Saber Partners, LLC

Direct Testimony of

Barry Abramson, Senior Advisor

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DIRECT TESTIMONY OF BARRY ABRAMSON, CPUC R.17-06-026

Q. Please state your name and business address.

A. Barry M. Abramson, Saber Partners, LLC, 44 Wall Street, New York, New York 10005

Q. By whom are you employed and what is your position?

A. I am with Saber Partners, LLC, and serve as a Senior Advisor.

Q. Please describe your duties and responsibilities in that position.

A. I serve in a senior advisory position which includes participating in businesses strategy and procurement of new business; meeting with Saber Partners' clients and potential clients; meeting with senior officers of the utilities and investment banks with which we work, and assisting in the development and review of presentations we make to our clients and potential clients. I closely follow many utilities, public service commissions, federal utility regulators, and state and federal legislation that may affect utilities.

Q. Please describe your educational background and professional experience.

A. I have a bachelor's degree in economics from Yale University. I have a Certified Financial Analyst (C.F.A.) designation from the Institute of Chartered Financial Analysts. I have covered the U.S. utilities sector from the investment side for more than 40 years. From 1977 continuously through 2002, I worked for various Wall Street investment banking firms in the equity research department, always as an analyst covering electric and gas utilities stocks.

From 2002 continuously through 2016, I worked in two large money management firms as an analyst and portfolio manager, managing large portfolios that invested primarily in electric and gas utility stocks, and secondarily in electric and gas utility debt securities. During my 25 years on Wall Street, I worked at the following major investment banking firms in the equity research department, in chronological order, at Kidder, Peabody & Company, Merrill Lynch, Goldman Sachs, Prudential Securities, PaineWebber, and UBS Securities.

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During my 14 years as a portfolio manager, I invested billions of dollars primarily in U.S. utility stocks, and secondarily in utility debt securities. I worked first at a large mutual fund company, Gabelli Funds, and then at the world's largest sovereign wealth fund, Norges Bank Investment Management.

In 2016, I joined Saber Partners, LLC, as a Senior Advisor, analyzing electric and gas utilities.

I am one of the only electric and gas utilities analysts who has worked for long periods of time at both Wall Street firms and at large money management firms.

Q. Whom do you represent in this proceeding?

A. I represent Saber Partners, LLC that has been hired by the California Community Choice Association to provide an independent evaluation and opinion as to the benefits, costs, risks, and rewards for PCG and EIX customers and shareholders, of using securitization as part of the California Commission's Rulemaking 17-06-026, to "consider alternatives to the Power Charge Indifference Adjustment."

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to describe the potential effects on PG&E Corporation and Edison International shareholders, their stock prices and investor perception and access to the capital markets of the utilities if their respective subsidiary utility companies use securitization debt to remove utility-owned generation from their respective rate bases. PG&E Corporation (New York Stock Exchange (NYSE) symbol: "PCG") owns Pacific Gas & Electric Company. Edison International (NYSE symbol: "EIX") owns Southern California Edison Company.

Q. How long have you been following the electric and gas utilities industry and the common stocks of PCG and EIX?

A. I have been following both utilities and their parent company's stock for my entire 40+ year career, because they have always been among the largest companies in the U.S. investor-

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owned utilities sector. To follow any industry, an analyst must always follow the major companies in that industry. That needed me to always include PCG and EIX in my research and analysis of the industry.

Q. What do investors look for when deciding whether to own and invest in a utility stock?

A. From investments in utility common stocks, investors seek relatively low risk, low stock market volatility, and stability and predictability of earnings and dividends. In addition, most investors choose common stocks for long-term growth in earnings and dividends, which should drive stock values higher. Even though U.S. utility stocks are not considered a high-growth sector, in the long run they have produced steady, modest growth for investors.

In general, U.S. utility common stocks have been attractive to income-oriented investors, whether they are institutional investors (pension funds, mutual funds, endowments) or individual investors who need dividend income. During periods of low interest rates, many investors view utility stocks as a substitute for investments in debt securities. Even during periods of moderate to high interest rates, many investors are attracted to utility stocks as a bond substitute because most utility stocks have historically raised their dividends annually, providing growing income to investors versus fixed-income securities (i.e., debt securities).

Q. How have investors viewed the common stocks of PCG/PG&E and EIX/SCE over the past several years?

A. Utility stock investors are mostly risk-averse. The California Energy Crisis of 2000-01, almost two decades ago, shook the confidence of many utility investors. However, by about ten years after the Crisis, utility investors had become comfortable with the long-term outlook for the California utilities.

The general view in the most recent years has been that PCG and EIX have become companies that had opportunities to make significant investments, for many years, in their

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electric distribution systems. The opportunities for long-term rate base growth, leading to earnings growth, made the stocks of PCG and EIX relatively attractive.

However, beginning in 2017, the consensus favorable investment viewpoint of PCG and EIX changed significantly due to the uncertain financial liability caused by the California wildfires.

For this discussion, I am focusing on the electric utility business and not the gas utility and gas transmission operations of PCG. Obviously, issues and risks have arisen with PCG's gas business, and one cannot ignore the tragic gas pipeline explosion in San Bruno.

Q. What makes PCG and EIX different and possibly more attractive than many other large U.S. electric utility stocks?

A. Several other states deregulated power generation around the same time as California. Several large utilities in some of these states did *not* fully divest their power generation, but instead moved it to a separate part of the holding company.

However, the wholesale power business has proven to be quite volatile. Earnings from wholesale power operations have fluctuated widely for various reasons. Furthermore, over the past several years, the wholesale power business has been hurting because many supply trends have pressured power prices, such as a surprisingly great abundance of cheap natural gas and the incredible growth in solar and wind power.

Compared with major utilities that stayed in the power generation business after deregulation, PCG and EIX did not invest heavily in generation (a competitive business). Instead PCG and EIX invested heavily in their core regulated monopoly businesses (electric distribution and transmission).

Therefore, overall, the stock market has viewed, and continues to view electric distribution and transmission as low-risk businesses. In most regions, electric distribution and transmission have been slow-growth sectors. However, in California, growth in the so-called wires business has been faster.

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Q. How do the capital markets value the stocks of the California utilities in comparison to the value of other large utility stocks that remained fully-regulated and vertically integrated?

A. Electric utility holding companies with minimal amounts of generation, or no generation, such as PCG and EIX, have lower business risk. Even compared with vertically integrated utilities (utilities or utility holding companies that own the generation, transmission, and distribution facilities within a specific service territory) that operate in states that did not deregulate generation, such as Southern Company and Duke Energy, electric utilities in California that mainly operate as distribution and transmission businesses have lower risk. For example, vertically integrated utilities must deal with the uncertainties of changing environmental rules for power plants, from both federal and state regulations, fuel procurement risk, and power plant operational risks.

Therefore, for many years, investors considered PCG and EIX to have less risk, but better growth potential, than vertically integrated utilities such as Southern Company and Duke Energy.

The third major investor-owned utility company in California, Sempra Energy (SRE), the owner of San Diego Gas & Electric and Southern California Gas, is an extremely diverse holding company, and therefore, its stock does not trade in the same way as EIX and PCG. While some of SRE's businesses are similar to those of EIX and PCG, SRE also owns South American utilities, major pipelines, and LNG export facilities. SRE is also about to complete the acquisition of Oncor, a Texas electric transmission and distribution company, in a deal valued at $18 billion.

Q. What makes electric distribution and transmission a relatively faster growth business in California?

A. California's energy policies cannot be carried out without large investments in the electric grid. California leads the other U.S. states in its goals for battery-powered

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transportation (zero emission vehicles), energy storage. The state's renewable energy mandate for electric power (50% by 2030) is second only to Hawaii's (where the goal is 100% by 2045). In states with less ambitious goals for zero emission vehicles, energy storage and renewable energy, the capital spending budgets of the local utilities are more modest as it relates to grid modernization.

Over the past several years, the California Public Utilities Commission (CPUC) has approved capital spending programs for both PG&E and SCE that resulted in strong rate base growth in distribution and transmission. These trends should continue into the foreseeable future.

EIX's capital budget for 2018 for SCE is $4.2 billion, consisting of $3.4 billion for distribution, $0.6 billion for transmission, but only $0.2 billion for generation. SCE's base case forecast for rate base growth from 2017 to 2020 is a compound annual growth rate of 9.7%, among the highest in the U.S. (The SCE capital spending and rate base forecast numbers come from EIX's February 2018 Business Update slide presentation for investors.)

PG&E is forecasting $6.3 billion of capital spending in 2018 and $6.0 billion in 2019 (these numbers are from PG&E's 2017 10-K). My forecast is that only about $600-$700 million per year will go toward power generation capital spending.

Q. How have the capital spending trends affected the overall earnings contributions from distribution and transmission versus power generation at both PG&E and SCE?

A. Over the past several years, the proportion of rate base from distribution and transmission has grown, while the proportion from generation has shrunk. These trends should continue based upon capital spending forecasts.

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Q. If PG&E and SCE have good long-term growth potential from a growing distribution and transmission rate base, then why are the stocks of both PCG and EIX trading at significant discounts to most other large U.S. electric utility stocks?

A. The primary reason for the weakness in the stock prices of both PCG and EIX, is the uncertain liability from the recent large wildfires in California. The state's history of inverse condemnation in legal proceedings, relating to liability, creates a large financial uncertainty for both companies. The potential liabilities could total several billions of dollars.

In general, under inverse condemnation law in California, a utility is generally liable for physical damage to private property that is caused by a property improvement made by the utility. This often means that the utility can be held liable even if the property improvement was properly designed, constructed and maintained. As it relates to California wildfires, state courts have ruled that private property owners can sue the public utility for damages, claiming the public utility can recover the costs from ratepayers. However, the CPUC must authorize recovery, and therefore, recovery is not guaranteed. In December 2017, the CPUC denied recovery of costs that San Diego G&E stated that it incurred because of the doctrine of inverse condemnation. San Diego G&E is challenging the ruling.

Relative price/earnings ratio (P/E ratio) is one way to compare stock valuations. Using the closing prices of March 19, 2018, the average P/E ratio for 12 other large regulated U.S. utility stocks was 17.69 times estimated 2018 earnings, a P/E of 17.69. On the same date the P/E for EIX stock was 15.21 and the P/E for PCG stock was 11.67. (For this comparison, I used a group of U.S. utilities that are most like EIX and PCG, because they derive most of their earnings from regulated utility businesses. I excluded utilities with a large amount of non-utility earnings and/or a large amount of unregulated generation earnings.)

Stock symbols in the sample: AEE, PNW, ED, WEC, SO, DUK, AEP, CMS, DTE, LNT, XEL, ES.

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Included in the sample are two U.S. utilities stocks that are the most like PCG and EIX, in terms of business mix, Eversource Energy (symbol ES) and Consolidated Edison (symbol ED). The P/E ratio of ES stock was 17.80 and the P/E ratio of ED stock was 18.04. The stock of Consolidated Edison, symbol ED, trades at P/E of 18.04, even though its projected annual rate base growth is 6.0% for the next 3 years, while the expected annual rate base growth at EIX for the same 3-year period is 9.7%. (Consolidated Edison's forecast is from Page 43 of the company's March 2018 investor update slide presentation.)

Eversource Energy, symbol ES, trades at a P/E of 17.80, and its forecasted annual rate base growth over the next three years is 8.1%, also below the 9.7% projection of EIX. (Eversource Energy's forecast is from Page 19 of the 2017 year-end earnings slide presentation.)

Comparison of Price/Earnings Ratios of Major Regulated U.S. Utilities Stocks and PCG and EIX

	Stock Symbol	Stock Price	Consensus 2018E EPS	P/E Ratio On 2018E EPS
Ameren Corp.	AEE	55.20	3.03	18.22
Pinnacle West Capital	PNW	77.73	4.46	17.43
Consolidated Edison	ED	77.05	4.27	18.04
WEC Energy Group	WEC	61.77	3.30	18.72
Southern Company	SO	44.17	2.90	15.23
Duke Energy	DUK	77.04	4.70	16.39
American Electric Power	AEP	66.99	3.89	17.22
CMS Energy	CMS	43.71	2.33	18.76
DTE Energy	DTE	101.72	5.81	17.51
Alliant Energy	LNT	39.83	2.11	18.88
Xcel Energy	XEL	44.17	2.44	18.10
Eversource Energy	ES	58.04	3.26	17.80
Average of the sample				17.69
PG&E Corp.	PCG	44.48	3.81	11.67
Edison International	EIX	64.03	4.21	15.21

Note: Some major companies were excluded because they have significant earnings from unregulated power, such as Public Service Enterprise Group (PEG), Exelon Corp. (EXC) and Entergy Corp. (ETR).

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Q. How do the depressed stock prices affect PCG's and EIX's ability to finance the large capital spending programs of their respective utility subsidiaries?

A. The lower stock price for EIX raises its cost of equity capital, making it more expensive to finance its capital spending. If and when EIX needs to raise equity in the public markets, it would have to issue more shares at a lower price, compared to if EIX stock were selling at a P/E closer to its peer group. Despite the large uncertain potential financial risk from the recent wildfires, the board of directors of EIX has not changed its dividend policy. This has prevented EIX stock from declining further.

Unfortunately, the situation with PCG is much worse. The potential financial risk to PCG from the recent wildfires is greater than for EIX. For this reason, the board of directors decided in late 2017 to stop paying common dividends altogether. Equity investors consider the decision to omit common dividends to be an extreme move. Consequently, this caused the price of PCG stock to plunge, making it very expensive to issue new shares, if at all, to finance PG&E's capital spending.

Without a dividend, PCG stock cannot meet the investment criteria for most utility stock investors, whether they are individuals or institutional investors. By stopping the payment of dividends, PCG would save about $250 million in cash per quarter, which might be a near-term solution. However, in the long run, PG&E needs to be able to access the equity markets through PCG's issuance of stock. PCG might not be able to do so until it reinstates a common dividend and PG&E regains investors' confidence that the payment of dividends will continue.

Q. Can you imagine why PG&E or SCE might be interested in securitization financing under current conditions?

A. Yes. The major risk overhanging the stocks of PCG and EIX, is the risk of significant financial liability from the inverse condemnation theory that historically has been used in the

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State of California relating to wildfires. This risk currently is causing both stocks to trade at significant discounts. Therefore, investors in PCG and EIX should be less concerned about the potential for a small near-term impact on earnings that might occur due to the timing of securitization financings that remove generation from rate base, especially if the securitization is voluntary on the part of the utilities. (Even if the inverse condemnation issues are resolved in a way that is more acceptable to the utilities, PCG and EIX may still have some wildfire liability risk.)

PG&E's Annual Report for 2017 on SEC Form 10-K[1] supports the conclusion that securitization could be viewed positively by investors under these circumstances. It provides an extensive "Risk Factor" disclosure about threats to PG&E's cash flow and access to the capital markets in connection with recent wildfires. That "Risk Factor" disclosure is reproduced as Exhibit [1] to my testimony. It includes the following caution:

> On December 21, 2017, Moody's Investor Services and on December 22, 2017, Standard & Poor's Global Ratings, each placed all of the ratings of PG&E Corporation and the Utility under review for downgrade, and Standard & Poor's Global Ratings additionally lowered its ratings on the Utility's preferred stock. If PG&E Corporation's or the Utility's credit ratings were to be downgraded or the ratings on the Utility's preferred stock are further downgraded, in particular to below investment grade, their ability to access the capital and credit markets would be negatively affected and could result in higher borrowing costs, fewer financing options, including reduced, or lack of, access to the commercial paper market and additional collateral posting requirements, which in turn could affect liquidity and lead to an increased financing need.

It is in precisely such circumstances that California utilities likely would welcome the possibility of utilizing securitization as an important financial tool especially under distressed conditions. But that will be possible only if enabling State of California legislation is in place.

[1] https://www.sec.gov/Archives/edgar/data/75488/000100498018000003/form10k.htm

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Q. Are you offering any opinion on the utilities' liability for wildfires or the ultimate effect of the wildfires on their cost of capital?

A. Absolutely not. I am not in a position to draw those conclusions. I am simply observing that the wildfires are a risk factor from an investor's standpoint, securitization could directionally could reduce that risk and, consequently, the utilities may see securitization as a constructive option.

Q. What would happen to the stock prices of PCG and EIX if their respective utility subsidiaries used securitization debt to remove utility-owned generation from their rate base?

A. As mentioned above, investors view PG&E and SCE as utility companies that should derive most or all their earnings growth from rate base growth in distribution and transmission assets, with distribution being the major growth driver by a wide margin. Investors have not been projecting the power generation business to be a source of rate base growth at either company.

Therefore, from a strategic point of view, investors would *not* be disappointed to see either company move further away from owning and operating utility power generation. Nevertheless, investors might be concerned in the short run about the potential for a small decline in earnings, due to the loss of income from the rate-based generation. Investors would want the companies to clearly communicate their plans for using the cash proceeds from securitization. If the two utilities used the cash proceeds to fund capital spending in distribution and transmission infrastructure required by the Commission as a consequence of wildfire events, then investors should feel less concerned, even though there may be a time lag before the new investments start earning a return based on additional rate base. Investors would assume, therefore, that there will be a net increase in the utilities' overall rate base.

In addition, if EIX were able to announce a delay in the need for a new common equity issuance, due to securitization, it is my opinion that investors would view this as a near-term

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positive. Similarly, if PCG used the securitization proceeds to make an equity contribution to its utility subsidiary, PG&E, I believe investors also would view this as a near-term positive despite the time lag before the new investments start earning a return based on additional rate base.

Q. In the short run, wouldn't the stock prices fall anyway, just to reflect the near-term earnings decline?

A. Typically, yes. Stock prices should fall in the short-run if proceeds of securitization are not either distributed as dividends or almost immediately invested in a net increase in rate base. However, as mentioned above, the prices of both stocks are already depressed, due to the wildfire liability risks. In addition, the price of PCG stock also is currently depressed due to the lingering regulatory and political overhang from the San Bruno events in PG&E's gas utility operations. Therefore, I believe that most short-term investors have already exited both stocks, and this likely minimizes the degree of any further near-term stock price decline. Furthermore, in general, most buyers of utility stocks are long-term investors, who are more concerned about the long-term earnings trend than the risk of a small near-term drop in earnings. If the utilities do not change the long-term trend line of earnings, then many current holders of both stocks will not exit the stocks. The timing of securitization financings and how the utilities use the proceeds of securitization would affect the ability of their parent corporations to support long-term earnings trends.

Q. Could this earnings lag be mitigated by issuing securitized debt in phases over time?

A. Yes. For example, the targeted total amount of securitized bonds for PG&E might be issued in several series over a period of time, structured in times and amounts reflecting expected net increases in PG&E's aggregate transmission and distribution rate base. This could reduce, and perhaps even eliminate, even any short-term decline in earnings on rate base. This also should enable PCG to defer selling additional PCG stock while the price of PCG stock is depressed.

Q. Is there any precedent for utilities issuing securitized bonds in phases over time for a single purpose?

A. Yes. This was the case for PG&E as well as for a utility in Texas. In Decision No. 03-12-035, the CPUC established a regulatory asset to facilitate PG&E's emergence from bankruptcy. The regulatory asset was a specific dollar amount of $3 billion that PG&E would recover from customer rates at PG&E's full weighted average cost of capital. Shortly thereafter, the California legislature passed a new law to allow securitization. Sections 848 – 848.8 of the California Public Utilities Code authorized the issuance of securitized debt to refinance the unamortized balance of that PG&E regulatory asset.

On November 19, 2004, the CPUC adopted a Financing Order authorizing the issuance of up to $3 billion of securitized bonds for this purpose, in up to two series. Pursuant to that Financing Order, $1,887,864,000 of securitized bonds were issued for the benefit of PG&E in February 2005, and an additional $844,461,000 were issued for the benefit of PG&E in November 2005.

In Texas, regulators approved a similar two-phase issuance of bonds related to stranded cost securitization in that state. Five hundred million of securitized bonds were issued in 2003 and then $7.9 million of additional securitized bonds were issued in 2004 for Oncor Electric Delivery Company, a wholly-owned subsidiary of TXU Corp. Saber Partners served as the financial advisor to the Public Utilities Commission of Texas on these transactions.

Q. If PCG and EIX reduced ownership in generation, would the two utilities have lower business risk?

A. Yes. However, because both utilities already derive only a small portion of total earnings from utility owned generation, I do not expect this to be a significant change in the overall risk profile of either company, from the investors' point of view.

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Q. *Are there any indirect benefits to either PCG or EIX if their utility subsidiaries use securitization financing to remove utility-owned generation from rate base?*

A. Yes. Voluntary use of securitization should generate goodwill among regulators, consumer advocates and members of the legislature. My Saber Partners colleague, Paul Sutherland, has presented testimony in this proceeding, that demonstrates significant savings for ratepayers, if securitization financing is used for utility-owned generation. In general, equity investors understand the indirect benefits that might accrue to them if a utility can reduce customer rates. In my experience, good relationships between utilities and their regulators, customers, and consumer advocates, are usually good for investors in the long run.

Securitization financing, therefore, should be used by EIX and PCG to remove utility-owned generation from rate base in a way that has the smallest impact on short-term earnings. This can be done by issuing securitized debt in phases over time. Therefore, my recommendation is for a multi-phase securitization financing, rather than a single-phase financing.

The Commission, utilities and other stakeholders should work together to explore the potential for securitization to benefit their interests and the approach that would optimize that benefit.

Q. *Can you summarize your recommendations?*

A. Yes. I recommend that the parties to this proceeding seek State of California legislation authorizing the issuance of securitized utility bonds as described in my testimony and in the testimony of Mr. Fichera, Mr. Sutherland and Mr. Schoenblum.

Q. *Does this conclude your testimony?*

A. Yes, it does.

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