

EXISTING WILDFIRE LEGAL LIABILITY REGIME

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TO THE COMMISSION ON CATASTROPHIC WILDFIRE COST AND RECOVERY

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INVERSE CONDEMNATION

An inverse condemnation action is lawsuit initiated by a property owner against a public entity for damages. It derives from the California constitution, which requires “just compensation” for the taking or damaging of private property for “public use.”

Originally, inverse condemnation was applied solely to public entities, such as municipal water districts (*e.g.*, a water main break that flooded a homeowner’s property). LADWP has been found liable in inverse condemnation for property damage caused by fires linked to downed powerlines.

California courts later determined that investor owned utilities (“IOUs”) are considered to be “public entities” and can be liable for inverse condemnation according to the same standards that apply to government entities. (Barham v. Southern Cal. Edison Co., 74 Cal. App. 4th 744, 751-52 (1999)).

To establish a “taking” or damage for public use, the plaintiff “must demonstrate a causal relationship between the governmental activity and the property loss complained of,” and “[t]ypically, this element is referred to as ‘proximate cause.’” Thus, the public entity “may be held strictly liable, *irrespective of fault*, where a public improvement constitutes a substantial cause of the plaintiff’s damages *even if only one of several concurrent causes.*” (Marshall v. Dept. of Water and Power, 219 Cal. App. 3d 1124, 1138.).

In other words, unlike many lawsuits alleging damages, a plaintiff does *not* need to show that the public entity (or IOU) was negligent, or that the incident giving rise to the damage was foreseeable. If there is a causal connection between the public project and the incident giving rise to the damages, the public entity will be automatically liable.

The policy rationale for inverse condemnation is that it causes the public entity *to spread the costs* associated with a public good as widely as possible so that the damaged property owners will not be disproportionately burdened. When inverse condemnation was applied to IOUs, the court assumed that an IOU could spread the costs through rates, just as a public entity could through taxation or other means. That assumption proved to be unfounded.

2007 SOUTHERN CALIFORNIA WILDFIRES

In October 2007, Southern California experienced more than a dozen major wildfires during an exceptionally severe Santa Ana wind event.

The October 2007 wildfires collectively burned more than 500,000 acres. 3,069 homes and buildings were destroyed, and there were 17 fatalities attributed to the fires.

The ignitions of three of these fires – the Witch, Guejito and Rice Fires – were attributed by Cal Fire to SDG&E powerlines. These three fires burned more than 200,000 acres. More than 1,800 structures were destroyed, and there were two fatalities attributed to the three fires.

Thousands of property owners sued SDG&E asserting inverse condemnation and other claims, and these lawsuits were coordinated in San Diego Superior Court. Plaintiffs asserted approximately \$5.6 billion in claims. SDG&E settled the lawsuits, paying approximately \$2.4 billion in settlement costs and legal fees.

SDG&E’S FERC AND CPUC COST RECOVERY PROCEEDINGS FOR 2007 WILDFIRE EXPENSES

SDG&E partially offset the \$2.4 billion with \$1.1 billion in insurance reimbursements, and \$824 million in third party recoveries.

SDG&E then sought to recover the unreimbursed portion through rates regulated by the Federal Energy Regulatory Commission (“FERC”) and the California Public Utilities Commission (“CPUC”).

FERC authorized recovery (~\$80 million), finding that recovery was justified because, among other reasons, “under California law SDG&E would likely have been held responsible for such costs regardless of fault.” San Diego Gas & Elec. Co., 146 FERC ¶ 63,017 (2014).

The CPUC, however, denied recovery of the \$379 million SDG&E recorded to its Wildfire Expense Memorandum Account (“WEMA”).¹

The WEMA proceeding marked the first occasion on which the CPUC addressed the rate recoverability of wildfire expenses exceeding insurance, and the interplay of inverse condemnation and its Prudent Manager standard under Section 451 of the Public Utilities Code.

SDG&E argued that the CPUC should fulfill the cost spreading rationale of inverse condemnation by permitting recovery, just as FERC had done, and that the fires occurred due to circumstances beyond SDG&E’s control. The CPUC disagreed on both grounds, and specifically deemed inverse condemnation “not relevant” to its review under its Prudent Manager standard.

In a Joint Concurrence to the CPUC’s decision denying the WEMA Application (D.17-11-033), Commissioners Picker and Guzman Aceves noted that “the logic for applying inverse condemnation to utilities – costs will necessarily be socialized across a large group rather than borne by a single injured property owner, regardless of prudence on the part of the utility – is unsound,” but this observation did not change the fact that California courts have applied (and continue to apply) inverse condemnation to investor owned utilities on that basis.

The Joint Concurrence also recognized the negative signals to utility investors, and the negative consequences to utility financing, that the application of inverse condemnation to investor owned utilities subject to Commission reasonableness reviews would cause:

We are also concerned that the application of inverse condemnation to utilities in all events of private property loss would fail to recognize important distinctions between public and

¹ SDG&E petitioned both the California Court of Appeals and the California Supreme Court to review the CPUC’s decision, but both courts summarily denied the petitions.

private utilities and that the financial pressure on utilities from the application of inverse condemnation may lead to higher rates for ratepayers. Investor owned utilities are partially dependent on the capital markets to raise money and the insurance market to mitigate financial risk. If strict liability is imposed for damage associated with wildfires caused in whole or in part by utility infrastructure, the risk profile of the investor-owned utility may be questioned by investors and insurance providers alike. The increase in the cost of capital and the expense associated with insurance could lead to higher rates for ratepayers, even in instances where the investor-owned utility complied with the Commission's safety standards.

SB 901

In the aftermath of the catastrophic 2017 wildfires, the Legislature enacted Senate Bill 901. SB 901 contains several provisions that relate to utility wildfire liabilities.

No Inverse Condemnation Reform: Although Governor Brown proposed draft legislation in July 2018 that would have changed inverse condemnation in certain respects, that proposal did not make into the final version of what became SB 901.

Commission on Catastrophic Wildfire Cost and Recovery: this Commission is tasked with evaluating and making recommendations on (1) options for the Legislature and the Governor to consider for enactment that would socialize the costs associated with catastrophic wildfires in an equitable manner; (2) options for the Legislature and Governor to consider for enactment that would establish a fund to assist in the payment of costs associated with catastrophic wildfires.

Wildfire Management Plans: utilities are required to prepare and submit annual Wildfire Mitigation Plans (first plans submitted in February 2019) to be reviewed and approved by the CPUC in consultation with Cal Fire, with further compliance reviews.

Reasonableness Reviews of Applications to Recover Costs Arising from Catastrophic Wildfires: adds Section 451.1 to the Public Utilities Code and directs the CPUC to consider 12 factors relating to the utility's conduct in evaluating the justness and reasonableness of the recovery of wildfire costs.

Stress Test/Disallowance Threshold: for applications for cost recovery relating to catastrophic wildfires with a 2017 ignition date, the CPUC is required to allocate costs between shareholders and ratepayers, and in doing so, it 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."

Securitization: for costs deemed reasonable by the CPUC, utilities may file an application to the CPUC for a financing order to authorize recovery through fixed recovery charges.

WHERE WE STAND TODAY

While the SB 901 reforms were important, they did not comprehensively resolve the liability problems that the California IOUs continue to face.

As noted, inverse condemnation reform was not included in SB 901.

As a consequence, investors assume that IOUs will be strictly liable under inverse condemnation for wildfires linked to utility equipment. And in light of the CPUC's WEMA decision, investors also assume that the CPUC will not permit cost recovery of wildfire costs, which means those costs will be borne by investors.

The status quo with respect to wildfire liabilities has seriously harmed the IOUs' abilities to access capital markets, which are critical to funding not only routine capital and operational needs, but also the increased capital investments and operational changes that will be necessary to mitigate the risk of future catastrophic wildfires.

PG&E's bankruptcy is the most glaring example of this loss of access to capital markets. In its January 13, 2019 SEC Form 8-K, PG&E described the dilemma IOUs currently face – strict liability and the unlikelihood of cost recovery at the CPUC – as a precipitating factor in its decision to seek Chapter 11 reorganization.

Bloomberg recently reported that “PG&E's stock price has plunged more than 80 percent since the 2017 fires broke out.”² In addition to these equity impacts, the IOUs have also been repeatedly downgraded by the credit rating agencies in 2018 and 2019, which increases the cost of debt financing.

SDG&E equipment did not start any of the catastrophic wildfires of 2017 or 2018. Nevertheless, like the other IOUs, SDG&E's credit ratings have suffered downgrades in 2018 and 2019 because of the existing liability and cost recovery regime.

For instance, on January 21, 2019, S&P lowered SDG&E's rating from “A-“ to “BBB+.” In its Outlook, S&P expressed the following concerns:

Our outlook on SDG&E is negative, reflecting the unique and elevated credit risks that California's electric utilities face because of climate change, their susceptibility to frequent and devastating wildfires, and the legal doctrine of inverse condemnation. We could lower our rating on the company by one or more notches if regulators and/or politicians do not take concrete steps to explicitly address these growing risks before the start of the 2019 wildfire season.

² “PG&E Bankruptcy's Ripple Effects Will be Felt Beyond California,” Bloomberg (Jan. 28, 2019).

S&P also noted that while SB 901 was an important first step “further reform is necessary to preserve the credit quality of the state’s electric utilities.”

On March 5, 2019, Moody’s similarly downgraded SDG&E. Moody’s expressed similar concerns to S&P’s, and indicated further downgrades could be on the horizon:

Failure to pass legislation or enact regulatory changes to insulate SDG&E’s credit profile before the end of this year’s California legislative session in the third quarter will lead us to take a more negative view of the legislative and regulatory environment in California and will likely result in a further down grade of the utility’s ratings.

Moody’s also noted that, post SB-901, a “significant amount of uncertainty associated with the cost recovery process remains because of the CPUC’s 2017 decision that disallowed the entire \$379 million wildfire cost request (pre-tax) related to SDG&E’s 2007 wildfires.”

Increased capital costs are harmful to both the IOUs and their customers since the cost of capital is passed onto customers through rates. This will certainly be an issue in the upcoming IOU cost of capital proceedings at the CPUC, which begin in April.

RECOMMENDATIONS

In conclusion, I want to stress the urgent need to action. Specifically, SDG&E makes the following recommendations:

1. The issue of inverse condemnation vs. utility cost recovery is the heart of the matter. Either the State needs to reform inverse condemnation, or it needs to establish a clear path for utilities to recover liability costs when they are prudent operators.
 - The determination of a prudent operator needs to be established in statute and approved by the PUC up-front. A utility should be deemed prudent if it is in substantial compliance with its Wildfire Management Plans.
 - Substantial Compliance means the utility has meet every reasonable objective of its approved WMP. Gross negligence, willful misconduct and a pattern of non-compliance means a utility did not meet substantial compliance. I should also note that when a utility is out of compliance with the PUC's rules, the Commission has broad authority to penalize.
2. A statewide wildfire insurance fund should be established to socialize the costs of wildfire liability broadly. Such a fund should include investor owned utilities and municipal utilities. The fund should operate on top of a utility's insurance coverage. Utilities should contribute to the fund based on their relative risk profile, factoring in their service territory size and fire risk, as well as the investment and programs they have initiated to mitigate catastrophic wildfires.
3. Utilities should be able to access the wildfire fund or securitize their liabilities through a dedicated rate component prior to an after-the-fact reasonableness review. This is essential to avoid future liquidity crisis that could lead to bankruptcy.
4. California needs to reconsider its policies regarding home development in the High Fire Threat Zones. Wildfires will continue to erupt in California's back country. Policy makers need to consider whether development in these areas should continue at all. If so, should homeowners in the HFTZ bear a larger proportion of the costs associated with wildfire damage?

SDG&E fully supports the efforts of this Commission to develop effective recommendations that will improve the status quo with respect to the existing wildfire liability regime. We look forward to working with the Commission as it focuses on its core tasks of developing proposals for the Legislature and the Governor with respect to equitable cost socialization and the establishment of a fund.