

# Heated Conflict: Investor-Owned Utility Liability for California Wildfires Under the Doctrine of Inverse Condemnation

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## I. INTRODUCTION

Seven of the top 20 largest wildfires in California history occurred within the last decade.<sup>1</sup> At the time of this publication, the top two largest wildfires in California history occurred in the last two years.<sup>2</sup> Since 2007, trends show an increase in the number of wildfires ignited, total area burned, and total impact on ecosystems.<sup>3</sup> The California Department of Forestry and Fire Protection (“Cal Fire”) notes that these increasing trends mirror the signatures of climate change, which include “rising mean temperatures and increasing length of fire seasons.”<sup>4</sup> As climate patterns continue to shift, this trend can be expected to continue.

These wildfires can be ignited naturally or by human activities like camp fires, debris burning, and intentional acts of arson.<sup>5</sup> Five percent of wildfire ignitions in California are attributed to electric utilities.<sup>6</sup> These fires typically start when high winds bring down power lines or conductors, or when animals or vegetation make contact with power lines.<sup>7</sup> High wind speeds also create conditions where wildfires spread more rapidly and are harder to contain.<sup>8</sup> Given these conditions, utility-ignited wildfires tend to be larger and more destructive.<sup>9</sup>

Courts consistently hold electric utility companies strictly liable for all costs related to property damages, suppression costs, and other economic and natural resource damages arising from a utility-started wildfire.<sup>10</sup> This strict liability standard is rooted in the principle of inverse condemnation which holds that if a public entity damages private property in pursuit of a public purpose, that entity must provide just compensation.<sup>11</sup> Historically, utilities cover these costs through customer rates and liability insurance. However, given the increase in wildfire frequency and California Courts’

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1. CalFire Top 20 Largest Wildfires, Feb. 19, 2019, [https://www.fire.ca.gov/media/5510/top20\\_acres.pdf](https://www.fire.ca.gov/media/5510/top20_acres.pdf) [<https://perma.cc/32RE-NPKN>].

2. *Id.*

3. California Department of Forestry and Fire Protection (Cal Fire), *2018 Strategic Fire Plan for California*, Aug. 22, 2018, at 6 [hereinafter *Cal Fire Strategic Plan*].

4. *Id.* at 7.

5. Carolyn Kousky, Katherine Greig, Brett Lingle, and Howard Kunreuther, *Wildfire Costs in California: The Role of Electric Utilities*, Wharton Risk Management and Data Processes Center, Univ. of Pennsylvania (Aug. 2018), at 3, <https://riskcenter.wharton.upenn.edu/wp-content/uploads/2018/08/Wildfire-Cost-in-CA-Role-of-Utilities-1.pdf> [<https://perma.cc/CP4H-B8U3>].

6. *Id.* (based on an analysis of Cal Fire data from 2007 to 2016).

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* at 5.

11. CAL. CONST. art. I, § 19.

consistent adherence to the strict liability regime under inverse condemnation, insurance carriers have drastically reduced or eliminated their coverage.<sup>12</sup> The increasingly limited availability of insurance coverage places a large financial burden on investor-owned utilities who must then recover these costs through either customer rates or shareholder profits.

This Article addresses California Investor-Owned Utilities' liability for wildfire damage due to equipment failure and mismanagement. Part II highlights the doctrine of inverse condemnation and how California Courts apply the doctrine to cases involving investor-owned utilities. Part III provides an overview of the statutory and regulatory provisions that govern how a utility may recover costs through customer rates. Part IV addresses the apparent conflict between these frameworks and how utilities and regulators have sought to reconcile this conflict. Part V concludes with an overview and discussion of SB 901 which seeks to maintain utility financial stability while holding the entities accountable for their actions that gave rise to catastrophic wildfires.

## II. INVERSE CONDEMNATION

Article I, Section 19 of the California Constitution states that “private property may be taken or damaged for a public use only when just compensation . . . has first been paid to, or into the court for, the owner.”<sup>13</sup> Just compensation for public use is generally enforced through direct condemnation, or eminent domain proceedings, wherein a government actor takes formal steps to acquire private property prior to a public use project. When private property is incidentally taken or damaged for public use, the owner may pursue an inverse condemnation claim against the government actor to receive just compensation. The policy rationale behind the inverse condemnation doctrine is to protect the owner of damaged property from contributing “more than his proper share to the public undertaking.”<sup>14</sup> The California Supreme Court holds that this strict liability doctrine allows for individual losses that arise from a public undertaking to be “distribute[d] throughout the community.”<sup>15</sup>

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12. Joint Application of San Diego Gas & Electric Company, Southern California Edison Company, Southern California Gas Company, and Pacific Gas and Electric Company, A. 09-09-020, filed Aug. 31, 2009.

13. CAL CONST. art. I § 19.

14. *Belair v. Riverside County Flood Control Dist.*, 47 Cal. 3d 550 (1988).

15. *Id.*

Courts have consistently held private, investor-owned utilities (“IOUs”) strictly liable for incidental property damage under this doctrine. The policy rationale for extending application to IOUs represents the notion that the utility is in the best position to distribute costs amongst the general public, which benefits from the undertaking. Theoretically, such costs can be recovered through customer rates. As we will see, this is not guaranteed.

Two major California court cases that illustrate how the court came to justify this position towards IOUs are *Barham v. Southern California Edison Company* and *Pacific Bell Telephone Company v. Southern California Edison Company*. *Barham* held that the determinative factor was the nature of the service being provided rather than the nature of the entity. *Pacific Bell* reinforced the *Barham* court’s interpretation and rejected the notion that IOUs were exempt from a strict liability approach.

#### A. *Barham v. Southern California Edison Company*

In *Barham*, various plaintiffs suffered property damage in the Mill Creek Fire of 1993.<sup>16</sup> The court determined that the fire resulted from a failure in Southern California Edison’s (“SCE’s”) overhead power line equipment.<sup>17</sup> SCE claimed that inverse condemnation principles did not apply because SCE was a privately-owned public utility, and not a public entity.<sup>18</sup> In considering whether to apply inverse condemnation to the case, the California Court of Appeal had to first determine whether SCE was properly considered a “public entity.”

The court cited *Gay Law Students Assn. v. Pacific Tel. & Tel. Co.*, in which the California Supreme Court stated that “a public utility is in many respects more akin to a governmental entity than a purely private employer.”<sup>19</sup> The *Gay Law Students* Court further held that “the nature of the California regulatory scheme demonstrates that the State generally expects a public utility to conduct its affairs more like a governmental entity than like a private corporation.”<sup>20</sup>

The Court of Appeal in *Barham* then noted that municipal, publicly owned electric utilities have been held liable under inverse condemnation in virtually identical past cases.<sup>21</sup> Because the appeals court did not find

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16. *Barham v. Southern Cal. Edison Co.*, 74 Cal. App. 4th 744, 747 (1999).

17. *Id.*

18. *Id.* at 74 Cal. App. 4th 752.

19. *Gay Law Students Assn. v. Pacific Tel. & Tel. Co.*, 24 Cal. 3d 458, 469 (1979),

20. *Id.*

21. *Barham v. Southern Cal. Edison Co.*, 74 Cal. App. 4th 744, 753 (referencing *Marshall v. Dept of Water and Power* (1990), 219 Cal. App. 3d 1124; *Aetna Life & Casualty Co. v. City of LA*, 170 Cal. App. 3d 865).

any rational basis for distinguishing between privately and publicly owned utilities, the court found SCE liable as a public entity under the doctrine of inverse condemnation.<sup>22</sup>

With the entity question answered, the court then considered whether SCE's activities constituted "public use." Officials traced the cause of the Mill Fire back to faulty transmission lines located above SCE property.<sup>23</sup> SCE argued that this created a private rather than public use.<sup>24</sup> The power lines in question, however, were responsible for providing electricity to more than 1,000 households.<sup>25</sup> Citing to *Slemons v. Southern Cal. Edison Co.*, the court in *Barham* found that electric transmission to three customers constituted public use, and held that the transmission of electric power through the facilities that caused damage to the Barham's property was for the benefit of the public.<sup>26</sup>

Without much discussion, the California Court of Appeal's 1999 decision in *Barham* rejects the notion that there is any significant difference between publicly and privately owned utilities.<sup>27</sup> As such, the court found it reasonable to hold Edison strictly liable in furtherance of the "fundamental policy underlying the concept of inverse condemnation."<sup>28</sup> The court's opinion ignored at least one fundamental difference between the two entities; the way in which costs may be recovered.

#### B. *Pacific Bell Telephone Company v. Southern California Edison Company*

In *Pacific Bell Telephone Company v. Southern California Edison Company*, Pacific Bell asserted an inverse condemnation claim against SCE after a ground fault sent electricity through several telephone cables and caused \$75,767.39 in damage.<sup>29</sup> SCE attempted to escape inverse condemnation by first arguing that the *Barham* court's interpretation of

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22. *Id.*

23. *Id.* at 74 Cal. App. 4th 753.

24. *Id.* at 74 Cal. App. 4th 754.

25. *Id.*

26. *Id.* (citing *Slemons v. Southern Cal. Edison Co.*, 252 Cal. App. 2d 1026 (1967)).

27. *Id.* at 753.

28. *Id.* at 752.

29. *Pacific Bell Telephone Co. v. Southern California Edison Co.*, 208 Cal. App. 4th 1400, 1403 (2012).

Supreme Court precedent was incorrect.<sup>30</sup> SCE cited two California Supreme Court cases where private entities were subject to inverse condemnation because of their joint partnership with a government entity or their exercise of eminent domain power delegated by the Legislature.<sup>31</sup> Since neither applied to Edison, it argued, inverse condemnation should not apply.

The Court of Appeal in *Pacific Bell* rejected Edison's narrow interpretation of these cases and found that while such circumstances could give rise to inverse condemnation liability, they were not required.<sup>32</sup> The court pointed to the monopolistic or quasi-monopolistic authority of the utility to distinguish SCE from the private entities in those two cases.<sup>33</sup>

Whereas the *Barham* court ignored the rate-recovery discrepancy, the *Pacific Bell* court deemed it irrelevant to distinguish between publicly and privately owned utilities. SCE argued that the loss-spreading rationale behind inverse condemnation should not apply because SCE does not have taxing authority and can only raise rates with the approval of the California Public Utilities Commission ("CPUC").<sup>34</sup> The court was not convinced by this argument, however, since SCE did not provide any evidence that the CPUC would prohibit cost recovery through rates.<sup>35</sup>

Interestingly, the court also referenced in a footnote the California Supreme Court holding in *County of Inyo v. Public Utilities Company*. The court in that case held that the California Constitution does not prohibit the Legislature from charging the CPUC with regulating the rates of municipally owned utilities as well.<sup>36</sup> Without further explanation, the *Pacific Bell* court noted that such a restriction on ability to spread costs, should it arise, would not suffice to bar application of inverse condemnation liability to municipal utilities.<sup>37</sup>

Both IOUs and municipally owned utilities ("MOUs") recover a portion of their liability costs from their rate bases. Since MOU rates are not subject to regulatory review, MOUs may spread all liability costs across their rate base. This principle supports the loss-spreading rationale behind inverse condemnation. IOUs, on the other hand, must have their rates reviewed and approved by the CPUC. As such, IOUs are often prohibited from recovering certain liability costs through customer rates.

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30. *Id.* at 208, Cal. App. 4th 1404.

31. *Id.* at 1404 (citing *Breidert v. Pacific Southern Pac. Co.*, 61 Cal. 2d 659 (1964), *Pettis v. General Tel. Co.*, 66 Cal. 2d 503 (1967)).

32. *Id.* at 1405.

33. *Id.* at 1406.

34. *Id.* at 1407.

35. *Id.*

36. *Id.* at n.6 (citing *County of Inyo v. Public Utilities Com.*, 26 Cal.3d 154 (1980)).

37. *Id.*

The case's footnote suggests that regulatory limitations on the ability to recover costs through customer rates should have little to no bearing on inverse condemnation liability. While that interpretation upholds the Constitution's protection of the private property owner, it discounts the loss-spreading rationale traditionally relied upon in inverse condemnation cases. Thus, the disproportionate burden of the public use is essentially shifted from the property owner to the IOU.

There have been exceptions to this strict liability doctrine. In light of policy concerns, the California Supreme Court developed a reasonableness rule for assessing utility liability arising from flood control efforts. In general, the rule seeks to encourage beneficial flood control projects by only allowing compensation for property found to be unfairly damaged.<sup>38</sup> Even if inverse condemnation applied, SCE requested that the *Pacific Bell* court use that same reasonableness standard because the operation of high voltage power lines implicated similar policy concerns.<sup>39</sup> The Appeals Court in the *Pacific Bell* rejected this reasonableness standard on the basis that, unlike in the flood control cases, "it is the public improvement, not nature, that creates the risk of disaster."<sup>40</sup>

The court then referenced a California Court of Appeal decision in *Pacific Bell v. City of San Diego*.<sup>41</sup> In that case, the plaintiff pursued an inverse condemnation claim for damages from a burst pipe in the defendant city's water delivery system.<sup>42</sup> The defendant in that case argued that the flood-case exemption "supplanted the ordinary rule of strict liability with a rule of unreasonableness in constructing or maintaining the public improvement."<sup>43</sup> Although that case involved flooding, the exemption did not apply because the defendant utility was not acting to prevent an existing risk.<sup>44</sup> Similarly, since Pacific Bell's lines suffered damage from a risk it would not have been exposed to in the absence of SCE's lines, the exception was not applicable.<sup>45</sup>

Collectively, *Barham* and *Pacific Bell* reflect the court's firm stance on holding IOUs strictly liable for inverse condemnation claims. Like in

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38. *Id.* at 1409 (citing *Bunch v. Coachella Valley Water Dist.*, 14 Cal 4th 432 (1997)).

39. *Id.* at 1408.

40. *Id.* at 1410.

41. *Id.* at 1410.

42. *Pacific Bell v. City of San Diego*, 81 Cal. App. 4th 596 (2000)

43. *Pacific Bell v. City of San Diego*, at 610.

44. *Id.* at 614–15.

45. *Pacific Bell v. Southern California Edison*, at 1410–11.

*Barham*, this approach applies to property damage arising from wildfires started by an IOU's equipment. Traditionally, these costs are covered through the IOU's liability insurance. In recent years, however, insurance companies have cited the court's application of the inverse condemnation doctrine to justify their reduction or elimination of coverage.<sup>46</sup> This leaves IOUs financially vulnerable as wildfires grow in frequency and intensity each year. In response, IOUs have sought to recover uninsured wildfire liability costs through customer rates.

### III. REGULATORY STRUCTURE

California's investor-owned electric utilities<sup>47</sup> are regulated by the California Public Utilities Commission ("CPUC" or "Commission").<sup>48</sup> CPUC jurisdiction over IOUs is derived from Article XII, Section 3 of the California Constitution. The Constitution classifies private corporations that ". . . own, operate, control, or manage . . . the production, generation, transmission, or furnishing of . . . power . . . directly or indirectly to or for the public . . ." as public utilities subject to legislative control.<sup>49</sup>

Section 454 of the California Public Utilities Code authorizes the Commission to review and approve a public utility's proposed customer rate.<sup>50</sup> Generally, the CPUC approves rates that "permit the utility to recover its costs and expenses plus a reasonable return on the value of property devoted to public use."<sup>51</sup>

The Commission's ratemaking authority is guided by a "just and reasonable" standard derived from Section 451 of the Public Utilities Code.<sup>52</sup> Section 451 holds that all utility rates must be deemed just and reasonable, and that any rate found to be unjust or unreasonable is unlawful.<sup>53</sup> Using this standard, the CPUC conducts a reasonableness review of a proposed rate

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46. Joint Application of San Diego Gas & Electric Company, Southern California Edison Company, Southern California Gas Company, and Pacific Gas and Electric Company, A. 09-09-020, filed Aug. 31, 2009.

47. Pacific Gas & Electric (PG&E), Southern California Edison (SCE), and San Diego Gas & Electric (SDG&E).

48. *American Microsystems, Inc. v. City of Santa Clara*, 137 Cal. App. 3d 1037, 1042 (1982); *see also County of Inyo v. Public Utilities Com.*, 26 Cal. 3d 154, 166 (1980) (clarifying that publicly owned municipal utilities are not regulated by the CPUC or any other supervising agency absent another legislative grant of authority).

49. CAL. CONST. art. XII, § 3.

50. CAL. PUB. UTIL. CODE § 454(a)

51. *Southern California Gas Co. v. Public Utilities Com.*, 23 Cal. 3d 470. (1979).

52. CAL. PUB. UTIL. CODE § 451.

53. *Id.*



to determine whether the utility incurred recoverable costs in a reasonable and prudent manner.<sup>54</sup> This is known as the prudent manager standard.

The prudent manager standard considers whether a utility's actions or decisions “. . . follow[ed] the exercise of reasonable judgement in light of the facts known or which should have been known . . .” and were expected to “. . . accomplish the desired result at the lowest reasonable cost consistent with good utility practices.”<sup>55</sup>

#### *A. The 2007 Fires*

In 2007, over a dozen major fires burned through seven counties in Southern California.<sup>56</sup> Investigations revealed that three of those fires were caused by SDG&E's power lines.<sup>57</sup> As a result, over 2,500 lawsuits were filed against SDG&E for \$2.4 billion in total wildfire liability costs.<sup>58</sup> In pre-trial proceedings, the California Superior Court allowed plaintiffs to pursue inverse condemnation claims against SDG&E.<sup>59</sup> Since SDG&E knew it would be held to a strict liability standard, the IOU resolved a majority of the cases through settlements and mediations in an attempt to avoid higher litigation costs.<sup>60</sup>

#### *B. The Hearings*

In August 2009, prior to SDG&E's resolution of the 2007 wildfire claims, the three electric IOUs, along with Southern California Gas Company (“SCG”), filed a Joint Application to the CPUC.<sup>61</sup> In this application, the IOUs sought CPUC authority to establish a Wildfire Expense Balancing Account (“WEBA”) and to recover these balances through retail rates.<sup>62</sup> The proposed WEBA would allow the IOUs to record and recover all uninsured costs arising from wildfire liability unless the Commission found

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54. 24 CPUC 2d 476, 486.

55. *Id.*

56. Application to Recover Costs, A 15-09-010, filed Sept. 25, 2015, at 2.

57. *Id.*

58. *Id.* at 3.

59. *Id.*

60. *Id.* at 4.

61. Joint Application of San Diego Gas & Electric Company, Southern California Edison Company, Southern California Gas Company, and Pacific Gas and Electric Company, A. 09-09-020, filed Aug. 31, 2009.

62. *Id.* at 1.

the IOU acted recklessly in accruing the costs.<sup>63</sup> The IOUs declared that limited insurance coverage options made it necessary to have a mechanism allowing for rate recovery of growing uninsured wildfire costs.<sup>64</sup>

In July 2010, the CPUC issued Resolution E-4311, which held that the applicants could establish Wildfire Expense Memorandum Accounts (“WEMAs”) while the Commission considered the Joint Application.<sup>65</sup> The resolution emphasized that, while the WEMAs would act to record most of the same costs in the proposed WEBA, the costs could not be included in rates before a final decision was made.<sup>66</sup>

By the time the CPUC came to a final decision in December 2012, both PG&E and SCE withdrew as applicants.<sup>67</sup> The CPUC ultimately denied SDG&E’s and SCG’s WEBA requests on the grounds that the application created an unlimited potential for ratepayers to cover uninsured wildfire costs while disincentivizing preventative measures to reduce the risk of wildfires.<sup>68</sup> Though the WEBA was denied, the CPUC did allow SDG&E’s and SCG’s WEMAs to remain open subject to a later reasonableness review.<sup>69</sup>

Pursuant to that decision, SDG&E later applied for CPUC authorization to recover the 2007 wildfire costs recorded in their WEMA.<sup>70</sup> Of the \$2.4 billion in total costs accrued, SDG&E sought to recover \$379 million through customer rates.<sup>71</sup> In a prehearing motion, SDG&E stressed that the application presented a legal issue of first impression to the Commission.<sup>72</sup> Since the costs were incurred in the context of inverse condemnation, the IOU requested that the cost recovery be considered in the same context. Using inverse condemnation law, SDG&E would have been strictly liable regardless of fault. As such, SDG&E pushed for a reasonableness review of the steps taken to reduce total wildfire liability costs through settlement, and not to the operating and engineering practices that may have sparked the fire.<sup>73</sup>

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63. *Id.* at 5.

64. *Id.*

65. Resolution E-4311, Issued July 29, 2010.

66. *Id.*

67. Joint Application, at 3.

68. *Id.* at 18.

69. *Id.*

70. Application of San Diego Gas & Electric Company (U 902 E) for Authorization to Recover Costs Related to the 2007 Southern California Wildfires Recorded in the wildfire Expense Memorandum Account, filed Sept. 25, 2015.

71. *Id.*

72. San Diego Gas & Electric Company’s (U 902 E) Application for Rehearing of Decision 17-11-033 and Request for Expedited Action, A.15-09-010, filed Sept. 25, 2015, at 26.

73. Application to Recover, at 10–11.

Despite SDG&E's emphasis on its cost reduction measures, CPUC applied the prudent manager standard to the IOU's management and operation of its facilities prior to the ignition of each of the three fires.<sup>74</sup> Ultimately, CPUC found that SDG&E failed to "reasonably and prudently maintain its facilities."<sup>75</sup> As such, the costs were deemed unreasonable and the request to recover through rates was denied.<sup>76</sup> The decision also ordered SDG&E to close its WEMA.<sup>77</sup>

The denial signaled to the IOUs that, just as the courts will rule regardless of the regulators, the regulators will rule regardless of the courts. Though this was a novel legal issue, the Commission applied its traditional "prudent manager standard" to the circumstances of the case. The Commission stated that inverse condemnation principles were "not relevant" to a Section 451 reasonableness review.<sup>78</sup> Indeed, the denial affirmed the Commission's "exclusive jurisdiction" over ratemaking issues while citing an absence of superseding case law.<sup>79</sup>

SDG&E filed a subsequent application for rehearing of the decision which argued, amongst other things, that the decision erred in preventing rate recovery consistent with the cost spreading principle under the doctrine of inverse condemnation.<sup>80</sup> Ultimately, the CPUC denied SDG&E's challenge on all grounds.

#### IV. THE CONFLICT REALIZED

SDG&E's rehearing application and the CPUC's subsequent denial illustrate the reality of the conflict that Edison alluded to in *Pacific Bell*. In its application, SDG&E argued that the CPUC's failure to apply the cost spreading principle in its reasonableness review: (1) created an unnecessary conflict of laws; (2) produced an unjust and unreasonable result; and (3) violated Constitutional takings principles. SDG&E's position was that inverse condemnation's strict liability standard superseded the Commission's prudent

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74. *Id.*

75. *Id.* at 72.

76. *Id.*

77. *Id.*

78. Order Denying Rehearing of Decision (D.) 17-11-033, D. 18-07-025, issued July 13, 2018, at 64.

79. *Id.* at 65.

80. *Id.* at 3.

manager standard. As such, IOU facility operations were irrelevant to wildfire cost recovery considerations since they would have been irrelevant to a court’s liability considerations. The Commission retained its position that inverse condemnation had no effect on the Legislature’s mandate that all cost reviews be just and reasonable.

#### A. *Unnecessary Conflict of Laws*

SDG&E first argued that the CPUC committed legal error in denying the relevance of inverse condemnation to its review.<sup>81</sup> It asserted that the Commission is bound by the doctrine’s cost-spreading principle since it was derived from judicial interpretation of the California Constitution.<sup>82</sup> As such, the Commission improperly adhered to Section 451 rather than inverse condemnation in the proceeding. In support, SDG&E cited *PG&E Corp. v. Public Utilities Com.*, which found the Commission may not disregard “express legislative directions” or “restrictions upon its power found in other provisions of [the Public Utilities Act] or elsewhere in general law.”<sup>83</sup> The Commission was unconvinced; neither the Court’s interpretation of inverse condemnation, nor its assumption that the CPUC would permit recovery amounted to an express directive or prohibition.<sup>84</sup>

While it did not do so, the Commission could have further argued that *PG&E Corp.* only applied insofar as it *prohibited* the Commission from disregarding Section 451. Instead, the Commission rejected SDG&E’s conflict-of-law argument by making its own. The Commission reiterated that not only did Section 451 require it to conduct a reasonableness review, the California Constitution also prohibited it from doing otherwise.<sup>85</sup> Thus, absent an appellate court ruling or an express legislative direction, the CPUC’s hands were tied.

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81. Rehearing App., at 13 (citing CAL. PUB. UTIL. CODE § 1757(a)(2) “The commission has not proceeded in the manner required by law,” and § 1757(a)(6), “The order or decision of the commission violates any right of the petitioner under the Constitution of the United States or of the California Constitution.”).

82. *Id.*

83. *Id.* at 14, *PG&E Corp. v. Public Utilities Com.*, 118 Cal. App. 4th 1174, 1199 (2004) (citing *Pacific Tel. & Tel. Co. v. Public Util. Com.*, 62 Cal. 2d 634, 653 (1965)).

84. Order Denying Rehearing, at 27.

85. *Id.* at 26, (citing CAL. CONST., art. 3, § 3.5. “An administrative agency . . . has no power to declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional.”).

*B. Unjust and Unreasonable*

SDG&E then argued that the Commission’s approach created a “fundamentally unjust and unreasonable whipsaw of inconsistent and incompatible legal standards” in violation of SDG&E’s due process rights.<sup>86</sup> Under inverse condemnation, SDG&E would have been at fault regardless of how prudently it managed its facilities. Despite this, the Commission based its reasonableness determination solely on imprudent maintenance and operation of facilities. SDG&E felt this failure to align cost recovery considerations with how the costs were incurred “defie[d] logic and the law.”<sup>87</sup>

In response, the Commission doubled down on its statutory obligations, stating that inverse condemnation’s indifference towards reasonableness had no impact on Section 451.<sup>88</sup> The Commission relied heavily on the fact that the proceedings were split into two phases. Phase 1 considered maintenance and operation of facilities and Phase 2 was to evaluate the reasonableness of settlement costs. Since SDG&E failed to meet the Prudent Manager standard in Phase 1, the overall application was denied and the Commission never conducted a Phase 2 evaluation.<sup>89</sup> As inverse condemnation had no effect on SDG&E’s operations prior to the fires; it was immaterial to Phase 1’s reasonableness review.<sup>90</sup>

*C. Economic Taking*

In its application, SDG&E made an economic takings argument that attempted to put the Commission in SDG&E’s shoes by applying inverse condemnation to the denial. SDG&E argued that the Commission’s denial amounts to an economic taking of SDG&E’s funds, without just compensation, for the public use of compensating those injured by the fires.<sup>91</sup> Since the California Constitution prohibits such unjust taking for public use, the Commission’s decision was improper. To remedy this, SDG&E proposed

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86. Rehearing App., at 16–17.

87. *Id.*

88. Order Denying, at 29.

89. *Id.* at 30.

90. *Id.* at 29.

91. Rehearing App., at 21.

that the Commission base its cost recovery review on the reasonableness of their Phase 2 conduct.<sup>92</sup>

As the Commission points out in its response, this argument's main flaw is that it presumes guaranteed rate recovery for all costs.<sup>93</sup> The Commission points to two Supreme Court cases which held: (1) an unlawful taking does not occur unless a regulation or rate is unjust or unreasonable; and (2) whether a regulation is just and reasonable depends on a balancing of the interests of the entity and the ratepayers.<sup>94</sup> Since the decision was based on statutory obligations and established ratemaking practices meant to advance the protection of ratepayers from unjust and unreasonable rates, the Commission determined there was no unlawful taking.<sup>95</sup>

#### *D. Deadlock*

Just as *Barham* and *Pacific Bell* solidified the court's approach to IOU wildfire liability, these proceedings solidified the Commission's approach to the matter. Throughout the proceedings, the Commission remained steadfast not only in its adherence to Section 451, but also in its position that the reasonableness review ought to apply solely to facility management and operation. Given the circumstances of inverse condemnation, SDG&E felt this focus was unreasonable.

The CPUC's emphasis on facility management seemed to indicate a position that IOUs can and must take steps to effectively avoid situations giving rise to wildfires.<sup>96</sup> Indeed, the December 2012 Denial essentially used Commission ratemaking authority to incentivize prudent wildfire risk management techniques.<sup>97</sup> While this may be beneficial in the abstract, such factors as climate change and increasing development along the wildlife-urban interface suggest this approach may become increasingly expensive and ultimately unrealistic.<sup>98</sup> On the other hand, SDG&E's suggestion to consider only the reasonableness of the settlement actions may be too lenient a standard.

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92. *Id.* at 22.

93. Order denying, at 31.

94. *Id.* at 31 (citing *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989), and *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216, 292 (1994)).

95. *Id.* at 31–32.

96. Decision Denying WEBA, at 14 (“The duty to furnish and maintain safe equipment and facilities is paramount for all California public utilities.”).

97. *Id.* at 15.

98. That is not to suggest that the December 2017 Denial was unrealistic in its assessment of SDG&E's maintenance and operation. The analysis of circumstances leading up to each of the three fires seems thoroughly substantial. Regardless, the sufficiency of the reasonableness review is not relevant to the topic at hand.

Since the Commission denied SDG&E's application after Phase 1, it is unclear if or how inverse condemnation would have shaped the Phase 2 review. In theory, Section 451's vague language gives the Commission the discretion to afford the doctrine some weight in a reasonableness review.

The Commission could have first completed both phases of review in which it applied a prudent manager standard to SDG&E's pre-fire operations and post-fire settlements. The Commission could have then offset a portion of reasonable Phase 2 costs depending on the severity of Phase 1's finding of overall imprudence.

This approach embraces inverse condemnation insofar as it allows SDG&E to spread only the costs it reasonably incurred while holding it accountable for all costs that could have been avoided or mitigated through prudent management. Such an approach reflects a certain middle ground that punishes imprudent management and prevents limitless liability from bankrupting the IOUs. This seems to align with the California Legislature's desire. As discussed below, the Legislature has sought to address these issues through recent measures meant to encourage wildfire risk mitigation and maintain IOU financial stability.

## V. SB 901

As wildfires become increasingly common and increasingly destructive, the inverse condemnation conflict poses a significant financial threat to the California IOUs. To address this, the California Legislature passed Senate Bill 901 ("SB 901") into law in August 2018. SB 901, dubbed "The Wildfire Bill," contains various measures meant to encourage both prudent facility management and the IOUs' financial stability in the face of growing wildfire threats. Two examples of these measures are the newly added Sections 451.1 and 451.2 to the California Public Utilities Code.

### *A. Section 451.1*

The original Section 451 contained a vague just and reasonable standard to guide Commission review of cost recovery applications. Section 451.1, however, provides the Commission with twelve non-exclusive criteria with which to review and approve costs specifically associated with catastrophic

wildfires.<sup>99</sup> While this may signal relief to the IOUs, it is hardly a bailout. Of the twelve criteria: six question the reasonableness of the IOU's operation and management of assets in light of wildfire risk and two focus on compliance with various regulations. These effectively serve to codify the considerations the CPUC was already weighing.

This new wildfire reasonableness standard also allows the Commission to consider the extent to which expenses were caused by circumstances beyond the IOU's control and whether "extreme climate contributions" exacerbated damages.<sup>100</sup> Inclusion of these criteria signal the Legislature's recognition that conditions may not always be within the IOU's control.

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99. CAL. PUB. UTIL. CODE § 451.1(a):
- (1) The nature and severity of the conduct of the electrical corporation and its officers, employees, contractors, and other entities with which the electrical corporation forms a contractual relationship, including systemic corporate defects.
  - (2) Whether the electrical corporation disregarded indicators of wildfire risk.
  - (3) Whether the electrical corporation failed to design its assets in a reasonable manner.
  - (4) Whether the electrical corporation failed to operate its assets in a reasonable manner.
  - (5) Whether the electrical corporation failed to maintain its assets in a reasonable manner.
  - (6) Whether the electrical corporation's practices to monitor, predict, and anticipate wildfires, and to operate its facilities in a reasonable manner based on information gained from its monitoring and predicting of wildfires, were reasonable.
  - (7) The extent to which the costs and expenses were in part caused by circumstances beyond the electrical corporation's control.
  - (8) Whether extreme climate conditions at the location of the wildfire's ignition, including humidity, temperature, or winds occurring during the wildfire, contributed to the fire's ignition or exacerbated the extent of the damages. The electrical corporation shall provide the commission with specific evidence and data demonstrating the impact of climate conditions on the severity of the wildfire.
  - (9) The electrical corporation's compliance with regulations, laws, commission orders, and its wildfire mitigation plans prepared pursuant to Section 8386, including its history of compliance.
  - (10) Official findings of state, local, or federal government offices summarizing statutory, regulatory, or ordinance violations by any actor that contributed to the extent of the damages.
  - (11) Whether the costs and expenses were caused by a single violation or multiple violations of relevant rules.
  - (12) Other factors the commission finds necessary to evaluate the reasonableness of the costs and expenses, including factors traditionally relied upon by the commission in its decisions.
100. § 451.1(a), 7, 8.



Going forward, it remains unclear whether Section 451.1 will help to resolve the present conflict of laws or create new ones. IOUs may argue these wildfire-specific liability considerations demonstrate a legislative intent to not hold IOUs strictly liable for wildfire damages. Alternatively, courts may find these express criteria to be unconstitutional since they potentially conflict with the Constitution’s cost-spreading rationale.

### *B. Section 451.2*

While Section 451.1 only applies to review of wildfire costs incurred on or after January 1, 2019,<sup>101</sup> Section 451.2 addresses costs incurred as a result of wildfires ignited in the 2017 calendar year.<sup>102</sup>

This Section creates a financial “stress test” for the Commission to utilize in cost recovery proceedings. The CPUC must “. . . 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.”<sup>103</sup> Upon this determination, the CPUC must ensure that the disallowed costs do not exceed that maximum amount.<sup>104</sup> Subdivision (c) of this Section further allows for the IOU to seek a financing order for both the just and reasonable costs, as well as any costs and expenses in excess of that maximum amount.<sup>105</sup>

Under Section 451.2, IOUs are still prohibited from recovering a majority of imprudently incurred wildfire costs from their rate bases, but only up to the amount that their financial situation allows. The new law now requires the CPUC to allocate any disallowed liability costs in excess of the maximum amount to the ratepayers, rather than to the IOUs.<sup>106</sup> This stress test provision is important as it represents the Legislature’s attempt to temper the potentially devastating financial consequences of holding IOUs strictly liable for all 2017 wildfire costs.

In a way, Section 451.2 creates an inverse condemnation safety valve that allows for liability costs to be distributed between an IOU’s investors and ratepayers. IOUs remain liable for imprudently incurred costs, but only to the point they can pay without going bankrupt. This outcome aligns with

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101. § 451.1(a).

102. § 451.2(a).

103. § 451.2(b).

104. *Id.*

105. § 451.2(c).

106. CAL. PUB. UTIL. CODE § 850.1(a)(1).

public interest, as it maintains utility stability while ensuring the IOU covers most of the costs it could or should have mitigated through preventative measures.

This approach also preserves the Commission's desire to incentivize prudent wildfire mitigation practices through its ratemaking authority. Any 2017 wildfire costs remain subject to the original Section 451 prudent manager standard.<sup>107</sup> Thus, the CPUC retains discretion to disallow recovery for any and all costs arising from imprudent facility management.

As litigation for damages related to the 2017 fires moves forward, Section 451.2 will likely provide some financial relief to IOUs but may ultimately weaken their position in the courts. In past cases, IOUs attempted to argue that inverse condemnation should not apply because regulators prevented them from spreading losses as envisioned by the doctrine. Now, regulators could allow for recovery of certain liability costs through rates. As such, in the case of the 2017 fires, IOUs cannot claim that the loss-spreading policy rationale behind inverse condemnation does not (in part) apply.

Section 451.2's safety-valve mechanism only applies to cost recovery applications related to 2017 fires. Recovery for future fire costs will be governed by Section 451.1's new reasonableness standard without consideration for whether or not disallowance will bankrupt the utility. If a utility declares bankruptcy, property owners seeking compensation for wildfire damages will then have to compete with the IOUs' creditors and insurers for payment. Further, utility bankruptcy could cause service interruptions or a fluctuation in customer rates. If utility-ignited wildfires continue to grow in size and frequency, Legislators may need to take additional action to avoid these outcomes.

One way Legislators could act is by requiring the CPUC to incorporate inverse condemnation considerations in its cost-recovery review as suggested at the end of Part IV of this Article. To achieve this, Legislators could amend Section 451.1's review criteria to include whether an IOU prudently settled its wildfire liability claims. In its review, the CPUC can use its discretion to offset any portion of their disallowance if total imprudently incurred costs were significantly reduced by prudent settlement. That would allow for the CPUC to incentivize both prudent pre-fire facility management and prudent post-fire settlement activities. This outcome serves the public interest insofar as IOUs remain liable for imprudent pre-fire and post-fire activities, while ratepayers continue to only cover costs associated with just and reasonable business practices.

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107. § 451.2(a).

Alternatively, Legislators could require the CPUC to conduct Section 451.2's stress test in all future wildfire cost-recovery reviews. While this will help to avoid IOU bankruptcy, it may significantly impact customer rates if wildfire trends continue.

## VI. CONCLUSION

It seems likely that courts and regulators will remain steadfast in their respective positions towards IOU wildfire liability. Indeed, utilities are in the best position to spread costs incurred for the public good. Further, ratepayers should not foot the bill for an IOU's imprudent actions. However, the reality and uncertainty of climate change suggest traditional notions may need slight adjustment. As climate patterns shift and wildfires increase in frequency and intensity, IOUs must be proactive and take steps to prudently manage their operations. Additionally, Legislators and regulators must consider the potential impact of holding IOUs liable to the point of insolvency. Such an outcome would deprive harmed individuals of just compensation and destabilize service for customers throughout California.

