Application of San Diego Gas & Electric Company (U902M) for Authority, Among Other Things, to Increase Rates and Charges for Electric and Gas Service Effective on January 1, 2012.	A.10-12-005 (Filed December 15, 2010)
Application of Southern California Gas Company (U904G) for authority to update its gas revenue requirement and base rates effective on January 1, 2012.	A.10-12-006 (Filed December 15, 2010)

Applications: A.10-12-005
Exhibits No.: SDG&E-226/ SCG-220

PREPARED REBUTTAL TESTIMONY OF DAVID SARKARIA ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY AND SOUTHERN CALIFORNIA GAS COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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PREPARED REBUTTAL TESTIMONY OF

DAVID SARKARIA

ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY AND

SOUTHERN CALIFORNIA GAS COMPANY

I. INTRODUCTION

The following rebuttal testimony addresses the Division of Ratepayer Advocates' (DRA) proposals related to pension and postretirement benefits other than pensions (PBOP) as presented in its Report on the Results of Operations for San Diego Gas & Electric Company (SDG&E) and Southern California Gas Company (SCG) in Exhibit DRA-30 dated September 1, 2011. It also discusses the intervenor testimony submitted by the Utility Consumers' Action Network (UCAN) as presented in the Testimony of Steven McClary and Laura Norin on Behalf of UCAN Concerning SDG&E's General Rate Case dated September 22, 2011.

II. SUMMARY OF REBUTTAL TESTIMONY

DRA generally agrees with the SDG&E and SCG (the Companies) proposal regarding pension and PBOP expenses for Test Year 2012, including recovery of pension and PBOP expense based on 2009 actual amounts (see Attachment A) and continuation of the current balancing account mechanism for recovery of future pension and PBOP expenses. However, there are additional aspects of the Companies' request that were either modified or omitted from DRA's Report.

Specifically, my testimony rebuts the following points:

- DRA did not address the Companies' request to modify the current funding mechanism, if required in the future, to avoid benefit restrictions.[1] The

[1] Exh. SDG&E-26-R, p. DS-13 and SCG-20-R, p. DS-13.

Commission should adopt the Companies' proposal to avoid potential disruption in benefit distributions for retiring employees.

- DRA did not address SDG&E's request for recovery of the surety bond cost which is required to maintain an 80% funded ratio, thereby avoiding benefit restrictions for retiring employees.[2] Since DRA failed to provide a justification for opposing this request, the Commission should approve SDG&E's proposal.
- Contrary to DRA's agreement with two-way balancing accounts for pension benefits, DRA recommends changing from the current two-way balancing account to a one-way balancing account for PBOP expenses.
- UCAN misinterpreted the Companies' intent in proposing 2009 pension and PBOP expense levels for purposes of rate recovery in Test Year 2012.[3]

My testimony is organized as follows:

- Section III – Rebuttal to DRA Regarding Pension Benefits;
- Section IV – Rebuttal to DRA Regarding PBOP;
- Section V – Rebuttal to UCAN Regarding Pension and PBOP;
- Section VI – Summary and Conclusion.

III. REBUTTAL TO DRA REGARDING PENSION BENEFITS

The Companies and DRA agree that maintaining the two-way pension balancing account (PBA) for pension benefits serves to protect both ratepayers and shareholders.[4] Actuarial determinations of funding requirements under the Employee Retirement and Income Security Act of 1974 (ERISA) are effected by numerous external economic variables (e.g., return on

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[2] Exh. SDG&E-26-R, p. DS-3, DS-11.
[3] Exh. SDG&E-26-R, p. DS-3 and SCG-20-R, p. DS-3.
[4] Exh. DRA-30, p. 3.

pension assets, interest rates, federal legislation, etc.), which are beyond the control of the Companies. Consequently, the Commission has consistently approved the use of PBAs to account for the variability in pension expense for the Companies (D.08-07-046) as well as Southern California Edison (D.09-03-025), and Pacific Gas and Electric Company (D.06-06-014).

The Companies have a long history of determining pension expense based on ERISA minimum required contributions. However, funding based on the minimum required contribution may not be sufficient to avoid an additional potential impact. ERISA imposes limitations on the distribution of benefits if a plan's funding falls below the 80 percent level. If a pension plan's funded status falls below 80 percent, the plan would be subject to limitations on benefit distributions, higher required minimum contributions, and higher Pension Benefit Guarantee Corporation premiums.[5] The above consequences can be avoided by either contributing additional funds or providing additional security (e.g., a surety bond).[6] The security instrument is considered to be a plan asset for purposes of determining the benefit limitation threshold. In order to avoid the possibility of benefit restrictions in the future, the Companies proposed to determine future funding amounts based on the greater of the minimum required contribution or the amount necessary to maintain an 85 percent funding level.

A. SDG&E Pension Benefits[7]

As a result of the 2008 financial crisis, the value of SDG&E's pension assets declined to the extent that the funded ratio fell below 80 percent. In order to avoid benefit restrictions and increase the funded ratio to the 80 percent level, the Company secured a surety bond, backed by

[5] Exh. SDG&E-26-R, p. DS-6.
[6] Exh. SDG&E-26-R, p. DS-7.
[7] Exh. SDG&E-26-R, pp. DS-3, -6, -7, and -11.

a letter of credit, with an aggregate face value of $110 million. Pursuant to ERISA, the security bond must remain in place until the plan's funded ratio reaches 90 percent. SDG&E's projected minimum required contribution for Test Year 2012 would have to be increased by approximately $90.5 million in order to attain a 90 percent funded level. Consequently, the Company requested an additional $1.65 million to cover this expense which is not included in the minimum required pension contribution (see Attachment A). In effect, the surety bond defers a significant increase in contributions and the resulting impact on ratepayers assuming the Company was to request and receive Commission approval. Since the cost of surety bonds tends to vary based on market interest rates and other economic factors, the Company believes the expense can be tracked using the two-way balancing account process.

As noted above, SDG&E must maintain the surety bond until such time as the funded percentage reaches 90 percent. Thereafter, the funded percentage is expected to remain well above 80 percent due to anticipated improvement in market returns and required future contributions pursuant to ERISA as amended by the Pension Protection Act of 2006.

B. SCG Pension Benefits

The market value of the SCG pension assets significantly declined as a result of the economic downturn, however, its funded ratio remained above 80 percent. Unlike SDG&E, the SCG plan did not face the risk of benefit restrictions. Consequently, no surety bonds were required to maintain benefit distributions to pension plan participants.

The funded percentage of the SCG plan is not expected to fall below 80 percent based on the latest actuarial projections. However, in order to avoid potential benefit restrictions in the future, SCG proposed that future contributions be based on the greater of the ERISA required minimum or the amount necessary to maintain an 85 percent funding level.

IV. REBUTTAL TO DRA REGARDING PBOP

DRA recommends changing the current two-way balancing account for PBOP to a one-way balancing account.[8] This position is totally inconsistent and contrary to DRA's endorsement of two-way balancing accounts for pension benefits. The rationale for maintaining the two-way balancing account mechanism is the same for both pension and PBOP: the inability to accurately predict the impact of external economic factors such as interest rates, return on benefit trust assets, legislative changes and, in the case of PBOP, health care trend rate.[9]

A. DRA's Basis for Eliminating Two-Way Balancing Accounts Disregards the Existing Tax Exempt Trusts

DRA accurately describes how two-way balancing accounts "serve to protect both ratepayers and shareholders"[10] including the impact of variability due to "factors not subject to management control."[11] It then proceeds to totally abandon the concept of two-way balancing accounts on the basis that "the cost of the risk to shareholders is already included in the opportunity to earn a rate of return."[12] This makes no sense. It appears that DRA considers PBOP expense to be a component of the Companies' fixed asset rate base upon which it earns an approved rate of return. This is simply not true. The opportunity to earn a rate of return arises within the PBOP trusts whose assets are segregated for the benefit of participants.

The Commission established criteria related to rate recovery of PBOP expenses in its Phase II Decision of the Order Instituting Investigation (D.92-12-015) which have been in place since 1993. The Companies' have recovered PBOP expenses based on the Financial Accounting Standard 715-60 (formerly FAS 106). Annual PBOP expenses are determined based on actuarial

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8 Exh. DRA-30, p. 7.
9 Exh. SDG&E-26-R, pp. DS-12 and -19; SCG-20-R, pp. DS-12, -19, and -20.
10 Exh. DRA-30, p. 6.
11 Exh. DRA-30, p. 6-7.
12 Exh. DRA-30, p. 7.

calculations performed by the Companies' enrolled actuaries, Towers Watson. The Companies maintain several independent trusts, both Voluntary Employees' Benefit Association (VEBA) trusts and IRC Section 401(h) trusts, dedicated solely to the funding of PBOP. Unlike pensions, PBOP trusts are not subject to minimum required funding levels. Rate recovery is based on the lesser of the FAS 760-15 expense or the maximum tax deductible contribution. Certain VEBAs (those that fund union-represented PBOP) and 401(h) trusts are, like the pension trusts, tax exempt. Consequently, the return on investment from PBOP trust assets is dependent on economic conditions and market performance. The two-way balancing account "balances" the risk to shareholders and ratepayers by insuring that ratepayers receive the benefit of high returns (i.e., refund of over-collections) and shareholders avoid the risk of low returns (i.e., adjustment in rates to reflect a lower than projected return on PBOP trust assets).

B. PBOP Expense is Difficult to Accurately Project Due to the Impact of External Variables Outside the Control of the Companies

The Companies' actuaries, Towers Watson, prepare annual projections of PBOP expenses which incorporate estimates of numerous variables including: benefit claims experience, return on trust asset investments, applicable discount rate, participant mortality, plan enrollment patterns, projected retirement dates, dependent status, health care trend rate, plan design changes, and premium cost sharing.[13] Of particular significance are the discount rate and health care trend rate assumptions which extend over the life of the plan.

Pursuant to generally accepted accounting principles, the applicable discount rate is determined at a single point in time – the last day of the plan year (December 31). No options for discount rate averaging or smoothing is permitted. Consequently, the level of variance

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[13] Exh. SDG&E-26-R, pp. DS-16, -17, and -19; SCG-20-R, pp. DS-16, -17, -19, and -20.

between the assumed and actual rate can significantly increase or decrease the plan liability and resulting PBOP expense.

It is not surprising that the Commission and DRA have supported two-way balancing accounts for PBOP. As DRA states in its report, medical escalation is one of the major cost drivers that impacts the estimated Test Year 2012 expense. It goes on to state: "the risk of over-estimation in this instance is reduced because only the actual expense will be borne by the ratepayers, and DRA does not take issue with this [medical] escalation rate being used for PBOP expense forecast."[14] Clearly, DRA understands that an estimate related to any external variable will be corrected by virtue of the balancing account mechanism. If the actual medical escalation rate is lower than projected, the related over-collection will be refunded to ratepayers.

Attachment B shows the history of projected versus actual PBOP expense for the period 2007 thru 2010. A comparison of the projected PBOP expenses submitted in the Companies' 2008 General Rate Case with the actual expenses shows the variability of actual expenses, either over or under the projected amount. The two-way balancing account mechanism is functioning as designed and there is no material basis for changing it.

C. Commission Precedent Supports Two-Way Balancing Accounts

DRA challenges the Companies' claim that the Commission has "consistently approved the use of a two-way balancing account mechanism," citing a single decision (PG&E D.11-05-018).[15] Consistency is demonstrated by historical precedent. The Commission approved two-way PBOP balancing accounts for SDG&E (D.08-07-046 – Appendix 1), SCG (D.08-07-046 – Appendix 2) and SCE (D.06-05-016 and D.09-03-025). In fact, DRA supported, or did not object to, two-way balancing accounts for PBOP in each of the above-referenced cases.

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[14] Exh. DRA-30, p. 8.
[15] Exh. DRA-30, p. 7.

In 2009, the Commission approved the Companies' petition to modify the mechanism for recovery of PBOP expenses which are now subject to an annual accounting and true-up (D.09-09-011). The Commission's Order modified the 2008 Settlement for SDG&E and SCG (D.08-07-046) but did not change the fundamental two-way PBOP balancing account mechanism. Annual true-up of PBOP expenses reduces rate volatility by smoothing the annual impact of various external economic variables while avoiding the potential accrual of a large over- or under-collection in rates. The periodic true-up process insures that any under-collection will be recovered by shareholders and any over-collection will be refunded to ratepayers with interest.

V. REBUTTAL TO UCAN REGARDING PENSION AND PBOPS

UCAN misconstrued the Companies' proposal[16] related to funding of pension and PBOP benefits by stating that such proposal was entirely conditioned on continuation of two-way balancing accounts for these expenses.[17] The intent of the proposal was to use the existence of the two-way balancing account for pension and PBOP funding to allow an extra year to pass before the impact of higher required pension funding took effect. By allowing this extra year, there is an expectation that market returns will recover from the 2008 market decline and reduce ERISA minimum required pension funding and PBOP expense levels.

The Companies have no reason to believe the Commission would consider eliminating two-way balancing accounts given their rationale and historical precedent. As previously discussed, the Commission has a long history of supporting two-way balancing accounts for expenses whose estimation is difficult due to the external variables that impact any forecast. These accounts provide a mechanism that serves the public interest by mitigating the impacts on

[16] Exh. SDG&E-26-R, p. DS-3 and SCG-20-R, p. DS-3.
[17] Exh. UCAN-3, McClary and Norin, p. 14.

ratepayers associated with rate volatility that may occur due to the numerous economic factors that impact pension and PBOP funding.

As DRA noted in its report supporting the proposal, the Companies' goal was to relieve ratepayers of the projected pension funding increase for one year while the economy continues to improve and, hopefully, yields higher returns on the pension asset portfolio and lower required minimum contributions for 2013 and beyond.[18] In the case of PBOP expenses, the expectation was to smooth the level of expense given the year-to-year volatility of factors such as medical trend, discount rates and legislative impacts.

VI. SUMMARY AND CONCLUSION

In conclusion, the Companies believe the continuation of two-way balancing accounts for PBOP expenses is supported by the inherent difficulty in accurately projecting expense. The treatment of pension and PBOP expenses should be consistent since the underlying rationale for the two-way balancing account is the same: to protect ratepayers and shareholders from the risks attributable to external economic variables that are difficult to predict with a high level of accuracy. The two-way mechanism protects against over- or under-collection of expense, thereby insuring the equitable balance of risk and reward that may result when comparing what was expected to occur versus what actually occurred. The Commission has consistently supported the use of two-way balancing accounts for the reasons stated above, none of which have changed since the Companies' last General Rate Case decision.

As a result of the 2008 financial market collapse, SDG&E was faced with either the imposition of benefit restrictions on retiring employees or a significant additional contribution to its pension plan. Rather than pursue recovery of contributions in excess of the ERISA-required

[18] Exh. DRA-30, pp. 4-5.

minimum, the Company procured a surety bond in order to avoid benefit restrictions. The solution was cost-effective, deferred the need to contribute an additional $90.5 million to the pension trust, and resulted in no disruptions to the Company's employees due to the decline in SDG&E pension asset values. DRA, and the other interveners who filed testimony, did not contest the Company's request to include this expense. The Company believes this expense was reasonable and necessary and, therefore, should be recoverable in rates.

This concludes my prepared rebuttal testimony.

ATTACHMENT A

Table 1
Summary of SDG&E Pension and PBOP Expenses for TY 2012
($ in thousands)

Description	SDG&E Proposed	DRA Report on Results of Operations	SDG&E – DRA Variance
Pension	$56,833	$56,833	$ 0
Surety Bond	$ 1,650	$ 0	$1,650
PBOP	$15,554	$15,554	$ 0
TOTAL	$74,037	$72,387	$1,650

Table 2
Summary of SCG Pension and PBOP Expenses for TY 2012
($ in thousands)

Description	SCG Proposed	DRA Report on Results of Operations	SCG - DRA Variance
Pension	$75,105	$75,105	$ 0
Surety Bond	$ 0	$ 0	$ 0
PBOP	$25,942	$25,942	$ 0
TOTAL	$101,047	$101,047	$ 0

ATTACHMENT B

Table 1
2008 GRC SDG&E PBOP Expense Projection versus Actual Expense thru 2010
($ in millions)

Description	2007	TY 2008	2009	2010	2011	2012	2013
2008 GRC Projection							
PBOP (FAS Expense)	**$15.67**	**$15.52**	**$15.32**	**$15.08**	**$14.84**	**$14.59**	**$13.67**
Discount Rate	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**
Expected Return on Assets	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**
Health Care Rate – BC	**10.0%**	**10.0%**	**9.0%**	**8.5%**	**8.0%**	**7.5%**	**7.0%**
Health Care Rate - HMO	**8.5%**	**8.5%**	**8.0%**	**7.5%**	**7.0%**	**6.5%**	**6.0%**
Actual Results							
PBOP (FAS Expense)	**$15.02**	**$14.97**	**$15.56**	**$15.16**			
Discount Rate	**5.85%**	**6.20%**	**6.10%**	**5.75%**			
Return on Assets	**4.7%**	**-22.0%**	**16.1%**	**8.6%**			
Health Care Trend Rate*	**9.5%**	**7.0%**	**3.5%**	**13.0%**			

***Healthcare trend rate is applied to the subsequent year. For example, the 2010 trend rate is applied to 2010 premiums to project 2011 premiums.**

Table 2
2008 GRC SCG PBOP Expense Projection versus Actual Expense thru 2010
($ in millions)

Description	2007	TY 2008	2009	2010	2011	2012	2013
2008 GRC Projection							
PBOP (FAS Expense)	**$32.99**	**$31.42**	**$30.37**	**$30.80**	**$31.35**	**$32.04**	**$32.85**
Discount Rate	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**	**5.85%**
Expected Return on Assets	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**	**7.0%**
Health Care Rate – BC	**10.0%**	**10.0%**	**9.0%**	**8.5%**	**8.0%**	**7.5%**	**7.0%**
Health Care Rate - HMO	**8.5%**	**8.5%**	**8.0%**	**7.5%**	**7.0%**	**6.5%**	**6.0%**
Actual Results							
PBOP (FAS Expense)	**$28.57**	**$16.70**	**$25.91**	**$32.67**			
Discount Rate	**5.85%**	**6.20%**	**6.10%**	**5.9%**			
Return on Assets	**7.0%**	**-26.6%**	**21.2%**	**12.6%**			
Health Care Trend Rate*	**9.5%**	**7.0%**	**3.5%**	**13.0%**			

***Healthcare trend rate is applied to the subsequent year. For example, the 2010 trend rate is applied to 2010 premiums to project 2011 premiums.**