

Application No.: 09-08-020
Exhibit No.: _____
Witnesses: J. Ball
M. De Bont
K. Deremer
N. Kohls
G. Orozco-Mejia
L. Schavrien

(U 902-M) and (U 904-G)

***UPDATED AMENDED AND RESTATED
TESTIMONY IN SUPPORT OF JOINT AMENDED
APPLICATION FOR AUTHORITY TO ESTABLISH
A WILDFIRE EXPENSE BALANCING ACCOUNT
TO RECORD FOR FUTURE RECOVERY
WILDFIRE-RELATED COSTS***

Before the

Public Utilities Commission of the State of California

Los Angeles, California

January 5, 2012

Amended and Restated Testimony in Support of Joint Amended Application for Authority to Establish a Wildfire Expense Balancing Account to Record for Future Recovery Wildfire-Related Costs

Table Of Contents

Section	Page	Witness
I. POLICY TESTIMONY	1	
A. Introduction.....	4	
B. Summary of Amended Cost Recovery Request.....	8	
1. Recovery Of Eligible Wildfire Costs	9	
C. Major Wildfires Are Natural Disasters	11	
D. Historically, The Commission Has Authorized The Utilities To Recover Costs Associated With Wildfires And Other Disasters	14	
1. Allowing The Utilities To Recover The Costs Of Wildfire Claims Is Consistent With Commission Treatment Of Other Natural Disasters	15	
2. Commission Policies Recognize That Insurance Costs And Claims Are Part Of The Reasonable Cost Of Providing Public Utility Service.....	16	
E. Inverse Condemnation Theory Has The Potential to Increase Claims Costs Regardless Of Utility Actions	17	
F. The Commission Should Continue Its Policy Of Allowing The Utilities To Recover Costs Associated With Wildfires	19	
1. Wildfire Risks Come With The Utility Franchise, And As Such, Must Be Addressed In Rates	19	
2. The Need For Financial Strength To Maintain Utility Operations And Reliable Service Has Been Recognized Both By The Commission And The Legislature.....	19	
G. The Amended Proposal Creates Appropriate Incentives For Utilities To Prevent Fires and Defend Wildfire Claims.....	21	
1. The Amended Proposal Creates New Financial Incentives To Prevent Fires	22	

Amended and Restated Testimony in Support of Joint Amended Application for Authority to Establish a Wildfire Expense Balancing Account to Record for Future Recovery Wildfire-Related Costs

Table Of Contents (Continued)

Section	Page	Witness
2. The Proposed Mechanism For Recovering Wildfire Costs Encourages Utilities To Comply With Safety Regulations And Avoid Fault For Wildfires.....	22	
3. Excluding Wildfires That Result In Damage of \$10 Million Or Less From WEBA Encourages Utilities To Reduce All Fires.....	23	
4. The Amended Proposal Preserves Current Safety Incentives.....	24	
5. The Amended Proposal Maintains Utility Incentives To Defend Wildfire Claims.....	25	
6. The Amended Proposal Creates Incentives To Develop Innovative Fire Risk Management Programs.....	26	
II. COST RECOVERY TESTIMONY.....	27	
A. Introduction.....	27	
B. Amended Cost Recovery Proposal.....	27	
1. Costs Eligible For Recovery.....	27	
2. Disposition of WEBA and WIPBA Balances.....	31	
C. Balancing Account Recovery Is Appropriate For Wildfire Costs.....	33	
1. Self-Insurance.....	34	
III. TESTIMONY OF JONATHAN E. BALL REGARDING INSURANCE.....	36	
A. Introduction.....	36	
B. Purpose of Testimony.....	37	
C. Summary Of Conclusions.....	37	
D. Background.....	37	

Amended and Restated Testimony in Support of Joint Amended Application for Authority to Establish a Wildfire Expense Balancing Account to Record for Future Recovery Wildfire-Related Costs

Table Of Contents (Continued)

Section	Page	Witness
1. Insurance Concepts – Overview	39	
2. Insurance Company Financial Ratings And Stability	39	
3. Liability Insurance Programs	40	
4. Insurance Companies	41	
5. Liability Insurance Program Design	42	
E. Market Conditions	45	
1. Geographic Risk.....	45	
2. 2009 Insurance Market Condition – Power And Utility Industry	46	
3. 2010 And Future Insurance Market Conditions - Power And Utility Entities Exposed To Potential Wildfire Liability Claims	49	
IV. UTILITIES’ INSURANCE TESTIMONY	50	
A. SDG&E and SoCalGas Insurance Testimony	50	
1. Purpose Of Testimony	50	
2. Overview of the SDG&E/SoCalGas Liability Insurance Procurement Process	50	
3. 2008-2009 Liability Insurance Renewal.....	54	
4. 2009-2010 Liability Insurance Renewal.....	54	
5. 2010-2011 Liability Insurance Renewal.....	61	
6. Potential Alternatives to Traditional Liability Insurance	63	
ATTACHMENT 1 To Chapter IV-A	65	
ATTACHMENT 2 To Chapter IV-A	67	

Amended and Restated Testimony in Support of Joint Amended Application for Authority to Establish a Wildfire Expense Balancing Account to Record for Future Recovery Wildfire-Related Costs

Table Of Contents (Continued)

Section	Page	Witness
B. Insurance Procurement Consultative Process	69	
V. RATEMAKING - FINANCING TESTIMONY	70	
A. Introduction.....	70	
B. Wildfire Expense Memorandum Accounts.....	70	
1. Resolution E-4311	70	
2. WEMA-Related Proposals.....	71	
C. Wildfire Expense Balancing Accounts	72	
1. WEBA-Related Proposals.....	72	
2. WEBA Applications	73	
3. WEBA Advice Filings	74	
D. Wildfire Insurance Premium Balancing Accounts	75	
E. Rate Recovery	76	
F. Financing Wildfire Costs	76	
G. Summary of Proposals	78	
VI. SPENDING METRICS	83	
A. SDG&E Spending Metrics.....	84	
1. O&M Metric	84	
2. Capital Spending Metric	85	
B. SoCalGas Spending Metrics	85	
1. O&M Metric	85	
2. Capital Spending Metric	86	
VII. Witness Qualifications	87	

**Amended and Restated Testimony in Support of Joint Amended
Application for Authority to Establish a Wildfire Expense Balancing
Account to Record for Future Recovery Wildfire-Related Costs**

Table Of Contents (Continued)

Section	Page	Witness
QUALIFICATIONS OF MAURY B. DE BONT	88	
QUALIFICATIONS OF KENNETH J. DEREMER.....	89	
QUALIFICATIONS OF NORM G. KOHLS.....	90	
QUALIFICATIONS OF GINA OROZCO-MEJIA.....	92	
QUALIFICATIONS OF LEE SCHAVRIEN.....	93	

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

I.

POLICY TESTIMONY

Executive Summary

- The Joint Amended Application of San Diego Gas & Electric Company (SDG&E) and Southern California Gas Company (SoCalGas) (collectively, the Utilities or individually, the Utility), filed concurrently herewith (Amended Application), amends the Joint Application for Authority to Establish a Wildfire Expense Balancing Account (WEBA) to Record for Future Recovery Wildfire-Related Costs, A. 09-08-020 (2009 Application), in order to address concerns raised in the Ruling of the Assigned Commissioner and Administrative Law Judge Directing Applicants to Amend Application, filed on December 21, 2009 (ACR).
- The California Public Utilities Commission (CPUC or Commission) should authorize the Utilities (1) to establish a WEBA to record wildfire Claims and Defense costs, and (2) to recover WEBA balances in retail rates.
 - Although the insurance market has improved since the Utilities originally filed the 2009 Application, there is still a pressing need for a mechanism to recover uninsured wildfire costs. SDG&E/SoCalGas have approximately \$1 billion in wildfire insurance. Given the uncertainty and volatility in the insurance market, the Utilities may not be able to obtain even this amount of insurance in the future. Because a large wildfire could easily result in claims far in excess of available insurance, and multiple wildfires within one policy year may not be insured to the extent insurance coverage was exhausted by a prior fire, the Utilities are exposed to the risk of substantial uninsured claims.
- The Commission should also authorize the Utilities (1) to establish a Wildfire Insurance Premium Balancing Account (WIPBA) to record all increases or decreases from the amounts adopted in the Utility’s General Rate Case (GRC) in insurance premiums

1 attributable to coverage for wildfire-related claims; and (2) consolidate and recover
2 WIPBA balances annually.

- 3 • Insurance costs have traditionally been recovered in rates, as have extraordinary costs
4 resulting from natural disasters. Uninsured wildfire costs should likewise be recoverable.
- 5 • Commission-authorized funding only provides for wildfire liability coverage up to a
6 finite level. Such coverage, while large in comparison to the coverage obtained by most
7 other utilities throughout the United States, has at most been \$1.2 billion, which is less
8 than the potential claims from very large wildfires. To the extent insurance coverage is
9 insufficient to cover wildfire claims, the Commission needs to provide a different cost
10 recovery mechanism, as proposed in this application.
- 11 • Wildfires are inevitable. And like other natural disasters, the magnitude of damage
12 depends on factors outside the Utilities' control, such as weather, demography, and local
13 fire-fighting capabilities. Because these costs are volatile and unpredictable, a balancing
14 account is a more appropriate way to address them than through forecasting in the GRC.
- 15 • The risk of fire is inherent in the provision of utility service and, unlike other businesses,
16 the Utilities cannot limit their risk by withdrawing from fire-prone areas. Thus, wildfire
17 costs are properly recoverable.
- 18 • Inverse condemnation and strict liability claims can increase wildfire-related claims costs
19 regardless of utility actions. Even if a utility is in full compliance with the Commission's
20 safety regulations and there is no proof of negligence, when utility equipment or facilities
21 start a fire, the utility faces the prospect of claims for all the ensuing damages. For a
22 major wildfire, those claims can easily total billions of dollars.
- 23 • Large uninsured wildfire costs could threaten the Utilities' financial integrity, contrary to
24 the public interest.
- 25 • The Utilities propose a mechanism under which they would retain the risk of a portion of
26 wildfire claims in excess of insurance: up to \$10 million for claims below \$1.2 billion,
27 and 5% for claims in excess of \$1.2 billion, up to specified caps. In exchange, the

1 Utilities would receive a revenue requirement to compensate them for this retained risk,
2 and also would be entitled to keep a portion of third-party recoveries. This mechanism
3 would not only preserve current Utility safety incentives, but would also create additional
4 incentives for the Utilities to mitigate their fire risk and vigorously defend wildfire-
5 related claims.

- 6 • The Utilities propose an annual consultative process to advise the Commission and other
7 interested parties of their proposed insurance procurement plan and give such parties an
8 opportunity for input.

1 **A. Introduction**

2 In their Amended Application, the Utilities ask the Commission for authority to (1) establish a
3 WEBA to record wildfire-related costs, (2) establish a WIPBA to record wildfire insurance premium
4 costs, and (3) recover WEBA and WIPBA balances in retail rates. The Amended Application and this
5 Joint Amended and Restated Testimony (Amended Testimony) are intended to address the concerns
6 raised in the ACR, as well as to update and supplement the record in this proceeding. The Amended
7 Application and this Amended Testimony supersede the 2009 Application and the testimony filed in
8 support of that 2009 Application.

9 Wildfires have always been part of California’s landscape due to the State’s geography and
10 weather patterns. Recent experience suggests, however, that the risk of large claims from wildfires has
11 increased due to population growth in fire-prone areas and changing weather conditions. In October
12 2003, in the worst fire outbreak up to that point, 14 major wildfires raged across Southern California,
13 destroying 3,700 homes, burning over 750,000 acres, and taking 24 lives.¹ Four years later, drought
14 conditions and hot, dry Santa Ana winds again spawned fires across Southern California. Fire resources
15 were stretched thin as eight fires broke out within 24 hours, multiplying to 16 locations within days.
16 Those October 2007 fires ultimately burned over 500,000 acres, destroying some 3,000 buildings and
17 costing 17 lives. They also marked the first time a fire ignited by utility equipment resulted in over a
18 billion dollars in damages in California.²

19 Less than a year later, in June 2008, northern California faced its own wildfire crisis. Lightning
20 and drought conditions contributed to the worst fire outbreak in California history based on acres
21 burned. Over 50 major fires blazed across northern California’s forests and foothills, ultimately burning

¹ For a detailed discussion of the 2003 fires, see *California Fire Siege 2003: The Story*, California Department of Forestry and Fire Protection (CALFIRE), available at http://www.fire.ca.gov/fire_protection/downloads/2003FireStoryInternet.pdf.

² *California Fire Siege 2007 – An Overview*, California Department of Forestry and Fire Protection, Governor’s Office of Emergency Services (OES), and the United States Department of Agriculture (U.S. Forest Service) with the cooperation of other local, state and federal agencies, available at http://www.fire.ca.gov/fire_protection/downloads/siege/2007/Overview_CompleteFinal.pdf.

1 more than 1 million acres.³ Continuing the trend, the 2009 fire season started unusually early. In
2 mid-May, dry winds spread fire across the hills above the city of Santa Barbara, destroying 80 homes.
3 That wildfire, unintentionally sparked by an individual operating vegetation removal equipment, spread
4 under conditions bearing the hallmarks of recent major fires: high temperatures, strong winds, low
5 humidity and dense vegetation.

6 These events have created a heightened awareness of wildfire risks on the part of utility
7 insurers.⁴ Prior to the 2007 fires, insurer losses from utility wildfire claims were modest.⁵ This fact is
8 not surprising, based on a review of historical wildfire statistics. According to (CALFIRE data,
9 approximately 5,000 wildfires start annually,⁶ most of which are promptly extinguished, and CALFIRE
10 attributes only 2 percent of these fires to power lines.⁷ As a result of damage claims from the 2007
11 wildfires, insurers are now focused on this risk. In addition, as discussed in Chapter I, Section E below,
12 a California Court of Appeal ruling currently being cited by plaintiffs' lawyers increases the potential
13 for sizeable wildfire damage payouts based on the theory of inverse condemnation. Insurers fear that
14 this theory imposes strict liability on the Utilities, making them responsible for property damage from
15 any fire ignited by utility equipment, even if there is no proof of utility negligence.

16 This insurer anxiety has created an unstable insurance market and, with the 2010 fire season
17 upon us, there is an urgent need for Commission action to provide a mechanism for rate recovery of
18 uninsured wildfire costs. As temperatures rise after an unusually wet winter, and as the state of
19 California continues to juggle already stretched resources, any small spark can become a conflagration.

³ *California Wildfires, FEMA EM - 3278 - CA, Total Incidents from 6/22/08-8/11/08*, (2008) California Governor's Office of Emergency Services (OES), available at www.fire.ca.gov/downloads/incidents/All_statewide_Fires_0622_0806_a.pdf.

⁴ Indeed, the Insurance Information Institute recently reported that eight of the ten most costly wildland fires in the United States occurred in California. See www.iii.org/facts/wildfires.

⁵ See Chapters III and IV below for discussions of the Utilities' loss experiences.

⁶ Between 2004 and 2008, an average of 5,759 fires occurred annually in CALFIRE's jurisdiction. See 2009 Fire Summary, *2009 Wildfire Activity Statistics Annual Report*, CALFIRE, available at www.fire.ca.gov/downloads/redbooks/2009/02-wildland-statistic-all-agencies/11_2009_Fire_Summary.pdf.

⁷ Based on CALFIRE Direct Protection Area Wildfires By Cause, *2009 Wildfire Activity Statistics Annual Report*, CALFIRE, available at www.fire.ca.gov/downloads/redbooks/2009/05-fire-activity/37_graphic_Fire_Activity_CalFire_DPA_byCause.pdf.

1 During the 2010-2011 renewal process that PG&E and SDG&E/SoCalGas recently completed, the
2 Utilities obtained more insurance coverage than they were able to purchase in 2009. As described below
3 in Chapter IV, SDG&E and SoCalGas were able to purchase \$400 million in wildfire coverage, and
4 SDG&E was able to obtain an additional \$600 million of wildfire property damage reinsurance coverage
5 through an insurance product that was not available prior to this year. But the cost of wildfire coverage
6 for SDG&E and SoCalGas remains far higher than in past years.

7 Despite the increased availability of insurance relative to 2009-2010, a mechanism to recover
8 uninsured wildfire costs is still urgently needed.⁸ Recent experience has shown that fires ignited during
9 adverse weather conditions can result in extensive damage, potentially far greater than \$1 billion. In
10 addition, there is no guarantee that insurance will continue to be available in the future. One costly fire
11 could be enough to convince insurance carriers to exit the California wildfire insurance market entirely,
12 leaving the Utilities defenseless. Therefore, it is imperative that the Commission implement a system
13 for cost recovery now, before disaster strikes. The Utilities offer this Amended Application to establish
14 an effective mechanism for addressing this problem before it happens.

15 Although wildfire liability is more commonly associated with electric facilities than with gas
16 facilities, this application seeks cost recovery for gas utility operations as well. Though less frequent,
17 gas facilities can also be associated with a wildfire. Both gas and electric operations for SDG&E are
18 covered by the same insurance policies, and the limited availability of liability coverage for wildfires
19 affects gas and electric operations equally. SoCalGas owns some electric distribution facilities and is
20 insured under the same policies as SDG&E.

21 As discussed further in the testimony below, the proposed rate recovery mechanism will protect
22 the Utilities against excess wildfire costs now and in the future, while providing a flexible and effective
23 method for managing wildfire claims risk. There are several reasons this proposal is appropriate and
24 advantageous:

⁸ The insurance companies that provide liability insurance coverage to the Utilities are not regulated by the California Department of Insurance.

- 1 • Major wildfires are natural disasters stemming from factors such as climatic conditions,
2 geography and demography over which the utilities have no control. Costs resulting from
3 natural disasters are traditionally included in rates.
- 4 • Unlike insurance carriers, who can limit their risk by choosing whom to cover, the
5 Utilities have an obligation to serve all customers in their service territories and cannot
6 withdraw from fire-prone areas. Wildfire risks come with the utility franchise and, as
7 such, must be addressed in rates.
- 8 • The Commission recognizes that insurance costs and claims are part of the reasonable
9 cost of providing public utility service; the Commission treats self-insurance costs the
10 same way.
- 11 • Commission-authorized funding only provides for wildfire liability coverage up to a
12 finite level. Liability coverage in excess of traditional amounts, even if it could be
13 obtained, is not likely to be a reasonable proposition from a cost/benefit standpoint, and it
14 will never be large enough to fully cover the risk of potential claims from extremely large
15 and destructive wildfires. Utilities in California will never be fully insured against all
16 potential claims from wildfires that could take place in their service territories.
- 17 • Significant uncompensated costs could threaten the Utilities' financial strength and their
18 ability to provide reliable service, contrary to the Commission's and Legislature's
19 policies in support of the Utilities' financial creditworthiness.
- 20 • The Utilities are responsible for maintaining thousands of miles of lines and millions of
21 poles; imposing on the Utilities broad responsibility for wildfire claims would hold them
22 to a standard of perfection the Commission has expressly recognized is unattainable.
- 23 • Even if a utility is in full compliance with the Commission's safety regulations and there
24 is no proof of negligence, when utility equipment or facilities start a fire, the utility faces
25 the prospect of claims for all the ensuing damages as a result of inverse condemnation
26 and strict liability doctrines. For a major wildfire, those claims can easily total billions of
27 dollars.

- Most importantly, this approach will not interfere with any of the Utilities’ current incentives for operating safely and defending wildfire claims vigorously. Rather, the proposal will enhance those incentives to provide optimal protection to both customers and the Utilities against the physical and financial threat posed by wildfires.

This Amended Application addresses an extraordinary problem that lies at the intersection of geography, climate, market forces, California law and utility operations. Due to the unusual nature of the threat posed by wildfires and the uncertain ability of the Utilities to continue to obtain adequate insurance coverage at a reasonable cost, the ACR correctly observes that any “risk management program must be comprehensive; that is, all facets of risk reduction and liability funding must be considered.”⁹ The Utilities are currently trying to develop just such a program. In November 2008, the Commission opened a rulemaking (Fire Safety OIR) to consider changes to the rules governing the design, construction, and maintenance of overhead supply and telecommunication lines to reduce wildfire risks,¹⁰ a proceeding which is still ongoing. In addition to their efforts in the Fire Safety OIR, the Utilities will propose prudent and cost-effective measures in their GRCs to mitigate the risk that their facilities will be involved in a wildfire. In a future phase of this proceeding, the Utilities and the Commission can consider ways in which the Commission can limit Utility (and consequently customer) liability for wildfires. Those are all critical components of any comprehensive solution to the challenges presented by wildfires, but another key element, one that requires immediate attention, is rate recovery for uninsured wildfire costs. The fact that there are multiple sides to this problem is no reason to delay action here.

B. Summary of Amended Cost Recovery Request

The Utilities submit the Amended Application and this Testimony in response to the ACR, which directed the Utilities to amend their application to address concerns raised in various protests that 100% rate recovery would remove the Utilities’ “financial motivation to defend” third-party claims for

⁹ ACR, p. 7

¹⁰ *Order Instituting Rulemaking to Revise and Clarify Commission Regulations Relating to the Safety of Electric Utility and Communications Infrastructure Provider Facilities*, R.08-11-005.

1 wildfire damages and that “[f]inancial incentives for prudent risk management and safety regulation
2 compliance are substantially undermined by the presumption of recovery from ratepayers.”¹¹ The
3 Utilities currently administer strong programs to mitigate the risk of fire and to minimize the cost of
4 third-party claims, and the confirmation of their ability to recover wildfire claims costs will not weaken
5 their commitment to continue to take such actions. Nevertheless, to address the concerns raised in the
6 ACR and by other parties, the Utilities submit this amended request for authority to establish a WEBA
7 to record and recover wildfire costs not covered by insurance. This proposed recovery mechanism
8 (Amended Proposal), summarized below, is described in full in Chapter II of this Amended Testimony.

9 **1. Recovery Of Eligible Wildfire Costs**

10 Each Utility will create a WEBA to record all Wildfire Costs, defined to include all
11 uninsured Claims and Defense costs¹² paid by a Utility that are not authorized for recovery in that
12 Utility’s base rates, and the costs of financing WEBA balances. In the event of a wildfire, each Utility
13 will first record all Claims and Defense costs as they are paid in a subaccount of the Wildfire Expense
14 Memorandum Account (WEMA).¹³ Once the Claims and Defense costs for a given fire exceed \$10
15 million, the Utility may transfer the WEMA subaccount balance for that wildfire to the WEBA for
16 potential recovery. The Utility may then record in the WEBA all additional Claims and Defense costs
17 for that fire, as well as the costs of financing WEBA balances.¹⁴ The Utilities will continue to forecast
18 Claims and Defense costs for wildfires where Claims and Defense costs total \$10 million or less in their
19 GRCs. Claims and Defense costs for such wildfires, as well as any other costs already authorized for

¹¹ ACR, p. 7

¹² “Claims Costs” are payments to satisfy Wildfire-related claims including, without limitation, damage claims by third parties and their insurers, claims by governmental entities for the reimbursement of Wildfire suppression costs, and other governmental claims against the Utilities arising from a Wildfire. “Defense Costs” are outside legal expenses incurred by a Utility arising out of a Wildfire.

¹³ As explained in Resolution E-4311 (July 29, 2010), the WEMA will allow the Utilities to record the same wildfire costs that would be recorded and recovered in the WEBA, prior to the establishment of the WEBA, with the exception of certain financing costs. Res. E-4311, p. 3. For further discussion of WEMA, *see* Chapter V.

¹⁴ As described in Chapters II and V below.

1 recovery in a GRC, Z Factor¹⁵ or other proceeding, would not be eligible for recovery through the
2 WEBA.

3 The WEBA will be credited by amounts the Utility receives from insurance carriers to
4 reimburse it for Claims and Defense costs. In addition, the WEBA will be adjusted in the event that the
5 Utilities are able to reduce their liability for Claims and Defense costs by amounts paid by third parties,
6 for example vegetation management contractors or others whose acts or omissions may have caused or
7 contributed to a fire. The Utilities would retain 90% of third-party recoveries (net of legal costs relating
8 to the recovery) until the Utility has been fully reimbursed for Wildfire Costs it has absorbed (as
9 described below). Thereafter, 90% of Third Party Recoveries will be credited to Utility ratepayers, via a
10 credit to the WEBA, and 10% will be retained by the Utility. This will provide the Utilities with an
11 added incentive to reduce their liability, which in turn will inure to their customers' benefit.

12 Recording of Wildfire Costs in a WEBA does not create a presumption of recoverability.
13 Rather, recovery will depend on a Commission determination regarding both the total Wildfire Costs
14 and the degree of Utility responsibility. The details of these determinations are set forth in Chapter II of
15 this Amended Testimony. In summary, if the Wildfire Costs result from claims based on inverse
16 condemnation or strict liability where the Utility was not at fault or the wildfire was due to forces
17 beyond the Utility's control, the Utility will be able to recover its costs in full. On the other hand, if the
18 Wildfire Costs are the result of intentional or reckless misconduct by Utility management,¹⁶ the Utility
19 will not be allowed to recover its costs through the mechanism established by this Amended
20 Application. For all other Wildfire Costs, the Utility can recover its full Wildfire Costs up to \$1.2
21 billion, except that for each wildfire incident, the Utility will absorb \$5 million (up to a maximum of \$10
22 million for all wildfires within any 12-month period) after the limits of insurance are reached. For
23 Wildfire Costs in excess of the \$1.2 billion threshold, the Utility can recover 95% of the Wildfire Costs,
24 with the Utility absorbing the remaining 5% up to a cap. To compensate the Utility for the retained risk

¹⁵ Utilities may request a Z-Factor adjustment in some circumstances to obtain rate recovery of unexpected and uncontrollable expenses incurred between GRCs.

¹⁶ As defined in Chapter II, Section B.1.

1 of self-insurance, the Utilities would receive an annual revenue requirement based on their actual
2 wildfire insurance premium rates.

3 The financing costs recorded in the WEBA will depend on the size of the WEBA balance
4 and the time over which that balance will be recovered. The default rate will be the commercial paper
5 rate consistent with that of other balancing accounts, based on the presumption that balances will be
6 recovered within one year. If a Utility finances balances with long-term debt, and/or a mix of long-term
7 debt and equity, the Utility may ask the Commission for authority to record its higher financing costs in
8 the WEBA.

9 Finally, because recent experience demonstrates that the cost of wildfire insurance is
10 volatile and unpredictable, the Utilities propose balancing account treatment for insurance premiums as
11 well. Specifically, each Utility would record all increases or decreases from the amounts adopted in the
12 Utility's GRC in insurance premiums attributable to coverage for Wildfire-related claims in a WIPBA.
13 WIPBA balances will be consolidated and recovered annually, in accordance with established
14 procedures for the recovery of similar balancing accounts, such as the Medical Program Balancing
15 Accounts and Pension and Post-Retirement Other than Pension (PBOP) Balancing Accounts.

16 **C. Major Wildfires Are Natural Disasters**

17 Wildfires have always been a danger in California due to climatic and geographic conditions.
18 The State as a whole is subject to distinct wet and dry seasons, with the vast majority of precipitation
19 occurring in the late fall through spring. High winds and low humidity often coincide at the end of the
20 dry season, and these winds are concentrated in the canyons and hillsides common to each Utility's
21 service territory. Wind speeds at the mouths of some canyons can accelerate greatly, creating the
22 potential for a single spark to escalate into a fire storm. With low humidity and little summer rainfall,
23 the State's natural vegetation ignites quickly, producing embers that spread fire rapidly in high winds.¹⁷
24 Wildfire risks will only increase to the extent climate change results in higher temperatures and drier

¹⁷ For descriptions of vegetation at risk in California wildfires see *General Guidelines for Creating Defensible Space*, (February 8, 2006) pp. 6-7, State Board of Forestry and Fire Protection (BOF) and CALFIRE, available at www.fire.ca.gov/cdfbofdb/PDFS/4291finalguidelines2_23_06.pdf.

1 vegetation. Both the Commission’s Consumer Protection and Safety Division and the Commission itself
2 have recognized a link between global warming and increased danger from wildfires.¹⁸ The risk of
3 extensive damage from wildfires has increased as populations have spread to canyons and other
4 fire-prone areas, or areas with limited local fire-fighting resources.

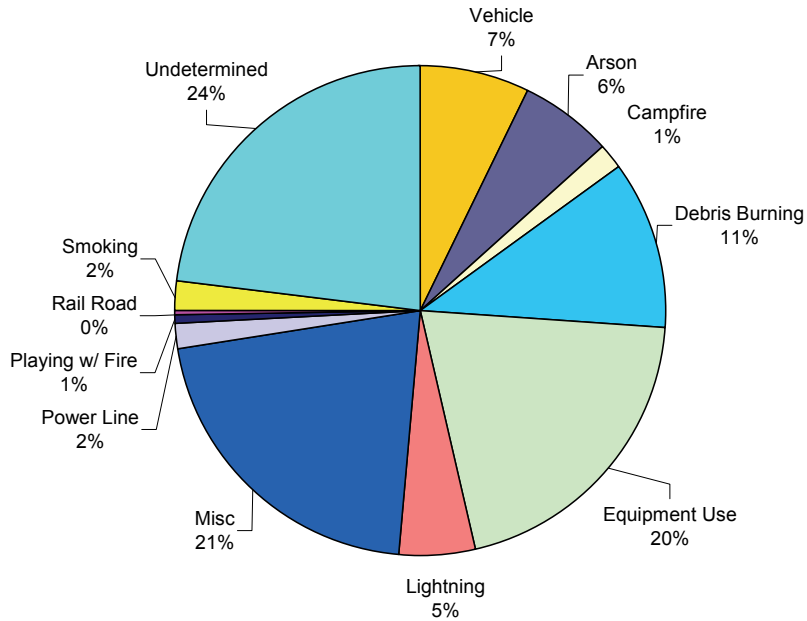
5 Although state and local laws have tightened building and vegetation clearance requirements
6 with the aim of limiting fire losses, not all homes meet current codes, nor can all meet recommended
7 standards for vegetation clearance.¹⁹ Furthermore, in recent years the State has faced multiple fires at
8 once, stretching firefighting resources to the limit.

9 As Figure I-1 shows, the vast majority (98 percent) of wildfires tracked by CALFIRE each year
10 result from sources other than power lines. Yet, by providing electric service to customers in the
11 developments now spreading across California’s fire-prone foothills, the Utilities face an unavoidable
12 risk that their equipment will contribute to a major wildfire. The high winds that can transform a small
13 fire into a fire storm also increase the likelihood that trees or vegetation will blow into power lines, as
14 well as the potential that poles or wires may fail under the strain, irrespective of compliance with
15 applicable installation and inspection rules.

¹⁸ See *The Consumer Protection and Safety Division’s Proposed Rules to Be Implemented in Time for the 2009 Fall Fire Season*, R.08-11-005 (March 9, 2009), pp. 16-17; and *Interim Opinion on Phase 1 Issues: Greenhouse Gas Emissions Performance Standard*, D.07-01-039, p. 214.

¹⁹ California Public Resources Code (PRC) § 4291 expands vegetation clearance requirements maintained around buildings and structures from 30 feet to a distance of 100 feet. However, property owners are not required to clear vegetation beyond their property line, regardless of the distance. See *General Guidelines for Creating Defensible Space* (February 8, 2006) State Board of Forestry and Fire Protection (BOF) and CALFIRE, p. 2 (available at http://www.fire.ca.gov/cdfbofdb/PDFS/4291finalguidelines2_23_06.pdf.)

Figure I-1
California Wildfires By Cause, 2005-2009
California Department of Forestry and Fire Direct Protection Area(b)



- (a) CALFIRE Direct Protection Area Wildfires By Cause, 2009 Fire Activity Compared to Last Year and 5-Year Average, *2009 Wildfire Activity Statistics*, California Department of Forestry and Fire Protection, available at www.fire.ca.gov/downloads/redbooks/2009/05-fire-activity/37_graphic_Fire_Activity_CalFire_DPA_byCause.pdf.
- (b) Note that CALFIRE appears to attribute utility lines as the “cause” of a fire any time utility lines are involved in a fire (e.g., if a car knocks over a power pole causing a spark that ignites a fire). The Utilities do not agree with this definition of causation.

1 Like other natural phenomena such as tornadoes and earthquakes, fire is highly unpredictable.
 2 As exemplified by the October 2007 fire siege, fires may be ignited under similar circumstances, yet
 3 lead to vastly different results.²⁰ Though occurring during the same time frame and under similar
 4 weather conditions, each of the sixteen October 2007 wildfires had unique features. Some were
 5 contained within hours, causing minimal damage, while others took well over a week to contain, taking

²⁰ See *California Fire Siege 2007 – An Overview*, footnote 3, *supra*, at Appendix II for descriptions of each major fire.

1 lives and burning thousands of acres and hundreds of structures. Although power lines were associated
2 with some fires, others stemmed from equipment use or arson. The fires' sources bear no discernable
3 relationship to the extent of damages. For example, of the fires ignited by power lines, the Sedgwick
4 fire burned only 700 acres and destroyed no structures while the Witch fire destroyed over 1,500
5 structures and covered nearly 200,000 acres, underscoring fire's capricious nature.

6 While many wildfires cause only modest damage, some wildfires can have catastrophic
7 consequences. For example, restated in 2009 dollars the insured property damage from the
8 October/November 2003 San Diego fire was \$1.2 billion and from the October 1991 Oakland fire was
9 \$2.5 billion.²¹

10 The factors that influence the course of major wildfires once ignited—weather, geography,
11 building standards, vegetation density, and available local firefighting resources²²—are all beyond the
12 Utilities' control. Recent research affirms the importance of weather, particularly wind speed,
13 temperature and humidity, in the growth of major fires. As one expert observed: “Wildfires are started
14 all over the landscape, mostly by people The ones that survive and develop into large fires [do so]
15 because of the meteorology.”²³ Because these elements, and not the Utilities, shape fire outcomes, the
16 Commission should permit the Utilities to recover wildfire-related costs in rates, consistent with the
17 treatment of other natural disasters, including earthquakes, tornadoes, and major storms.

18 **D. Historically, The Commission Has Authorized The Utilities To Recover Costs Associated**
19 **With Wildfires And Other Disasters**

20 As noted, until recently the Utilities were able to purchase reasonably-priced insurance in
21 amounts they deemed adequate to cover the risks associated with wildfires and, until 2007, there had not

²¹ The Ten Most Costly Wildland Fires in the United States, Insurance Information Institute, available at <http://www.iii.org/facts/wildfires/>.

²² See, e.g., *The Fire Next Time - Will We be Ready?*, San Diego County Grand Jury 2007 - 2008, pp. 1, 13 (finding that San Diego County “does not comply with [national] standards for emergency response time or emergency response locations,” and is “woefully unprepared” for a major fire) available at http://www.co.san-diego.ca.us/grandjury/reports/2007_2008/Firereport.pdf.

²³ UCLA Professor Alex Hall, as quoted by the Los Angeles Times. (Bettina Boxall, “Hot, dry Santa Anas a particular threat in some Southern California areas” *Los Angeles Times*, April 2, 2010, available at <http://articles.latimes.com/2010/apr/02/local/la-me-firemaps2-2010apr02/2>.)

1 been large losses. As a result, there was no need for the Commission to address cost recovery for
2 wildfire claims outside of policy limits. Precedents for both natural disasters and insurance make clear,
3 however, that such costs should be treated as a cost of ongoing business operations and recovered in
4 rates.

5 **1. Allowing The Utilities To Recover The Costs Of Wildfire Claims Is Consistent With**
6 **Commission Treatment Of Other Natural Disasters**

7 The Utilities recover costs from storms and other natural disasters in two ways,
8 depending on the magnitude and predictability of the event. Weather-related costs due to wind, heat,
9 rain, or lightning storms, including damage to utility facilities and claims by customers, are common
10 enough to be forecast in GRCs. The Commission approves an annual amount based on historical data
11 that is expected to enable the Utility to fully recover such costs, on average, over time.

12 For natural disasters, which by their nature occur infrequently and cannot be predicted,
13 the Commission authorizes the Utilities to record and recover costs to restore utility service through the
14 Catastrophic Event Memorandum Account (CEMA). The Commission authorized the establishment of
15 CEMAs by all utilities in 1991. These accounts were a response to regulatory and ratemaking issues
16 that arose after the Loma Prieta earthquake.²⁴ The Legislature codified disaster cost recovery through
17 CEMA in Section 454.9 of the Public Utilities Code in 1994.

18 As explained by the Commission, the resolution authorizing utilities to establish CEMA
19 was intended “to preserve the opportunity for utilities incurring unusual and extraordinary costs to seek
20 their recovery subsequently.”²⁵ CEMA currently only addresses the costs of restoring service, repairing
21 damaged utility facilities, and complying with government orders; thus, it does not apply to liability
22 claims. The principles embodied in CEMA, however, are applicable to wildfire claims: natural
23 disasters cannot be predicted; therefore, it is appropriate to include costs resulting from these events in
24 rates, after-the-fact, rather than on a forecast basis.

²⁴ Res., *Order Authorizing All Utilities to Establish Catastrophic Event Memorandum Accounts* (July 24, 1991), *codified as Cal. Pub. Util Code § 454.9.*

²⁵ D. 93-11-071, p. 4.

1 **2. Commission Policies Recognize That Insurance Costs And Claims Are Part Of The**
2 **Reasonable Cost Of Providing Public Utility Service**

3 The Utilities maintain insurance coverage to protect them from the cost of large,
4 infrequent and unpredictable losses. Each Utility purchases liability insurance because events leading to
5 third-party claims, including those resulting from employee accidents or errors, are an unavoidable part
6 of operating a business. Liability insurance costs, including the cost of policies covering wildfire
7 claims, are recovered in GRCs. The Utilities forecast insurance premium levels in their GRCs as part of
8 their test-year cost-of-service, and the Commission authorizes the inclusion of premium costs in
9 customer rates.

10 The Utilities' insurance policies typically require that a deductible be met before the
11 insurer pays claims. Accidents and uncontrollable events can and do happen, and some amount of
12 claims within the deductible amount are paid each year. As a result, GRC revenues also incorporate cost
13 recovery of annual expenses for estimable insurance deductibles. Forecasts of these insurance
14 deductible expenses, a cost of self-insurance, are based on historical losses.²⁶

15 The ratemaking for the two categories of natural disasters provides a guide to the
16 appropriate treatment for deductibles and wildfire costs exceeding insurance coverage: The costs of
17 storms where their occurrence can be predicted are forecast and recovered in GRCs, whereas the costs of
18 unpredictable disaster events are recovered through CEMA accounts. Applying the same logic here,
19 Wildfire Claims and Defense Costs up to \$10 million, which will be forecast in GRCs, are not eligible
20 for recovery through WEBA in the Amended Proposal. The occurrence of a wildfire that results in
21 Claims and Defense Costs greater than \$10 million, however, cannot be readily predicted and is not
22 appropriate for test-year ratemaking. Instead, Wildfire Costs associated with such fires should be
23 afforded separate balancing account treatment.

24 By providing for the recovery of insurance premiums in rates, the Commission
25 recognizes that liability for claims by third parties resulting from wildfires is an ordinary, unavoidable

²⁶ The Utilities' practices regarding test-year forecasts of deductibles vary based on their insurance programs or other factors.

1 cost of doing business. The Utilities will continue to rely on insurance to the extent it can be obtained at
2 a reasonable price. But Commission-authorized funding only provides for wildfire liability coverage up
3 to a finite level. Such coverage, while large in comparison to the coverage obtained by most other
4 utilities throughout the United States, has at most been \$1.2 billion, which is less than the potential
5 claims from very large wildfires. Moreover, liability coverage in excess of traditional amounts, even if
6 it could be obtained, is not likely to be a reasonable proposition from a cost/benefit standpoint, and it
7 will never be large enough to fully cover the risk of potential claims from extremely large and
8 destructive wildfires. Just as utilities in Florida are never fully insured against all potential losses from
9 hurricanes, Utilities in California will never be fully insured against all potential claims from wildfires
10 that could take place in their service territories. And to the extent insurance coverage is insufficient to
11 cover wildfire claims, the Commission needs to provide a different cost recovery mechanism, as
12 proposed in this application. And to the extent insurance coverage is insufficient to cover wildfire
13 claims, the Commission needs to provide a different cost recovery mechanism, as proposed in this
14 application.

15 **E. Inverse Condemnation Theory Has The Potential to Increase Claims Costs Regardless Of**
16 **Utility Actions**

17 Under the California Constitution, private parties are entitled to compensation when their
18 property is damaged for “public use.”²⁷ One way property owners enforce this right is by bringing an
19 action in civil court under the legal doctrine of inverse condemnation.²⁸ California courts have awarded
20 damages under the inverse condemnation doctrine when government-owned facilities, operating as they
21 were deliberately designed and constructed, damage private property. Damages have been awarded
22 even in the absence of a showing of negligence.

²⁷ See Cal. Const., Art. I, § 19(a).

²⁸ The term “inverse condemnation” is used to describe a claim that the government has taken or damaged private property for public use without paying just compensation, even though the property has not actually been condemned through eminent domain.

1 In 1999, a California Court of Appeal ruled that an investor-owned utility (IOU) is effectively a
2 governmental entity and can be held liable under the inverse condemnation doctrine for damage to
3 private property caused by a fire when the source is a utility facility. The court based its decision to
4 extend inverse condemnation liability to IOUs in this circumstance on the assumption that IOUs can
5 pass through to their customers any amounts they are required to pay to property owners. The court
6 explained that “[t]he fundamental policy underlying the concept of inverse condemnation is to spread
7 among the benefiting community any burden disproportionately borne by a member of that community,
8 to establish a public undertaking for the benefit of all.”²⁹

9 As a result of this decision, private property owners have brought inverse condemnation claims,
10 as well as traditional negligence claims, against IOUs for property damaged in fires allegedly caused by
11 utility facilities operating as they were deliberately designed and constructed. Although the Utilities
12 continue to contest this theory of liability, plaintiffs’ claims in this regard have increased insurers’
13 concerns that the Utilities are now at risk for substantial damage claims payouts. In addition, successful
14 inverse condemnation plaintiffs are entitled to attorneys’ fees and pre-judgment interest, which not only
15 add to the total litigation cost, but also encourage plaintiffs to sue under this theory.

16 Even if a utility is in full compliance with the Commission’s safety regulations and there is no
17 proof of negligence, when utility equipment or facilities start a fire, the utility faces the prospect of
18 inverse condemnation claims for all the ensuing damages. For a major wildfire, those claims can easily
19 total billions of dollars. As discussed above, the magnitude of the damage caused by wildfires depends
20 on factors such as weather conditions, population density, geography, and local fire-fighting resources,
21 all of which are beyond the control of any utility. In this way, inverse condemnation has the potential to
22 dramatically increase claims regardless of whatever precautionary measures the Utilities take.

²⁹ *Barham v. Southern California Edison Co.* (1999) 74 Cal.App.4th 744, 752.

1 **F. The Commission Should Continue Its Policy Of Allowing The Utilities To Recover Costs**
2 **Associated With Wildfires**

3 **1. Wildfire Risks Come With The Utility Franchise, And As Such, Must Be Addressed**
4 **In Rates**

5 Supplying customers with gas or electricity brings with it an inherent risk of fire. The
6 Utilities can and do take measures to reduce this risk, but they cannot eliminate it. Measures to mitigate
7 the risk of fires have limits. Some limits are financial—for example, the Commission does not authorize
8 the Utilities to collect revenue in rates for every conceivable risk management project, only for those
9 deemed cost effective or necessary for business purposes. Some limits are physical. In order to provide
10 electrical services, the Utilities must operate and maintain power lines and other energized equipment
11 that have the potential to cause a fire. Unlike ordinary businesses that can choose whether to take on the
12 risks associated with selling a product, the Utilities are obligated to provide service to all customers
13 throughout their service territories, including customers who choose to live in fire-prone areas.

14 When the risk of fire materializes, third parties may assert claims; and when utilities are
15 held liable for such claims, the resulting payments are an unavoidable cost of providing utility service.
16 The Utilities are entitled to recover such costs, just as they are entitled to recover all other costs
17 necessary to carry out their mission, as part of the regulatory compact. In exchange for providing utility
18 service under regulated rates, long-standing regulatory policies provide that utilities are entitled to an
19 opportunity to recover their operating costs, plus a reasonable return.

20 **2. The Need For Financial Strength To Maintain Utility Operations And Reliable**
21 **Service Has Been Recognized Both By The Commission And The Legislature**

22 With the possibility of fire comes the threat that any single fire can escalate into a
23 disaster, with potentially enormous consequences both for property owners and for any utility that may
24 be liable for the costs. In this way, wildfires pose a unique threat to the Utilities' financial integrity.
25 California has already learned the bitter lesson of what happens when the financial condition of the
26 Utilities is impaired. After 2001, the Commission, working in partnership with the Legislature and the
27 Utilities, helped the Utilities regain their financial health by working to restore the confidence of

1 financial markets, leading rating agencies to upgrade the Utilities’ credit ratings, which in turn has
2 reduced costs to customers. Now the Commission needs to take strong and certain measures to protect
3 the Utilities from another potentially significant threat to their financial strength.

4 “Reasonable financial health is necessary so that each utility may serve reliable, safe and
5 adequate electricity at just and reasonable rates.”³⁰ Key to that financial health is creditworthiness, as
6 lack of access to credit significantly impedes the Utilities’ ability to procure and supply electricity at
7 reasonable cost. Both the Legislature and the Commission recognized this in the aftermath of the energy
8 crisis. The Legislature passed Assembly Bill (AB) 57, directing the Commission to review procurement
9 plans with the goal of enhancing utility financial stability and creditworthiness.³¹ The Commission also
10 acknowledged that restoring the affected Utilities to investment-grade creditworthiness was in the public
11 interest, as it was necessary to “protect consumers from the potential impact of . . . volatility in
12 electricity prices and unreliable service,” as well as to enable the Utilities to fulfill their obligation to
13 provide service.³²

14 The financial health of the Utilities is so critical to their mission that the Commission has
15 stated that it must be protected, even at the cost of higher rates: “While authorizing refunds and
16 reducing rates might appear to benefit ratepayers, ratepayers and the economy are actually harmed when
17 utilities are unable to procure and deliver reliable, safe and adequate electricity. No party presents a
18 convincing argument that financially ill utilities are able to fulfill these public utility responsibilities and
19 obligations.”³³

20 Uninsured wildfire costs expose the Utilities to significant financial risk. It is important
21 for the Commission to act now to provide assurance that the Utilities’ financial well-being will be
22 protected. Uncertainty about the Utilities’ ability to obtain full recovery of wildfire costs could, in the

³⁰ D.02-11-026, *Interim Opinion Modifying Decision 01-03-082 To Change Restriction On Use of Surcharge Revenues*, p. 4.

³¹ AB 57 is codified at Cal. Pub. Util. Code § 454.5.

³² Stipulated Judgment (U.S.D.C., C.D.Cal., Oct. 5, 2001, No. 00-12056), p.2, Ex. A at 3:14-19 (SCE Settlement Agreement).

³³ D.02-11-026, *supra*, p. 10.

1 event of a catastrophic fire, undermine third-party confidence in California’s regulatory regime and the
2 ability of the Utilities to withstand the cost of a catastrophic fire should one occur. Such uncertainty
3 could once again hurt Utility creditworthiness and the Utilities could face higher borrowing costs and
4 other obstacles in their efforts to contract for power and sustain operations for the benefit of customers.

5 As both the Commission and the Legislature have recognized, this long-term detriment
6 would more than offset any short-term advantage to customers of lower rates. To prevent this outcome,
7 it is essential that the Commission act now, before a major fire occurs, to maintain the confidence of
8 lenders and investors in the stability of the financial condition of the Utilities. The Commission should
9 act to assure that a natural catastrophe does not undermine the Utilities’ financial integrity, and it can do
10 so by providing a strong assurance of cost recovery.

11 **G. The Amended Proposal Creates Appropriate Incentives For Utilities To Prevent Fires and**
12 **Defend Wildfire Claims**

13 The Utilities have in their care thousands of miles of lines, millions of poles, and tens of millions
14 of trees. Any one of the millions of components under the Utilities’ care could start a fire. The Utilities
15 take operational and design steps to mitigate wildfire risks, but attempts to completely eliminate those
16 risks would be cost prohibitive and ultimately futile. Utility poles, lines and other facilities are exposed
17 to the elements and can be impacted by others’ actions (*e.g.*, Mylar balloons, animal contact). In
18 providing electric service, the Utilities must meet not only the goal of safe and reliable service, but also
19 the goal of providing service at a reasonable cost. Unlike insurance carriers, the Utilities have an
20 obligation to serve all customers in their service territories and thus cannot withdraw from fire-prone
21 areas.

22 The Commission has already recognized, in the context of compliance with General Orders, that
23 it is not possible to attain perfection while keeping the goals of safe and reliable service and reasonable
24 cost in balance. Instead, the Commission focuses on utility knowledge and opportunity to cure, so that
25 the Utilities have “an incentive to engage in maximally effective preventive maintenance.”³⁴ The

³⁴ D.04-04-065, p. 31.

1 Commission has also acknowledged that a utility’s “100% compliance . . . at all times is not realistic.”³⁵
2 Indeed, a utility “cannot maintain its distribution system so that there are no GO 95 and 128 violations at
3 a given time.”³⁶ Because, as noted above, many of the factors that contribute to a major fire—including
4 weather, population density, construction materials used by third parties, and local fire-fighting
5 resources—are beyond utility control, perfect fire avoidance is no more feasible than perfect compliance
6 with the Commission’s General Orders.

7 Nevertheless, in directing the Utilities to file the Amended Application, the ACR expressed
8 concern that allowing rate recovery for wildfire costs could “undermine[.]” Utility incentives for prudent
9 risk management and safety regulation compliance and remove the Utilities’ financial motivation to
10 defend wildfire claims effectively.³⁷ The Utilities believe they currently administer strong programs to
11 mitigate the risk of fire and to minimize the cost of third-party claims, and that the confirmation of their
12 ability to recover wildfire costs will not weaken their commitment to take such actions. Nevertheless, to
13 address the concerns raised in the ACR and by other parties, the Amended Proposal creates new
14 financial incentives and preserves existing incentives.

15 **1. The Amended Proposal Creates New Financial Incentives To Prevent Fires**

16 Although the proposed balancing account will effectively protect the Utilities from the
17 potentially disastrous financial consequences of a catastrophic wildfire, the Amended Proposal does not
18 completely insulate Utilities from financial exposure to wildfire costs. Instead, the Amended Proposal
19 implements a comprehensive scheme to encourage the Utilities to maximize the safety of their
20 operations and minimize claims costs.

21 **2. The Proposed Mechanism For Recovering Wildfire Costs Encourages Utilities To**
22 **Comply With Safety Regulations And Avoid Fault For Wildfires**

23 Because Wildfire Costs eligible for recovery through the WEBA vary based on the
24 magnitude of the wildfire and the Utility’s conduct, the Utilities will remain strongly motivated to

³⁵ *Id.*

³⁶ *Id.*, p. 38.

³⁷ ACR, p. 8

1 prevent any wildfires. Where a wildfire results from negligent or otherwise actionable conduct by a
2 Utility employee,³⁸ the Utility faces financial consequences: it must bear a portion of costs—up to \$10
3 million for the first \$1.2 billion of Wildfire Costs, and 5% of costs over \$1.2 billion up to a cap. These
4 features of the proposed mechanism ensure that the Utilities potentially bear a portion of the Wildfire
5 Costs and thus have an immediate financial interest in taking steps to minimize the incidence of
6 avoidable actions by Utility employees that can lead to wildfires. The mechanism puts the Utility at
7 greater risk, and thus arguably creates stronger incentives, than traditional insurance, which provides full
8 coverage except in the case of intentional acts.

9 In fact, the only Wildfire Costs that receive comparable “insurance-style” treatment are
10 those incurred through inverse condemnation and/or strict liability where the Utility bears no fault or the
11 wildfire is due to forces beyond the Utility’s control. By allowing full recovery for this category, the
12 Amended Proposal insulates the Utilities from unwarranted financial harm under circumstances in
13 which, as a practical matter, the Utility could not have taken any action to prevent the wildfire from
14 occurring. Where the Commission determines that the costs belong in this category, there is no
15 inappropriate Utility action at issue, and therefore, there should be no concern that cost recovery may
16 dilute incentives for the Utility to act in an appropriate manner.

17 **3. Excluding Wildfires That Result In Damage of \$10 Million Or Less From WEBA**
18 **Encourages Utilities To Reduce All Fires**

19 Claims and Defense Costs for wildfires that result in Claims and Defense Costs of \$10
20 million or less are not recoverable through WEBA but instead are subject to normal GRC forecast risk.
21 This reinforces the Utilities’ interest in reducing the overall incidence of Utility-related fires. Because
22 the revenue requirement for Claims and Defense Costs for these smaller fires is fixed in the GRC, the
23 Utility has an incentive to take actions to reduce those costs. In turn, this will lead the Utility to take
24 actions to reduce the risk of all fires. As discussed above, the difference between a \$2 *million* wildfire
25 and a \$2 *billion* wildfire does not lie within a Utility’s control. Rather, whether any individual fire

³⁸ Excluding misconduct by a Utility officer that meets the criteria under Category C as described below in Chapter II, Section B.1.

1 escalates from small to large depends on a variety of factors unrelated to Utility operations, such as
2 weather and local fire-fighting capabilities. Since the Utility does not know if the Claims and Defense
3 Costs for any given fire will come from base rates or the WEBA, it remains in the Utility's best interest
4 to avoid any incident of fire.

5 **4. The Amended Proposal Preserves Current Safety Incentives**

6 Until recently, liability insurance, paid for through rates, appeared to be sufficient to
7 protect Utilities from the risk of fire claims. Thus, Utilities have traditionally had incentives to avoid
8 wildfires, even though they believed they would obtain full recovery of any claims costs. The incentives
9 that have always existed for the Utilities to prevent fires continue to exist. Regardless of the status of
10 their liability insurance coverage, Utilities are still subject to Commission oversight, and Utilities are
11 acutely aware that the Commission may impose penalties in connection with fires that are associated
12 with the Utility's failure to comply with safety regulations. Moreover, a major wildfire threatens not
13 only a Utility's reputation, but also the Utility itself. Utilities have extensive infrastructure, including
14 buildings and generation equipment, in their service territories, not to mention thousands of employees,
15 many of whom reside in their service territories, and millions of customers who depend on the Utility for
16 service. Fires threaten the well-being of all Californians, including the Utilities themselves, their
17 employees and their customers.

18 The Amended Application addresses the ACR's concerns regarding financial incentives,
19 but it is important to note that the Utilities' proposal does nothing to interfere with the traditional Utility
20 incentives to effectively manage fire risk. Allowing cost recovery for excess claims will not jeopardize
21 public safety any more than liability insurance does. The costs of claims could have a significant impact
22 on the financial health of the Utilities, but ensuring the Utilities' ability to recover such costs will not
23 diminish their incentive to ensure compliance with safety rules. The Commission already has in place a
24 process for investigating possible violations of General Orders, thus providing oversight of utility
25 diligence with respect to the safety of their facilities. The Amended Proposal does nothing to interfere
26 with that investigative process or with the ability of the Commission to impose penalties on Utilities
27 "where (a) there is a violation of a GO of which the utility either knows or should have known; and (b)

1 after acquiring either actual or constructive knowledge of the violation, the utility fails to cure it within a
2 reasonable period.”³⁹

3 Cost recovery and penalties serve different purposes. The purpose of ratemaking is to
4 give utilities the opportunity to recover costs that are necessarily incurred in the provision of service to
5 customers. The purpose of penalties, by contrast, is to punish past violations that were within the
6 utility’s control to prevent and deter future noncompliant behavior. The Amended Proposal recognizes
7 and respects that distinction—recovery will vary based on the size of a wildfire as well as Utility
8 culpability. This approach enhances Utility incentives to prevent fires while preserving the deterrent
9 function of penalties, ensuring both that the Utilities make safety the high priority it should be and that
10 the Utilities are not financially impaired by the capriciousness of wildfires.

11 **5. The Amended Proposal Maintains Utility Incentives To Defend Wildfire Claims**

12 In addition to financial incentives to prevent fires, the ACR highlights a concern that rate
13 recovery could leave the Utilities with “no financial motivation to defend such claims,” thus creating the
14 possibility of unending third-party claims.⁴⁰ However, the Utilities already face a near “limitless
15 potential for third-party claims,”⁴¹ including claims from government entities, in part because of the
16 inverse condemnation doctrine. In fact, as explained above, the reason California courts have extended
17 inverse condemnation liability to investor-owned utilities is due to the perception that Utilities have
18 “deep pockets” with which to pay the claims. In short, parties who believe they have potential claims
19 against the Utilities relating to fires already sue the Utilities, and the Amended Application will not
20 change or even aggravate this perception.

21 Furthermore, the Amended Proposal has no effect on a Utility’s incentives to defend
22 itself against wildfire claims. First, the proposal only applies to costs in excess of insurance, which
23 means that insurance companies will still play an active role in any wildfire litigation. Second, because
24 the Utilities must absorb some Wildfire Costs, they have an even stronger incentive to vigorously defend

³⁹ D.04-04-065, pp. 15-16.

⁴⁰ ACR, p. 7.

⁴¹ *Id.*

1 against claims under the Amended Proposal than they had in the past. In particular, it is in the Utilities'
2 best interest to keep total Wildfire Costs below the limit of their insurance coverage to the fullest extent
3 possible.

4 **6. The Amended Proposal Creates Incentives To Develop Innovative Fire Risk**
5 **Management Programs**

6 Because Utilities retain significant risk of Wildfire Costs under the Amended Proposal,
7 Utilities have a strong incentive to develop innovative approaches to reduce wildfires, to the fullest
8 extent possible. But because fire risk management measures are specific to each Utility and unique to
9 each service region, consideration of specific proposals should be left to more suitable venues, such as
10 the Utilities' GRCs.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

II.

COST RECOVERY TESTIMONY

A. Introduction

The Utilities request authorization to create a WEBA to record Wildfire Costs for recovery in retail rates. The proposed WEBA differs in significant respects described below from the WEBA proposed in the 2009 Application. As in the 2009 Application, Wildfire Costs include all amounts not authorized for recovery in that Utility’s base rates or otherwise, that are paid by a Utility for wildfire claims, the costs of defending such claims, and the costs of financing such amounts until recovered. As explained below, this proposal will not allow the Utilities to double-recover (i.e. to recover any amount already authorized in a GRC or any amount paid by insurance carriers). Unlike the 2009 Application, however, this proposal does not completely shield the Utilities from the financial consequences of wildfires. Instead, it is designed to offer the Utilities protection against substantial costs not covered by insurance to prevent a catastrophic wildfire from undermining the Utilities’ financial integrity, while providing incentives to minimize the risk of wildfire ignitions and to reduce claims expenses associated with wildfires.

B. Amended Cost Recovery Proposal

1. Costs Eligible For Recovery

In their respective GRCs, the Utilities may forecast Claims and Defense Costs for wildfires that result in Claims and Defense Costs of \$10 million or less. In the event of a wildfire, the Utility may record in a subaccount of the WEMA Claims and Defense Costs as they are paid. Once the Claims and Defense Costs for a given fire exceed \$10 million, the Utility may transfer the WEMA subaccount balance for that wildfire to a WEBA, and may record in the WEBA all additional Claims and Defense Costs paid with respect to such wildfire, as well as the costs of financing WEBA balances.⁴² Claims and Defense Costs recorded in the WEBA, along with the costs of financing WEBA balances, constitute Wildfire Costs. Claims and Defense costs relating to a wildfire that results in Claims and

⁴² As described in Chapter V below.

1 Defense costs of \$10 million or less are not Wildfire Costs and shall not be eligible for recording in a
2 WEBA. In addition, because recent experience demonstrates that the cost of wildfire insurance is
3 volatile and unpredictable, the Utilities propose to create a WIPBA to record all increases or decreases
4 from the amounts adopted in the Utilities' GRCs for insurance premiums attributable to coverage for
5 wildfire-related claims. Recording of costs in either a WEMA, WEBA or WIPBA does not create a
6 presumption of recoverability.

7 WEMA and WEBA will be credited for amounts received from insurance carriers to
8 reimburse the Utility for amounts paid by the Utility for Claims and Defense costs. In addition, WEMA
9 and WEBA will be adjusted for Third Party Recoveries.⁴³ With respect to wildfires where the Claims
10 and Defense Costs are recorded in WEMA, 100% of amounts received by the Utility from a Third Party
11 will be recorded as a credit to the WEMA. With respect to wildfires where the Claims and Defense
12 Costs are recorded in WEBA, Third Party Recoveries, net of legal expenses, will be shared 90% to the
13 Utility and 10% to ratepayers until the Utility has been fully reimbursed for Wildfire Costs it has
14 absorbed for that wildfire. Thereafter, 90% of Third Party Recoveries will be credited to Utility
15 ratepayers and 10% to the Utility.⁴⁴

16 a. Categorization of Costs Recorded in WEBA

17 As explained in detail in Chapter V of this Testimony, the Utility may file a
18 WEBA Application for recovery of Wildfire Costs recorded in its WEBA. A Utility may also file one or
19 more advice letters to obtain recovery of Wildfire Costs relating to a wildfire that are paid after the filing
20 of a WEBA Application relating to such wildfire. The Commission shall authorize recovery of such
21 costs consistent with its decision on the WEBA Application.

⁴³ Third Party Recoveries are amounts paid by any person, other than the Utility's insurer, e.g. a vegetation management contractor, that reduce the net amount the Utility pays in Claims and Defense costs, including amounts paid by a third party pursuant to a claim for indemnity or contribution and amounts paid to plaintiffs in settlement or following judgment. Payments that must be returned by a Utility to its insurers pursuant to subrogation or other rights are not Third Party Recoveries and shall not be recorded in WEMA or WEBA.

⁴⁴ In the case of payments made by third parties directly to claimants, rather than to the Utility, the shareholder share would be debited to the WEBA.

1 The WEBA Application shall demonstrate how the Commission should
2 categorize the Wildfire Costs that are the subject of the application, according to the following criteria:

3 Category A: Wildfire Costs shall be deemed to fall within Category A if they relate to
4 inverse condemnation⁴⁵ or strict liability claims to the extent the Claims and Defense Costs result from
5 circumstances in which the Utility was not at fault and/or that were beyond the Utility's ability to
6 control. If no determination is made in the civil action as to the Utility's fault (e.g., the claims are
7 settled), the Commission may allocate a portion of Wildfire Costs to Category A based on the relative
8 strength of the inverse condemnation and/or strict liability claims as compared to claims based on
9 negligent, reckless, or intentional acts or omissions.

10 Category B: Wildfire Costs shall be deemed to fall within Category B if they do not fall
11 within Categories A or C. Category B is intended to cover Wildfire Costs arising from acts or
12 omissions, including ordinary negligence, that would typically be covered by liability insurance. The
13 following is a non-exhaustive list of examples of situations in which Wildfire Costs would be
14 categorized as Category B costs (unless the costs qualify for treatment under Category A):

15 a. Claims and Defense Costs relating to a claimed failure to inspect a Utility
16 facility, or to take corrective action with respect to a Utility facility identified by a Utility inspection as
17 requiring corrective action where (i) the Utility has timely completed inspections required by General
18 Orders 95, 128 or 165, or (ii) the Utility's inspection program as a whole was not reckless;

19 b. Claims and Defense costs relating to a claimed failure to prevent the
20 overloading of a Utility pole, where the Utility's program for preventing overloading conditions as a
21 whole was not reckless; and (i) Utility employees or agents did not identify the overloaded condition
22 during inspections; or (ii) the overloaded condition was scheduled to be corrected but the wildfire
23 occurred prior to the correction; or (iii) the overloaded condition resulted from the action of a third
24 party;

⁴⁵ See Chapter I above for discussion of the inverse condemnation doctrine.

1 c. Claims and Defense costs relating to a claimed failure to manage vegetation,
2 where the Utility's vegetation management program as a whole was not reckless; and (i) Utility
3 employees or agents did not observe prior to the wildfire the need to clear or remove the vegetation
4 associated with the wildfire; or (ii) the vegetation was scheduled for clearance or removal but the
5 wildfire occurred prior to the clearance or removal;

6 d. Claims and Defense costs relating to a claimed failure to prevent contact
7 between Utility facilities and communication lines, where the Utility's program for preventing and
8 correcting such conditions as a whole was not reckless; and (i) Utility employees or agents did not
9 identify the condition during inspections; or (ii) the condition was scheduled to be corrected but the
10 wildfire occurred prior to the correction; or (iii) the condition resulted from the action of a third party.

11 The foregoing list of examples is not exhaustive; allocation of excess Wildfire Costs to
12 Category B may also be appropriate where other acts or omissions occur. Specifically, the listing of
13 these examples does not create any presumption that Wildfire Costs resulting from acts or omissions
14 falling outside these examples would be allocated to Category C.

15 Category C: Wildfire Costs shall be deemed to fall within Category C only under two
16 circumstances. First, Wildfire Costs resulting from acts or omissions intentionally engaged in or
17 directed by an officer with an intent to cause harm shall be Category C costs. Second, Wildfire Costs
18 resulting from acts or omissions intentionally engaged in or directed by an officer of a Utility who knew
19 or should have known of the probable dangerous consequences of those actions and willfully and
20 deliberately disregarded those consequences shall also be Category C costs, provided that the following
21 shall not be deemed to meet the standard set forth in this sentence:

22 a. A claimed failure to spend sufficient amounts on the Utility's system, where
23 the Utility has met defined spending metrics. The metrics, which will be established separately for each
24 Utility, are described in Part VI of this testimony.

25 b. An action (or a decision not to take an action), where the Utility disclosed to
26 the Commission in advance, in accordance with the Wildfire Program Advice Filing procedure
27 discussed below, its intention to take such action (or its decision not to take an action), along with facts

1 material to the Utility's decision, and the Commission did not direct the Utility to behave in a different
2 manner.

3 These circumstances are not exclusive; other circumstances could exist in which acts or
4 omissions by an officer fail to meet this standard. Specifically, the listing of these circumstances does
5 not create any presumption that Wildfire Costs resulting from acts or omissions falling outside these
6 circumstances should be allocated to Category C.

7 Wildfire Program Advice Filings are voluntary filings by a utility to update the
8 Commission on decisions pertaining to wildfire mitigation. A Utility may (but is not required to) submit
9 Wildfire Program Advice Filings to disclose decisions by Utility officer(s) regarding wildfire mitigation
10 activities (which may include Utility officer(s) decisions not to undertake certain activities) that are not
11 described in either the Utility's most recent GRC application or an application by the Utility for
12 approval of capital or Operations and Maintenance (O&M) expenditures that are designated by the
13 Utility in the application as wildfire mitigation measures. Wildfire Program Advice Filings are solely at
14 a Utility's discretion, and shall be Tier 2 filings with a 45-day protest period. If the Commission directs
15 a Utility to make additional expenditures in response to a Wildfire Mitigation Program Advice Filing,
16 the Utility would be authorized to record such expenditures in a memorandum account for potential
17 future recovery. If a wildfire results from an action or omission described in and occurring after the
18 submission of a Wildfire Program Advice Filing, and before the Commission directed the Utility to
19 behave in a different manner, the Wildfire Costs associated with such wildfire should not be deemed to
20 fall within Category C.

21 **2. Disposition of WEBA and WIPBA Balances**

22 The Utilities request that the Commission authorize the Utility to recover WEBA
23 balances as follows: The Utility should be authorized to recover in rates 100% of Wildfire Costs in
24 Category A. Recovery of Wildfire Costs in Category B would depend on their magnitude. The Utility
25 should be authorized to recover in rates 100% of Category B Wildfire Costs up to \$1.2 billion minus
26 wildfire liability insurance coverage held by the Utility (Tier 1 Costs), except as follows: For each

1 Wildfire Event,⁴⁶ the Utility would absorb the first \$5 million in Wildfire Costs that exceed the limit of
2 the Utility's highest level insurance, provided, however, that a Utility's cost responsibility for Tier 1
3 costs would not exceed \$10 million for all wildfires within any 12-month period. With respect to
4 Category B Wildfire Costs that exceed Tier 1 Costs (Tier 2 Costs), the Utility should be authorized to
5 recover in rates 95% of Wildfire Costs. The remaining 5% of Tier 2 Wildfire Costs would be absorbed
6 by the Utility, up to a cap. For SCE and PG&E, the cap on Tier 2 costs absorbed by the Utility should
7 be \$40 million for all wildfires within any 12-month period. For SDG&E and SoCalGas, the cap on Tier
8 2 costs absorbed by the Utility should be \$20 million for all wildfires within any 12-month period. Once
9 the costs absorbed by the Utility reach the cap, 100% of remaining Tier 2 costs would be recovered from
10 Utility customers.⁴⁷

11 The Utilities propose that the Commission authorize recovery of Category A and
12 B costs as set forth herein without reasonableness review. Commission review should be limited to (a)
13 allocating costs to Categories A, B, and C according to the criteria set forth above, (b) verifying that the
14 Utility actually incurred the costs recorded, and (c) determining whether the timing of rate recovery
15 proposed by the Utility is appropriate.

16 Because the WIPBA is intended to protect both the Utilities and customers from
17 fluctuations in the insurance market, and to reinforce Utility incentives to maintain the highest level of
18 insurance coverage that can be obtained at a reasonable cost, the Utilities request that WIPBA balances
19 be consolidated and disposed of annually, in accordance with established procedures for the recovery of
20 similar balancing accounts, such as the Medical Program Balancing Accounts and PBOP Balancing
21 Accounts.

⁴⁶ A "Wildfire Event" means all Wildfires within a Utility's service territory that are ignited within 14 calendar days of each other.

⁴⁷ The \$1.2 billion threshold, the \$5 million and \$10 million figures for Tier 1, and the cap for Tier 2 shall be escalated annually by the consumer price index.

1 **C. Balancing Account Recovery Is Appropriate For Wildfire Costs**

2 Balancing account recovery for Wildfire Costs is proper for two main reasons. First, as
3 described above, major wildfires are natural disasters for which the costs are beyond the Utilities’
4 control. Despite the Utilities’ efforts to limit wildfires’ ignition and spread, the risk of fire is inherent in
5 their operations and cannot be avoided. Thus, the cost of insurance and claims for such fires is a cost of
6 doing business and should be recovered in rates.

7 Second, Wildfire Costs are volatile, unpredictable and potentially financially devastating. Many
8 factors suggest heightened risk – potential drought, real estate development in fire-prone areas and
9 climate change – yet there is no clear way to measure the Utilities’ risk or to reasonably project costs.
10 As discussed below, insurers are unwilling to cover Wildfire Costs that could result from the most
11 catastrophic fires, and those risks remain with the Utilities. These are precisely the risks that are least
12 understood; thus it is proper that recovery for these risks should take place through a balancing account
13 process.

14 Recent events make it clear that uninsured wildfire claims could amount to billions of dollars,
15 but forecasting the timing and extent of such claims for ratemaking purposes would unnecessarily
16 increase rates while exposing the Utilities to unreasonable risks. The Commission has historically relied
17 on balancing accounts in cases where costs are unpredictable and beyond Utility control. Balancing
18 accounts were first set in place in 1975 to address significant swings in fuel costs due to volatility in fuel
19 prices and variations in hydroelectric power production. After a review of the operations of the Energy
20 Cost Adjustment Clause (ECAC) in 1980, the Commission stated:

21 We find that ECAC is an essential tool that can fairly balance the interests of the utilities and
22 ratepayers, while allowing this Commission the flexibility to recognize changes in price and
23 resource mix that would otherwise present enormous risks or opportunities in terms of
24 economic consequences for the utility. The dollars at stake are simply too substantial to
25 leave to the vicissitudes of nature such as we have experienced in California during the
26 existence of ECAC. “Feast or famine” is not a useful maxim of regulation.⁵⁰

27 Attempting to forecast and recover Wildfire Claims costs in GRCs could result in a similar feast
28 or famine. During years in which insurance covers most claims, the Utilities would gain excess profits.

⁵⁰ D. 92496, 1980 Cal. PUC LEXIS 1023; 4 CPUC 2d 693, 698 (12/05/80).

1 On the other hand, a major wildfire resulting in billions of dollars in claims could have negative
2 financial consequences as claims far outstrip the extent of annual cost recovery.

3 The ACR notes that the Utilities' proposed balancing account is extraordinary, and indeed it
4 represents a change in ratemaking for wildfire Claims and Defense Costs. However, the Commission
5 has applied balancing accounts in a number of instances where costs are outside a utility's control and
6 imposing the risks of cost variations on the utility is inappropriate. In addition to fuel and purchased
7 power costs recovered in ECAC⁵¹, utility costs from natural disasters are recovered through the
8 CEMA.⁵² Among the other costs receiving balancing account treatment are costs for nuclear
9 decommissioning trust contributions⁵³, pension contributions⁵⁴, and nuclear generation O&M costs for
10 plants not operated by the utility.⁵⁵ This list is not all-inclusive; in fact, the Preliminary Statements in
11 the Utilities' Tariff books include as many as 25 separate balancing account and/or cost adjustment
12 mechanisms.⁵⁶

13 1. **Self-Insurance**

14 The ACR also suggests self-insurance as a possible alternative to the use of balancing
15 accounts:

⁵¹ In 2003 ECAC was replaced by the Annual Transition Cost Proceeding in 1997, and then by the Energy Resource Recovery Account (ERRA), which covers both fuel related and purchased power costs. *See* D.02-10-062 (Oct. 24, 2002).

⁵² Res. E-3238 Order Authorizing All Utilities to Establish Catastrophic Event Memorandum Accounts (July 24, 1991), codified as Cal. Pub. Util Code § 454.9.

⁵³ Balancing account treatment was reauthorized in the Commission's last Triennial proceeding. *See* D.07-01-003, mimeo, p. 33.

⁵⁴ *See* Alternate Decision Of President Peevey On Test Year 2009 General Rate Case For Southern California Edison Company D. 09-03-025, March 12, 2009, mimeo, p. 142. This decision also authorizes balancing account recovery for medical costs.

⁵⁵ SDG&E receives balancing account recovery for its share of the San Onofre Nuclear Plant's costs. *See* D.06-11-026, pp. 12-13. SCE receives equivalent treatment for its share of the Palo Verde Nuclear Plant (*See* D.09-03-025, p. 16).

⁵⁶ *See, e.g.*, SCE's Preliminary Statements at <http://www.sce.com/AboutSCE/Regulatory/tariffbooks/PreliminaryStatements.htm>

1 Self insurance is another approach that has been suggested for the utilities to consider. This
2 approach, where a utility would set aside a sum as a protection against a potential loss, is
3 more accurately described as risk retention because no external insurance is involved.
4 Extensive analysis of wildfire probability and potential liability would be critical to
5 demonstrate the soundness of this approach to risk management, and to quantify any funding
6 amount to be included in regulated revenue requirement.⁵⁷

7 The ACR's admonition that such funding would need to be quantified with extensive
8 analysis of wildfire liability makes self-insurance unsuitable for large wildfires. As discussed above,
9 there is no reliable basis for forecasting uninsured claims from major wildfires at this time. However, as
10 previously noted, the Utilities are recommending self-insurance for wildfires with claims of \$10 million
11 or less. These claims would fall under the self-insured retention, or deductible, excluded from insurance
12 coverage. Because these costs are more readily forecast, they are appropriate for cost recovery through
13 GRCs.

⁵⁷ ACR, p. 8.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

III.

TESTIMONY OF JONATHAN E. BALL REGARDING INSURANCE

A. Introduction

My name is Jonathan E. Ball.

I am a Managing Director employed by Marsh USA Inc., where I am the National Casualty Leader & Placement Director for Marsh Power & Utility Practice. I am also a senior relationship manager between Marsh and the leading utility industry insurers – AEGIS and EIM.

My responsibilities involve the design and negotiation of liability insurance programs for Marsh clients in the power and utility industry sector. In performing these duties, I am in daily contact with clients, Marsh representatives and leading insurers around the world. Annually I am directly engaged in such negotiations for approximately 50 of these clients in the U.S. I keep abreast of emerging trends relevant to the liability insurance industry and disseminate that information to Marsh representatives in our offices throughout the U.S. I am called upon to offer advice and guidance to colleagues and clients as they conduct their own annual insurance renewal negotiations, as well. When negotiations become difficult, or hit the proverbial “snag,” I am brought in as a troubleshooter to assist in arriving at an acceptable outcome. This frequently requires that I engage senior insurance company management to resolve impasses.

My career focus has been on the provision of casualty consulting and placement services for clients in the energy sector. I have been employed in this endeavor by Marsh since 1985, when I joined its Marine & Energy Division as a trainee. I have held various positions within Marsh ever since, always focused on energy insurance. I assumed my present responsibilities in 2001.

Risk & Insurance magazine, a highly respected insurance industry publication, selected me as a 2009 “Power Broker” in recognition of my work on behalf of utility industry clients. (The title “Power Broker” refers to excellence in representing insurance clients generally, not just to electric power or energy insurance clients. The award is given to brokers who provide services to clients in many different industry groups.)

1 **B. Purpose of Testimony**

2 I have been retained by San Diego Gas & Electric Company and Southern California Gas
3 Company to explain current insurance market conditions with respect to the utility industry and to
4 discuss the unique situation that utilities operating in the state of California face in the current market as
5 they attempt to obtain adequate amounts of liability insurance at reasonable premium levels.

6 **C. Summary Of Conclusions**

7 The amount of liability insurance available to California-based electric and gas utilities
8 decreased substantially in 2009 and may not be adequate to cover potential exposures. At the same
9 time, the cost to purchase liability insurance escalated dramatically in 2009. Liability insurance costs
10 for these gas and electric utilities are substantially higher than such costs paid by utilities operating in
11 other states.

12 The primary cause of this situation is the liability insurance markets' response to the prospect of
13 paying large claims arising out of wildfires in recent years. I am not qualified to predict whether or not
14 wildfires will continue to plague California. However, in my opinion, if large wildfires should occur in
15 the future that are alleged to involve electric or gas utilities, it will become increasingly difficult –
16 perhaps impossible – for California utilities to find insurers willing to provide coverage for this type of
17 loss. Available amounts of insurance will certainly decrease significantly. If available at all, insurance
18 coverage will become increasingly expensive.

19 **D. Background**

20 Human error is inevitable. Mistakes and uncontrollable events are an ordinary part of business
21 and will occur in even the most prudently managed enterprises. Businesses purchase liability insurance
22 to protect themselves against the possibility that they may be sued and held liable for bodily injury,
23 property damage, or other costs to third parties when such accidents occur. To the extent that such
24 claims result in an obligation on the part of the enterprise to pay monetary damages, and insurance is in
25 place to pay those damages on behalf of the enterprise (or to reimburse the enterprise for any such
26 payments), the enterprise can continue to fund its normal activities. In the absence of insurance
27 protection, after using its capital to pay damages, an enterprise may find itself lacking necessary funds to

1 conduct its business in a prudent manner. It may encounter difficulty in meeting its normal expenses,
2 maintaining adequate staffing levels, and investing in the maintenance of its facilities. It may be forced
3 to reduce these types of important expenditures because of the depletion of its funds from uninsured
4 losses.

5 Much as people consider the liability insurance that is included in their homeowner's or renter's
6 insurance policies to be a prudent purchase to ensure that they can continue to pay their own bills and
7 maintain their properties, a business enterprise will make similarly prudent decisions. Many people
8 purchase personal umbrella policies to increase the amount of their insurance protection, recognizing
9 that in today's legal environment the potential always exists that they might be sued because someone is
10 injured on their property, or because one of their family members is involved in an auto accident that
11 injures a person. With no real way of knowing whether this will happen, or how much it might cost
12 them if it does happen, they elect to buy more insurance when they find a policy that is reasonably
13 priced. They can budget for the cost of that insurance policy far better than they can budget for the
14 unknown costs that they may face if they do not have the insurance. This allows them to conduct their
15 normal pursuits with more confidence – they can decide to replace the aging roof before it leaks, or they
16 can purchase a new vehicle to replace an unreliable clunker. In short, they can invest in their immediate
17 needs and make plans for their future expenditures without fear that all might be lost if someone were to
18 fall and injure themselves on their property, or their teenage driver becomes involved in an auto
19 accident, and the resultant lawsuit wipes out their funds.

20 Prudent business enterprises make similar decisions in order to ensure their own capital liquidity.
21 The ability to transfer the unknown costs of possible litigation to insurance companies in exchange for
22 the payment of a reasonable fixed premium amount allows them to conduct their business operations
23 while continuing to make prudent investments in their facilities. They can do this because insurance
24 improves their ability to forecast the amount of funds they will have available to do so. When
25 enterprises are better able to meet obligations such as payroll, while also investing in the maintenance of
26 their facilities to enhance safe and reliable operations, benefits accrue, enhancing the financial security,
27 health and safety of those who come in contact with them.

1 **1. Insurance Concepts – Overview**

2 Fundamentally, the concept of liability insurance is to spread the financial risks that
3 might be faced by one business among the many businesses that purchase insurance, thereby protecting
4 the individual business against very large costs that might otherwise negatively impact its ability to
5 continue safe and effective operations. It is by collecting premiums from their many clients, and
6 investing those funds wisely, that insurance companies are able to pay the claims of the few (they hope)
7 clients who face liability in a given year.

8 **2. Insurance Company Financial Ratings And Stability**

9 a) Surplus

10 Surplus is money held by an insurance company which is available to pay claims.
11 An important feature of any insurance program is the ability of the insurance company to pay any claims
12 that may arise. Paying a very low price for a policy that appears to provide broader coverage or much
13 higher limits than another available insurance policy would seem to be a great idea. And it is a great
14 idea, as long as the company from which you buy the insurance actually has the funds to pay a claim.
15 For this reason, the financial stability of insurance companies is a key criterion – along with breadth of
16 coverage and premium costs – in choosing the insurer with whom you would want to do business.

17 Various rating agencies measure the financial stability of insurers, which is in
18 large part a function of their surplus. BEST is a rating agency that specializes in the insurance industry.
19 As a result, their ratings are the most widely recognized in this industry. Standard & Poors (S&P) and
20 other agencies also rate insurance companies.

21 Generally, a BEST rating of A- is the lowest rating that Marsh would consider
22 relatively safe to utilize for a large commercial enterprise such as a major public utility.

23 b) Loss Ratio

24 Insurance companies measure their performance based upon their “loss ratio.”
25 Simply stated, the loss ratio is a percentage derived by dividing the amount of losses the company pays
26 out (or reserves) by the premium income that the company receives. In other words:
27

1 Loss Ratio = Claim Payments and Reserves by Company
2 (\$) / Premium Revenue Received (\$)

3 A loss ratio in excess of 100 percent means the insurance company is paying out
4 more than it takes in. That is not a strong business model. The company, in order to make its claims
5 payments, would be forced to draw upon its surplus funds. Reductions in surplus get the attention of the
6 rating agencies, and that can lead to a lower rating. By way of example, BEST recently reduced the
7 rating of a leading utility industry insurer, AEGIS (discussed below) from "A" to "A-," in part because
8 of its negative (greater than 100%) loss ratio and the resultant reduction in its surplus.

9 Insurance companies also make decisions about the amount of coverage, if any,
10 that they are willing to sell to a buyer based upon that particular buyer's loss ratio, i.e., the amount of
11 losses that the insured has claimed against its policies divided by the amount of premium that it has paid
12 to its insurers for the policies over a period of time (5 or 10 years, typically).

13 c) Reinsurance

14 Insurance companies often purchase insurance from other companies. These
15 other companies are known as "reinsurers." The reinsurers' policies help pay for any claims that the
16 insurer may owe. The insurance company is buying reinsurance to help protect its own balance sheet, in
17 the same way that a business buys insurance to help protect the business' balance sheet.

18 **3. Liability Insurance Programs**

19 Businesses attempt to purchase enough insurance to protect themselves against unusually
20 large losses. Because those losses can amount to many millions, even hundreds of millions of dollars or
21 more in a given year, large businesses often seek insurance in amounts that far exceed what any one
22 insurance company is willing to sell. Insurance brokers play an active role in these circumstances. They
23 negotiate with many different insurers to put together a program in which multiple insurers participate,
24 in order to deliver a large enough amount of insurance to meet their clients' desires.

25 Program design involves the selection of a "lead" insurer, whose premiums and type of
26 coverage offered set the tone for all other participants in the program. Various factors go into the design
27 and negotiation of these programs, which I will explain in this testimony. Depending on the amount of

1 insurance desired, a program design often includes the development of an insurance “tower” containing
2 multiple “layers.”

3 The negotiation process that develops the eventual design of the total excess liability
4 program can be described as fitting together pieces of a complicated puzzle. Quotes are negotiated for
5 various limits and different attachment points (described below) with a variety of insurers. Then,
6 somewhat like a puzzle, the pieces are fitted together to create a tower of insurance policies. Each level
7 of the tower (“layer of insurance”) is occupied by insurance company(s) willing to provide the best
8 combination of coverage and premium in that “layer.” Each layer attaches, or sits on top of, the layer
9 immediately below.

10 The dollar amount excess of which an insurance policy begins to pay losses is also
11 referred to as the policy’s “attachment point.” For example, a policy may provide limits of insurance
12 that are described as being “\$25 million excess of \$100 million,” which in this case would mean that the
13 loss amount paid must exceed \$100 million before this particular policy will have to pay up to an
14 additional \$25 million in claims. The “attachment point” of this \$25 million “layer” is therefore \$100
15 million.

16 **4. Insurance Companies**

17 a) Mutual Insurance Companies

18 AEGIS (Associated Electric & Gas Insurance Services Limited) and EIM (Energy
19 Insurance Mutual) are mutual insurance companies who together provide as much as \$135 million in
20 insurance limits to policyholders. They were formed to serve the needs of the utility industry and are
21 owned by their policyholders, principally utilities. They are not publicly traded companies. AEGIS
22 provides insurance coverage to more than 400 “policyholder-members.” EIM provides insurance
23 coverage to approximately 175 “policyholder-members.” Given the fact that these companies provide
24 insurance to a large number of policyholder-members, individual policyholders do not have the ability to
25 impose their unique desires for coverage and pricing on the companies.

26 These companies traditionally sell insurance products at lower cost and/or provide
27 a broader scope of coverage (i.e. covering more possible losses with fewer exclusions) than the balance

1 of the insurance market, which consists of stockholder-owned insurance companies. In addition, since
2 they were formed by the utility industry to serve its insurance needs, both AEGIS and EIM have tailored
3 their coverage to address those needs. They provide coverage that is important to utilities but is
4 extremely difficult to obtain in other liability insurance policies.

5 Finally, for policyholder-owned mutual insurance companies to remain
6 financially viable, their premium and investment income must keep pace with the amount of claims
7 being paid.

8 b) Commercial Insurance Market

9 There are, of course, other providers of insurance available to utilities. Several
10 U.S. based insurance companies, most notably Chartis (formerly AIG), and ACE, as well as insurance
11 providers domiciled in London (including Lloyds of London), Europe (such as Swiss Re and Scor) and
12 Bermuda (such as XL, ARCH, Allied World, and a host of others) offer liability insurance to utilities. I
13 will discuss these other insurance “markets” in more detail later in this testimony.

14 **5. Liability Insurance Program Design**

15 a) Lead Insurer

16 To construct a liability insurance program, the first step is to identify insurance
17 companies that will pay claims of relatively low value, which typically occur more frequently than large
18 claims. These insurers are known as “lead” or “first layer” insurance carriers. They sell policies that
19 pay claims in excess of a “deductible” or “Self Insured Retention” (“SIR”). The insurance policy
20 therefore “attaches excess of the SIR,” meaning that the policy will not pay for claims until the SIR has
21 been paid by the insured. These lead policies are the most expensive when measured in terms of the cost
22 per million dollars of insurance, because they are far more likely to pay claims compared to policies that
23 do not have to pay until a loss reaches a much higher dollar value. In other words, policies that “attach”
24 only after higher dollar amounts are paid by the insured (or by policies that attach at lower dollar
25 amounts) charge less premium for each million dollars of insurance than “lead” policies.

26 In this testimony, I am focusing on AEGIS because it is the lead insurer for the
27 vast majority of utility companies in the US, and it is the lead insurer on the programs that insure Pacific

1 Gas and Electric Company, San Diego Gas & Electric, Southern California Gas Company and Southern
2 California Edison Company. I have mentioned that AEGIS coverage is broad compared to other
3 insurers. By this I mean that the language of the policy document assures that it will pay for more types
4 of claims than the policies that are sold by other lead insurers. Because of this broad coverage and
5 AEGIS' willingness to provide coverage at relatively low attachment points, AEGIS policies are usually
6 preferable to those offered by other insurance companies.

7 In addition, both the premiums charged by the lead insurer and the breadth of the
8 coverage that it provides have a direct bearing on the premiums and scope of coverage offered by the
9 other insurers who agree to follow the lead policy's coverages.

10 AEGIS offers \$35 million in insurance, which becomes available to the insured
11 after the insured has paid losses up to the negotiated SIR amount. AEGIS therefore pays up to \$35
12 million excess of the SIR.

13 b) Other Insurers

14 Once the insurance broker and the client have identified the lead insurer, and have
15 negotiated a policy with that insurer in accordance with the client's needs, they can negotiate additional
16 limits of insurance with insurance companies who are willing to cover the exposures involved, but are
17 unwilling to put their own policy at risk at the lower attachment points.

18 I discussed EIM earlier. EIM has in recent years offered up to \$100 million of
19 coverage (although, as described below, that amount is being reduced in some instances in California),
20 but it will not agree to pay losses until the loss amount exceeds \$35 million. In other words, EIM's
21 policy will attach excess of the amounts paid by AEGIS. EIM offers this large amount (limit) of
22 insurance because its higher "attachment point" means that it is less likely to have to pay a claim. EIM
23 is the only insurance company that will agree to provide nearly exactly the same broad coverage that
24 AEGIS offers. That willingness, the large limit it offers, and the relatively lower price that it charges
25 makes it an attractive option for utility insureds – who are, after all, its owners as well. Many large
26 utilities choose EIM as their "second layer" insurer for these reasons.

1 Commercial market insurers can also provide coverage excess of AEGIS, in
2 competition with EIM. However, since the coverage that these insurers offer is not as broad as AEGIS
3 and EIM, and their policies are generally more expensive than EIM, most utilities will purchase
4 coverage from EIM before they will consider using the commercial market insurers. These commercial
5 market insurers then provide additional limits of insurance, attaching excess of EIM, for utilities who
6 desire more than \$135 million of insurance coverage.

7 c) How Much Insurance Should A Utility Purchase?

8 Utility companies of any substantial size will often purchase both AEGIS and
9 EIM, buying up to \$135 million limits of liability insurance. The total amount that they purchase is a
10 decision made individually by each buyer, taking into account such issues as:

11 The potential financial impact on their business of uninsured losses,

12
13 The legal environment in which they operate (US legal system, propensity of state or
14 other local jurisdictions to award large verdicts, etc),

15 Their prior loss experience,

16
17 The loss experience of other utility companies in the same geography or of similar size in
18 other geographies,

19
20 The cost of the available additional limits of liability vs. the likelihood of claims reaching
21 the attachment point of that layer.

22 When a utility decides that it wants or needs more than the \$135 million limit
23 available from AEGIS and EIM, the broker works with other insurance companies to negotiate the best
24 deal available, in terms of the cost of the policy and the breadth of the coverage. Every insurance
25 company has its own appetite for risk, translating into its own preferred attachment points and pricing
26 models, which vary according to the utility's business operations (and therefore the resultant perceived
27 exposure to potential losses).

28 The cost of the policy in each layer is evaluated in terms of the premium charged
29 for each million dollars of insurance. This is necessary because the amount of insurance offered in each
30 layer is not necessarily the same as the amount offered in all other layers. Typically, that cost per
31 million dollars decreases as the attachment point of the layer in question increases so that the cost of the

top layer of a large program will usually be significantly less than the cost of the lead – or first – layer of the tower. With the understanding that utility companies’ program designs vary widely in response to their unique circumstances, an example of a utility liability insurance program of \$1 billion is presented in the diagram below:

INSURANCE COMPANY	LIMIT (\$ Millions)	ATTACHMENT POINT (\$ Millions)
J	\$90	\$910
I	\$100	\$810
H	\$50	\$760
G	\$50	\$710
F	\$150	\$560
E	\$50	\$510
D	\$100	\$410
C	\$100	\$310
B	\$75	\$235
A	\$50	\$185
AEGIS London Syndicate	\$50	\$135
EIM	\$100	\$35
AEGIS	\$35	SIR

Sample Listing of Commercial Insurers

Chartis Energy (US and Bermuda)
 ACE (US and Bermuda)
 Zurich Global Energy (US)(US and Bermuda)
 Swiss Re
 Scor Re
 Lloyds of London
 XL (Bermuda)
 Allied World Assurance
 Argo Re
 Torus
 Canopus
 OCIL
 Aspen (UK and Bermuda)
 Endurance
 Chubb Atlantic

E. Market Conditions

1. Geographic Risk

All insurance companies, whether mutual or publicly traded, can face unexpected spikes in costs when they have a concentration of insureds in a geographic region whose unique characteristics create a greater potential for losses to occur. Consider, for example, homeowner’s insurance. In

1 California, where earthquakes are more common than in other areas, homeowners (and businesses) may
2 find it difficult to obtain reasonably priced insurance policies for damage caused by earthquakes.
3 Property owners may find that many insurers will simply refuse to sell insurance to them, and those that
4 are willing to do so charge premiums that are far more expensive than premiums charged to owners of
5 similar premises located in areas that are less susceptible to earthquakes.

6 In the commercial liability insurance arena, California has become associated with
7 wildfire liability risks in a more direct way than any other part of the country. Prior to 2009, wildfire
8 liability was not a focus of significant attention in the negotiation of business liability insurance policies.
9 Owing to substantial fire activity, and the resulting large financial damages for which utilities in
10 California are alleged to be liable, wildfire liability has now received similar attention to the earthquake
11 risk discussed above. The wildfires that occurred in 2007 have altered the insurance industry's
12 perception of the chances that they may have to pay more such claims in the future. In addition, while I
13 will remind you that I am not an attorney and am not qualified to interpret California law, underwriters
14 from several insurers have indicated to me that they believe that California's "inverse condemnation"
15 doctrine imposes a strict liability standard which makes it far more likely that electric utilities in
16 California will be held liable for damages caused by wildfires.

17 **2. 2009 Insurance Market Condition – Power And Utility Industry**

18 The power and utility liability insurance market experienced dramatic changes in 2009.
19 Among the reasons for these changes are significant increases in the number and amount of claims,
20 lower insurer investment income (which previously helped offset negative loss ratios), and increased
21 costs of "reinsurance." (Reinsurers have experienced the same market realities as the insurers, and are
22 taking similar steps to protect their own ongoing financial stability including raising premium levels and
23 reducing or eliminating coverage.) Power and utility clients are feeling the results of these changes.

24 California wildfires have also been a major contributor to this situation, so much so that
25 they are featured prominently in the AEGIS 2008 Annual Report, which states that "fires involving
26 natural resources" account for 19 percent of its Claims Reserves, which refers to the amount of claims it
27 expects to pay, as opposed to the amount already paid. Sempra has advised that homeowners' insurers

1 have paid out and reserved approximately \$1.6 billion for claims relating to the 2007 wildfires. If those
2 claims amounts hold up and payments reach that level, this could easily be the largest insured liability
3 loss ever for a U.S. electric utility. Elsewhere in its Annual Report, AEGIS states “For the past three
4 years, our excess liability net loss ratios have been 135 percent, 170 percent and 173 percent.”
5 Obviously, with diminished prospects for investment income in 2009, overall premiums must increase to
6 fund losses.”

7 As a result of this increasingly difficult claims environment, beginning in the fourth
8 quarter of 2008, AEGIS’ premium increases generally ranged from 15 percent to 30 percent. The
9 increases charged to each insured largely depend upon its own specific loss record as compared to its
10 premiums paid to AEGIS over the past few years.

11 Following AEGIS’ lead, EIM renewals evidenced premium increases in the range of 5
12 percent to 10 percent since year end 2008. Based upon recent trends and my experience in the insurance
13 industry, I anticipate that EIM’s premiums will continue to escalate in the near future to a range of 10
14 percent to 40 percent higher than their 2008 pricing.

15 Insurance companies located in London and Bermuda generally provide insurance that
16 comes closest to following the broad coverage offered by AEGIS and EIM. As a result, utilities that
17 need higher amounts of insurance than those offered by AEGIS and EIM usually purchase policies from
18 London and Bermuda insurance companies. However, a number of London insurers have discontinued
19 writing insurance for US utilities. Accordingly, the amount of insurance that is available from London
20 insurers has decreased substantially as compared to prior years. The few London insurers who continue
21 to offer coverage have been quoting substantial premium increases as well.

22 Many European insurers, as well as many of the Bermuda insurance companies, will not
23 provide coverage for any liability arising out of wildfires and/or will not provide coverage to electric
24 utilities located in California. With fewer insurers offering smaller amounts of insurance, there is less
25 competition among the insurers to sell insurance to California electric utilities. As a result, those that
26 continue to offer coverage are doing so at premiums that are significantly higher than the amounts
27 charged prior to 2009.

1 The result has been that California electric utilities saw overall premium increases from
2 AEGIS in 2009 of 25 percent or more. At the same time, AEGIS imposed “coinsurance” requirements
3 (similar to the copayments that we make under our medical insurance policies) of as much as 50 percent
4 of their total \$35 million limit. This means that an AEGIS \$35 million policy actually paid only \$17.5
5 million for wildfire liability; the policyholder would pay the other \$17.5 million.

6 EIM provides as much as \$100 million of insurance to electric utilities, but in 2009 for
7 California electric utilities they did not sell more than \$25 million of coverage for wildfire liability.
8 EIM may also ask for a coinsurance arrangement similar to the AEGIS arrangement described above.
9 Meanwhile, EIM’s premium for the \$25 million limit could be many times the size of the premium that
10 it previously charged to California insureds (again, measured in terms of the cost per \$ million in limits).

11 AEGIS established a Lloyds of London syndicate to provide broad coverage in excess of
12 that supplied by AEGIS and EIM. The AEGIS London Syndicate, which has historically provided \$50
13 million of limits attaching excess of EIM with similar broad coverage excluded wildfire liability on
14 many of its policies in 2009. When it did offer wildfire liability coverage to a California based utility,
15 premium costs were dramatically increased as compared to previous years.

16 Thus a utility that obtained the first \$185 million of limits, including wildfire liability,
17 from AEGIS, EIM, London, and other European insurers in 2008 found that in 2009, the same insurers
18 would provide as little as \$30 million (\$12.5 million from EIM and \$17.5 million from AEGIS)—a 78
19 percent reduction in available coverage.

20 At this point, electric utilities will likely turn to the Bermuda market. In the past, a
21 typical attachment point for Bermuda insurer layers has been at least \$135 million to \$185 million (for
22 example, \$35 million from AEGIS + \$100 million from EIM + \$50 million from Lloyds of London). As
23 I have described, this amount of insurance for wildfire liability may no longer be available from these
24 insurers. That means that we now have to ask Bermuda or other insurers to provide coverage at much
25 lower attachment points than in the past, for an exposure that is far more worrisome to them.

26 Insurer’s decisions may vary among the utilities depending upon the extent to which the
27 insurers’ perceive ongoing exposure to future wildfire losses, as well as each utility’s prior loss

1 experience. In my experience, those who are willing to provide this coverage now charge much higher
2 premiums than ever before for doing so.

3 **3. 2010 And Future Insurance Market Conditions - Power And Utility Entities**
4 **Exposed To Potential Wildfire Liability Claims**

5 Thus far in 2010, premium levels for power and utility industry clients of Marsh have
6 generally not returned to pre-2008 levels. Industry mutual insurers AEGIS and EIM premiums have
7 risen in 2010, over and above the amounts charged in 2009. Power and utility clients conducting
8 operations in the state of California continue to experience liability insurance premium levels that are
9 typically substantially higher than those charged to similar companies in other geographic areas of the
10 US, to the extent that insurers determine that the utility is exposed to wildfire risk.

11 Based on my observations, I do not expect that this situation will improve in the
12 foreseeable future. I do not believe that premiums will return to pre-2008 levels. In fact, I would
13 suggest that annual increases will probably continue, albeit at perhaps a more modest rate than we have
14 seen in the past year. None of us, however, can guarantee future market performance. Ongoing turmoil
15 in the financial markets that continues to impact investment returns earned by insurance companies'
16 surplus funds may cause these companies to continue to focus on pure underwriting profitability. This is
17 not good news for insurance buyers who have been responsible for insurance company losses in the past.

18 I have noted the emergence of a new insurance product in 2010 which delivers additional
19 limits of insurance designed specifically to pay for property damages arising from wildfires. This new
20 product has made it possible for certain California-based power and utility clients to obtain additional
21 limits of insurance protection. The premium charged for this additional protection remains quite high in
22 comparison to premiums charged to clients who are not exposed to claims arising out of damages caused
23 by wildfires in California.

24 In the case of wildfire liability coverage, I believe that should a catastrophic wildfire
25 occur causing the insurance market to pay substantial losses, the amount of insurance protection
26 available to California utilities for future wildfire damages will at best be greatly reduced, if available at
27 all. I believe this statement to be true of the new reinsurance product discussed above, as well.

1 IV.

2 **UTILITIES' INSURANCE TESTIMONY**

3 **A. SDG&E and SoCalGas Insurance Testimony**

4 **1. Purpose Of Testimony**

5 I am the Director - Risk Management for Sempra Energy, which obtains liability
6 insurance for SDG&E and SoCalGas as an approved shared service. My responsibilities include
7 the development and implementation of insurance programs for SDG&E and SoCalGas, and I
8 have been personally involved in the design of the program and procurement of liability
9 insurance for SDG&E and SoCalGas.

10 The purpose of my testimony is to build upon Mr. Ball's overview of the
11 insurance market and its impact on gas and electric utilities, and to describe the impact of recent
12 changes in the liability insurance market on SDG&E and SoCalGas. In particular, I will provide
13 a general overview of the SDG&E/SoCalGas liability insurance procurement process, and
14 describe our process and results for the 2008-2009, 2009-2010, and 2010-2011 policy years. In
15 addition, I will describe alternatives to traditional general liability and wildfire liability insurance
16 considered by SDG&E and SoCalGas.

17 **2. Overview of the SDG&E/SoCalGas Liability Insurance Procurement**

18 **Process**

19 Sempra Energy's liability insurance program renews on June 26 every year.
20 Sempra Energy procures liability insurance on behalf of itself and its affiliates, including
21 SDG&E and SoCalGas, and allocates a portion of the total expense to each affiliate. For ease of
22 reference, I will simply refer to SDG&E and/or SoCalGas liability insurance procurement in the
23 remainder of my testimony.

24 SDG&E and SoCalGas buy liability insurance because human error is an inherent
25 part of any business enterprise, and accidents happen. Liability insurance protects utilities and
26 their customers from the financial consequences of claims resulting from incidents involving
27 utilities. The policies procured for SDG&E and SoCalGas provide insurance coverage for third-

1 party claims for bodily injury, property damage, and related costs, such as fire suppression costs.
2 The policies include a deductible, as do nearly all commercial insurance policies. Sometimes
3 called a self-insured retention, the deductible is an “out-of-pocket” expense the insured must
4 incur before the insurer pays out money for an insured claim. Liability policy deductibles are
5 typically on a “per occurrence” basis.

6 The focus of the SDG&E/SoCalGas liability insurance procurement process each
7 year is to obtain the maximum amount of liability insurance that is available at a reasonable
8 price. Comparison with other gas and electric utilities in past years has indicated that the billion
9 dollar limits generally purchased by SDG&E and SoCalGas are matched by few others. Each
10 layer of policies is designed to provide the most reasonably-priced coverage available before the
11 next layer is approached. Liability insurance for SDG&E and SoCalGas is procured by using an
12 approach that identifies potential risk exposures and seeks to minimize the overall cost of these
13 risks by blending insurance with manageable deductibles. Deductible levels and premium levels
14 are generally linked – all else being equal, the higher the deductible the lower the premium level.
15 We believe our process is effective, prudent, and a reasonable way to purchase large amounts of
16 liability insurance coverage. While SDG&E cannot control underwriters’ decisions on limits
17 offered and pricing, this process allows us to make our best efforts to positively influence
18 underwriters’ decisions.

19 We purchase insurance for the initial layers of SDG&E’s liability program from
20 the industry mutual insurers, AEGIS and EIM.⁵⁸ AEGIS currently insures over 95% of the
21 utility industry in the United States as well as utilities in Canada and Europe. AEGIS offers
22 coverage designed for utilities that in many ways is broader than coverage available in the

⁵⁸ Associated Electric & Gas Insurance Services Limited (AEGIS) is a mutual insurance company owned by its policyholder-members. AEGIS was formed to serve the utility and related energy industry. Member companies currently include gas and electric utilities, related energy companies, oil and gas exploration and production companies, water utilities, and transmission and distribution companies. Energy Insurance Mutual Limited (EIM) is a mutually owned excess liability insurance carrier. Membership is available to utilities along with members of the energy services industry that meet the underwriting standards established by the company.

1 commercial market. EIM always follows AEGIS in the next layer of insurance since it will only
2 write insurance above a minimum of \$35 million, and therefore does not compete with AEGIS.
3 EIM follows the broad terms and conditions of the underlying AEGIS policy. As explained by
4 Mr. Ball, AEGIS and EIM were formed to serve the needs of the utility industry and are owned
5 by their policyholders, principally utilities. SDG&E has a long history of coverage with AEGIS,
6 going back to 1975.⁵⁹

7 The commercial market comes into play for liability insurance above the layers
8 supplied by the industry mutual insurers. SDG&E and SoCalGas seek competing quotes from
9 the London, Bermuda, United States domestic, and other world markets. Underwriting
10 discussions are conducted with all interested markets. We also take into consideration the
11 financial capability of insurers in every layer of the program to pay claims when they occur, and
12 will not purchase insurance from insurers who do not meet minimum financial standards or those
13 whose rates would negatively impact their layer and the rates above and below. Minimum
14 financial standards are based upon insurer ratings from A.M. Best Company, and our policy is to
15 buy insurance from companies who are rated “A-” or better.⁶⁰

16 Best’s Financial Strength Rating (FSR) or “alphabetical” designation is an
17 independent opinion of an insurer's financial strength and ability to meet its ongoing insurance
18 policy and contract obligations to policyholders. Ratings are outlined in the Best’s FSR table:

⁵⁹ SDG&E was the 22nd member of AEGIS, which was formed in 1975. This long-term history is due to the valuable and economical coverage AEGIS provides to its insured members, which is why 95% of the utility industry places its primary liability insurance layer with AEGIS, including PG&E and SCE.

⁶⁰ A.M. Best Company is a worldwide insurance-rating and analysis agency with more than 100 years of history. Policyholders refer to the Best's ratings in “*Best's Insurance Reports*” as a means of assessing the financial strength of insurers.

Secure	Vulnerable
A++, A+ (Superior)	B, B- (Fair)
A, A- (Excellent)	C++, C+ (Marginal)
B++, B+ (Good)	C, C- (Weak)
	D (Poor)
	E (Under Regulatory Supervision)
	F (In Liquidation)
	S (Rating Suspended)

1 The minimum financial standard of “A-” rating (“excellent”) is assigned to
2 companies that have, in A.M. Best's opinion, an excellent ability to meet their ongoing
3 obligations to policyholders. Ratings from A to C also may be enhanced with a “++” (double
4 plus), “+” (plus) or “-” (minus) to indicate whether credit quality is near the top or bottom of a
5 category.

6 SDG&E and SoCalGas are assisted in their liability insurance procurement by
7 experienced insurance brokers who specialize in placing insurance for utilities. The use of
8 insurance brokers is common for a company of Sempra’s size, and nearly every AEGIS and EIM
9 member uses a broker in their liability renewal process, especially to negotiate price and
10 premiums. We rely upon the skill and experience of insurance brokers to assist in determining
11 appropriate insurance coverage levels and types, and, most importantly, to deal directly with
12 insurance underwriters in negotiating liability insurance pricing and premiums. We utilize
13 prominent and well-respected insurance brokerage firms who broker numerous placements with
14 AEGIS and EIM, using their knowledge and experience to help secure the best deals from these
15 insurers. In addition, while Sempra’s risk management representatives are permitted to deal
16 directly with mutual insurers AEGIS and EIM without being licensed, we are not licensed to deal

1 directly with insurers in London or Bermuda. Our insurance brokers, however, are licensed to
2 conduct insurance business on behalf of their clients in those jurisdictions. Sempra's risk
3 management representatives works closely with Marsh representatives, particularly Joseph
4 Phillips, during each renewal process. Mr. Phillips has represented SDG&E for over 20 years,
5 and did so during all recent renewals. He is among the top insurance brokers in the utility sector.
6 Each year's liability insurance renewal process involves an almost constant dialogue between
7 SDG&E and our insurance broker, who negotiates pricing with underwriters, reports back with
8 ongoing status updates, receives instructions from SDG&E, and carries out the negotiation
9 process.

10 **3. 2008-2009 Liability Insurance Renewal**

11 During the 2008-2009 renewal process, virtually all insurers who had
12 written liability insurance for SDG&E in 2007 renewed their coverage, and several new
13 underwriters also offered coverage. Rates were slightly higher than in 2007, but SDG&E
14 was able to acquire \$1.17 billion of liability insurance, including coverage for wildfire
15 liability, for a premium cost to SDG&E and SoCalGas of \$13.6 million. As in prior
16 years, wildfire liability coverage was provided through standard liability policies. The
17 liability insurance underwriters were well aware of the 2007 San Diego wildfires at the
18 time of this renewal. But only AEGIS had actually posted a reserve for potential losses
19 from these fires, and the occurrence of the fires did not appear to have a substantial effect
20 on the price of the policies or the amount of coverage offered to SDG&E and SoCalGas.

21 **4. 2009-2010 Liability Insurance Renewal**

22 a) Changes in the Liability Insurance Market

23 The 2009 liability insurance renewal was much different than what
24 SDG&E and SoCalGas had experienced in prior years. There was far less insurance
25 available, and the cost of the insurance had dramatically increased. By the time the
26 renewal season began in 2009:

- 1 • Over 100 lawsuits with over a thousand plaintiffs had been
- 2 filed against SDG&E seeking to recover damages and other
- 3 costs associated with three of the October 2007 San Diego
- 4 County wildfires;
- 5 • While the total amount of these claims is still unknown to
- 6 SDG&E at this time, the homeowner insurer plaintiffs have
- 7 paid and reserved claims in excess of \$1.6 billion;⁶¹ and
- 8 • All of the underwriters who insured SDG&E in 2007 had
- 9 established full limit loss reserves for these losses.⁶²

10 I believe there were at least five factors that contributed to insurers
11 decreasing available coverage and increasing their 2009 premiums for SDG&E and
12 SoCalGas. First, is the belief that an investor owned utility (IOU) in California could be
13 held strictly liable under the inverse condemnation doctrine for damages caused by a
14 utility power line, even if the utility was not negligent.⁶³ All of the underwriters with
15 whom we communicated in our renewal process were extremely concerned that this
16 inverse condemnation theory of recovery would increase their exposure to liability in

⁶¹ As part of settlements in 2009, homeowner insurers for approximately 1,000 of the 1,300 houses, mobile homes, and apartment units identified in public records as having been destroyed by the three fires have agreed to accept 57.5 cents on the dollar to resolve these claims. In addition to the claims of homeowner insurers, the wildfire litigation also includes claims for damage to uninsured and underinsured structures, business interruption, evacuation expenses, agricultural damage, emotional harm, personal injuries and other losses. Of the approximately 2,500 remaining plaintiffs, primarily individuals and businesses, only approximately 500 had submitted settlement demands as of February 2010, with such demands totaling approximately \$430 million. In addition, government entities have submitted a total of approximately \$135 million in demands, and additional demands from these entities are expected. After giving effect to the amounts paid and to be paid in connection with the homeowner insurer settlements, additional reserves and estimated defense costs, SDG&E's remaining insurance coverage as of February 2010 for the 2007 wildfire liabilities was approximately \$20 million. SDG&E is continuing to gather information to evaluate and assess estimated liabilities related to the wildfires and establishes reserves as data for specific claims becomes available and probable damages are able to be estimated.

⁶² Loss reserves are an estimate what loss costs are expected to be. A "full limit" loss reserve means that for an insurer who offers \$1 million policy limit, the insurer has set a loss reserve equal to the full \$1 million policy limit.

⁶³ A discussion of this theory can be found in Chapter I.

1 future wildfire claims. In fact, some of the underwriters cited the inverse condemnation
2 liability theory as the reason not to participate in the wildfire liability program.

3 The second factor contributing to decreased coverage and
4 increased 2009 premiums was that SDG&E experienced liability claims related to three
5 fires (the Witch, Guejito, and Rice fires) and other non-wildfire losses,⁶⁴ and
6 consequently the underwriters who participated in the SDG&E's 2007 liability insurance
7 program added a significant element of "pay-back" in their renewal premiums. It is a
8 common insurance industry practice for insurers to raise premiums on insureds that cause
9 them to pay claims. Just as an individual may see his or her auto insurance rates go up
10 after the insurance carrier pays for an accident, commercial insureds, like SDG&E and
11 SoCalGas, are subject to the same "pay back" through higher premiums.

12 The third factor contributing to decreased coverage and increased
13 2009 premiums was the underwriters' assessment of the risk of future wildfire losses.
14 Given the last few years of wildfire severity in southern California, insurers perceived an
15 increased exposure and have expressed their concern about the continuing impact of
16 climate change on the fire season. Some underwriters have decided that California
17 wildfire is an uninsurable risk and have exited the market.

18 The fourth cause of decreased coverage and increased 2009
19 liability premiums was a loss of reinsurance due to wildfire exposure. In the liability
20 insurance market, insurers purchase reinsurance to protect themselves from significant
21 losses on the companies they underwrite. Due largely to losses sustained as a result of
22 the 2007 wildfires in San Diego County, and an increasing awareness of inverse
23 condemnation, in 2009 reinsurers either refused to provide wildfire liability reinsurance
24 or severely limited the amount offered. Without reinsurance, insurance companies who
25 wanted to continue providing insurance for SDG&E had to reduce the amount of

⁶⁴ SDGE had a nearly 100% loss ratio for the prior 10 years for non-wildfire third party liability losses. This means \$1 in claims was paid out for every \$1 paid in premiums.

1 insurance offered to an amount that could be supported solely with their internal capital.
2 Underwriters that were able to obtain some wildfire reinsurance saw an increase in their
3 reinsurance premiums, and this increase was passed on to SDG&E and SoCalGas.

4 The fifth cause of decreased coverage and increased 2009 liability
5 premiums was general market pressure unrelated to California wildfires or potential
6 inverse condemnation liability. Overall market conditions can be impacted by global
7 insurance losses, and worldwide economic conditions. In particular, the spreading
8 worldwide financial crisis led to investment income losses for insurers, and as income
9 from investments decreased, insurers raised premiums in an effort to maintain
10 profitability. In addition, the market for utility liability insurance in California is affected
11 by losses in other areas of the country, and increased losses in the utility industry during
12 2008 caused an increase in premiums for utility companies nationwide.

13 With the losses related to the catastrophic San Diego wildfires,
14 inverse condemnation, a reduction in wildfire liability reinsurance, the underwriters'
15 perception of increasing wildfire exposure, there has been a deep drop in available
16 wildfire liability insurance capacity and severe premium increases. General liability
17 losses had a similar impact on limits and premiums for general liability insurance as well.
18 This change was emphasized during the course of our renewal discussions last year. As a
19 result of a wildfire in May 2009 in Santa Barbara, which burned over 8,000 acres,
20 destroyed a commercial property and 80 homes, damaged another 22 homes, and caused
21 30 injuries, SDG&E's and SoCalGas' lead insurer, AEGIS, advised our brokers that,
22 prior to the renewal, if the Santa Barbara wildfire or any other wildfire were associated
23 with a utility, no wildfire liability coverage would be made available to us upon renewal.

24 b) Renewal Process and Results

25 The 2009 liability insurance renewal process was completed on
26 June 26, 2009. We used a renewal approach that identified potential exposures and
27 sought to minimize the overall cost of these risks by blending insurance with manageable

1 deductibles. As explained above, the process of buying liability insurance consists of
2 identifying sources of coverage, communicating with underwriters on risk avoidance and
3 mitigation, negotiating placement structure (as described below), setting appropriate
4 deductibles, and agreeing to terms and conditions. Given SDG&E's and SoCalGas'
5 exposure to wildfire liability, and understanding that this exposure could exceed the
6 insurance market's ability to provide protection, our philosophy was to buy all the
7 liability insurance that was reasonably available in the world's insurance market.

8 SDG&E's and SoCalGas' program includes as many insurance
9 company sources as possible because individual insurers only offered wildfire liability
10 coverage in limits of \$5 million to \$50 million each. We canvassed the world's insurance
11 markets to reach as many qualified insurers as possible, including utility industry mutual
12 companies, United States domestic markets, Lloyds of London, other European
13 companies, and the Bermuda insurance markets. Since the insurance limits required by
14 SDG&E and SoCalGas exceed the amount any one insurer can provide, the total limit of
15 insurance is obtained by stacking blocks of insurance to create a "tower" of coverage.
16 The "tower" consists of multiple, individual layers of insurance provided by different
17 companies. Each layer builds upon the one below it resulting in a "tower" of different
18 policies that, together, provide the maximum limit obtainable. Negotiation for each layer
19 involves seeking the best discount factor against the layer below and building layer sizes
20 that take advantage of underwriter interest and willingness to participate at the level in
21 play.

22 Early on, we decided to build two "towers" of coverage within one
23 insurance program: a wildfire liability tower and a general liability tower. Prior to the
24 2009 policy year, wildfire liability risk and general liability risk were homogenous;
25 wildfire losses were treated as general liability losses and there was no differentiation
26 between the two. The two-tower structure was chosen in 2009 because of the extreme
27 cost anticipated for the wildfire coverage, along with limited capacity, and a desire to

1 preserve the wildfire liability insurance for only wildfire losses. This structure also
2 allowed the general liability tower to be completed at a higher limit of liability, which
3 SDG&E and SoCalGas believe is necessary for exposures other than wildfire.

4 Liability insurance (other than the first layer of the non-wildfire
5 tower) is written on an aggregate limit basis. That means that the stated limit on the
6 policy is both the limit for each loss, and the limit for the whole policy term of one year.
7 If a program had been built with wildfire liability included within the limits for general
8 liability, a single non-wildfire loss could consume the limits in that layer, including the
9 very expensive wildfire limits.

10 The initial layers of our 2009-2010 insurance structure were again
11 led by AEGIS and EIM. While we did search the commercial market for competing
12 coverage in the first two layers, commercial insurers were not able to match the price,
13 terms, and coverage conditions that AEGIS and EIM offered. We met with underwriters
14 to discuss current issues, in particular SDG&E's initiatives to prevent and reduce future
15 wildfire occurrences, and to obtain the best terms and conditions possible.

16 Above the initial layers, we obtained the best available coverage
17 terms, conditions, and lowest premiums for all following layers. Competitive bids, to the
18 extent competition was available in the limited wildfire liability market, were solicited
19 for each layer among London, European, and Bermuda insurance companies to build the
20 most cost-effective program.

21 Our practice has been to seek a deductible at the level which is
22 expected to produce the lowest overall cost – premium plus retained losses. We would
23 typically obtain insurance quotes at various deductible levels and compare the expected
24 total cost of each using historical losses. Unfortunately, limited deductible options were
25 offered by AEGIS and EIM. AEGIS, the lead layer, imposed an increase in the
26 deductible from \$1 million to \$5 million per occurrence. Further, both AEGIS and EIM
27 required SDG&E and SoCalGas to accept additional deductibles for the peril of wildfire

1 liability in the form of co-insurance. Specifically, they required that SDG&E share 50%
2 of wildfire losses above the deductible through their layers. (As mentioned above,
3 AEGIS and EIM provide the first two layers of insurance with a total limit of \$60 million
4 in wildfire liability coverage). For example, if SDG&E or SoCalGas were responsible
5 for \$65 million in claims due to a wildfire, the company would have to pay the \$5 million
6 deductible and 50% of the remaining \$60 million in damages – a total of \$35 million.
7 AEGIS and EIM would pay \$30 million.

8 Ultimately, we built seven layers of wildfire liability coverage
9 totaling \$399 million and eight layers of non-wildfire liability coverage totaling \$800
10 million. In each layer, the underwriters were selected based upon their willingness to
11 offer the requested coverage at layer pricing dictated by the best discount factor obtained.
12 Attachment 1 shows the final results of the 2009 renewal as well as the differences in
13 coverage amount and cost between the 2008-2009 liability program and the 2009-2010
14 renewal. The layers represent various insurers that provide insurance within the program.
15 SDG&E's and SoCalGas' expiring liability program (including wildfire liability) had
16 \$1.2 billion in limits, a \$1 million deductible, and a premium cost of \$13.6 million. By
17 contrast, the 2009 renewal produced a limit of \$800 million for non-wildfire liability and
18 was limited to \$399 million of wildfire liability with a total liability program cost of
19 \$55.2 million – four times the cost for significantly less coverage. In addition, of the
20 \$399 million of wildfire liability, SDG&E and SoCalGas would have to pay \$35 million
21 in self insured retention and co-insurance.

22 The 2009 liability insurance market had very little appetite for
23 wildfire risk due to insurers' realization of how devastating wildfires can be and their
24 perception that California utilities will be held strictly liable for wildfire costs. I believe
25 our detailed and time-intensive procurement process produced the maximum wildfire
26 liability limits available under the very difficult circumstances in which the renewal was
27 conducted.

1 **5. 2010-2011 Liability Insurance Renewal**

2 SDG&E and SoCalGas most recently renewed their liability and wildfire
3 liability insurance for the June 26, 2010 through June 26, 2011 coverage period. Our
4 goal was to maximize additional capacity, if possible, within our wildfire tower, and to
5 try to reduce premiums and/or improve coverage terms and conditions for both the
6 general liability and wildfire towers. The renewal process itself was very similar to the
7 process described above for the 2009-2010. Accordingly, my discussion will focus on
8 the results of our 2010-2011 liability insurance renewal process rather than the process
9 itself.

10 For the wildfire tower, SDG&E and SoCalGas were able to obtain
11 essentially the same limits (it increased slightly, from \$399 million to \$400 million) at a
12 premium cost slightly higher than last year. The same held true for the general liability
13 tower—coverage stayed the same at \$800 million, with premiums slightly higher than
14 last year. Attachment 2 compares the results of the 2010 renewal with the 2009 renewal,
15 including changes in the layers within each tower.

16 SDG&E and SoCalGas were also able to lower their deductible from
17 under the AEGIS insurance policy from \$5 million to \$4 million per occurrence. This is
18 a beneficial change. However, our AEGIS deductible is still \$3 million higher than it
19 was (\$1 million) prior to the 2009-2010 policy year.

20 In addition, SDG&E and SoCalGas were able to obtain “drop down”
21 coverage to \$60 million from all insurers above the first two insurers (AEGIS and EIM)
22 for no additional premium. This feature was traditionally an element of liability policies
23 issued to SDG&E and SoCalGas above the AEGIS and EIM lead layers, but no insurers
24 would provide drop down coverage last year. A drop down provision provides that the
25 policy will “drop down” to the layer below it when another insurers' aggregate policy
26 limits have been exhausted. This feature would be particularly valuable in the event of
27 two or more utility-involved wildfires within the policy year that are not individually

1 large enough to exhaust coverage within the wildfire tower. For example, if SDG&E
2 should be involved in two separate wildfire losses during the 2010-2011 policy year, each
3 involving \$200 million in claims, the first loss would be covered in excess of \$4 million
4 in deductible costs and \$30 million for loss sharing provisions; for the second loss,
5 because of the drop down provision, the loss would be covered in excess of \$4 million
6 deductible and \$60 million of policy limits used up in the first loss. The drop down
7 provision (to \$60 million) eliminates a potential \$136 million gap in coverage.

8 In addition, on August 4, SDG&E completed the process of obtaining
9 \$600 million in wildfire property damage reinsurance coverage from worldwide property
10 reinsurers to help fill the gap between our current \$400 million in wildfire coverage, and
11 the \$1.2 billion in wildfire coverage we held before the wildfire insurance market
12 changed dramatically for us in 2009.⁶⁵ SDG&E is utilizing a sponsored protected cell
13 captive insurance company (Energy Insurance Services (EIS), a wholly-owned subsidiary
14 of mutual insurer EIM), to obtain reinsurance coverage. EIS is a licensed captive insurer
15 in the state of South Carolina, offering captive insurance services and authorized to write
16 reinsurance business for EIM members only. The protected cell structure allows SDG&E
17 to insulate the resources of our captive cell from claims of other EIS captive participants.
18 Coverage is narrower than the commercial wildfire coverage in our \$400 million wildfire
19 tower, and could be expensive. The reinsurance SDG&E has obtained will cover damage
20 to, destruction of, or loss of use of property that is caused by wildfires. Reinsurance does
21 not provide coverage for other types of claims such as governmental fire suppression cost
22 reimbursement claims, personal liability (bodily injury), medical payments, or business
23 interruption. But since property damage claims make up the bulk of the claims
24 emanating from a typical wildfire, SDG&E believes that there is substantial value in
25 pursuing this reinsurance.

⁶⁵ This wildfire property damage reinsurance coverage would apply only to SDG&E, not SoCalGas.

1 SDG&E found that the property reinsurance market provided the best
2 alternative to supplement the traditional liability insurance available to SDG&E.
3 Property reinsurers were willing and able to provide the desired limits, and do so cost
4 effectively. This is a brand new insurance product that has never before been offered to a
5 utility. The \$600 million in limits SDG&E obtained, provided by multiple property
6 reinsurers, will have an average rate of \$0.0534 per million. By comparison, for the
7 commercial insurance program providing \$400 million wildfire liability limits, the
8 average rate was \$0.08 in the final \$100mm layer (\$300mm-\$400mm) of the program.
9 Other alternative risk transfer options (catastrophe bonds, commercial liability insurance
10 markets, pooling with other California utilities) simply could not provide the limits
11 needed.

12 Attachment 2 shows the final results of the 2010 renewal, including
13 reinsurance, as well as the differences in coverage amount and cost between the 2009-
14 2010 liability program and the 2010-2011 renewal.

15 **6. Potential Alternatives to Traditional Liability Insurance**

16 SDG&E and SoCalGas have explored, and continue to explore,
17 alternatives to traditional liability policies, particularly for wildfire liability coverage.
18 One such alternative is purchasing reinsurance through the captive insurer described
19 above. Other than reinsurance, however, no potentially viable alternatives have emerged.

20 The possible need for alternatives to traditional insurance markets is a
21 relatively recent issue for SDG&E and SoCalGas. As discussed above, until the 2009-
22 2010 policy year, general liability coverage included coverage for wildfires, and the level
23 of coverage SDG&E and SoCalGas had historically obtained was available in the liability
24 insurance marketplace for relatively reasonable prices. This historical level of coverage
25 was admittedly not adequate for a truly catastrophic wildfire or series of wildfires. But
26 prior to the 2007 wildfires, SDG&E had no reason to believe it needed to obtain liability

1 coverage greater than historical levels, particularly since SDG&E and SoCalGas
2 generally carried higher liability coverage than most other utilities.

3 Since the 2007 wildfires in San Diego County, SDG&E has looked at
4 catastrophe bonds, reinsurance, pooling wildfire liability with other IOUs, and formation
5 of a “captive” insurance company. To date, SDG&E has found that the only viable
6 alternative to traditional liability insurance is wildfire property damage reinsurance,
7 coupled with the utilization of the sponsored protected cell captive insurance company.
8 Moreover, our efforts to obtain wildfire property damage reinsurance are in response to
9 the unavailability of traditional liability insurance at historical levels. The reinsurance
10 product SDG&E purchased has not been offered before in the reinsurance marketplace,
11 and was not available to SDG&E or any other utility prior to this year. All of the other
12 alternatives considered by SDG&E would have been even more expensive, and provided
13 even less coverage compared to traditional liability insurance.

14 During the 2009-2010 insurance renewal process, SDG&E also looked at
15 the option of self-insuring the first \$35 million of liability rather than participating in
16 50% loss sharing for the first \$35 million layer. SDG&E also explored putting AEGIS
17 capacity limits above the primary \$35 million layer that AEGIS offered. However the
18 AEGIS underwriter advised that the price for AEGIS’ capacity would remain the same
19 even if SDG&E placed AEGIS atop a \$35 million self insured retention. The AEGIS
20 underwriter felt that the catastrophic potential of wildfires would cause a loss much
21 greater than the \$35 million capacity limits he was offering, regardless of whether AEGIS
22 limits would start to pay for losses above a \$5 million or \$35 million self insured
23 retention. Thus, it was more cost-effective for SDG&E to participate in the 50% sharing
24 than to self-insure the first \$35 million.

1

ATTACHMENT 1

2

To Chapter IV-A

Attachment 1

SDG&E and SoCalGas Liability Renewal

De Bont - Exhibit 1

Expiring June 26, 2008-09 Program

Total Premium: \$13,600,000

\$1.170 bil	
12th Layer	\$150M
\$1.020 bil	
11th Layer	\$50M
\$970 mil	
10th Layer	\$200M
\$770 mil	
9th Layer	\$25M
\$745 mil	
8th Layer	\$50M
\$695 mil	
7th Layer	\$100M
\$595 mil	
6th Layer	\$100M
\$495 mil	
5th Layer	\$160M
\$335 mil	
4th Layer	\$150M
\$185 mil	
3rd Layer	\$50M

Renewal June 26, 2009-10

Total Premium: \$55,200,000

	General Liability			
	Premium: \$15,200,000			
\$800 mil				
8th Layer	\$53.5M			
\$746.5 mil				
7th Layer	\$81.5M			
\$665 mil				
6th Layer	\$195M			
\$470 mil				
5th Layer	\$180M			
\$290 mil				
4th Layer	\$130M			
\$160 mil				
				\$399 mil
				7th Layer
				\$362.5 mil
				6th Layer
				\$317.5 mil
				5th Layer
				\$200 mil

ATTACHMENT 2

To Chapter IV-A

Attachment 2

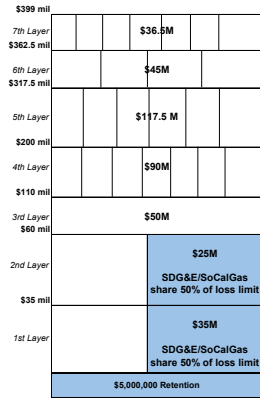
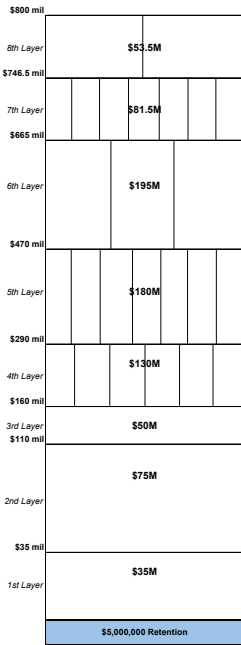
SDG&E and SoCalGas Liability Renewal

De Bort - Attachment 2

Renewal June 26, 2009-10 Program
Total Premium: \$55,200,000

General Liability
Premium: \$15,200,000

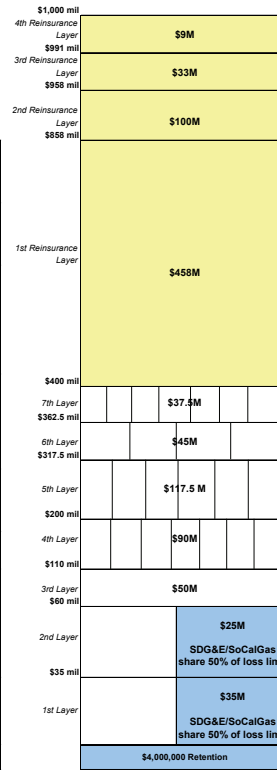
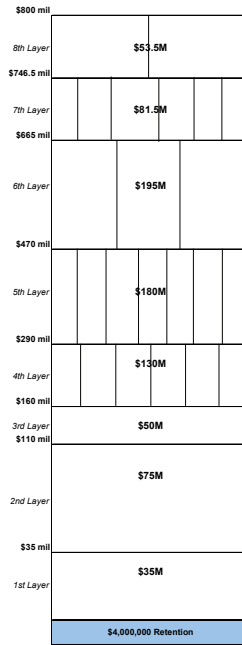
Wildfire Liability Only
Premium: \$40,000,000



Renewal June 26, 2010-11 Program
Total Premium: \$87,700,000

General Liability
Premium: \$15,300,000

Wildfire Liability Only
Premium (\$600M): \$32,000,000
Premium (\$400M): \$40,400,000



\$600M Reinsurance

\$400M Commercial Insurance

1
2

3

1 **B. Insurance Procurement Consultative Process**

2 In order to ensure that the Utilities have the input of customer representatives in the decisions to
3 acquire insurance coverage, the Utilities propose to consult with customer representatives during the
4 annual procurement process. The Utilities ask the Commission to direct Division of Ratepayer
5 Advocates and Energy Division, and invite other stakeholder groups, to participate in this process.

6 Although meetings with liability insurance carriers span months, many of the insurance
7 companies do not quote binding offers until the end of the process. At that point, the Utilities must
8 decide quickly whether to purchase the insurance offered. To facilitate stakeholder input consistent with
9 the realities of the procurement of liability insurance, the Utilities propose the following process:

- 10 • Meeting with stakeholders at least two months prior to the renewal to review the procurement
11 strategy, including current market conditions and the utilities' insurance needs.
- 12 • Periodic updates as necessary.
- 13 • Shortly prior to renewal, inform status of procurement.

14 Within 30 days of the date on which a Utility makes final decisions with respect to wildfire
15 insurance, the Utility will submit a report with the Commission describing the process and outcome of
16 the insurance procurement effort.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21

V.

RATEMAKING - FINANCING TESTIMONY

A. Introduction

This testimony describes the proposed ratemaking treatment for wildfire-related costs, how the Utilities propose to recover those costs in rates, and how they expect to finance them.

B. Wildfire Expense Memorandum Accounts

1. Resolution E-4311

Pursuant to Resolution E-4311, each of the Utilities has been authorized to establish a WEMA.⁶⁷ As explained in this Resolution, the initial purpose of the WEMA is to allow the Utilities to record wildfire-related costs incurred while the Commission considers the Utilities' proposal to establish WEBAs in this proceeding.⁶⁸

Also pursuant to Resolution E-4311, the Utilities have been authorized to record the following costs in their WEMAs: a) payments to satisfy wildfire claims including coinsurance and deductibles expense paid by the Utilities, but excluding costs already adopted in the Utilities' GRCs; b) outside legal expenses incurred defending wildfire claims; c) increases or decreases in wildfire insurance premiums from amounts adopted in the utilities' GRCs.⁶⁹ The Utilities sought, but did not receive, authorization to record the cost of financing the account balances in their WEMAs. In denying this request, the Resolution explains that long-term financing of WEMA balances is not appropriate because interest on memorandum accounts generally is at the three-month commercial paper rate.⁷⁰ Resolution E-4311 also requires: (1) that the electric Utilities' WEMA tariffs include a credit entry for any wildfire costs recovered through revenues authorized by the Federal Energy Regulatory Commission (FERC);⁷¹

⁶⁷ Resolution E-4311 was adopted by the Commission on July 29, 2010.

⁶⁸ Draft Res. E-4311, p. 1.

⁶⁹ *Id.*, pp. 2, 6, and 10.

⁷⁰ *Id.*, p. 8.

⁷¹ *Id.*, pp. 7-8 and 10.

1 and (2) that SDG&E and SCE include credit entries in their WEMAs for any wildfire costs recovered
2 through their Z-Factor mechanisms.⁷²

3 **2. WEMA-Related Proposals**

4 As noted above, the initial purpose of the WEMA is to allow the Utilities to record
5 wildfire-related costs incurred while the Commission considers the Utilities’ proposal to establish
6 WEBAs in this proceeding. When they filed the advice letters that led to Resolution E-4311, the
7 Utilities envisioned that there would be no need for WEMAs once WEBAs have been approved and
8 WEMA balances transferred to the new WEBAs. In keeping with this approach, Resolution E-4311
9 refers to the WEMA as an “interim mechanism for recording wildfire related costs.”⁷³ As a result of
10 further refinement of the Utilities’ overall wildfire cost recovery proposal, however, the Utilities now
11 believe that WEMAs should be retained even after WEBAs are established.

12 As described above in Chapter II, the Utilities are proposing a bright line between
13 wildfires that involve \$10 million or less in Claims and Defense Costs and wildfires that involve more
14 than \$10 million in Claims and Defense Costs. As explained in Section II.B above, “Claims Costs” are
15 payments to satisfy wildfire-related claims including, without limitation, damage claims by third parties
16 and their insurers, claims by governmental entities for the reimbursement of wildfire suppression costs,
17 and other governmental claims against the utilities arising from a wildfire. “Defense Costs” are outside
18 legal expenses incurred by a utility arising out of a wildfire. Wildfires that involve more than \$10
19 million in Claims and Defense Costs will be subject to WEBA treatment and the cost recovery
20 mechanism described in the Amended Application and supporting supplemental testimony. Wildfires
21 that involve \$10 million or less in Claims and Defense Costs will continue to be forecasted by the
22 Utilities in their respective GRCs, and will not be subject to the WEBA cost recovery mechanism.

23 The Utilities propose to achieve this \$10 million bright line by excluding any wildfires
24 that involve more than \$10 million in Claims and Defense Costs from their GRC forecasts, and by

⁷² *Id.*, p. 9 and 11.

⁷³ *Id.*, p. 6.

1 recording Claims and Defense Costs relating to a particular fire in their WEBA only after the costs paid
2 by the Utility relating to the fire exceed \$10 million. But Claims and Defense Costs are generally paid
3 by Utilities over time, rather than all at once. This creates a potential retroactive ratemaking issue
4 because Utilities would be making payments to satisfy the first \$10 million of Claims and Defense Costs
5 relating to a wildfire in advance of being able to record the payments in their WEBAs. To resolve the
6 potential retroactive ratemaking issue, the Utilities propose that they be authorized: (1) to retain their
7 WEMAs even after WEBAs have been approved and initial WEMA balances have been transferred to
8 WEBAs, and (2) to record Claims and Defense Costs, and payments received from Insurers and Third
9 Party Recoveries, in their WEMAs until net costs for a particular wildfire exceed \$10 million. Once net
10 costs relating to a particular wildfire exceed \$10 million, those costs would be transferred to the Utility's
11 WEBA, and all future costs and credits relating to that wildfire would be recorded by the Utility in its
12 WEBA rather than its WEMA.

13 As explained below, because recent experience has shown that the cost of wildfire
14 insurance is volatile and unpredictable, the Utilities propose that increases or decreases in wildfire
15 insurance premiums from amounts adopted in the utilities' GRCs no longer be recorded in their
16 WEMAs for potential future recovery. Rather, the Utilities propose two-way balancing account
17 treatment for wildfire liability insurance premiums, recording all increases or decreases from the
18 amounts adopted in their GRCs for wildfire liability insurance coverage in new Wildfire Insurance
19 Premium Balancing Accounts. The remaining WEMA characteristics described in Resolution E-4311
20 could continue unchanged. In particular, there would be no need for the cost of financing WEMA
21 account balances to be anything other than the three-month commercial paper rate since the net WEMA
22 balance for any particular wildfire would be transferred to WEBAs once the costs exceed \$10 million.

23 **C. Wildfire Expense Balancing Accounts**

24 **1. WEBA-Related Proposals**

25 The Utilities request that the Commission authorize each Utility to establish a WEBA to
26 record for future recovery Claims and Defense Costs, reduced by payments received from third parties,
27 including insurance carriers. As just discussed, the Utilities propose that only WEBA balances be

1 eligible for recovery pursuant to the cost recovery mechanism described in this Amended Testimony,
2 and that WEBA treatment be limited to wildfires that have net costs that exceed \$10 million.

3 The categories of wildfire-relate costs recordable in Utility WEBAs would be the same as
4 those recordable in the Utilities' WEMAs: Claims and Defense costs, excluding costs already authorized
5 in the Utilities' GRCs, plus the costs of financing WEBA balances at the commercial paper rate (unless
6 the Commission approves a different rate in response to a Utility application). Once net costs relating to
7 a particular wildfire exceed \$10 million, those net costs would be transferred by a Utility to its WEBA,
8 and all additional costs relating to that wildfire would be recorded in the WEBA as they are paid by the
9 Utility, and all additional credits (insurance reimbursements and Third Party Recoveries (as described
10 above in Chapter II)) would be recorded in the WEBA as they are received by the Utility.

11 The Utilities propose that all Wildfire Claims costs be booked to the WEBA for recovery
12 in CPUC-jurisdictional retail rates. Current regulatory policies would allocate some portion of these
13 costs to rates under the jurisdiction of FERC. To the extent that FERC authorizes recovery of a portion
14 of Wildfire Costs in FERC-jurisdictional rates, the WEBA will be credited by that amount. As with
15 recording wildfire costs in a WEMA, recording of wildfire costs in a WEBA would not create a
16 presumption of recoverability.

17 **2. WEBA Applications**

18 The Utilities propose that they be authorized to file an application for recovery of wildfire
19 costs (WEBA Application) at any time after net costs relating to a particular wildfire exceed \$10
20 million, and those costs have been transferred by the Utility to its WEBA. WEBA Applications may
21 relate to more than one wildfire. In their WEBA Applications, the Utilities will seek a Commission
22 determination regarding the appropriate cost recovery categorization—A (full WEBA recovery), B
23 (partial recovery), or C (no WEBA recovery)⁷⁴—of past and future costs relating to such wildfires, and

⁷⁴ See Chapter II above.

1 will provide detailed information regarding the relevant wildfire(s), and wildfire-related costs and
2 recoveries to that date.⁷⁵

3 This WEBA Application proposal is substantially different from the Utilities' original
4 cost recovery proposal, which called for a March 31 advice filing describing WEBA activity any year
5 that a rate change would go into effect that includes the recovery of a WEBA balance. The Utilities
6 have made this change in order to implement the wildfire cost categorization proposal the Utilities are
7 presenting in their Amended Application. Pursuant to this proposal, a Commission decision regarding
8 categorization will be required for each wildfire with substantial costs, and it appears to the Utilities that
9 an application is the appropriate vehicle to pursue such a decision. The additional time required to
10 process an application rather than an advice filing adds to the uncertainty that is an inherent element of
11 the Utilities' wildfire cost categorization proposal. In order to help mitigate this additional uncertainty,
12 it is important that the Utilities be authorized to file their WEBA Applications as soon as net costs
13 relating to a particular wildfire exceed \$10 million. In addition, wildfire costs are generally paid by
14 Utilities over years rather than months, and any particular WEBA Application is likely to be filed well in
15 advance of a Utility paying all costs (or receiving all recoveries) relating to a wildfire. The Commission
16 should explicitly recognize this fact and provide that the wildfire cost categorization determination it
17 makes in response to a WEBA Application will apply to future costs and recoveries relating to the
18 wildfires that are the subject of that application.

19 **3. WEBA Advice Filings**

20 As just noted, a WEBA Application is likely to be filed well in advance of a Utility
21 paying all costs (or receiving all recoveries) relating to a wildfire. Accordingly, the Utilities propose an
22 advice letter process for recovery of additional Claims and Defense costs, net of any additional
23 insurance recoveries or Third Party Recoveries relating to the wildfire(s) that were not included in the
24 original WEBA Application. So long as the WEBA Application results in a Commission determination

⁷⁵ In most instances the Utilities will likely be able to say very little about potential future costs from the same wildfire(s) because of pending litigation or the potential for litigation.

1 that the costs from a wildfire are in either Category A or Category B, a Utility should be authorized to
2 file advice letters to obtain recovery of the additional wildfire costs.

3 The Utilities propose that these advice filings provide the following information: (a) the
4 name of the wildfire(s) that the costs and recoveries relate to; (b) the relevant WEBA Application
5 decision number; (c) the category, or categories, for these costs and recoveries established by the
6 Commission in the WEBA Application decision; and (d) a description of each of the costs and
7 recoveries that are the subject of the advice filing, including the amount and timing of each payment and
8 recovery. Because the Commission will have already determined the appropriate categorization for the
9 costs and recoveries, the Utilities propose that these be standard Tier 2 advice filings with a 20-day
10 protest period.

11 **D. Wildfire Insurance Premium Balancing Accounts**

12 As explained above, liability insurance costs, including the cost of policies covering wildfire
13 claims, are recovered in GRCs. The Utilities forecast insurance premium levels in their GRCs as part of
14 their test-year cost of service, and the Commission authorizes the inclusion of premium costs in
15 customer rates. Recent experience, however, has shown that the cost of wildfire insurance is volatile
16 and unpredictable. Accordingly, the Utilities propose two-way balancing account treatment for
17 insurance premiums. Under this approach, each Utility would record all increases or decreases from the
18 amounts adopted in the Utility's GRC for insurance premiums attributable to coverage for wildfire-
19 related claims in a new WIPBA. WIPBA balances would be consolidated and recovered annually,
20 consistent with established procedures for the recovery of similar balancing accounts, such as the
21 Medical Program Balancing Accounts and PBOP Balancing Accounts. As with these other accounts,
22 the amounts recorded to the WIPBA should be adjusted, as applicable, for costs capitalized to ratebase,
23 intercompany billings, and costs recovered through FERC-jurisdictional rates. This new two-way
24 balancing account treatment would be implemented at the same time as the new insurance procurement
25 consultation process proposed by the Utilities.

1 **E. Rate Recovery**

2 The Utilities propose that the time frame for recovery of WEBA balances vary depending on the
3 amount of any undercollection in the WEBA, and that prior to implementing a WEBA undercollection
4 in rates a Utility would inform the Commission of its plan for amortizing the undercollection after
5 analyzing the magnitude of all of the pending revenue requirement and rate changes for the subsequent
6 year. The Utilities propose to provide this information in the Regulatory Account Balance Update
7 filings for SDG&E and SoCalGas. Each Utility will allocate and recover the WEBA balance in rates in
8 the same manner as other liability insurance expenses.

9 The amount and timing of Claims and Defense Costs covered by WEBA Applications could vary
10 tremendously, and flexibility with respect to inclusion of WEBA balances into rates appears to be the
11 most beneficial approach for Utility customers. As an alternative, the Utilities could present ratemaking
12 proposals in each WEBA Application and WEBA Advice Filing. But such an approach would not have
13 the benefit of coordination with other rate changes.

14 **F. Financing Wildfire Costs**

15 The size of wildfire liabilities could range from modest to extremely large, and WEBA financing
16 will vary accordingly. Balances that remain small may be accommodated within a Utility's existing
17 short-term borrowing program. In that event, WEBA balances will simply accrue at the 3-month
18 commercial paper rate, consistent with the Commission's approach to WEMA balances in Resolution E-
19 4311, and similar to the approach used for many other balancing accounts.

20 However, the Utilities' short-term borrowing capacity is limited, and much of that capacity is
21 needed to meet day-to-day operational needs, other balancing account under-collections and collateral to
22 support energy procurement. Thus, a Utility may need to resort to financing with long-term debt and/or
23 equity to support sizeable WEBA balances. If such circumstances occur and a Utility proposes that
24 correspondingly higher financing costs be recorded in its WEBA, the Utility will present a proposal to
25 that effect in a separate application to the Commission. The Utilities believe that this potential should be
26 reflected in the Commission's decision in this proceeding.

1 Under California law, Commission authorization is required before a Utility may issue debt or
2 equity, including authorization of the amount and purpose of the financing. In the event of a severe
3 wildfire for which a Utility incurs substantial liability, the affected Utility will likely need advance
4 financing authority in order to meet its obligations. If the Utility believes that its undercollection
5 financing will require additional authority to issue debt or equity to finance wildfire costs, it will file an
6 application with the Commission seeking the necessary approvals. Depending on the circumstances,
7 such an application may require expedited approval. The Utilities believe that this potential should also
8 be reflected in the Commission's decision in this proceeding

9 The WEBA balance is not a permanent asset of the Utility; instead, a WEBA reflects costs of
10 extraordinary events, and the associated expenses will be recovered through rates over a limited time
11 frame. Consistent with ratemaking treatment of other debt used to finance balancing accounts, the
12 Utilities propose to exclude any long-term debt used to finance a WEBA balance from their capital
13 structures in measuring compliance with the Capital Structure Condition. In addition, the Utilities will
14 exclude such debt from the embedded cost of debt used to calculate their ratemaking return on rate base,
15 and exclude WEBA-related short-term and long-term debt financings from calculations that accrue
16 Allowance for Funds Used During Construction (AFUDC) on assets held in Construction Work in
17 Progress (CWIP).

18 One way to reduce the cost of financing large WEBA undercollections is through a utility
19 securitization, meaning the issuance of bonds whose repayment is secured by a dedicated rate
20 component authorized by legislation. The Commission took this approach in the case of the Rate
21 Reduction Bonds as well as with the Energy Recovery Bonds PG&E issued to refinance the regulatory
22 asset created in connection with the settlement of PG&E's Chapter 11 bankruptcy proceeding. This type
23 of financing is able to obtain higher credit ratings, and thus lower financing costs. It is similar to the
24 approach used by regulators and utilities in Florida to recover costs from hurricane damage.⁷⁶ In

⁷⁶ Florida's investor-owned-utilities have legislative authority to issue securitized debt to pay for hurricane recovery to fund reserves against future hurricane costs. Interest and principal on the debt are paid through a dedicated rate component. See Fla. Stat. § 366.8260.

1 addition, the bonds will not be treated as utility debt in the rating agencies' assessment of the utility's
2 credit, eliminating the need to support the debt with higher-cost equity financing. The Utilities therefore
3 ask the Commission to support legislation to effectuate financing large WEBA balances with debt
4 secured by a dedicated rate component. If securitization receives legislative authorization, the Utilities
5 would file an application to finance WEBA undercollections with securitized debt.

6 **G. Summary of Proposals**

7 For ease of reference, the Utilities' ratemaking and financing proposals in this proceeding are as
8 follows:

9 **WEMA-Related Proposals**

- 10 • The interim WEMA tariffs authorized by Resolution E-4311 should be made permanent,
11 and the Utilities should continue to be authorized to record Claims and Defense Costs,
12 including coinsurance and deductibles expense paid by the utilities, but excluding costs
13 already adopted in the utilities' GRCs;
- 14 • The Utilities should record in their WEMAs Claims and Defense Costs as they are paid
15 by the Utilities, and credits (insurance reimbursements and recoveries from third parties)
16 as they are received by the Utilities, until net costs (costs paid less credits received) for a
17 particular wildfire exceed \$10 million;
- 18 • Increases or decreases in wildfire insurance premiums from amounts adopted in the
19 utilities' GRCs should no longer be recorded by a Utility in its WEMA. Rather, both
20 should be recorded in a separate Wildfire Insurance Premium Balancing Account for
21 annual recovery through rates;
- 22 • Once net costs relating to a particular wildfire exceed \$10 million, those net costs should
23 be transferred by a Utility to its WEBA, and all future costs and credits relating to that
24 wildfire would be recorded by the Utility in its WEBA rather than its WEMA;
- 25 • The remaining WEMA characteristics described in Resolution E-4311 should continue
26 unchanged;

- Only WEBA balances would be eligible for recovery pursuant to the cost recovery mechanism described in the Amended Application; costs relating to wildfires that do not exceed the \$10 million WEBA threshold would not be eligible for recovery through the recovery mechanism; and
- Recording of Wildfire Costs in a WEMA does not create a presumption of recoverability.

WEBA-Related Proposals

- Each Utility should be authorized to establish a WEBA to record for future recovery wildfire-related costs, reduced by payments received from insurance carriers and by Third Party Recoveries (subject to the sharing mechanism described above);
- Only WEBA balances are eligible for recovery pursuant to the cost recovery mechanism described in this Amended Application, and WEBA treatment is limited to wildfires that have net costs in excess of \$10 million;
- The Utilities should be authorized to record the following costs in their WEBAs: Claims and Defense Costs, excluding costs already adopted in the utilities' GRCs, reduced by payments received from insurance carriers and by Third Party Recoveries (subject to the sharing mechanism described above); b) costs of financing WEBA balances at the commercial paper rate (unless the Commission approves a different rate in response to a Utility application);
- SDG&E's WEBA tariff should include a credit entry for any Wildfire Costs recovered through revenues authorized by FERC;
- SDG&E should include credit entries in its WEBA for any Wildfire Costs recovered through its Z-factor mechanisms;
- WEBA balances are eligible for recovery pursuant to the cost recovery mechanism described in this Amended Application;
- Interest on WEBA balances should accrue at the 3-month commercial paper rate; and
- Recording of Wildfire Costs in a WEBA does not create a presumption of recoverability.

1 **WEBA Application Proposals**

- 2 • The Utilities should be authorized to file a WEBA Application at any time after net costs
- 3 relating to a particular wildfire exceed \$10 million, and those costs have been transferred
- 4 by the Utility to its WEBA;
- 5 • WEBA Applications may relate to one or more wildfire(s);
- 6 • WEBA Applications should seek a Commission determination regarding the appropriate
- 7 cost recovery categorization -- A, B, or C -- of past and future costs relating to the
- 8 wildfire(s) in questions, and should provide detailed information regarding the
- 9 wildfire(s), and wildfire-related costs and recoveries to that date;
- 10 • Wildfire Costs and recoveries that the Commission determines are in either Category A
- 11 or B should be recovered in accordance with the cost recovery mechanism described in
- 12 the Utilities' Amended Application and supporting testimony;
- 13 • Wildfire Costs and recoveries that the Commission determines are in Category C would
- 14 not be recovered through this mechanism, but could still be the subject of a separate
- 15 Utility application; and
- 16 • The Wildfire Cost categorization determination made by the Commission in response to a
- 17 WEBA Application should apply to all future costs and recoveries relating to the
- 18 wildfires covered by that application.

19 **WEBA Advice Filing Proposals**

- 20 • Once the Commission has determined in response to a WEBA Application that the costs
- 21 from a particular wildfire are in either Category A or Category B, a Utility should be
- 22 authorized to file advice letters to obtain recovery of additional Claims and Defense
- 23 Costs, net of any additional insurance recoveries or Third Party Recoveries, and
- 24 recoveries relating to the wildfire(s) that were not included in the original WEBA
- 25 Application;
- 26 • These advice filings should provide the following information: (a) the name of the
- 27 wildfire(s) that the costs and recoveries relate to; (b) the relevant WEBA Application

1 decision number; (c) the category, or categories, for these costs and recoveries
2 established by the Commission in the WEBA Application decision; and (d) a description
3 of each of the costs and recoveries, including the amount and timing of each payment and
4 recovery; and

- 5 • These should be standard Tier 2 advice filings with a 20-day protest period.

6 **Wildfire Insurance Premium Balancing Accounts**

- 7 • Utilities should record all increases or decreases from the amounts adopted in the
8 Utilities' GRCs for insurance premiums attributable to coverage for Wildfire-related
9 claims in a new WIPBA. WIPBA balances should be consolidated and recovered
10 annually, consistent with established procedures for the recovery of similar balancing
11 accounts; and
- 12 • Amounts recorded to the WIPBA should be adjusted, as applicable, for costs capitalized
13 to rate base intercompany billings, and costs recovered through FERC-jurisdictional
14 rates.

15 **Rate Recovery Proposals**

- 16 • Utilities should propose the rate recovery of authorized WEBA balances in the
17 Regulatory Account Balance Update filings for SDG&E and SoCalGas. Each Utility will
18 allocate and recover the WEBA balance in rates in the same manner as other liability
19 insurance expenses.

20 **Financing Proposals**

- 21 • If a Utility uses long-term debt and/or equity to finance a WEBA balance and wishes to
22 propose that correspondingly higher financing costs be recorded in its WEBA, the Utility
23 should present a proposal to that effect in a separate application to the Commission;
- 24 • If a Utility requires additional Commission authority to issue debt or other securities to
25 finance a WEBA balance, the Utility should present a proposal to that effect in a separate
26 application to the Commission. Depending on the circumstances, such an application
27 may require expedited approval;

1
2
3
4
5
6
7

- The Commission should support legislation to effectuate financing large WEBA balances with debt secured by a dedicated rate component; and
- The Utilities should be authorized to exclude long-term debt used to finance a WEBA balance from their capital structures in measuring compliance with the Capital Structure Condition, to exclude such debt from the embedded cost of debt used to calculate their ratemaking return on rate base, and to exclude WEBA-related short-term and long-term debt financings from calculations that accrue AFUDC on assets held in CWIP.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

VI.

SPENDING METRICS

As discussed in Chapter II above, wildfire costs will be included in the WEBA for recovery in rates unless the costs result from acts or omissions intentionally engaged in or directed by a Utility officer that are either intentional or reckless, as defined.⁷⁷ In order to clarify the intent of the cost recovery criteria and limit the potential for extended and contentious regulatory proceedings, the utilities recommend that spending metrics be defined for wildfire-related operation and maintenance costs and capital expenditures. If a Utility's spending falls within these metrics, decisions by Utility officers with respect to spending cannot be regarded as meeting the recklessness standard. On the other hand, spending outside the metrics does not necessarily prove that an officer's spending decisions were reckless.

Each Utility's operations are structured differently to best meet the needs of its unique service territory, and each Utility faces different wildfire risks; as a result, each Utility has developed its own spending metrics. All of the metrics recognize that utility management must make spending decisions based on the Commission's GRC spending authorizations, and that the judgment exercised by Utility officers in setting priorities in good faith in order to operate within Commission revenue authorizations should not constitute recklessness for purposes of WEBA recovery.

Utilities must adapt budgets to changing conditions and priorities unforeseen in GRC decisions. Spending within Utility functions and/or FERC accounts may vary substantially from year to year based on operational and system needs. As a result, the metrics are designed to provide management the flexibility to allocate resources where needed. A proper metric will not hamper management's ability to reallocate funds when circumstances warrant.

⁷⁷ The two criteria are defined in Chapter II as follows: First, wildfire costs resulting from acts or omissions intentionally engaged in or directed by an officer with an intent to cause harm shall be Category C costs. Second, wildfire costs resulting from acts or omissions intentionally engaged in or directed by an officer of a Utility who knew or should have known of the probable dangerous consequences of those actions and willfully and deliberately disregarded those consequences

1 **A. SDG&E Spending Metrics**

2 **1. O&M Metric**

3 SDG&E proposes that decisions by SDG&E officers with respect to O&M spending
4 cannot be regarded as meeting the Category C recklessness standard if SDG&E's expenditures for
5 the three calendar years preceding the relevant wildfire are on average at least 70% of Commission-
6 adopted spending for each of the following specific Functional Work Groups (FWGs) and
7 transmission-related FERC accounts:⁷⁸

- 8 i. FWG - Electric Regional Operations (electric distribution O&M expenses).
- 9 ii. FWG - Construction Services (electric distribution O&M expenses).
- 10 iii. FWG - Vegetation Management (electric distribution O&M expense).
- 11 iv. FWG - Field Operations and Maintenance (routine work on natural gas pipelines and
12 facility accessibility, including right-of-way (ROW) maintenance).
- 13 v. FERC Account 560 - Operation Supervision and Engineering (supervision and
14 engineering related to operational and fire prevention activities charged to FERC
15 Accounts 563 and 566).
- 16 vi. FERC Account 563 - Overhead Line Expenses.
- 17 vii. FERC Account 566 - Miscellaneous Transmission Expenses (O&M training and
18 miscellaneous fire prevention expenses).
- 19 viii. FERC Account 568 - Maintenance Supervision and Engineering (supervision and
20 engineering related to maintenance and fire prevention activities).
- 21 ix. FERC Account 571 - Maintenance of Overhead Lines (vegetation management,
22 inspections, and repairs).

23 SDG&E's current adopted revenue requirement was decided at a FERC-account
24 level. SDG&E will use its 2012 GRC FERC mapping process to determine the translation of FWG
25 to FERC accounts should that be necessary.

⁷⁸ SDG&E has FERC accounts rather than FWGs for transmission.

1 **2. Capital Spending Metric**

2 SDG&E proposes that decisions by SDG&E officers with respect to capital spending
3 cannot be regarded as meeting the Category C recklessness standard if SDG&E’s electric
4 distribution and routine transmission-related capital expenditures and natural gas distribution and
5 transmission capital expenditures for the three calendar years preceding the relevant wildfire are on
6 average at least 70% of CPUC and FERC-adopted spending in these categories.

7 SDG&E proposes that “Commission-adopted spending” be the amount approved in
8 the applicable GRC decision(s) and used by the CPUC to determine SDG&E’s GRC revenue
9 requirement. If the CPUC does not adopt a specific amount for some or all of the referenced O&M
10 and capital expenditures, SDG&E proposes that “Commission-adopted spending” for such
11 expenditures be derived by a scaling factor equal to the amount adopted by the CPUC for all
12 SDG&E expenses during the relevant year divided by the amount requested by SDG&E for all
13 expenses during the relevant year. In addition, if any regulatory or judicial actions outside of the
14 GRC limit SDG&E spending in one of the referenced areas (e.g., a court decision prohibits SDG&E
15 from moving forward with a particular capital project), then “Commission-adopted spending” in that
16 particular area should be reduced by the amount that SDG&E is prohibited from spending.

17 **B. SoCalGas Spending Metrics**

18 **1. O&M Metric**

19 SoCalGas proposes that decisions by SoCalGas officers with respect to O&M
20 spending cannot be regarded as meeting the Category C recklessness standard if SoCalGas’
21 expenditures for the three calendar years preceding the relevant wildfire are on average at least 70%
22 of Commission-adopted spending for each of the following specific Functional Work Groups
23 (FWGs):

- 24 • FWG - Field O&M (routine pipeline maintenance and facility accessibility,
25 including ROW maintenance).
- 26 • FWG - Pipeline Operations and Maintenance (routine work on pipelines,
27 including ROW maintenance and vegetation management).

- FWG - Underground Storage (routine work on gas facilities and private overhead electrical systems, including vegetation management).

As with SDG&E, SoCalGas' current adopted revenue requirement was decided at a FERC account level. SoCalGas will use its 2012 GRC FERC mapping process to determine the translation of FWG to FERC accounts should that be necessary.

2. Capital Spending Metric

SoCalGas proposes that decisions by SoCalGas officers with respect to capital spending cannot be regarded as meeting the Category C recklessness standard if SoCalGas' transmission, distribution, and storage capital expenditures for the three calendar years preceding the relevant wildfire are on average at least 70% of Commission-adopted spending in these categories.

SoCalGas proposes that "Commission-adopted spending" be the amount approved in the applicable GRC decision(s) and used by the CPUC to determine SoCalGas' GRC revenue requirement. If the CPUC does not adopt a specific amount for some or all of the referenced O&M and capital expenditures, SoCalGas proposes that "Commission-adopted spending" for such expenditures be derived by a scaling factor equal to the amount adopted by the CPUC for all SoCalGas expenses during the relevant year divided by the amount requested by SoCalGas for all expenses during the relevant year. In addition, if any regulatory or judicial actions outside of the GRC limit SoCalGas spending in one of the referenced areas (e.g., a court decision prohibits SoCalGas from moving forward with a particular capital project), then "Commission-adopted spending" in that particular area should be reduced by the amount that SoCalGas is prohibited from spending.

VII.
Witness Qualifications

1 **QUALIFICATIONS OF MAURY B. DE BONT**

2
3 My name is Maury Brendon De Bont, and my business address is 101 Ash Street, San
4 Diego, California 92101.

5 I am currently employed by Sempra Energy as the Director of Risk Management, a
6 position I was promoted to in January 2010. Prior to this position, I was the Risk Manager
7 for Sempra Energy since January 1999. Sempra Energy is the parent company of San Diego
8 Gas & Electric Company (SDG&E) and Southern California Gas Company (SoCalGas). My
9 responsibilities on behalf of SDG&E and SoCalGas include the design and placement of
10 Sempra’s corporate-wide insurance programs; insurance broker and services management;
11 management of the department staff; supporting GRC and the insurance budgetary cost
12 forecasting process; and educating and advising employees on risk management and
13 insurance issues. As the Risk Manager, I was responsible for construction project related
14 insurance placements and managing insurance brokers services; contract review, analysis and
15 negotiations of insurance terms and conditions; managing insurance claims; supporting GRC
16 and the insurance budgetary cost forecasting process; and educating and advising employees
17 on risk management and insurance issues.

18 I received a bachelor’s degree in Business Finance from California State University
19 Long Beach in June 1985, and obtained an Associate in Risk Management professional
20 designation in 1991. I am currently working towards completing the Chartered Property &
21 Casualty Underwriter and Enterprise Risk Management professional designations.

22 Prior to joining Sempra, I was employed at Southern California Edison as a Risk
23 Analyst for four and a half years, where I was responsible for insurance placement and risk
24 management for Edison Mission Energy projects (development, construction, bank financing
25 negotiations) and utility matters. I have over 30 years experience in the insurance and risk
26 management industry. I have previously testified before the California Public Utilities
27 Commission.
28

1 **QUALIFICATIONS OF KENNETH J. DEREMER**

2
3 My name is Kenneth J. Deremer and my business address is 8330 Century Park
4 Court, San Diego, California 92123. I am currently employed by San Diego Gas & Electric
5 Company (SDG&E) as the Director of Financial Planning, Budgets and Claims. My current
6 responsibilities include the development, implementation and analysis of SDG&E's annual
7 and multi-year financial planning and budget process. I assumed my current position in May
8 2011. Prior to this, I served as the Director of Financial Analysis & Assistant Treasurer since
9 January 2009, where my responsibilities include overseeing the development, analysis, and
10 implementation of revenue requirements, regulatory accounts, and cost recovery strategies
11 for SDG&E and Southern California Gas Company (SoCalGas). From May 2007 through
12 January 2009 I served as the Director of Tariffs and Regulatory Accounts, where my
13 responsibilities included the implementation and oversight of SDG&E's and SoCalGas'
14 tariffs and regulatory accounts, including the preparation of testimony in various regulatory
15 proceedings, including the General Rate Case. Prior to May 2007, I served as the Regulatory
16 Accounts Manager since April 2002. In that position, I managed the process for
17 implementing and maintaining regulatory accounts, including serving testimony in ERRA
18 proceedings.

19 I have been employed by SDG&E and Sempra Energy since 1991. In addition to my
20 work experience described above, I worked from 1999 through 2002 as a Regulatory Tariff
21 Administrator and held various positions in the Financial Reporting Department.

22 I received a Bachelors of Science in Business Administration from the University of
23 California, Riverside, in June 1987. I also received a Masters in Business Administration,
24 with an emphasis in Finance, from the University of California, Riverside, in December
25 1989.

26 I have previously testified before this Commission.
27

QUALIFICATIONS OF NORM G. KOHLS

1
2
3 My name is Norm G. Kohls. I am employed by San Diego Gas & Electric Company
4 (SDG&E) as the Manager of Transmission and Distribution Asset Management in the
5 Electric Operations Division. My business address is 8316 Century Park Court, San Diego,
6 California 92123.

7
8 In 1988, I earned a Bachelor of Science Degree in Mechanical Engineering with a Minor in
9 Economics from San Diego State University. In 1992, I earned my California State License
10 as a Registered Professional Engineer in Mechanical Engineering. I have been a member of
11 the American Society of Mechanical Engineers for approximately 25 years.

12
13 I have over 23 years of engineering and management experience of which 20 years are in the
14 utility industry. I joined SDG&E in 1992 as an Engineer and have worked in several
15 diversified areas of the utility business with increasing leadership responsibility.

16
17 While with SDG&E, I have held various positions in the functional areas of both Electric and
18 Gas Operations and Engineering. These areas include Electric Distributon System Capacity
19 Planning, Electric System Reliability, Overhead to Underground Conversion Programs, New
20 Business Extensions and Service Establishment, Distributed Generation Interconnections,
21 Emergency Operations, Compliance and Asset Management, Information Management
22 Support for Electric Distribution, Gas System Planning and Operations, Gas Standards and
23 Gas Transmission Major Projects.

24
25 In 2008, I joined the Asset Management Department in my current position. My current
26 management responsibilities include Electric Distribution Capacity Planning; Electric
27 Distribution Reliability Analysis; Reliability Reporting and also the Engineering and Design
28 of Electric Distribution Capacity and Reliability Projects. In addition, I have a variety of
29 other responsibilities related to ongoing regulatory matters including the Fire Safety OIR,
30 Distributed Generation Interconnections to the electric distribution system as well as
31 responsibilities related to SDG&E's 2012 General Rate Case.

32
33 Over my career at SDG&E, I have participated in and supported a variety of regulatory

1 matters with the CPUC and I have testified in CPUC matters prior to this proceeding.

2

3 The purpose of my testimony in this proceeding is to sponsor the SDG&E Spending Metrics
4 section of Application 09-08-020.

5

1 **QUALIFICATIONS OF GINA OROZCO-MEJIA**

2
3 My name is Gina Orozco-Mejia. My business address is 1919 South State College
4 Boulevard, Anaheim, California. I am employed by Southern California Gas Company
5 (SoCalGas) as Director, Orange Coast Region. Orange Coast Region includes Orange
6 County and the eastern portion of Los Angeles County. I have been employed by SoCalGas
7 since 1990 and have previously held responsibilities at both SoCalGas' and San Diego Gas &
8 Electric Company's Distribution Operations. I have 20 years of experience in the utility
9 industry. While at SoCalGas, I have held various staff and line positions in the functional
10 areas of Gas Distribution Field Operations and Technical Services, Gas Engineering, Gas
11 Operations Services, and Gas System Operations.

12 My present responsibilities include ensuring the safe and reliable delivery of gas
13 energy through the distribution pipeline network and the overall management related to the
14 operation, maintenance, installation, and replacement of the gas distribution system as well
15 as field customer services at the region level. I also direct a group that provides technical and
16 financial support for gas distribution project management and construction activities. This
17 includes gas distribution planning and system design; emergency preparedness; response and
18 recovery; and the preparation and management of O&M and capital budgets.

19 I earned a Bachelor of Science Degree in Electrical Engineering from California State
20 University, Los Angeles.

1 **QUALIFICATIONS OF LEE SCHAVRIEN**

2
3 My name is Lee Schavrien. My business address is 8306 Century Park Court, San
4 Diego, California, 92123. I am Senior Vice President – Finance, Regulatory & Legislative
5 Affairs for San Diego Gas & Electric Company (SDG&E) and Southern California Gas
6 Company (SoCalGas). I have held this position since November 1, 2008. In my present
7 capacity, I am responsible for all federal and state regulatory matters, including revenue
8 requirements and tariffs, as well as all financial and accounting matters for SDG&E and
9 SoCalGas.

10 I joined SDG&E in 1978 as a laborer. In 1979 I began working in the Regulatory
11 Affairs Department. Between 1979 and 1989 I held various positions of increasing
12 responsibility within SDG&E’s Regulatory Affairs Department, including working on
13 numerous SDG&E General Rate Cases. In 1989, I was promoted to Manager of Business
14 Planning and Budgets at SDG&E. In that position I was responsible for SDG&E’s
15 centralized budgeting and business planning activities. In 1991, I became SDG&E’s
16 Manager of Revenue Requirements. My responsibilities included overall project
17 management of SDG&E’s 1993 General Rate Case. In 1992 I became SDG&E’s Manager of
18 Regulatory Affairs, with responsibility for all state regulatory matters, including revenue
19 requirements. In 1996, I became Regulatory Affairs Director. In October 1996, I was
20 appointed the project manager of the Enova/Pacific Enterprises Merger. I served in that
21 assignment until I assumed the responsibility of Director Regulatory Affairs for SDG&E and
22 SoCalGas. In January of 2002, I was appointed to the position of Vice President of
23 Regulatory Affairs for SDG&E and SoCalGas. In December of 2006 I was promoted to
24 Senior Vice President of Regulatory Affairs. I held that position until assuming my current
25 position.

26 I have a Bachelor of Business Administration from National University, and I have
27 previously testified before the California Public Utilities Commission.

