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CALIFORNIA PUBLIC UTILITIES COMMISSION

Energy Division Staff Proposal Stress Test Framework April 5, 2019

R.19-01-006



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I. INTRODUCTION

In this document, the Energy Division staff (“Staff”) of the California Public Utilities Commission (“CPUC” or “Commission”) proposes a framework for conducting a financial “Stress Test” to consider an electrical corporation’s financial status and determine the maximum amount the corporation can pay for certain catastrophic wildfire costs, as required by Public Utilities Code section 451.2(b).¹

The Commission opened an Order Instituting Rulemaking (OIR), R.19-01-006, to consider and adopt criteria and a methodology for use in utility² applications to recover costs from catastrophic wildfires with an ignition date in 2017.

Staff is mindful that Governor Newsom is leading a Task Force to address the many issues related to wildfires, including wildfire costs. The Commission on Catastrophic Wildfire Cost and Recovery, created by SB 901, has been convened, hosted three meetings, and is working towards a statutory requirement of publishing a report and recommendations to the Governor and Legislature by July 1, 2019. Legislative action from these efforts may impact this proceeding. The Staff Proposal is provided as a starting point for a discussion to ensure California has financially viable utilities to provide safe and reliable electrical service in the future.

II. OVERVIEW OF THE PROPOSED STRESS TEST

Public Utilities Code Section 451.2 reads as follows:

(a) In an application by an electrical corporation to recover costs and expenses arising from, or incurred as a result of, a catastrophic wildfire with an ignition date in the 2017 calendar year, the commission shall determine whether those costs and expenses are just and reasonable in accordance with Section 451.

(b) Notwithstanding Section 451, when allocating costs, the commission shall consider the electrical corporation’s financial status and determine the maximum amount the corporation can pay without harming ratepayers or materially impacting its ability to provide adequate and safe service. The commission shall ensure that the costs or expenses described in subdivision (a) that are disallowed for recovery in rates assessed for the wildfires, in the aggregate, do not exceed that amount.

(c) An electrical corporation may apply for a financing order pursuant to Article 5.8 (commencing of Section 850) of Chapter 4 for the amount of costs and expenses

¹ Public Utilities Code, section 451.2(b) was enacted by Stats. 2018, chapter 626, section 27. References to code sections herein refer to the Public Utilities Code unless otherwise noted.

² The term “utility” in the context of this proposal refers to electrical corporations.

allocated to the ratepayer as just and reasonable or as disallowed for recovery but exceeding the amount determined pursuant to subdivision (b).

In short, the statute requires the Commission to undertake additional considerations resulting from a utility application to recover costs and expenses incurred as a result of a catastrophic wildfire with an ignition date in 2017. If the Commission finds that some costs would be disallowed for recovery in rates under the ordinary just and reasonable standard,³ then the Commission must undertake a further consideration of the utility’s financial status when allocating costs between shareholders and ratepayers.

Staff proposes the Commission adopt the following Stress Test framework as the process for determining what additional wildfire costs, if any, to allocate to ratepayers under Section 451.2(b) (“Stress Test Costs”):

- A utility requests application of the Stress Test to determine if disallowed wildfire costs should be allocated to ratepayers. This may be in a second phase within an existing application, or by filing a new application, following a Commission determination that all or some wildfire costs are disallowed. The proposed process will conserve administrative resources while allowing for a rapid determination under the Stress Test Framework adopted through this proceeding. Process guidance is set forth in Section V below.
- The Commission applies a three-factor Stress Test model to determine the maximum amount the utility can pay, which is the “Customer Harm Threshold.” The amount of Stress Test Costs allocated to ratepayers equals the total disallowed wildfire costs presented in the application for recovery, minus the Customer Harm Threshold amount. The Stress Test model is described in Section III below.
- The Commission considers potential ratepayer protection measures as conditions on the utility’s authorization to recover Stress Test Costs. These potential conditions are concepts that are intended to mitigate ratepayer impacts given that the determination of Stress Test Costs will be final and not subject to future revision. Concepts for ratepayer protection measures are discussed in Section IV.

Staff’s proposal attempts to balance the following concerns: 2017 wildfire costs, capital cost increases, threats to safe and adequate service, future benefits to ratepayers, and prudent utility facilities management. The proposal prescribes a thorough examination of a utility’s financial ability to pay for the greatest share of disallowed wildfire liability costs while retaining a minimum

³ Public Utilities Code, section 451.

investment grade credit rating. The proposal also offers potential options to enable ratepayers to participate in a utility’s financial upside.

III. DETERMINING THE CUSTOMER HARM THRESHOLD FOR ALLOCATING STRESS TEST COSTS TO RATEPAYERS

The proposed Stress Test model considers three component parts to determine the Customer Harm Threshold, which in turn determines the amount of otherwise disallowed wildfire costs that will be allocated to ratepayers for recovery in rates.

Maximum Incremental Debt Capacity	[A]
Excess Cash	[B]
Regulatory Adjustment	[C]
Customer Harm Threshold	[A+B+C]

The first component, and primary driver, of the Stress Test model is the implied maximum additional debt that a utility can take on and maintain a minimum investment grade issuer-level credit rating (the “Maximum Incremental Debt Capacity”). This is based on existing Moody’s Corporation (Moody’s) and S&P Global Ratings (S&P) analytical credit models at the time the Stress Test is performed. Credit ratings are a good proxy for a utility’s overall financial health because they are based on rating agencies’ views of a utility’s ability to meet its contractual obligations based on (i) non-financial factors, i.e., business and regulatory environment, as well as (ii) financial factors, e.g., utilities’ financial statements, accounting assumptions, and forecasted cash flow. As an example, a rating agency’s rating of a utility could be downgraded if it expected that a utility would issue a significant amount of debt to pay wildfire costs disallowed for recovery in rates (debt not used to fund capital investments does not generate future cash flow). This new development would negatively impact the utility’s Funds From Operations (FFO) to Debt ratio, a key metric of financial health.

The Stress Test therefore focuses on maintaining an investment grade credit rating because this metric is a predictable indicator of a utility’s ability to access capital markets on reasonable, acceptable terms, which is critical to avoid materially impacting its ability to provide adequate and safe service.⁴ Access to capital is critical for the utility to support reasonable and prudent capital investments and ongoing operational needs to provide adequate and safe service. As a utility’s credit rating declines, the cost of debt increases and access to debt capital becomes more difficult, with the greatest impact occurring as credit ratings drop below investment grade (i.e. junk status). Thus, when a utility’s credit rating falls below investment grade it materially impacts its ability to access capital. If the utility cannot reasonably obtain sufficient amounts of capital from external

⁴ Public Utilities Code, section 451.2(b).

sources, it will be forced to reduce spending on activities approved or mandated by the Commission.

In addition to materially impacting a utility's ability to provide safe and adequate service, utility ratings below investment grade have negative impacts that harm ratepayers.⁵ Increases to a utility's cost of debt in turn raise the overall cost of capital. A higher cost of capital is ultimately passed onto ratepayers as a higher rate of return earned on the utility's multi-billion-dollar ratebase.⁶ Loss of credit may also require posting additional collateral and further increase working capital requirements. The Stress Test model therefore looks at the utility's ability to take on additional debt while maintaining an investment grade credit rating, in order to also minimize financial harm to ratepayers.

The second component of the Stress Test model evaluates excess cash. The Customer Harm Threshold is adjusted upward to include those cash and cash equivalents above a desirable minimum cash level that are not captured by the implied Maximum Incremental Debt Capacity analysis ("Excess Cash").

The third component of the Stress Test model allows the Commission to adjust the Customer Harm Threshold up or down, within limits, to reflect the record developed in its regulatory proceedings ("Regulatory Adjustment"). The Regulatory Adjustment may be warranted in light of other reasonable opportunities available to the utility to access capital or based on the Commission's holistic view of the utility's financial metrics and in recognition of the subjective judgment involved in the rating agencies' credit analysis.

The individual components of the Stress Test model are described in greater detail below.

A. Maximum Incremental Debt Capacity

The Stress Test will use the most updated analytical rating frameworks from the two largest rating agencies, Moody's and S&P. At a high level, both of these analytical frameworks look at the legal and business environment of a utility as well as the utility's financials. The frameworks are similar but have differences. Therefore, to ensure a minimum investment grade issuer-level credit rating prevails under both frameworks, the proposed framework will assess results from both rating agencies and rely on the framework that yields the most conservative Maximum Incremental Debt Capacity for the underlying utility. Below Staff provides an abbreviated multi-step process for

⁵ Public Utilities Code, section 451.2(b). *See* D.03-12-035 at 42-43.

⁶ The Commission regularly reviews and authorizes cost of capital based on its components (cost of debt, cost of preferred stock, and cost of common equity). Sustained higher costs to the utility to finance long-term debt will be eventually reflected in the authorized cost of capital.

calculating the Maximum Incremental Debt Capacity; further, Moody’s as well as S&P’s frameworks are publicly accessible.⁷

1. Explanation of the Credit Rating Frameworks

The Moody’s framework uses a weighted sub-factor framework to arrive at an overall issuer-level credit rating, and S&P uses a comparative matrix to determine its core issuer rating. Under Moody’s “Grid-Indicated Rating” framework, each sub-factor is assigned a Moody’s credit rating category Aaa through C. The credit rating categories have associated scores which are applied to the sub-factor weightings to determine the utility’s overall credit rating. For each level of assessment in the test, from sub-factor to overall credit rating, the same ratings categories are used where Aaa is the highest rating, Baa3 is the minimum investment grade rating, and C is the lowest rating. After it reaches a Grid-Indicated Rating, Moody’s may make certain subjective adjustments that can impact the final rating assigned to an issuer. Moody’s Grid-Indicated Rating framework is shown below in Table 2:

Table 2: Moody’s Grid-Indicated Rating framework				
	Sub-Factor			Weighted Sub-Factor Score
	Rating	Score	Weight	
Regulatory Framework				
Legislative and Judicial Underpinnings of the Regulatory Framework			12.5%	
Consistency and Predictability of Regulation			12.5%	
Ability to Recover Costs and Earn Returns				
Timeliness of Recovery of Operating and Capital Costs			12.5%	
Sufficiency of Rates and Returns			12.5%	
Diversification				
Market Position			5.0%	
Generation and Fuel Diversity		Non-Financial Sub-Factors	5.0%	
Financial Strength				
CFO Pre-WC + Interest / Interest			7.5%	
CFO Pre-WC / Debt			15.0%	
CFO Pre-WC - Dividends / Debt			10.0%	
Debt / Capitalization		Financial Sub-Factors	7.5%	
Aggregate Weighted Total Factor Score				
Grid-Indicated Rating				

S&P determines core ratings through its “Anchor Rating Methodology Grid” framework. Under its anchor rating framework, the utility’s business risk (“Business Risk Profile”) and financial risk

⁷ For Moody’s, follow this link https://www.moody.com/research/Moodys-updates-its-methodology-for-rating-regulated-electric-and-gas--PR_368709 and accept the disclaimer then sign up for a free account so you can access “Moody’s Investors Service Regulated Electric and Gas Utilities Rating Methodology.” For S&P If you follow this link https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/corporates/filter/general and register for a free account so you can access “S&P’s Corporate Methodology (November 19, 2013).” Also, for S&P If you follow this link https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/corporates/filter/utilities and be register for a free account so you can access “S&P’s Key Credit Factors for the Regulated Utilities Industry (November 19, 2013).”

(“Financial Risk Profile”) are each evaluated to determine where each factor falls on a 6-point scale. The two risk categories are compared together to determine the utility’s anchor credit rating. For S&P, AAA is the highest rating, BBB- is the minimum investment grade rating, and D is the lowest rating. After it assigns a core anchor rating, S&P may also make certain additional modifications that can impact the final rating assigned to an issuer. The S&P Anchor Rating Methodology Grid framework is shown below in Table 3:

		Financial Factors					
		Financial Risk Profile					
Non-Financial Factors		1	2	3	4	5	6
		(Minimal)	(Modest)	(Intermediate)	(Significant)	(Aggressive)	(Highly Leveraged)
Business Risk Profile	1 (Excellent)	AAA/AA+	AA	A+/A	A	BBB	BBB-/BB+
	2 (Strong)	AA/AA-	A+/A	A-/BBB+	BBB	BB+	BB
	3 (Satisfactory)	A/A-	BBB+	BBB/BBB-	BBB-/BB+	BB	B+
	4 (Fair)	BBB/BBB-	BBB-	BB+	BB	BB-	B
	5 (Weak)	BB+	BB+	BB	BB-	B+	B/B-
	6 (Vulnerable)	BB-	BB-	BB-/B+	B+	B	B-
						Investment Grade	
						Partially Investment Grade	

2. Stress Test Methodology

Using the credit agencies’ analytical frameworks, staff proposes that the Commission follow the process described below to arrive at a utility’s Maximum Incremental Debt Capacity. The Maximum Incremental Debt Capacity is an implied value based on the utility meeting the target minimum investment grade credit ratings of Baa3 for Moody’s Grid-Indicated Ratings and BBB-S&P’s Anchor Ratings.

a) Step One: Most Recent Non-Financial Factor Scores

First, the Stress Test will evaluate the scores given to a utility for its non-financial factors, which reflect changes in the legislative, regulatory, and business environment. The utility will provide in its application the non-financial factor scores given to them in the most recent credit agency reports (any subsequent updates on credit opinions from Moody’s or S&P prior to any proposed or final decision should also be provided). The non-financial component for Moody’s framework makes up 60% of the total weight of a utility’s credit rating, and 50% for the S&P framework. As an example, in S&P’s grid framework, a utility with a “Business Risk Profile” that is “Strong” receives a score of two on the Y axis of the grid, as shown in Table 3.

b) Step Two: Minimum Financial Strength

Next, after identifying the current non-financial factor ratings, the Stress Test determines the utility's minimum financial strength to achieve the target rating of minimum investment grade. The minimum financial strength is implied based on the most recent non-financial factor score and the target rating. For example, the utility that had an S&P Business Risk Profile score of Strong in step one, would have an implied Financial Risk Profile of four, or "Significant," on the X axis, because this is the lowest financial strength the utility can have and retain an overall credit rating above BBB-. The categories that the Stress test will target for S&P, which include just investment grade credit ratings in Table 3, are shaded in dark gray.

c) Step Three: Maximum Incremental Debt Capacity

After going through the credit rating agency's analytical framework, the Stress Test then looks at the utility's ability to take on incremental debt. The ratings agencies consider different financial metrics to determine a utility's financial health. However, under both frameworks, once the financial ratios needed to achieve the target rating are identified, the Maximum Incremental Debt Capacity value can be calculated. The Maximum Incremental Debt Capacity value uses the utility's 3-year financial forecast including the current fiscal year (with the standard Moody's and S&P adjustments to financials) to see how much additional debt the company can add while maintaining the identified minimum financial strength ratios. The financial forecast should exclude the impact of any disallowed wildfire costs for which the utility is seeking recovery.

For example, using S&P's financial risk metrics as shown in Table 4 below, the utility that had an implied Financial Risk Profile of Significant in step two, needs a FFO to Debt ratio between 13-23% and a Debt to Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) ratio between 3.5-4.5x.⁸ In order to ensure the rating agencies' discretionary assessment yields investment grade ratings, utilities should target the midpoint of the desired financial ratios. Therefore, the Commission would utilize the midpoint of these ratios in tandem with the utility's forecasted financials to calculate the Maximum Incremental Debt Capacity the utility could take on and achieve the target credit rating.

⁸ Core ratios based on S&P's Medial Volatility table in its Corporate Methodology. The volatility table referenced may change as S&P's view of a utility's operating environment changes.

Table 4: S&P Financial Risk Metrics						
	Financial Risk Profile					
	1 (Minimal)	2 (Modest)	3 (Intermediate)	4 (Significant)	5 (Aggressive)	6 (Highly Leveraged)
FFO / Debt	>50 %	35% - 50 %	23% - 35%	13% - 23%	9 % - 13%	<9 %
Debt / EBITDA	<1.75x	1.75x-2.50x	2.50x-3.50x	3.50x-4 .50x	4 .50x-5.50x	>5.50x

As an example, a hypothetical utility could have \$10 B of preexisting debt, an FFO of \$2.9 B (FFO/Debt ratio of 29%), and an EBITDA of \$4.0 B (Debt/EBITDA of 2.5x). This company would have an Intermediate Financial Risk Profile. Building off the previous example this utility has an FFO of \$2.9 B but could move to a FFO/Debt ratio of 18%, the midpoint for the “Significant” range for the Financial Risk Profile, by taking on additional debt.⁹ Therefore the utility has an implied debt capacity of \$16.1 B (\$2.9 B / 18%).¹⁰ This hypothetical utility with \$10 B in preexisting debt can retain the minimum investment grade rating while taking on \$6.1 B of incremental debt. The \$6.1 B represents the utility’s Maximum Incremental Debt Capacity and is the first component of the Customer Harm Threshold.¹¹

B. Excess Cash

The Excess Cash component ensures that any excess cash available to a utility is used to satisfy disallowed wildfire costs by reducing the Customer Harm Threshold. This is intended to prevent a utility from unnecessarily hoarding cash. The Maximum Incremental Debt Capacity component of the Stress Test may not capture excess balance sheet cash and cash equivalents above a minimum cash threshold, but such excess cash should be counted as a resource for discharging these liabilities.

Under this second component of the Stress Test, a utility’s application should address what levels of minimum cash are reasonably necessary to operate the business in ordinary course and identify available balance sheet cash above a minimum threshold. An analysis of Excess Cash must be demonstrated as part of a financial forecast or other materials submitted to support the application of the Stress Test. Additionally, where applicable to reach the target credit rating, quantifiable

⁹ Similarly, if the ratings agencies viewed the non-financial factors more favorably, this would increase a utility’s ability increase its Maximum Incremental Debt Capacity further. This would result in higher Ratepayer Harm Threshold, *i.e.* reduce ratepayers Stress Test Costs. All else being the same, this would lower rates as the amount of Stress Test Costs passed on to ratepayers would be smaller.

¹⁰ This example is simplified and does not take into account that debt service costs that would reduce FFO by adding incremental debt. The actual test will account for a utility’s incremental interest expense and account for all other adjustments utilized to determine credit ratings.

¹¹ The implied Maximum Incremental Debt Capacity value from the different financial metrics will likely not match; therefore, staff proposes that a utility seek to maximize its Maximum Incremental Debt Capacity within the rating agencies’ frameworks for purposes of determining the Customer Harm Threshold.

cash proceeds from pending asset sales should be identified. Minimum cash should include optimal cash balances necessary to operate in the ordinary course, consistent with the company's and industry's historic norms.

C. Regulatory Adjustment

The third step of determining the Customer Harm Threshold enables the Commission to adjust the Customer Harm Threshold up or down by a maximum of 20% of the subtotal of the first two components. Regulatory adjustments may be warranted and in the public interest because of the credit rating agencies' analyses, while formulaic, involve certain subjective judgments and adjustments. It also accommodates concerns that a narrow focus on credit ratings may not sufficiently capture a utility's ability to finance disallowed wildfire liabilities from other reasonable business opportunities, including through raising additional equity capital. This proposed third component allows the Commission to apply its unique expertise in ratemaking for California utilities based on the record developed in the proceeding to recover wildfire costs. This element of Staff's proposal will ensure that the utility considers other business opportunities that could be leveraged by the corporation to pay wildfire liabilities before filing an application, but also maintains predictable outcomes by constraining the total amount of the adjustment.

Under the proposed Regulatory Adjustment component, a utility applying for the Stress Test must describe other options the utility considered to satisfy disallowed wildfire costs, or to otherwise access capital on reasonable terms. This could include, for example, asset sales, financial policy enhancements (e.g., changes in depreciation approaches, tax structuring), adjustments to dividend policies, and assessment of equity flows to or from the parent corporation, reducing or deferring discretionary spending. The utility must also present its assessment of whether it could feasibly raise additional equity capital based on observed equity market transactions.

If the utility identifies sources it can reasonably access that are ratepayer neutral over time and will enable the utility to reach or maintain target minimum credit ratings, then it must identify those amounts within its proposed Customer Harm Threshold. If the utility does not deem any of these options reasonable, the request for Stress Test Cost recovery should nevertheless include a detailed description of its analysis and the basis for the utility's conclusion that each potential opportunity is not reasonable.

As a hypothetical example, after assessing the first two components (Maximum Incremental Debt Capacity and Excess Liquidity), the Commission arrives at a Customer Harm Threshold of \$1 billion dollars. The Commission could use regulatory expertise to increase the Customer Harm Threshold by 20% to \$1.2 billion, for example if the record supports finding shareholders can absorb additional wildfire liabilities or the utility has other reasonable means to access capital. Likewise, the Commission could decide to reduce the Customer Harm Threshold by 20% to \$800 million, if it finds such adjustment is necessary to avoid harming ratepayers or materially impacting the utility's ability to provide adequate and safe service.

If a utility is already at the minimum credit rating that is investment grade, or if it has fallen below investment grade, the first two components of the Stress Test model may yield a Customer Harm Threshold that is very low or even zero. In this case, the Commission may still authorize Stress Test Costs if the utility can demonstrate a path back to investment grade (as discussed below) and may apply a Regulatory Adjustment arrive at the final Customer Harm Threshold. Staff proposes limiting the Regulatory Adjustment in this scenario to 5% of the disallowed wildfire liability.

D. Stress Test Model Assumptions

1. Primary Focus on Access to Debt Rather than Equity Capital

The Stress Test begins with an assessment of the Maximum Incremental Debt Capacity a utility can take on while maintaining an investment-grade rating. Staff favors looking at investment grade debt because it provides a simpler, more predictable, and more durable assessment of the utility's ability to access a specified amount of capital. Further, while direct equity is an alternative form of consideration that could be used instead of or in connection with (i.e. on top of) debt capacity,¹² Staff generally believes looking to equity causes more ratepayer harm than benefit.

Adding incremental equity financing introduces more speculation about the value shareholders will pay to acquire new shares and dilutes the utility's ownership, which in turn can impact credit ratings and returns on equity. Further, issuing additional debt to fund the disallowed portion of wildfire costs has less impact on ratepayers than issuing equity because debt reduces the effective return on equity as the shareholders cannot recover the debt financing costs. Finally, when a utility is already in a stressed situation, the cost of equity becomes even more costly given the uncertainty of economic and ownership dilution. In other words, adding uncertainty increases the cost of capital and limits access to capital which is needed to ensure safe, affordable, and reliable service and to deliver on the State's clean energy goals

2. Applicability of Stress Test to Utilities at or Below Investment Grade Credit Ratings.

The Stress Test is designed to ensure utilities maintain access to necessary capital on acceptable terms. If a utility has already been downgraded to a junk credit rating, the Stress Test may not be the right tool to prevent ratepayer harm and may not be sufficient to prevent material impacts to the utility's ability to provide adequate and safe service.

As an additional condition to ensure that application of the Stress Test reduce customer harm, Staff proposes that the Commission should only approve utility recovery of Stress Test Costs if: (i) it is currently at or above an investment grade credit ratings, or (ii) it is currently below and can demonstrate an ability (pathway) to achieving investment grade credit rating. A demonstrated ability to achieve a minimum investment grade credit rating could include, for example, the

¹² Consistent with the Regulatory Adjustment component, the proposed Stress Test requires the utility to at least present an analysis of whether equity financing is a reasonable option to allow the Commission to evaluate the appropriateness of equity financing.

allowance of wildfire related liabilities for recoveries in rates, equity issuances, asset sales, or other forms of capital infusions

3. No New Legislation

The Stress Test only applies to catastrophic 2017 wildfires and assumes no new or amended legislation will alter the existing Section 451.1 or Section 451.2. The Stress Test will evaluate the utility's financial health at the time it is assessed, however, and therefore it will reflect metrics utilized in the credit rating process to account for any additional liabilities the utility may face as a result of post-2017 wildfires. At the time it is implemented, the stress test will also reflect up-to-date views on the legislative environment prior to determining the utility's financial health, as appropriately taken into account in the credit rating process. In this way, the Stress Test model is designed with flexibility to address changes related to non-financial factors that affect a utility's creditworthiness and access to capital.

IV. RATEPAYER PROTECTION MEASURES

Staff proposes two optional concepts for consideration as part of the Stress Test Framework. These concepts would involve adopting ratepayer protection measures as a condition of authorizing the utility to recover Stress Test Costs, in order to address fairness concerns and mitigate ratepayer harm. These measures are intended to provide ratepayers with an opportunity to participate in a utility's financial upside as the utility's long-term financial health improves. They are also intended as a safeguard to encourage utilities to maximize the share of disallowed costs they absorb and ensure utilities view the Stress Test as a financing mechanism of last resort. Any Ratepayer Protection Measures, if adopted, will operate along with other safeguards the Commission may adopt in other proceedings such as in the Safety Culture OII (I.15-08-019), which is considering utility management and board accountability.

Stress Test Costs are determined at a snapshot in time – a time when the utility is in financial distress – and will not be revised in the future. Staff proposes that the Commission consider conditioning the authorization to recover Stress Test Costs on utility implementation of some measures or mechanism to ensure the utility's shareholders do not obtain a windfall of all future upside as the utility recovers financial health without returning some benefits to ratepayers.

Staff has considered two potential alternatives to mitigate the concern that equity holders are passing risk they have historically borne to ratepayers. These initial concepts are described below.

A. **Ratepayer Protection Concept 1: Return on Equity De-escalation**

Utilities have argued in the past for increasing the Commission's authorized cost of capital due to heightened perceived business risks associated with catastrophic wildfire events.¹³ Further, in

¹³ See D.12-12-034 at 30.

active transmission rate cases pending before the Federal Energy Regulatory Commission, California utilities are also seeking increases to their return on equity (“ROE”) for transmission assets due to uncertainties associated with catastrophic wildfires. The next round of comprehensive cost of capital applications are due on April 22, 2019.¹⁴ Commission Staff recognizes the possibility that the utilities may argue for increases to cost of capital (and specifically authorized ROE) in recognition of business risks associated with wildfires. At the same time, staff notes that the purpose of the Stress Test is to shift the risk burden from shareholders to ratepayers, at least for wildfire liabilities incurred due to 2017 fires. Conceptually, therefore, Staff suggests the Commission consider a downward adjustment to ROE if a utility applies for relief from wildfire liabilities under the Stress Test Framework, under the reasoning that when ratepayers are allocated wildfire costs above the maximum the utility can pay, ratepayers have assumed that wildfire risk.

Under this option, the utility will decrease its applied ROE from the authorized amount for a period of up to five years, based on the amount of wildfire liability allocated from shareholders to ratepayers. Staff proposes reducing ROE incrementally 20 basis points for every \$500 million-dollar block of authorized Stress Test Costs, capped at 300 basis points. Table five below shows a chart of incremental ROE reductions based on liability allocated to ratepayers.

Table 5: ROE De-escalation															
Basis Point Reduction	20	40	60	80	100	120	140	160	180	200	220	240	260	280	300
Maximum Liability (\$ Billion)	\$0.5	\$1.0	\$1.5	\$2.0	\$2.5	\$3.0	\$3.5	\$4.0	\$4.5	\$5.0	\$5.5	\$6.0	\$6.5	\$7.0	∞

Staff has conducted an initial analysis of the ratepayer impact of the ROE De-escalation concept. Staff found reducing ROE may slightly increase Stress Test Costs, i.e. add to ratepayer harm. This occurs because de-escalation reduces cash flow metrics analyzed to determine debt capacity.

B. Ratepayer Protection Concept 2: Provide Equity Upside to Ratepayers

Under this concept for a Ratepayer Protection Measure, a portion of future increases in the utility’s equity value will accrue to the benefit of ratepayers. Ratepayers would receive equity warrants as a condition of the Commission’s authorization to recover Stress Test Costs. These warrants would allow ratepayers to participate in a portion of increases in a utility’s equity value post-Stress Test; in other words, if the utility’s stock price increases post-Stress Test, ratepayers would receive some of that increase. These warrants would be held in a special purpose fund or trust to offset the rate impacts of allocated Stress Test Costs as the utility’s condition improves.

¹⁴ D.17-07-005 at 11.

Staff proposes increasing the percentage of ratepayers’ benefit from the utility’s equity value from the time of the application’s filing by 1% for every \$500 million-dollar block of securitized wildfire liability, capped at 15%. Table six below shows a chart of the incremental ratepayer share of future utility equity increases:

Table 6: Ratepayer Share of Future Equity Increases															
Share of upside (%)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%
Maximum Liability (\$ Billion)	\$0.5	\$1.0	\$1.5	\$2.0	\$2.5	\$3.0	\$3.5	\$4.0	\$4.5	\$5.0	\$5.5	\$6.0	\$6.5	\$7.0	∞

Staff also has conducted an initial analysis of the ratepayer impact from ratepayers receiving equity warrants. Staff found that requiring equity warrants for ratepayers in the long-term offsets some Stress Test Costs, i.e. this would create ratepayer benefit all else being equal (assuming there is no resulting upward effect on the cost of equity for a utility).

V. PROCESS FOR SEEKING STRESS TEST COSTS

Staff proposes that a utility seeking to recover Stress Test Costs must request application of the Stress Test, either as a second phase within an existing application to recover catastrophic wildfire costs or by filing a new application with the Commission requesting an allocation to ratepayers of wildfire costs the Commission has disallowed.

This phasing of process is necessary because the amount of disallowed wildfire costs must be known in order to determine the Customer Harm Threshold. Further, phasing of the prudency review before the Section 451.2(b) cost allocation determination will conserve administrative and judicial resources. If the Commission finds that all 2017 wildfire costs were prudently incurred, then there is no need to conduct a Stress Test analysis under Section 451.2(b), because prudent costs are recovered from ratepayers. If the Commission finds only some of the costs were prudently incurred then there may be a need to apply the Stress Test framework. This sequencing will also ensure the wildfire liabilities the utility seeks are reasonably quantified and in excess of insurance proceeds (although they may include contingent costs and expenses).

A request to recover Stress Test Costs that provides the detailed information discussed throughout the proposal will allow for a rapid determination of the Customer Harm Threshold. In order to provide the necessary record to support the Commission ultimately finding that catastrophic wildfire costs should be allocated to ratepayers, the utility’s request should include at least the following information:

- Identify total costs sought under the utility’s proposed application of the Stress Test model’s three components, including detailed

review of debt capacity based on the latest credit ratings methodologies.

- Financial metrics for the current fiscal year and two additional fiscal years, including financial and credit metrics as adjusted by both Moody's and S&P and excluding the impact of disallowed wildfire liabilities for which the utility is applying for cost recovery under the Stress Test, and any other catastrophic wildfire costs that are pending review by the Commission at the time the utility requests application of the Stress Test.
- Detailed analysis of alternatives available to minimize the cost borne by ratepayers and the proposed treatment of each under the regulatory adjustment component of the Stress Test model.
- If the utility has one or more credit ratings that are below investment grade at the time of filing, a showing of how recovery of Stress Test Costs will allow the utility to regain a stable minimum investment grade credit rating and a pathway for improved financial health over time.
- Specify whether the utility requests a waiver from the Commission of the authorized capital structure in connection with an allocation of Stress Test Costs.

Staff's proposed Stress Test should be easily quantifiable within a reasonable range, and thus will promote predictability of cost recovery outcomes.

The measurement date of a utility's financial health for the purposes of determining the Customer Harm Threshold is presumed to be the date the request is filed. The utility's financial status could materially change during the course of the cost recovery proceeding, however, and the utility or any other interested party can request an updated assessment of the utility's financial health before the record is submitted for decision.