applications for Post-Test Year 2004 and for earnings sharing and other incentive mechanisms.

4. The Comparison Exhibit, Ex. 168, served on June 18, 2004, provided a jointly-prepared summary of the parties' litigation positions in Phase 2.

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[95] Sempra comments, p. 19.

[96] Sempra comments, pp. 14-15.

5. On July 21, 2004 SoCalGas and SDG&E filed a motion to adopt a proposed partial settlement jointly with Aglet, NRDC, ORA, SCGC, TURN to settle certain issues in Phase 2. The motion was filed late, as Rule 51.2 requires this filing within 30 days after the last day of hearing. The parties to the proposed settlement also filed a motion for leave to late-file the motion to adopt the settlement. Finally, they also filed a *Settlement Agreement Regarding Phase 2 Base Margin Issues*.

6. The Base Margin Settlement is a not a complete settlement under Rule 51(c), because it fails to reach a "mutually acceptable outcome to the proceedings" which means all litigated issues. It is however a partial settlement.

7. The Base Margin Settlement is an all-party settlement.

8. The Commission reviews the settlement pursuant to Rule 51.1(e) of the Commission's Rules of Practice and Procedure, which provide that the Commission must find a settlement reasonable in light of the whole record, consistent with the law, and in the public interest.

9. The Base Margin Settlement represents a compromise when compared to the careful consideration of the litigated positions of the parties.

10. No term of the Settlement contravenes statutory provisions or prior Commission decisions.

11. The record supports the Base Margin Settlement.

12. The Base Margin Settlement contains an automatic reopening of negotiations if the proposed settlements for SoCalGas and SDG&E in Phase 1 are not adopted. This is moot as D.04-12-015 adopted the proposed settlements.

13. PBR is not limited to the program features proposed by SoCalGas and SDG&E; it may also mean a different ratemaking program with a different mix of features as proposed by other parties.

14. The Commission has a clear history of allowing for some form of attrition: adjusting rates in a simplified fashion in between major reviews of rates in a GRC to allow for the detrimental effects of inflation that would otherwise reduce the utility's opportunity to earn a reasonable rate of return.

15. The adopted revenue requirements in Phase 1 for the Test Year 2004 should be the beginning base for setting rates in 2005 and beyond.

16. For SDG&E's electric operations, indexing should start with the Phase I base margin and then exclude generation, transmission, SONGS, Catastrophic Event Memorandum Account (CEMA), California Alternative Rate for Energy (CARE), Demand-Side Management (DSM), Pension, Commission-imposed and Post Retirement Benefits Other than Pensions (PBOPs) costs.

17. For both SoCalGas and SDG&E's gas operations, indexing should start with the Phase I base margin and exclude CEMA, Hazardous Substance Cost Recovery Memo Account (HSCRA), Self-Generation Program Memo Account (SGPMA), CARE, Direct Assistance Program (DAP), DSM, Public Goods and Other Research Design & Development (RD&D), Pension, Commission-imposed and PBOPs costs.

18. The otherwise uncontested adjustments or exclusions to the Base Margin are reasonable consistent with previously adopted attrition adjustments for SoCalGas and SDG&E.

19. A Margin Per Customer (MPC) method previously adopted in D.97-07-054 converts the revenue requirements for the whole company to a dollar amount per customer.

20. A revenue adjustment method would annually adjust the base margin by some factor without a separate direct consideration of customer growth.

21. SoCalGas and SDG&E propose the use of utility-specific indices, a Gas Index and Electric Index.

22. ORA, TURN and Aglet generally oppose the Gas Index and Electric Index and propose (with some differences among themselves) that the post-test year adjustment should be based on the CPI.

23. The Settlement Agreement proposes to adopt the CPI adjustment.

24. If the base year is not adjusted to the actual indices' values before calculating the next period's rates, both ratepayers and utilities would be subjected to a compounding of any forecast error for the base year.

25. The Base Margin Settlement introduces the usage of a floor and ceiling to the index by setting maximum and minimum adjustments that change annually, that differ between SoCalGas and SDG&E. The SoCalGas gas department and the SDG&E gas department are treated differently.

26. The adoption of a minimum floor and maximum ceiling displace the use of a productivity factor and a stretch factor.

27. If the base year is not adjusted to the actual indices' values before calculating the next period's rates, the ratepayers and the utilities would both be subject to a compounding of any forecast error for the base year. Fairness dictates that the actual inflation rate should be applied to recalculate the correct 2005 base margin before forecasting 2006 base margin.

28. Based on the litigated record, there is one significant flaw in the base margin settlement: the failure to readjust the base, $MPC_{t-1}$ when setting $MPC_t$. However, consistent with the parties' negotiation of floors and ceilings on escalation for each year, it is reasonable to limit readjustment of the base to a figure within the settlement's floor and ceiling for the applicable year.

29. SoCalGas and SDG&E propose a symmetrical sharing mechanism whereby the companies and the customers would share either the excess earnings or losses on an annual basis. This is a change to the mechanism last adopted for SoCalGas in D.97-07-054 and SDG&E requests the identical mechanism.

30. Sharing of excess earnings or recouping shortfalls is a significant departure from the cost-of-service ratemaking convention of granting only an opportunity to earn a reasonable return. SoCalGas and SDG&E have been authorized such a departure in the past for excess earnings. There was no ratepayer sharing of a shortfall.

31. No party challenges the concept of a sharing mechanism; ORA and TURN proposed different mechanisms. ORA proposes the retention of an expanded asymmetrical system. TURN proposes a different sharing rate and to use the last adopted mechanism for SDG&E for both companies.

32. The asymmetrical sharing adopted by D.97-07-054 only shared earnings that were 25 basis points above the authorized rate of return.

33. SoCalGas showed that in 1998 it absorbed a shortfall $12.2 million but between 1999 and 2002 “shared” excess earnings with ratepayers and returned to ratepayers $54.4 million.

34. Sharing was requested by SoCalGas and SDG&E only as a part of the adoption of a proposed PBR package.

35. One-way balancing accounts are strictly limited by circumstances and by the expectation that all of the revenues included in rates will not be spent for the intended purpose. Sharing was treated as a one-way mechanism with ratepayers having only the up-side opportunity to share in savings.

36. SoCalGas and SDG&E have shown that Sharing may benefit ratepayers or shareholders, and that it provides a positive incentive for the company to manage its costs efficiently.

37. ORA proposed that earnings sharing should apply only to earnings in excess of authorized ROR and sharing bands currently effective for SDG&E, except that shareholder shares would be capped at 75% for all bands above 175 basis points above authorized ROR.

38. TURN recommended an earnings sharing mechanism of 50 / 50 ratepayer / shareholder for earned ROR in excess of 100 basis points above ROR.

39. SoCalGas has a previously authorized revenue balancing mechanisms that protects it from undercollecting base margin as a result of sales / throughput estimation errors. A similar balancing process would satisfy the requirements of § 739.10 to avoid material undercollections of SDG&E's authorized electric base margin. These mechanisms can also protect ratepayers from material overcollections. It is reasonable to continue the existing mechanism for SoCalGas and extend the process to both SDG&E's electric and gas operations.

40. It is necessary to use the adopted revenue requirements to calculate the Base Margin from Phase 1 for the earnings sharing start-point with a further adjustment of excluding the major balancing accounts adopted in Phase 1.

41. The Base Margin Settlement would adopt sharing above the authorized ROR for up to 300 basis points (3%). There would be no sharing in the event of earned ROR falling below authorized ROR for either of the two utilities individually.

42. The Base Margin Settlement provides the option for the utility to suspend the mechanism and file an application at 175 points.

43. ORA (or any other party) should also have the option to petition the Commission for an automatic formal review at 175 points.

44. The Phase 1 revenue requirement was made subject to refund in D.03-12-057 because the test year 2004 revenue requirement was adopted after the start of the test year. SoCalGas and SDG&E originally made the request in their rate applications that Sharing would apply to 2004. In the proposed Settlement parties agreed that, subject to its adoption, there would be no sharing for 2004.

45. In this case the final decision on 2004 revenue requirements was adopted extremely late in the year. The practical fact is that SoCalGas and SDG&E could not react and manage to a final revenue requirement.

46. The MICAM is a process to adjust rates in a predetermined fashion if or when certain conditions are met. The mechanism does not reflect the actual cost of capital for SoCalGas and SDG&E.

47. In a traditional ratesetting environment, the cost of capital would be determined by the actual reasonable costs of existing long-term debt and preferred stock, the forecast cost of new securities expected to be issued in the forecast period, and a reasonable return on the forecast equity (common stock and retained earnings).

48. Regardless of how current capital market prices vary, the debt and preferred cost components change in the traditional mechanism only because of new issues or retirements.

49. The traditional cost of capital mechanism recalibrates annually to reflect actual reasonable costs plus any forecast changes, and the Commission authorizes a reasonable return on equity.

50. The MICAM is a mechanism that, subject to triggering events, adjusts the cost of capital in post-test year rates and it is essentially the same mechanism as last adopted for SDG&E.

51. The Base Margin Settlement continues the use of the MICAM mechanism.

52. In post-test year ratemaking the Commission has recognized the need to protect both the utility and the customers and allow a way to adjust for unexpected and uncontrollable events. SoCalGas and SDG&E have a previously adopted Z-factor mechanism.

53. There are nine identified criteria for a Z-factor's occurrence: the event must be exogenous to the utility; the event must occur after implementation of rates; the costs are beyond the control of the utility management; the costs are a normal part of doing business; the costs must have a disproportionate impact on the utility; the costs and event are not reflected in the rate update mechanism; the costs must have a major impact on overall costs; the cost impact must be measurable; the utility must incur the cost reasonably. No party opposed the continued use of a Z-factor.

54. The Commission has previously adopted a $5 million "deductible" for all events before applying a Z-factor. SoCalGas and SDG&E are as randomly likely to have government mandates change in their favor, as they are to incur unexpected increases. We should apply the deductible to all Z-factors.

55. The sole burden of proof is on SoCalGas and SDG&E to show that they competently responded to the Z-factor event in a reasonable and efficient manner before they can recover any costs in a Z-factor Memorandum Account. There is no reasonable presumption of recovery of an identified event.

56. The decision in Phase 1 required SoCalGas and SDG&E to file a Notice of Intent for an application with a Test Year 2008. Nothing in Phase 2 has assuaged the concerns that the underlying base margin in Phase 1 for Test Year 2004 is not sufficiently robust to be an appropriate base for five years' of rates (2004 through 2008). Nothing in the post-test year ratemaking process can improve on the 2004 foundation to make it a reasonable component of rates for five years.

57. Decision 04-01-007 extended the performance indicators for 2004 but deferred consideration of incentives, rewards and penalties to this proceeding.

58. The only reason to adopt the incentives would be to achieve better service over time than would occur without the incentives.

59. The capital expenditures for cable maintenance and replacement, and other reliability-related expenditures adopted in Phase 1, have a direct bearing on identifying the appropriate Electric Reliability Incentive targets. No party proposes to separate the underground cable performance from overhead system performance.

60. The parties propose an array of SAIDI, SAFI and MAIFI goals and Aglet opposes the adoption of any incentive mechanism.

61. A deadband is a range around the target where no incentive penalty or reward is assessed. ORA's proposed deadband narrows the effective range of penalties or rewards because it did not widen the liveband. One benefit of a deadband is that minor random variances in performance do not trigger an undeserved penalty or reward. ORA's deadbands are too large; there is no evidence that supports the proposed range as likely to encompass only the random influences that affect the final result.

62. A liveband puts an outer limit on both a penalty or a reward in the event of extraordinary results because SDG&E has little direct control over specific outages.

63. The purpose of an incentive is to ensure proper attention, including expenditures on maintenance and capital improvements, is paid to electric reliability.

64. SDG&E proposes to use the ten most recent years' annual average of 71 minutes, rounded from 71.19. The problem with a ten-year average, especially when there have been incentives in place, is that any progress achieved over that time is diluted by earlier years' results. The only justification for providing incentives is to improve service.

65. ORA proposes the most recent five-year average and a "rolling" average adjusted each year, but the next rate case for both SoCalGas and SDG&E will have a Test Year 2007. It is reasonable to use the most current five-year average as a part of the correct base for setting the targets.

66. An incentive mechanism, based only on a penalty, is not an incentive. Based on a "value of service" measurement, commercial customers face significant financial hardships from any outage and therefore place a high value on avoiding outages. A reward / penalty cannot compensate / penalize SDG&E for the full cost expended or avoided for achieving the goals. The payments are rewards or penalties for a level of special performance, not the sole reimbursement for improving service reliability. The Commission can pursue other sanctions for any failure by SDG&E to meet its obligation to serve customers safely and reliably.

67. ORA's analysis suggests that commercial and industrial customers receive 97% of the benefit of a reduction in service interruptions, but only 46% of

the costs. The Commission can consider a reallocation of the costs in the appropriate rate design proceeding rather than reduce the penalty or eliminate the reward. If we eliminate the reward then there is no cost of a reward to allocate to any customer class.

68. The adopted base margin in Phase 1 would allow SDG&E to maintain current levels of reliability.

69. The 10-year status quo proposed is not an appropriate target for reliability incentives.

70. ORA's proposed five-year average, without the burden of annual adjustments, is the most reasonable base to set the Electric Reliability Incentives, but the use of averages does not sufficiently drive SDG&E to improve performance. Thus a small stretch factor, similar to the stretch factor in the base margin escalation process, would be beneficial.

71. SDG&E's control over reliability is not perfect and is not total; deadbands are needed to protect against unwarranted rewards or penalties.

72. A further ratepayer protection could be to lengthen the measurement period and any reward / penalty would need to be increased too. Reliability improvement is a long-term exercise, dependent upon consistent maintenance and timely capital expenditures. Annual measurement artificially distorts the long-term commitment necessary for reliability improvements.

73. The parties must consider the effects of adopting a multi-year evaluation in the next performance incentive proceeding.

74. SoCalGas and SDG&E both have a safety incentive mechanism in-place, and no party objects to some form of incentive continuing into the test year and post-test years. All parties agree on the use of reportable or recordable events as defined by the California Occupational Safety & Health Agency (OSHA).

Applicants propose different employee safety penalty / reward performance indicators.

75. Under SoCalGas or SDG&E's proposals, to receive a reward, they must exceed the average performance of the two best years ever, and to receive a penalty their performance would have to decline below the five-year average from 1999 through 2003. ORA's proposal sub-divides the mechanism into four broad categories that face different degrees and types of risks. ORA's proposal would eliminate any reward possibility, creating a penalty-only environment.

76. ORA's penalty structure would have disparate impacts depending on which category of worker is injured.

77. SoCalGas has earned a reward annually but did not consistently improve safety.

78. We do not know whether the same injury affects service reliability or the safety of other workers differently depending on the circumstances of the injury. SoCalGas and SDG&E and CCUE use a moral argument, that there should be no differentiation.

79. SDG&E's safety record between 1988 and 1993, shows that the OSHA rate rose from 5.07 to almost 11 in 1991 and was above 9 in 1993 before the first incentive was adopted in 1994. Over the next four years (1994-98), SDG&E's OSHA rate fell slightly from its 1993 level, to 8.65 in 1998, but after the incentives were matched to OSHA recordable events SDG&E's rates fell significantly and the rate has improved every year since 1998.

80. CCUE's proposed benchmark of SDG&E's 2003 OSHA recordable rate of 5.21 exceeds the projected trend of recorded rates. Some events are unavoidable and not attributable to the action or inaction of SDG&E. A small deadband

eliminates unfair rewards or penalties due to random chance, especially in a short one-year measurement cycle.

81. A balance of reward and penalty around a fair target is a reasonable tool to enhance service and provide a safer work environment.

82. There is no evidence that supports the width of the applicant's deadband proposals and large deadbands conflict with CCUE's valid concern about backsliding. However, a narrow deadband is appropriate because every accident is not a failure of the incentive mechanism because chance still plays a role on the outcome.

83. The financial incentives proposed by SoCalGas and SDG&E are too high, especially given recent consistent annual rewards to both companies. CCUE's reward / penalty of $8,000 per 0.1 change in the rates for both companies is not justified because there is no basis to suggest it would be effective. Halving the applicants' rates to $12,500 and $25,000 per 0.1 change in the rates, is a reasonable compromise between the Applicants proposals and CCUE's proposal. This approach is reasonable because it should still provide an adequate incentive to SoCalGas and SDG&E to achieve the targets.

84. SoCalGas and SDG&E should track the reportable incidents in the four categories proposed by ORA: meter reading, customer field service, distribution, transmission and storage, and office. It is not necessary to review this information before the next rate proceeding.

85. Standardizing the service quality indicators and reward mechanisms for the two companies is consistent with many other facets of these applications where past differences are now aligned. Since the adoption of service quality indicators in 1997, SoCalGas has met or exceeded benchmarks for most incentive-related indicators in each year, though performance did fall below the

benchmarks (but within the deadband) for a few indicators in 1997 and 1998. SoCalGas did not incur any penalties.

86. In the period 1999 through 2002, SDG&E earned rewards of $2.960 million and has paid out less than $28,000 to customers for missed appointments.

87. The intervenors argue for a monitor only or penalty only mechanism because they believe there is no definitive indication that rewards have provided any better incentive to maintain appropriate service quality as compared to reasonable base margin funding, monitoring requirements, or penalty-only indicators.

88. While the parties disagree whether SDG&E has shown that ratepayer funded financial rewards are warranted to ensure that SDG&E provides safe, reliable and adequate service to its customers, the existing system of incentives was successful in focusing management attention on service quality through monitoring the indicators, avoiding penalties, and earning rewards.

89. Monitoring alone will not provide an incentive for improvement or deter a decline in performance by SoCalGas and SDG&E.

90. The current Service Guarantee program in place for SDG&E tracks missed appointments and pays $50 to the affected ratepayer.

91. The service guarantee is shareholder-funded; ratepayers should not be asked to compensate themselves for the utility's service errors.

92. SDG&E made relatively few payments under its guarantee program.

93. By D.04-07-022, Edison was ordered to provide a service guarantee to its ratepayers similar to those proposed in this proceeding.

94. A service guarantee for SoCalGas and SDG&E is a reasonable and necessary mechanism.

95. The generic service quality measures, Phone / Office Contact Satisfaction, Field Visit Satisfaction, Field Service Orders Appointments Provided / Percent Made, and Call Center Responsiveness, ought to be more closely aligned considering the companies have essentially one management structure. They are not operational incentives, such as safety-related measures, that reflect the unique risks for the two companies.

96. There is no clear reason to accept poorer performance for a benchmark going forward simply because of poorer past performance. The Commission already adopts just and reasonable rates that are sufficient to fund safe and reliable service; therefore, any reward or penalty is solely an incentive to improve (or not backslide). There is no convincing argument that the rewards and penalties need be of different sizes for SoCalGas and SDG&E.

97. There is no reason to excuse either SoCalGas or SDG&E from the full set of measure-only service indications except for the unique electric measure and the similar gas emergency response time and gas leak response time measures; therefore it is reasonable to adopt them for both companies.

98. In the next proceeding applicants and interested parties may draw any appropriate conclusions based on the data. Absent a good reason at that time to continue the tracking, the Commission should consider dropping the reporting requirements as unnecessarily burdensome.

99. The year is so advanced that enforcing the adopted incentives for 2004 would be unfair to applicants and ratepayers. Like the sharing mechanism, the incentives adopted herein should begin in 2005.

100. In D.04-07-022 the Commission adopted a flexible outage schedule ratemaking mechanism for SONGS 2 & 3 and a per-outage O&M estimate. A part of that process is to forecast outage O&M costs in annual post-test year

filings based upon the adopted outage cost estimate and a forecast of the number of outages expected to occur in the next year. Those filings must include a proposal for refunding to ratepayers the costs of any outage that is forecast and included in rates but does not occur in that year. It is reasonable to adopt that requirement here.

## Conclusions of Law

1. The Commission's legal obligation to the residents of California is to ensure that SoCalGas and SDG&E both provide adequate service at just and reasonable rates.

2. For all uncontested issues not expressly addressed in this decision, SoCalGas and SDG&E made a *prima facie* showing that the requests were just and reasonable.

3. Only SoCalGas and SDG&E have an obligation to meet the burden of proof that their rate requests are reasonable.

4. We grant the Late-Filed Motion to adopt a proposed partial settlement.

5. The Settlement Agreement is a not a complete settlement under Rule 51(c), because it fails to reach a mutually acceptable outcome to the proceedings which means resolving all litigated issues.

6. The Settlement Agreement is reasonable in light of the whole record, consistent with the law, and in the public interest.

7. This decision may lawfully find only some of the individual features included in the requests by SoCalGas and SDG&E to be reasonable, and that some of the alternative features proposed by the intervenors, are reasonable in order to adopt a complete ratemaking package. A hybrid outcome can be reasonable in light of the whole record rather than a single parties' specific package of ratemaking program features.

8. It is reasonable to adjust rates in a systematic fashion between general rates cases.

9. The CPI is a reasonable indicator of inflation for SoCalGas and SDG&E for the post-test year period until the next GRC.

10. It is reasonable to recalibrate each base year to actual index values in order to calculate the next year's base margin.

11. A revenue balancing account mechanism satisfies § 739.10 to avoid material undercollections of SDG&E's authorized base margin. It is in the public interest to provide for revenue balancing for all of SoCalGas and SDG&E's base rate revenue requirements to insulate ratepayers from overcollections and shareholders from undercollections cause by errors in forecast sales/throughput.

12. Adoption of a sharing mechanism is not retroactive ratemaking.

13. A sharing mechanism should be adopted for post-test year ratemaking because it will provide an incentive to control costs and prevent undue hardship.

14. Sharing is not reasonable for 2004 because the applicants lack notice of the mechanism.

15. SoCalGas and SDG&E both have the burden of proof to justify any future recovery of a Z-factor exogenous event; there is no presumption of recoverability.

16. The three Electric Incentives, SAIDI, SAIFI, and MAIFI for SDG&E should be adopted as modified because they will provide an incentive to improve reliability.

17. A Service Guarantee mechanism should be adopted for both SoCalGas and SDG&E.

18. The four Customer Service incentives for both SoCalGas and SDG&E should be adopted because they provide an incentive to improve service.

19. The monitor-only service quality indicators should be adopted because they will provide useful information to evaluate service quality.

## O R D E R

**IT IS ORDERED** that:

1. Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E) shall file a compliance advice letter within 14 days of the effective date of this decision that makes the necessary changes to the preliminary statements to reflect the implementation of this decision.

2. For post-test year ratemaking beginning in 2005, SoCalGas and SDG&E are authorized to file for rate adjustments using the mechanisms as described in the Settlement Agreement and as modified in this decision.

3. In the next proceeding SoCalGas and SDG&E shall either propose an X factor adjusted to reflect good to excellent performance (by excluding poor performance from the request) or propose an appropriate stretch factor to offset mediocrity in the study group.

4. The adopted Sharing band, and rates of sharing, for SoCalGas and SDG&E are:

| Authorized Sharing | | | |
|---|---|---|---|
| Bands | Sharing Band (Basis Points) Above Authorized Rate of Return | Company | Customer |
| Inner | 0-50 | 100% | 0% |
| 1 | 51-100 | 25% | 75% |
| 2 | 101-125 | 35% | 65% |
| 3 | 126-150 | 45% | 55% |
| 4 | 151-175 | 55% | 45% |
| 5 | 176-200 | 65% | 35% |
| 6 | 201-300 | 75% | 25% |
| Outer | More than 300 | Suspend | |

5. The otherwise adopted sharing mechanism does not apply for SoCalGas and SDG&E to 2004.

6. SDG&E is authorized to have three Electric Incentives: System Average Interruption Duration Index (SAIDI), System Average Interruption Frequency Index (SAIFI), and Momentary Average Interruption Frequency Index (MAIFI). These include deadbands, livebands, and incremental rewards or penalties as shown:

| Adopted Reliability Incentives | | | |
|---|---|---|---|
| | SAIDI | SAIFI | MAIFI |
| 5 Year Base | 69 | 0.68 | 0.77 |
| Stretch Factor | 1 | 0.01 | 0.01 |
| Target | 68 | 0.67 | 0.76 |
| Deadband | +/-2 | +/-0.02 | +/-0.02 |
| Increment | 1 | 0.01 | .015 |
| Liveband | +/-15 | +/- 0.15 | +/- 0.30 |
| Reward/Penalty | $250,000 | $250,000 | $50,000 |
| Range - Millions | $3.75 | $3.75 | $1.00 |

7. SDG&E's Service Guarantee mechanism is continued and SoCalGas is ordered to adopt a similar Service Guarantee mechanism.

8. SoCalGas and SDG&E are each authorized to have four Service Quality incentives as shown:

| Adopted Indicators SoCalGas and SDG&E | Target | Deadband | Maximum Reward/Penalty Each Company |
|---|---|---|---|
| Phone/Office Contact Satisfaction | 83.4% | +/- 1.0% | +/- $500,000 |
| Field Visit Satisfaction | 94.1% | +/- 1.0% | +/- $500,000 |
| Field Service Orders Appointments Provided/Percent Made | Varies | 35-40% provided 99% Met | +/- $600,000 |
| Call Center Responsiveness | 80% within 60 Seconds | +/- 2% | +/- $1,500,000 |

9. SoCalGas and SDG&E shall include a detailed report in their next rate proceedings on the monitor-only service quality indicators as shown:

| Adopted Indicators | SoCalGas | SDG&E |
|---|---|---|
| Level of busy signal | √ | √ |
| Estimated meter reads | √ | √ |
| Leak response time | √ | N/A |
| Missed appointments | √ | √ |
| Problem resolved on first visit | √ | √ |
| Elapsed time | √ | √ |
| Percentage of abandoned calls | √ | √ |
| Shortest time to CSR | √ | √ |
| Gas emergency response time | N/A | √ |
| Electric emergency response time | N/A | √ |
| Complaints | √ | √ |

10. This proceeding is closed.

This order is effective today.

Dated March 17, 2005, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

Comr. Grueneich recused herself
from this agenda item and was not
part of the quorum in its consideration

## Acronyms

First Usage

**Error! No index entries found.**

**APPENDIX B**
**LIST OF APPEARANCES**

The current service lists for these proceedings are available on the Commission's web site, at the following links:

1. http://www.cpuc.ca.gov/published/service_lists/A0212027_50027.htm

2. http://www.cpuc.ca.gov/published/service_lists/A0212028_50027.htm

Further assistance is available by contacting the Process Office at (415) 703-2021.

**(END OF APPENDIX B)**

D0503023 Appendix C/Settlement Agreement