BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company in its 2009 Nuclear Decommissioning Cost Triennial Proceeding (U 39-E)	)))	A.09-04-007 (Filed April 3, 2009)
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RESPONSE OF SAN DIEGO GAS & ELECTRIC COMPANY (U 902-E) TO ASSIGNED COMMISSIONER'S RULING SEEKING ADDITIONAL INFORMATION

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RESPONSE OF SAN DIEGO GAS & ELECTRIC COMPANY (U 902-E) TO ASSIGNED COMMISSIONER'S RULING SEEKING ADDITIONAL INFORMATION

San Diego Gas & Electric Company ("SDG&E") provides the following response to the *Assigned Commissioner's Ruling Seeking Additional Information* ("*August Ruling*") issued August 13, 2012. In the pending phase of the above-captioned dockets, the Commission is considering whether the investment guidelines previously adopted by the Commission should be modified, *inter alia*, so as to allow the utilities' nuclear decommissioning trust funds to be invested in certain alternative investment classes not currently available to the trusts and, if so, the appropriate extent to which those alternative investment classes may be reflected in the trust investment portfolios. To assist the Commission's deliberations regarding these matters, the *August Ruling* requests SDG&E provide the following specific and additional information:

> Given the delays and uncertainty regarding the timing of any application for NRC license renewal for SONGS, would the utility's Nuclear Decommissioning Trust Fund Committee be likely in 2012 or 2013 to use any authority granted to invest trust funds into some or all of the alternate investment classes examined in the Callan feasibility study? Please explain your answer.

SDG&E would first point out the passage of time in the pending phase of the instant proceeding would, from a practical standpoint, make it unlikely that the SDG&E Nuclear Decommissioning Trust Funds could include investments in alternative asset classes by the end of 2012, irrespective of the uncertainties related to the timing and ultimate disposition of any applications seeking the extension of the operating licenses for San Onofre Units 2 and 3. Even if the Commission issued an order in 2012 amending the current investment guidelines to allow investments in and allocations to new asset classes, the order would only become effective very late in the year. Upon receipt of the Commission's order, SDG&E would analyze the potential returns which could be achieved from investing in any newly authorized asset classes, taking into account the associated guidance the Commission might provide as to the allocation limits for any of those asset classes. Following this analysis, SDG&E would commence vetting and selecting investment managers with expertise in the new asset classes. These regulatory and implementation processes will take time, rendering it unlikely SDG&E could take advantage of any orders the Commission might issue by year's end. In this light, SDG&E's response should generally be read to apply to periods commencing during 2013 at the earliest. Subject to the foregoing admonition, SDG&E submits its Nuclear Decommissioning Trust Fund Committee would seriously consider utilizing several of the asset classes evaluated and recommended by the Callan feasibility study[1] referenced in the *August Ruling*.

The operating licenses for San Onofre Units 2 and 3 expire during 2022. Assuming the operating periods for the units were not eventually extended by the Nuclear Regulatory Commission, the remaining pre-decommissioning investment periods for the SDG&E Nuclear Decommissioning Trust Funds would be approximately ten (10) years.[2] Even under this relatively short investment horizon, SDG&E believes diversifying the trust portfolios would reduce risk, improve returns relative to inflation and/or cost escalation, and therefore represent the prudent investment approach. For these reasons, SDG&E would likely take quick advantage of any additional flexibility the Commission might provide by modifying currently applicable investment guidelines and restrictions.

As presented in the Callan feasibility study and as further discussed on the record, the most effective way to improve funding assurance for the California nuclear decommissioning trusts would be to replace the Commission's current investment guidelines with an investment regulatory framework modeled after the California Uniform Prudent Investor Act ("UPIA"). This would effectively delegate investment decisionmaking authority to the trust committees, subject to the general duties imposed on trustees under California law. Short of adopting the UPIA framework and delegating full investment authority to the trust committees, the Callan feasibility study and various of the utility expert witnesses made specific recommendations for modifying the existing investment restrictions to provide more flexibility to the trust committees. These recommendations were as follows:

- Remove (or raise) the public equities limitation of sixty percent (60%);
- Remove (or raise) the international equities limitation of twenty percent (20%);

[1] See Exhibit No. PG&E-26.
[2] The decommissioning period for San Onofre Units 2 and 3 is currently planned to begin upon the expiration of their existing operating licenses in 2022 and end in 2053.

- Remove or relax the limitation on investment management fees;
- Remove or relax the restriction on the use of derivatives;
- Allow the use of high-yield bonds (below investment grade or below BBB-rated securities); and/or,
- Remove the restriction requiring that a certain percentage of assets be passively managed.

In addition, the Callan feasibility study provided the following evaluation of several alternative asset classes that might be considered by the nuclear decommissioning trust committees:

- **Real Estate:** Real estate investments offer diversification benefits due to their low correlation with traditional assets, have a strong income component, and can provide a hedge against rising inflation. However, real estate investments tend to have high fee structures, are relatively illiquid compared to traditional asset classes, and have relatively long investment horizons;

- **Hedge Funds:** Hedge funds can provide diversification benefits through exposure to risk premiums that are not available in a portfolio of traditional assets and are expected to improve the portfolio's risk-adjusted return. Hedge funds have relatively high fee structures and require the use of derivatives;

- **Commodities:** Commodities represent a liquid asset class and are highly correlated to inflation, thus offering a hedge for inflation-sensitive liabilities. Although cyclical in nature and bearing significant volatility risks, their low correlation to other traditional asset classes offers diversification benefits. Commodity strategies require the use of derivatives;

- **High-Yield Fixed Income:** High-yield fixed-income securities offer higher income and total returns than investment-grade bonds, but are less liquid than investment-grade securities and display greater volatility. Because high-yield bonds pay higher coupon rates, their interest-rate sensitivity, as measured by duration, is lower. Thus, in rising rate environments, high-yield securities may help to mitigate the price impact of short-term variations in interest rates; and,

- **Private Equity:** Historically, private equity has generated competitive returns. Successful implementation, however, typically requires a very long time horizon (*i.e*, in excess of twenty (20) years). In addition to poor liquidity, private equity investments typically have high fee structures and require extensive due diligence and on-going monitoring. Moreover, capital call requirements have the potential to generate taxable capital gains on short notice.

If the Commission authorizes the California nuclear decommissioning trust funds to invest in any of the foregoing alternative assets, SDG&E believes that its Nuclear Decommissioning Trust Fund Committee would seriously consider utilizing several of them. In particular, hedge funds, commodities, and high-yield fixed-income securities are relatively liquid investment options, offer diversification benefits, and would be expected to improve the risk-adjusted return of the SDG&E trust portfolios. On the other hand, at the present time and particularly in the absence of assumptions that the operating licenses for San Onofre Units 2 and 3 would be extended, private equity and real estate, characterized by longer lock-up periods, are not likely to be considered during 2013.

SDG&E would seriously consider including hedge funds within its nuclear decommissioning trusts. Investments in hedge funds would help diversify the portfolio's returns. That being said, SDG&E's use of hedge funds could be constrained if the Commission were not to grant greater fee flexibility since fees associated with these investments are generally, and greatly, in excess of the Commission's current limitations on management fees. Given the scale of SDG&E's nuclear decommissioning trusts and staffing constraints, a successful hedge fund strategy would most likely require a "fund-of-funds" approach. Under this approach, SDG&E would employ a single investment manager to perform due diligence, fund selection and portfolio management for a basket of underlying funds. Although this approach provides greater diversification, it also introduces an additional layer of management fees.

SDG&E would consider commodities as part of a real assets strategy designed to hedge against the risk of future inflation, which the Callan feasibility study identified as a significant threat to the trusts' status vis-à-vis federal regulatory requirements related to funding assurance. Commodities exhibit a high correlation with inflation and, when combined with other real assets such as global natural resources, real estate investment trusts and inflation-protected Treasury securities, they provide good diversification and an inflation hedge. Commodity portfolios typically employ the use of derivatives to manage risk effectively and thus would require modifications to current Commission guidelines prohibiting the use of derivatives.

Finally, SDG&E would likely add high-yield fixed-income securities to its existing fixed-income portfolio in order to capture the diversification benefits and relatively attractive returns these investments provide in comparison to investment-grade securities. The extent to which investments in these securities would be made, however, would be limited so that, in aggregate, the fixed-income portfolio of the trust would be of investment-grade quality. SDG&E anticipates that select, existing managers would be engaged to invest in high-yield bonds. Of all the investment choices under consideration, SDG&E expects that an allocation to high-yield bonds would be the easiest to implement and, therefore, the most likely to occur.[3]

[3] SDG&E adds that, depending on the timing of the Commission's orders in this phase of the proceeding, it could be possible for the SDG&E nuclear decommissioning trusts to make investments in high-yield fixed-income securities during 2012.

In contrast, it is unlikely the SDG&E nuclear decommissioning trusts would take positions in private equity or real estate during 2013 given the illiquidity of the investments themselves as well as the uncertainties salient to the operating periods for San Onofre Units 2 and 3. SDG&E specifically notes that investments in private real estate are compelling given their correlation with inflation and the trusts' sensitivity to inflation and/or cost escalation, but any decision to add portfolio exposure to real estate investments would be heavily influenced by the expected and licensed operating periods for the San Onofre units.

In conclusion, commodities, hedge funds and high-yield fixed-income securities would likely be considered for inclusion in SDG&E's portfolio during 2013 given the pre-decommissioning investment horizon currently assumed for the SDG&E nuclear decommissioning trusts. Investments in private equity and real estate are unlikely to be made during 2013 given the longer investment horizons associated with these asset classes. The actual assets, class selections and portfolio allocations would be guided by an asset allocation study performed and research conducted by SDG&E staff, and would be subject to the approval of the SDG&E Nuclear Decommissioning Trust Committee.

Respectfully submitted,

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