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Decision 99-04-068 April 22, 1999

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Pacific Gas and Electric Company (U 39 M) for Authorization to Implement a Plan of Reorganization Which Will Result in a Holding Company Structure.	Application 95-10-024 (Filed October 20, 1995)

(See Decision 96-11-017 for List of Appearances)

Additional Appearances:

Cheryl White Mason, O'Melveny & Meyers for Pacific Gas and Electric Company; Donald P. Garber and David J. Gilmore for Sempra Energy

43994

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PHASE TWO OPINION

1. Summary

This is the second decision in the application of Pacific Gas and Electric Company (PG&E) to form a holding company structure, in which we examined an audit prepared by the Office of Ratepayer Advocates (ORA) to determine whether it was necessary to impose any further conditions on PG&E as a result of the audit's findings.

Between ORA's audit and the Commission's review thereof, the Commission adopted the Affiliate Transaction Rules in Decision (D.) 97-12-088, as modified by D.98-08-035. PG&E also began the process of staffing and developing the holding company infrastructure and continues this process today. Because the Affiliate Transaction Rules and PG&E's restructuring into a holding company structure may resolve some of the problems found by ORA's audit, we do not adopt many of the additional conditions which ORA proposes. However, because we cannot validate that this is in fact the case, we direct a future verification audit to determine compliance with conditions adopted in this proceeding and in other Commission proceedings. We also maintain the conditions we adopted in D.96-11-017, the Interim Opinion in this case, and adopt several further conditions on PG&E with respect to internal controls. With these further conditions, we approve the application and close this proceeding.

ORA's recommended financial conditions were the most hotly disputed conditions in this case. We do not adopt these financial conditions for PG&E alone because ORA's justification for imposing these conditions is not unique to PG&E, but applies to all Commission-regulated energy utilities. However, we provide that parties who believe if necessary to raise the need for further financial conditions on all electric and gas utilities within our jurisdiction, either

as proposed by ORA in this proceeding or other appropriate financial conditions, may raise this issue when the Commission reviews the Affiliate Transaction Rules as provided for in D.97-12-088, *slip op.* at p. 99, Ordering Paragraph 10.

2. Background

2.1. Procedural Background

This is the second decision in PG&E's application for authorization to form a holding company structure. A February 15, 1996 Administrative Law Judge (ALJ) ruling determined that ORA should conduct an audit in this proceeding of all of PG&E's significant utility/affiliate transactions from the 1994 reporting period through the present. The Commission later affirmed this ruling in D.96-11-017, the Phase One Interim Opinion.

The ALJ ruling also stated that it was appropriate to address PG&E's application in an interim opinion before conclusion of the audit, which ORA estimated at the time of the motion to be mid-1997. The ruling further stated:

> "If the interim decision approves the application, it would do so conditioned upon the outcome of the audit. Once the audit is complete, the parties could comment thereon, and hearings, if appropriate, could be scheduled to take additional testimony addressing appropriate further conditions which may arise as a result of the audit." (February 15, 1996 Ruling at p. 7.)

The Interim Opinion granted PG&E the authority it sought in the application, subject to the conditions set forth in that decision, and "conditioned upon the outcome of the audit discussed in Section 6 of this decision, and any further conditions or modifications of existing conditions which may arise from Phase 2 of this proceeding." (D.96-11-017, *slip op.*, Ordering Paragraph 1 at p. 45.) The Interim Opinion discussed this proceeding's background and proposed reorganization in detail, and we do not repeat that discussion here.

On August 16, 1996, ORA issued a request for proposals to conduct the audit ordered by the Interim Opinion. ORA retained Overland Consulting Company (Overland) to perform the audit, which commenced on October 3, 1996. On November 26, 1997, ORA served on all parties a redacted version of Volume One of the audit. ORA ultimately served the full audit on the parties (some segments are under seal and were served pursuant to a nondisclosure agreement). PG&E filed written testimony in response to the audit, ORA filed rebuttal testimony thereto, and PG&E in turn filed surrebuttal testimony.

Hearings were held from August 31 through September 17, 1998. PG&E and ORA filed opening briefs on November 10, 1998, and reply briefs on November 25, 1998. The parties held closing argument before Assigned Commissioner Neeper on December 10, 1998. This application was submitted on November 25, 1998.

2.2. The Holding Company and Its Affiliates

After the formation of the holding company, PG&E Corporation became the parent of PG&E and PG&E's affiliates. Prior to the formation of the holding company, PG&E's investments in nonutility businesses were held through PG&E Enterprises, which was a wholly owned subsidiary of the utility. PG&E Enterprises' major business units and lines of business during the audit period were PG&E Generating Company (which held a partnership interest in U.S. Generating Company), PG&E Properties, Inc. (which is being liquidated), PG&E Energy Services, PG&E Overseas, Inc., PG&E Generating International (which held a partnership interest in International Generating Company which was subsequently sold), and DALEN Corporation, which was sold during the audit period.

With the formation of the holding company structure on January 1, 1997, PG&E became a subsidiary of the holding company and transferred its investments in PG&E Enterprises to PG&E Corporation. PG&E Corporation formed five business lines under the holding company. They include PG&E (the current California utility operations); U.S. Generating Company (electric generation); PG&E Energy Services (energy services); PG&E Energy Trading (energy trading); and PG&E Gas Transmission (gas transmission). The following entities remain subsidiaries of the utility: Alberta and Southern Gas Co. Ltd.; Alberta and Southern Gas Marketing Inc.; Calaska Energy Company; Eureka Energy Company; Mission Trail Insurance (Cayman), Ltd. (which PG&E states is being disbanded); Natural Gas Corporation of California; NGC Production Company; Pacific California Gas System, Inc.; Pacific Conservation Services Company; Pacific Energy Fuels Company; Pacific Gas Properties Company; and Standard Pacific Gas Line Incorporated.

3. The Audit and Subsequent Events

The Overland Audit Report covered the period between 1994 and 1996 (the audit period). The Audit Report included a review of all of PG&E's affiliate transactions during the audit period, and a review of the current business plans of PG&E affiliates. According to the Audit Report, the primary purposes of the audit were:

- To provide a baseline description of the business activities and plans of PG&E's affiliates;
- To determine whether PG&E's affiliate transactions during the period 1994 through 1996 were consistent with the Commission's applicable policies and standards for affiliate transactions;

- To assess the implications of holding company formation and PG&E Corporation's business plans on PG&E and its ratepayers;
- To develop and recommend additional conditions necessary to protect PG&E and its ratepayers from the risks associated with holding company formation and PG&E Corporation's business plans.

The Audit Report addressed 16 of the 18 conditions adopted by the Interim Opinion and recommends that 15 of them be continued and one be modified.[1] Additionally, Overland made 46 new recommendations and offered 23 new or modified conditions. In rebuttal, Overland withdrew some of the conditions, primarily based on the Commission's adoption of the Affiliate Transaction Rules in Rulemaking (R.) 97-04-011/Investigation (I.) 97-04-012. Overland's witnesses also withdrew or modified various recommendations in the hearings. This decision addresses the current conditions and recommendations still in controversy.

Two subsequent events occurred after the end of the audit period which the parties argue, to various degrees, affect this decision. First, the Commission enacted the Affiliate Transaction Rules in D.97-12-088, as modified by D.98-08-035. These rules cover transactions between certain gas and electric utilities and their affiliates which are engaged in the provision of a product that uses gas or electricity, or the provision of services that relate to the use of gas or electricity. We included a holding company within the definition of "affiliate"

[1] The two conditions in the Interim Opinion that the audit report did not address were those that mandated the audit and required the shareholders to bear the cost of the reorganization.

only to the extent the holding company is engaged in the provision of products and services as set out in the rules.

Prior to the issuance of D.97-12-088, ORA moved to consider the Audit Report, which is the subject of this proceeding, in the Affiliate Transaction proceeding. ORA argued that the report would provide the Commission with real and practical information about affiliate transactions with utilities. In. D.97-12-088, we denied ORA's motion without prejudice to raise it at a later time if conditions warrant. We articulated our desire to issue a decision in the Affiliate Transaction proceeding by the end of 1997, and recognized that consideration of the audit would require, at the least, another round of comments from the parties and could delay the issuance of that decision. However, we stated that nothing in the Affiliate Transaction proceeding prevents the Commission from issuing other utility-specific rules in this area in another proceeding, if the Commission believes it necessary to do so. (D.97-12-088, *slip op.* at p. 20.)

Indeed, Rule II.E articulates this principle:

> "**Existing Rules:** Existing Commission rules for each utility and its parent holding company shall continue to apply except to the extent they conflict with these Rules. In such cases, these Rules shall supersede prior rules and guidelines, provided that nothing herein shall preclude (1) the Commission from adopting other utility-specific guidelines; or (2) a utility or its parent holding company from adopting other utility-specific guidelines, with advance Commission approval."

To the extent we need them now, we can and will adopt more utility-specific rules. To the extent we believe that the generic rules address the issue raised, or that it is too early to tell (since the generic rules are relatively recent), we do not adopt additional utility-specific rules at this time.

Second, after the Commission, through its Interim Opinion, granted PG&E the conditional authority to reorganize into a holding company structure, PG&E began the process of staffing and developing the infrastructure for the holding company. The Audit Report is based on information gathered through about early 1997, yet PG&E has continued the process of staffing and developing the infrastructure. Because of this timing, the current holding company structure is not necessarily what Overland evaluated in its audit.

4. Standard of Review and Burden of Proof

As we stated in the Interim Opinion, in approving holding company applications, we have adopted a standard of review of ratepayer indifference. (Interim Opinion, at p. 14.)

> "Accordingly, when a utility seeks to reorganize under a holding company structure under Pub. Util. [Public Utilities] Code § 818, we do not require it to demonstrate more than that (1) a valid business purpose exists, and (2) the reorganization may be accomplished and future operations conducted pursuant to conditions that will be adequate to protect the public interest." (*Id.*)

We recognized in the Interim Opinion that the recent Commission history of utility reorganizations into holding companies has involved a series of conditions. The Interim Opinion further elaborated on this point:

> "As we stated in the *San Diego* and *Roseville Holding Co. Decisions*, in determining appropriate conditions of our approval for this application, 'we are left to strike a balance that will allow easing our oversight of competitive and unregulated enterprises of affiliates while retaining our ability effectively to regulate utility operations. As ever, we remain determined that the utility's remaining powers as a natural monopoly be clearly vested in operating units that we may readily identify and regulate. It only requires mention that in striking such balance, we find ourselves engaged in a quasi-legislative mode, concerned primarily with questions of policy, rather than in a quasi-legislative mode where we would be engaged in the application of law to facts.'" (Interim Opinion at p. 21, citing

Application of Roseville Telephone Company for Authorization to Implement a Plan of Reorganization Which Will Result in a Holding Company Structure, (*Roseville Holding Co. Decision*), D.96-07-059, *slip op.* at p. 10, and *Application of San Diego Gas & Electric Company for Authorization to Implement a Plan of Reorganization Which Will Result in a Holding Company Structure*, (*SDG&E Holding Co. Decision*), D.95-12-018, 62 CPUC2d 626, 636.)

ORA states that this transaction is also subject to Pub. Util Code § 854. We addressed this issue in the Interim Opinion, where we held that PG&E's proposed transaction should not be classified as an acquisition activity subject to § 854. (Interim Opinion at p. 10.) ORA has not presented arguments which cause us to change this conclusion.

The parties differ on the issue of burden of proof. PG&E recognizes that, as the applicant, it has the overall burden of proof. However, PG&E states that the Commission has recognized that an applicant cannot be required to conclusively prove the negative. According to PG&E, the Commission's general approach to burden of proof requires the applicant to present a *prima facie* case that the substantive standard for approving the application is satisfied. Thereafter, the burden of developing and presenting contrary proof shifts to those who oppose the application.

ORA agrees that as applicant, PG&E bears the overall burden of proof. However, it disputes PG&E's argument that ORA has the burden of proof in this phase of the proceeding because PG&E has made a *prima facie* case for approving the application. ORA maintains that PG&E has not made a *prima facie* case that, without appropriate conditions, PG&E's reorganization into a holding company structure meets statutory and Commission standards. According to ORA, PG&E continues to bear the burden in this phase of the proceeding to demonstrate that its reorganization will not be harmful to either ratepayers or competition.

The parties confuse the burden of proof with the burden to produce evidence. As applicant, PG&E has the burden of proof to demonstrate that its requested relief is reasonable under our adopted standard of ratepayer indifference for approving holding company applications. PG&E therefore has the burden of proof to demonstrate that (1) a valid business purpose exists, and (2) the reorganization may be accomplished and future operations conducted pursuant to conditions that will be adequate to protect the public interest. To the extent that it fails to meet this burden, we may add further conditions in order to protect the public interest or reject the application.

PG&E implies that ORA has attempted to place an unfair burden of proof upon it, namely, that PG&E must prove a negative and show that the factual circumstances (such as financial circumstances) by which ORA justifies its recommended conditions would never under any circumstances occur. We do not expect PG&E to disprove a negative. However, we expect PG&E to address positive evidence purporting to show that approval of its application is unreasonable in the absence of certain conditions. ORA, on the other hand, has the burden of producing evidence in support of its affirmative recommendations. However, the ultimate burden of proof as to our granting the application, as stated above, does not shift from PG&E.

As we stated in the context of decisions addressing proposed disallowances:

> "...where other parties challenge the utility's showing such parties have the burden of producing evidence in support of such challenge and in support of adoption of their recommended ratemaking disallowance or adjustment, but the ultimate burden of proof of reasonableness is never shifted from the utility to the challenging party." (*Re PG&E*, D.94-03-050, 53 CPUC2d 481, 499, citing *Re Pacific Bell*, D.87-12-067, 27 CPUC2d 1, 145.)

5. PG&E and ORA Differ Regarding the Need for Additional Safeguards

As discussed above, the Interim Opinion set forth various conditions which we imposed upon PG&E in order for it to reorganize into a holding company structure (subject to any additional conditions we might impose in this phase). Other safeguards also protect ratepayers from the potentially harmful consequences of PG&E's affiliate relationships. Certain, but not all, of PG&E's affiliates are also subject to the Affiliate Transaction Rules. Various sections of the Pub. Util. Code also address the utility/affiliate relationship and the Commission's general ratemaking authority and penalty powers. The Commission has also adopted certain reporting requirements in D.93-02-019, 48 CPUC2d 163.

The parties both agree that effective Commission regulation is needed here. However, they strongly disagree on what constitutes effective regulation. PG&E believes that the existing regulatory framework is fully adequate for the present and flexible enough for the future. ORA believes that the audit findings demonstrate that additional conditions are warranted. The specific disputes are discussed in the sections which follow, and are summarized in Appendix A, which contains a comparison exhibit prepared by the parties. A brief overview of PG&E's and ORA's positions is useful in order to put their specific arguments in a broader context.

PG&E argues that the specific audit findings do not support ORA's recommended conditions. In part, PG&E argues that the Overland audit was overtaken by events which diminished its relevancy. For example, some of ORA's recommendations have been superceded by the Affiliate Transaction Rules and PG&E's reorganization into a holding company structure. PG&E argues that, although ORA has modified its recommendations in part to reflect the Affiliate Transaction Rules, ORA has not sufficiently recognized the increased

separation and better cost allocation between the utility and its affiliates, which both the Affiliate Transaction Rules and the reorganization have brought to PG&E.

PG&E also believes that it will be competitively disadvantaged if the Commission adopts ORA's conditions because it will bear restrictions and burdens beyond those imposed on similarly situated utility holding companies. PG&E argues that the existing safeguards were carefully designed by the Commission to strike a balance between the goals of bringing ratepayers the benefits of aggressive but fair competition and protecting them from potential harms. Because of the need to strike this balance, PG&E maintains that rules that are more restrictive than general Commission standards are not necessarily more protective of the public interest. PG&E believes that restrictions intended to address particular concerns can, when applied in contexts where concerns do not exist, create perverse incentives, adversely affect competition, and impose needless administrative burdens that raise costs and detract from more productive utility activities.

ORA believes that additional conditions are warranted to protect ratepayers, and that the Commission has one good opportunity, namely this proceeding, to protect ratepayers from the harm which Overland had identified. ORA recognizes that although the holding company structure provides some legal protection of utility assets from claims arising out of nonutility business activities, it does not eliminate the risk that affiliate financial losses will impair the utility's access to capital.

ORA believes that the formation of a holding company creates at least four basic risks for ratepayers. These are the risks that: (1) financial losses incurred by affiliates will impair the utility's ability to attract capital on reasonable terms;

(2) the parent company will subordinate the interests of the utility to the interests of the other affiliates; (3) the parent company will use the holding company structure to reduce state regulatory authority over utility operations and costs; and (4) the parent company will use the utility's exclusive service territory franchise and ratepayer-funded assets to provide an unfair competitive advantage to affiliates.

ORA believes that risks created by holding company formation must be evaluated based on two factors: (1) the probability that an adverse outcome will occur; and (2) the amount of damages resulting from an adverse outcome. According to ORA, a catastrophic failure of the holding company's nonutility investments may have a relatively low probability of occurring, but the potential adverse economic consequences to ratepayers are large. As a result, the risk that failed diversification will impair PG&E's ability to attract capital on reasonable terms is the most significant risk associated with holding company formation.

ORA disagrees with PG&E that the Commission should not impose more stringent conditions on it than it has on other similarly situated utilities. ORA believes the facts in this proceeding are far different for PG&E than they were in the Affiliate Transaction Rulemaking or in previous holding company decisions, because these prior proceedings did not review the relief unique to PG&E's circumstances, and most prior holding company decisions were decided before electric industry restructuring. ORA maintains that PG&E's affiliates are aggressive but have at best achieved only limited success. Yet, PG&E's unregulated affiliates will soon eclipse PG&E in size. According to ORA, this is a recipe for significant ratepayer harm that has not been sampled before in the Affiliate Transaction Rulemaking or other holding company cases.

The parties weave these broad arguments throughout their presentation, and we address them in the context of our decisions on the specific points of contention addressed in the following sections.

6. Financial Conditions

ORA's proposed financial conditions were the most hotly debated issues in this case. ORA proposes the following five financial conditions, four of which PG&E strongly opposes.

1. **Restrictions on Lines of Business.** The total capitalization (debt and equity) of PG&E's non-energy related business lines shall not exceed 20% of PG&E's capitalization. Energy related business lines include fuel supply, energy conversion, storage, transmission, distribution, marketing, power quality, energy management, energy efficiency and associated technologies.
2. **Restriction on Total Investment.** The total capitalization of PG&E Corporation's business units other than PG&E shall not exceed PG&E's capitalization. PG&E Corporation will adjust the investment and dividend policies of its business units as necessary to satisfy this condition.
3. **Prohibition Against Parent Company Senior Securities and Pledging PG&E Stock.** All financings other than short-term debt and the sale of PG&E Corporation common stock shall occur at the subsidiary level. PG&E Corporation will not issue any preferred stock or any debt with a maturity greater than 12 months. PG&E Corporation will not pledge its stock as security for debt or make any other commitments substantially impairing its ability to distribute PG&E's common stock to PG&E Corporation's shareholders in a spin-off.
4. **Capital Requirements.** The capital requirements of PG&E, as determined to be necessary and prudent to meet the obligation to serve or to operate the utility in a prudent and efficient manner, shall be given first priority by PG&E Corporation's Board of Directors.

5. **Utility Divestiture.** The Commission may order PG&E Corporation to divest PG&E through a distribution of PG&E common stock to PG&E Corporation's shareholders (i.e., a spin-off) if the Commission determines that PG&E's affiliation with PG&E Corporation has caused or is likely to cause material harm to PG&E or its ratepayers. PG&E's affiliates will notify their creditors the Commission has the authority to order the divestiture of PG&E under certain circumstances.

We first address the financial condition on which both PG&E and ORA agree. In Condition 4 above, ORA has modified the requirement adopted in the Interim Opinion to give priority to capital needed to meet the utility's obligation to serve to include "or to operate the utility in a prudent and efficient manner." (See Interim Opinion, *slip op.* Ordering Paragraph 17 at p. 48-49.) PG&E has agreed to Overland's revised language of this condition, and we adopt the revision.

The parties disagree on the remaining financial conditions. ORA offers the following rationale for its recommended conditions. It proposes Condition 1, the restrictions on PG&E's non-energy related business lines, because it believes this condition will reduce the risk that PG&E Corporation's nonutility businesses will experience large financial losses by preventing PG&E Corporation from making large investments in business lines outside of its competency. ORA proposes Condition 2, limiting the capitalization of PG&E' affiliates to the amount of PG&E's capitalization, because it believes this condition will reduce the risk that failed diversification will impair PG&E's access to capital by limiting PG&E Corporation's exposure to losses. ORA also believes that this condition reduces the risk that PG&E Corporation will subordinate PG&E's interest to those of the affiliates.

ORA argues that Condition 3, prohibiting PG&E Corporation from issuing long-term debt and preferred stock at the holding company level and from

pledging PG&E common stock as support for debt, is designed to prevent what it calls "upstream" claims on PG&E's cash flow that might impair PG&E's access to capital on reasonable terms. ORA explains that using the common stock of a subsidiary as security for parent company debt is frequently referred to as double leveraging, and believes that double leveraging would reduce PG&E Corporation's consolidated equity ratio. According to ORA, excessive debt leverage increases financial risk in the consolidated holding company system, increasing the risk that PG&E Corporation's financial losses will impair PG&E's access to capital on reasonable terms. ORA also states that excessive leverage at the PG&E Corporation level can harm ratepayers by reducing PG&E's financial flexibility even if PG&E is not required to make excessive dividend payments to PG&E Corporation to support PG&E Corporation debt.

ORA argues that Condition 5, the utility divestiture condition, is intended to prevent PG&E Corporation from entering into loan agreements containing conditions which would prevent or complicate the Commission's ability to order PG&E Corporation to spin-off PG&E, and thus provides the Commission with the remedial power needed to respond to a catastrophic failure of PG&E Corporation's nonutility investments. According to ORA, this condition also provides the Commission with remedial powers needed to respond to material abuses of the affiliate relationship between PG&E and PG&E Corporation.[2]

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[2] ORA also presents several alternative recommendations in the event the Commission rejects its primary recommendations. ORA states that the Commission should preserve its authority to order management to sell stock directly to the public if needed to satisfy the capital structure condition included in the Interim Opinion. ORA also recommends that the Commission adopt a condition limiting long-term and intermediate term debt at the holding company level to 10% of PG&E Corporation's stand-alone capitalization. Finally, ORA agrees that the Utility Divestiture condition could provide some flexibility as to the method used to accomplish the divestiture.

ORA argues that it is necessary to impose these conditions on PG&E because of PG&E's aggressive growth plans and the business risks imposed by electric industry restructuring. ORA argues that PG&E has adopted an aggressive growth strategy for all of its major business lines except PG&E, whereby the capitalization of PG&E Corporation's nonutility subsidiaries may exceed PG&E's capitalization within five years, and PG&E could account for less than one third of PG&E Corporation's total capitalization within 10 years. Moreover, these other affiliates will be more risky than PG&E, since they operate in highly competitive evolving markets. ORA explains that the Commission should adopt the financial conditions even if the probability that PG&E Corporation will experience large losses is low, since the conditions could be viewed as insurance and justified on a risk-adjusted basis by the potential harm avoided.

PG&E opposes these conditions on a number of procedural and substantive grounds. We are persuaded by the argument that ORA's justification for imposing these conditions is not unique to PG&E alone, and therefore decline to adopt the financial decisions for PG&E alone in this proceeding.

Although there is evidence on this record that PG&E Corporation is planning to engage in newly competitive businesses through its affiliates, there is no evidence that the risks are greater for PG&E than they are for any other California investor-owned energy utility. For example, ORA did not review the business plans of any of the other California energy utility holding companies to see how their plans might compare to those of PG&E Corporation. PG&E and PG&E Corporation currently have high credit ratings, and PG&E Corporation is currently focusing its plans on the domestic energy business, and in energy-

related businesses where it has more expertise.[3] The evidence does not show that the business risks flowing from electric industry restructuring are greater for PG&E than they are for other California utilities. The evidence also demonstrates that several companies are pursing a national energy strategy, and only a small number of those are expected to be successful in continuing to pursue such a strategy. As such, we cannot make a finding that PG&E Corporation should be subject to the proposed financial restrictions while other California investor-owned energy utilities are not, because the evidence does not show that PG&E is unique vis-a-vis other California investor-owned energy utilities, and we do not wish to place PG&E at a competitive disadvantage with respect to such other California energy utilities.

PG&E also presented lengthy testimony on the merits, attempting to show why the proposed financial conditions are substantively flawed and should not be adopted. ORA strenuously opposed these arguments, and asserts that its proposed conditions are necessary to assure the utility's access to capital on reasonable terms. For example, PG&E disagrees with ORA's principal contention that holding company financial distress could impair the utility's access to capital, thereby harming ratepayers. PG&E believes that this contention raises unrealistic concerns given that PG&E's capital needs, which will be more modest in the future given that its operations are largely those of a transmission and distribution utility, are likely to be satisfied by internal cash generation, even during a severe economic downturn. Also, PG&E argues that the Interim

[3] Having affiliates in related lines of business could pose even greater cross-subsidization problems unless adequate safeguards exist. We address other proposed conditions below. Additionally, we have adopted our Affiliate Transaction Rules, in part, to address cross-subsidization concerns.

Opinion conditions and other existing safeguards make it virtually impossible for affiliate losses to adversely affect ratepayers. PG&E believes that given the existing conditions in the Interim Opinion, even if PG&E Corporation were to commence a Chapter 11 bankruptcy proceeding, this action would not materially impact PG&E, nor would it require PG&E to commence a separate Chapter 11 proceeding. PG&E maintains that under virtually all conditions, if utility regulation were just and reasonable, the utility would be able to issue debt, preferred stock or common stock directly to the public.

PG&E states that there is no empirical evidence that the financial difficulties of the utility holding companies which have experienced financial difficulty have harmed ratepayers, citing the example of Pacific Enterprises and Southern California Gas Company and several others. PG&E argues that the evidence it presented shows that, even theorizing a case of holding company financial trouble, the credit cost impacts, if any, on the utility would be at most temporary and modest (such as what occurred with Pinnacle West Capital Corporation and its subsidiary utility Arizona Public Service Company.)

PG&E maintains that most states do not find it necessary to impose such restrictive financial conditions. Of the five that do, most are applicable by statute or by a generic rulemaking. PG&E does not believe that the Public Utility Holding Company Act of 1935 (PUHCA) should serve as a model, since the Securities and Exchange Commission (SEC) believes that the investment limitations should be repealed and is relaxing them by rulemaking until Congress can act in this area. PG&E argues that, pending possible repeal, the SEC has the authority to revoke PG&E Corporation's exemption under PUHCA if affiliate losses cause significant harm to ratepayers.

PG&E also argues that the proposed financing conditions are contrary to the policies the Commission has adopted in past holding company decisions. PG&E states that ORA's proposals will likely increase holding company risk, impair shareholder value, and will more likely harm than prevent harm to customers. PG&E suggests that at least four possible benefits could be derived from PG&E's affiliation with PG&E Corporation, including the "halo effect," and diversification, managerial, and economic benefits to the San Francisco Bay area.

ORA argues that the loss of financial flexibility resulting from an inability to issue common stock[4] harms ratepayers in at least three ways: (1) cost saving investments may be deferred or forgone, increasing the utility's cost of providing service and ultimately, the utility's rates; (2) investments needed to maintain the quality of utility service may be deferred or forgone; and (3) the cost of new debt and preferred stock issues may increase because debt and preferred stock investors view common equity as a cushion against the risk of default on their securities. ORA maintains that both Standard & Poor's and Moody's Investor Services agree that holding company financial results can impact the credit quality of the holding company subsidiaries.

ORA believes that failed diversification by Pinnacle West, the parent of Arizona Public Service Company, contributed to the down rating of Arizona Public Service Company's debt. Similarly, ORA disputes PG&E's testimony that

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[4] ORA argues that if PG&E Corporation incurs substantial losses, the price of PG&E Corporation's common stock will decline. If PG&E Corporation's common stock price declines to low levels, PG&E Corporation may be unwilling or unable to sell additional shares of common stock. That, in turn, according to ORA, may cause PG&E Corporation to be unwilling or unable to purchase additional shares of PG&E common stock. ORA concludes that the loss of financial flexibility caused by an inability to market common stock would impair PG&E's access to capital.

the down rating of Southern California Gas Company's debt in 1992, a year in which Pacific Enterprises, its parent, experienced a net loss of $550 million because of failed diversification, is a coincidental fact.

ORA does not believe that the existing safeguards are sufficient to fully protect ratepayers from the risk that financial losses incurred by affiliates will weaken PG&E's credit quality or reduce its financial flexibility because they do not (a) reduce the risk that PG&E Corporation will experience large financial losses; (b) restore PG&E's financial flexibility to the levels that would have existed if the affiliate financial losses had not occurred; or (c) reduce PG&E Corporation's incentive to divert utility cash flow to affiliates experiencing financial losses. Furthermore, ORA states that Arizona, Connecticut, Ohio, Maine, and Wisconsin have limited the holding company's investments in nonutility subsidiaries to a specified percentage of capitalization or equity more restrictive than that which ORA recommends, to protect the utility's access to capital on reasonable terms. Also, the SEC limits the nonutility investments of registered holding companies pursuant to PUHCA.

We do not make findings on this lengthy testimony here, nor do we make a determination as to whether it is appropriate to adopt these proposed or other less strenuous financial conditions for all of California's energy utilities in light of changed circumstances which have evolved as a result of electric industry restructuring and the current growth strategies of the energy utilities' holding companies. For example, we rejected a similar divestiture condition in SDG&E's 1986 Holding Company Formation Decision, D.86-03-090, 20 CPUC2d 660, 682, for the following reasons:

> "As to the retention of authority to order the divestiture of the utility or nonutility subsidiaries, PSD [the predecessor to ORA] is obviously addressing extraordinary circumstances, namely, where a divestiture, either of the utility or some affiliated business, is necessary to preserve the integrity of the utility. We cannot believe that, except in the most dire situation, we would resort to enforcement of such a condition. ...We do not see the necessity of adopting a 'rescue' measure, intended to be invoked only under the most extreme circumstances.
>
> "...We believe the proper time at which to fashion extreme remedies addressing dire straits is when, if ever, they arise. We would want the fullest flexibility allowed under the extant law and, in this regard, find PSD's divestiture condition to be as delimiting as it is empowering. Preferring to leave our options open, we will not adopt PSD's proposal."

At the time of the 1986 proposal, electric industry restructuring had not occurred. Although we have decided other holding company or energy utility merger decisions after the advent of electric industry restructuring, we did not examine a comprehensive set of financial conditions similar to what ORA proposes here in those cases, nor have we recently examined the appropriateness of these or similar conditions to be applied to all of the energy utilities within our jurisdiction in a uniform manner. In our Preferred Policy Decision which addressed electric industry restructuring, D.95-12-063, as modified by D.96-01-009, *slip op.* at pp. 185-187, we discussed the Commission's role during the transition to electric industry restructuring and beyond. We stated we would continue to pursue the public interest by monitoring the transition to the restructured industry.

Moreover, under the PUHCA, 15 U.S.C. §§ 79 et seq., in order to obtain an exemption from the Act, a Commission such as ours, which has jurisdiction over a public utility company that is an associate or affiliate company of a foreign utility company, must certify to the SEC that we have the authority and resources to protect ratepayers subject to our jurisdiction and that we intend to exercise our

authority. The Commission may impose additional conditions to the SEC on a prospective basis. (See 15 U.S.C. § 79z-5b(a)(2).) We have conditioned our current certification on the utility's compliance with the requirements set forth in D.95-12-007, 62 CPUC2d 517, 529-532. However, we issued this decision prior to the enactment and implementation of Assembly Bill 1890 concerning electric industry restructuring, and before the recent turmoil in the overseas financial markets. It may therefore be appropriate that we examine whether it is necessary to impose additional financial conditions on the energy utilities with respect to their holding company operations in order for us to meet our obligations in providing such certification.

We therefore provide that parties who believe it necessary to raise the need for further financial conditions on all electric and gas utilities within our jurisdiction, either as proposed by ORA in this proceeding or other appropriate financial conditions, may raise this issue when the Commission reviews the Affiliate Transaction Rules as provided for in D.97-12-088, *slip op.* at p. 99, Ordering Paragraph 10. In D.97-12-088, we directed Commission staff to prepare for our consideration an Order Instituting Rulemaking (OIR)/Order Instituting Investigation or other appropriate procedural vehicle to review the Affiliate Transaction Rules. We further directed that this document should be prepared for the Commission's consideration no later than by December 31, 2000, and sooner if conditions warrant.

We emphasize that we do not here determine whether it is necessary to impose any additional conditions, let alone the specific conditions proposed by ORA. For example, financial conditions more limited in scope may more appropriately address our SEC certification obligations. However, we believe that it may be appropriate in the future to explore whether additional uniform

conditions, which would balance both ratepayer and shareholder concerns, are necessary at this juncture.

The utilities may argue that the Commission has approved their holding company applications, and therefore this Commission does not have the jurisdiction to undertake such an inquiry.[5] However, under Pub. Util. Code § 1708, the Commission may at any time, after providing notice and an opportunity to be heard, rescind, alter, or amend any order or decision made by it.

In *Re Southern California Edison Company* (Edison), D.90-09-088, 37 CPUC2d 488, 568, the Commission stated that it could reconsider Edison's holding company decision at any time if conditions warranted it.

> "Our decision not to impose a prohibition on Edison's ownership of QFs, however, does not mean that this Commission is without the jurisdiction or the tools to act on direct and compelling evidence of self-dealing. We remind Edison that its current corporate structure was the direct result of a Commission decision approving the holding company. We can and are prepared to reconsider that decision at any time when facts warrant such a change."

Therefore, the Commission has jurisdiction to proceed with the above inquiry, although it declines to do so in this decision.

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[5] For instance, at oral argument, PG&E was noncommittal on this issue. However, in its opening brief at p. 30, PG&E agrees with our conclusion that we may modify past holding company decisions: "Indeed, as a last resort, the Commission may modify its holding company decision and impose additional or revised conditions under Pub. Util. Code Section 1708."

7. Conditions Recommended To Maintain the Commission's Ability to Respond to Changing Circumstances

7.1. Assignment of Business Opportunities

ORA proposes that the Commission adopt the following condition:

> **Assignment of Business Opportunities.** Any business activities the Commission finds to be necessary, reasonably incidental or economically appropriate to utility operations will remain with PG&E.

ORA believes that PG&E Corporation management has an inherent conflict of interest in the assignment of business opportunities between PG&E and its nonregulated affiliates. According to ORA, its proposed condition is designed to ensure that revenue streams that are by-products of PG&E's ratepayer-supported utility system are used to reduce the utility cost of service. ORA maintains that this proposed condition does not require any new business opportunities to be assigned to the utility. Rather, the condition preserves the Commission's ability to review PG&E Corporation's assignments because PG&E Corporation has a conflict of interest when making such assignments. PG&E argues that the Commission should reject this proposed condition because it is partially redundant and partially inconsistent with current regulation.

We do not adopt this proposed condition. Rule VII of the Affiliate Transaction Rules, significantly modified in D.98-08-035, provides detailed rules and procedures for utilities to follow to offer nontariffed products and services, including an Advice Letter process requiring a detailed showing. Rule VII makes clear that a utility must still continue to comply fully with Pub. Util Code § 851 when necessary or useful utility property is sold, leased, assigned, mortgaged, disposed of, or otherwise encumbered as part of a nontariffed product or service offering by the utility. Rule VII.A also provides that a utility shall not offer nontariffed products and services unless the product or service offering meets

the narrowly tailored conditions specified in Rule VII. The Commission is also reviewing PG&E's application to adopt a revenue sharing mechanism for nontariffed products and services in A.98-05-007. We do not believe that an additional layer of regulation as proposed by ORA is necessary at this time, and therefore we do not adopt this proposed condition.

7.2. Conformed Agreements

ORA proposes that the Commission adopt the following condition:

> **Agreements with Affiliates to Conform with Commission Findings.** All nontariff transactions between PG&E and affiliates shall be subject to written "affiliate agreements." Affiliate agreements, by definition, are not the product of arm's-length negotiation. All PG&E affiliate agreements shall include a "regulatory out" clause allowing PG&E to terminate or modify the contract to conform with Commission findings if the Commission determines the terms of the agreement are unfair to PG&E or its ratepayers. PG&E will cause its affiliate agreements to be terminated or modified consistent with Commission findings.

ORA argues that the common ownership of PG&E and its affiliates creates an incentive for PG&E Corporation to force PG&E to enter into affiliate agreements which are unfair to PG&E. ORA states that its proposed condition provides the Commission with authority to order PG&E to modify the terms of agreements with affiliates that the Commission finds to be unfair to PG&E or its ratepayers, and is superior to disallowing unreasonable costs incurred by PG&E, since that would create a drain on PG&E's finances. ORA initially included all transactions within the scope of its recommended condition but modified it in its reply brief to address only nontariffed transactions.

PG&E argues that contracts are designed to create stability in relationships, not only between PG&E and its affiliates, but also third parties such as joint venturers, etc. PG&E argues that it is impossible to predict how inserting a regulatory out clause in each contract could affect legal rights and responsibilities, or restrict business and financing options. PG&E argues that the Commission has multiple tools available to ensure reasonable contracts with affiliates.

The Commission has several tools available to protect ratepayers from unreasonable contracts, including but not limited to disallowing unreasonable costs associated with performing the contract. Contrary to ORA's assertions, we do not concede here that our authority is limited to disallowances, or that the Commission cannot implement the remedy suggested by ORA without our adopting the proposed condition. We believe that existing regulation should provide PG&E with the incentive to enter into reasonable contracts, and do not adopt this recommended condition at this time. However, if it were to come to our attention that PG&E were violating the Affiliate Transaction Rules in this regard, or has otherwise been a party to a contract which is unfair to ratepayers, we would take the action necessary to protect ratepayers.

7.3. Audit Recommendation

ORA proposes that the Commission adopt the following condition:

> **Audit.** Within three to six years after the date of this Decision, the Commission will conduct an audit of PG&E Corporation, PG&E, and controlled affiliates, at the expense of shareholders of PG&E Corporation, to determine compliance with the conditions adopted in this proceeding, PG&E Corporation's Policies and Guidelines for Affiliate Transactions, and other applicable Commission orders and regulations. (Verification Audit.) PG&E, PG&E Corporation, and all controlled affiliates

shall retain until the completion of the verification audit (i) all internal and external correspondence between PG&E and affiliates; (ii) to the extent prepared in the normal course of business, desk calendars, meeting summaries, phone call summaries, or logs and E-mail correspondence between PG&E officers and department heads and affiliates; and (iii) marketing materials, proposals to customers, and business and strategic plans.

ORA argues that the scope of audits required by the Affiliate Transaction Rules may be narrower than the scope of this proposed audit, and therefore that its audit proposal is necessary to ensure compliance with this decision. ORA also notes that the audits conducted pursuant to the Affiliate Transaction Rules will be conducted by auditors selected by PG&E, whereas under ORA's proposal, the Commission would select the auditor. Additionally, ORA requests that the Commission provide the auditors who conduct the audit (pursuant to our direction in the Affiliate Transaction Rules) with explicit direction concerning review of Rule V.E transactions.

PG&E opposes this recommended condition as redundant, because the utilities must perform annual audits under the Affiliate Transaction Rules. Although PG&E recognizes that these affiliate audits will not specifically test for compliance with any utility's holding company formation conditions or internal procedures, such issues, according to PG&E, should be part of any auditor's overall effort to understand the context in which the affiliate transactions occur. PG&E states that this condition is unnecessary because the Commission has the power to order a special audit of PG&E's affiliate transactions at any time without adopting this condition. PG&E believes that ORA seeks this condition because it wants to "audit the independent auditors" chosen by PG&E to conduct the audit required by the Affiliate Transaction Rules. PG&E also believes that

ORA's request on detailed instructions to the auditors conducting audits pursuant to the Affiliate Transaction Rules should be denied for similar reasons.

The benefit of ORA's current audit has been somewhat eclipsed by the passage of time and intervening circumstances. The audit period covered affiliate transactions from 1994 to 1996. After the conclusion of the audit period, (1) PG&E changed its corporate structure to a holding company structure; (2) the Commission adopted the Affiliate Transaction Rules, which cover some, but not all, of PG&E's affiliates; and (3) PG&E instituted procedures to attempt compliance with these rules.[6] In its Reply Brief at p. 58, PG&E recognizes that it has recently implemented new procedures in order to improve its internal controls over affiliate transactions.

> "Although the overall system of internal controls was adequate to prevent financially material harm to the Company or ratepayers during the audit period, Pacific Gas and Electric Company recognized that its accounting system, overall internal control and affiliate transaction procedures needed to improve in order to meet the challenges of a changing business environment and new Commission requirements for tracking, pricing and reporting affiliate transactions. Pacific Gas and Electric Company has implemented many changes and has plans for both near term and long term enhancements. Pacific Gas and Electric Company has also made staffing changes associated with the formation of the holding company, and designed procedures for more efficiently handling affiliate transactions and meeting regulatory requirements."

[6] PG&E's compliance plan concerning the Affiliate Transaction Rules is the subject of separate Advice Letters and we do not reach any conclusion on PG&E's compliance plan in this decision.

PG&E has used the defense of the passage of time and intervening events to oppose many of the conditions proposed by ORA. Indeed, ORA has withdrawn some of its proposed conditions based on the Commission's passage of the Affiliate Transaction Rules and PG&E's formation of a holding company structure, and we have been judicious in adopting further conditions in this decision in light of these, and other, intervening events. However, PG&E's statements that the holding company structure and attendant safeguards which it has in place are sufficient to protect ratepayers have, as yet, not been tested. This proposed audit condition will give the Commission an opportunity to verify if PG&E's implementation of its new corporate structure, and the conditions adopted in this decision as well as other Commission decisions, are sufficient to protect ratepayers.

Our Interim Decision is consistent with this outcome. In that decision, we expressly stated that our granting the motion for the ORA audit which has lead to this decision "does not preclude the parties from raising the issue of whether another audit might be appropriate at some point after the holding company is formed. The parties are free to address this issue in Phase 2." (Interim Opinion, *slip op*. at p. 20.)

We do not believe that the audits we have ordered in the Affiliate Transaction proceeding make this audit redundant. The purpose of the audits ordered in the Affiliate Transaction proceeding is to verify that the utility is in compliance with the Affiliate Transaction Rules. The purpose of this particular audit is to verify compliance with the conditions we have adopted as part of our grant of authority for PG&E to form a holding company structure, as well as with other Commission decisions and orders. Of course, that type of audit will necessarily require an audit of certain affiliate transactions, and there might be some overlap with the transactions audited for the Affiliate Transaction

proceeding. However, the audits will not be redundant. For instance, not all of PG&E's affiliates are covered by the Affiliate Transaction Rules. The holding company is also not covered unless it is providing the products or services delineated in Rule II.B. Although we anticipate that the affiliate audit should audit holding company transactions to be sure that the holding company is not being used to circumvent the Affiliate Transaction Rules, the depth and scope of that audit might differ from the verification audit we propose today. Verification of the efficacy of and PG&E Corporation's implementation of its Policies and Guidelines for Affiliate Transactions also could not happen in today's decision, because PG&E has not yet submitted these policies to the Commission in final form for approval. (See Section 7.5 below.)

We also directed a verification audit in D.98-03-073, the decision approving the merger of Pacific Enterprises and Enova Corporation, even though both of these utilities are subject to the Affiliate Transaction Rules. PG&E distinguishes D.98-03-073 on the ground that the audit was part of the mitigation measures we ordered before approving the merger. PG&E also argues that there is no indication that the parties objected thereto, and that we cannot order a further audit over its objections. PG&E also cites the *Roseville Holding Co. Decision* in support of this proposition.

We disagree with PG&E. Although it is unclear from D.98-03-078 whether the parties objected to the audit, PG&E's objection here does not mean we cannot order a further verification audit if we believe it is necessary to ensure compliance and to protect the public interest. We recognize that in the *Roseville Holding Co. Decision, slip op.* at p. 26, we deferred decision on whether there should be a verification audit until a later point in time, because the parties

disagreed as to its necessity.[7] However, this decision does not stand for the proposition that we cannot direct an outcome if a party objects thereto.

As stated above, PG&E's response to many of ORA's proposed recommendations is that that the passage of time, P&GE's implementation of a holding company structure, and the Affiliate Transaction Rules, obviate the need for the conditions. While we adopt this position in some instances, we need timely verification of PG&E's compliance with our conditions with respect to all of its affiliates. Although there may be some overlap between the Affiliate Transaction audits and this audit, the auditors hired as a result of this decision should review the earlier audits, which should streamline the process. We place responsibility for the audit with our Energy Division, instead of ORA. Energy Division should consult with PG&E and ORA before selecting the auditor

We therefore adopt as a condition that within three years after the date of this decision, the Energy Division will conduct an audit of PG&E Corporation, PG&E, and controlled affiliates, at the expense of shareholders of PG&E Corporation, to determine compliance with the conditions adopted in this proceeding, PG&E Corporation's Policies and Guidelines for Affiliate Transactions, and other applicable Commission orders and regulations, as more specifically described in the Ordering Paragraphs of this decision. (Verification Audit.) PG&E, PG&E Corporation, and all controlled affiliates shall retain until the completion of the verification audit (i) all internal and external correspondence between PG&E and affiliates; (ii) to the extent prepared in the normal course of business, desk calendars, meeting summaries, phone call

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[7] In the *Roseville Holding Co. Decision*, as here, we decided that the parent, and not Roseville, should pay for an outside auditor, if an outside audit became necessary in that case.

summaries, or logs and E-mail correspondence between PG&E officers and department heads and affiliates; and (iii) marketing materials, proposals to customers, and business and strategic plans. (See *SDG&E Holding Co. Decision*, 62 CPUC2d at 650, Ordering Paragraph 4.)

We deny ORA's request that the Commission provide the auditors of audits conducted pursuant to the Affiliate Transaction Rules with explicit direction concerning review of Rule V.E transactions. PG&E states that it has indicated how it will interpret the rules in its publicly filed compliance plan, and has been working with auditors it has selected and with ORA to arrive at reports that meet regulatory requirements. We do not wish to resolve detailed questions in this proceeding about the scope or content of the audit mandated by the Affiliate Transaction Rules, which are applicable to many energy utilities, not just PG&E. If ORA or any other party requests that the Commission modify or clarify the Affiliate Transaction Rules in this regard, it should do so by an appropriate procedure in the Affiliate Transaction proceeding.

7.4. Acceptance of Affiliate Transaction Rules As Holding Company Conditions

ORA proposes that the Commission adopt the following condition:

> **Affiliate Transaction Rules Accepted as Holding Company Conditions.** PG&E, PG&E Corporation and PG&E's affiliates hereby grant the Commission the authority to enforce all of the Affiliate Transaction Rules adopted in D.97-12-088 and this Decision, even if the rules are subsequently determined to be invalid. In the event that some portion of the Affiliate Transaction Rules are determined to be invalid, PG&E, PG&E Corporation and PG&E's affiliates agree to continue to abide by the portion of the Affiliate Transaction Rules determined to be invalid, unless otherwise directed to do so by the Commission.

ORA states that it has relied upon the existence and applicability of the Affiliate Transaction Rules to withdraw several conditions recommended in the Audit Report. ORA believes that the holding company conditions are less susceptible to challenge than the Affiliate Transaction Rules because the utility and affiliates agree to abide by the holding company conditions in exchange for regulatory approval of holding company formation. However, according to ORA, the Affiliate Transaction Rules have not been tested. Replacing recommended conditions with Affiliate Transaction Rules does not protect ratepayers if the Affiliate Transaction Rules are subsequently determined to be unenforceable. Therefore, ORA recommends that PG&E be required to accept all of the Affiliate Transaction Rules adopted in D.97-12-088, as modified by D.98-08-035, as holding company conditions which the Commission has the authority to enforce, even if parts of the Affiliate Transaction Rules themselves are subsequently determined to be invalid by a court.

PG&E opposes this condition on the grounds that it should not have to comply with a rule later found to be illegal by the courts, and that incorporating the Affiliate Transaction Rules wholesale into holding company conditions could be procedurally unwieldy and make it harder for Commission policy to evolve.

We do not adopt ORA's recommendation here. PG&E must comply with the Affiliate Transaction Rules under the terms of the decisions which adopted the rules. Adding a condition that PG&E comply with the Affiliate Transaction Rules in this decision would not enhance that requirement. In the unlikely event that a court of last resort were to find a portion of the Affiliate Transaction Rules invalid, we would address that event if and when it occurs. For instance, we could decide to delete or modify that Rule in order to comply with a court's ruling, or take other action appropriate to the situation. We also

recognize that the Affiliate Transaction Rules have a savings clause which preserves the validity of the remaining Rules if a section or portion of the Rules were determined to be invalid. Thus, in the unlikely event a court of last resort were to hold a section of the Rules invalid, the validity of the remaining Rules would not be affected.[8]

7.5. Parent Company Policies and Guidelines for Affiliate Company Transactions

Ordering Paragraph 6 of the Interim Opinion at p. 46 requires PG&E to implement its proposed Policy and Guidelines for Affiliate Company Transactions as modified by the Commission in Phase 1 of this proceeding. The Interim Opinion further requires that the Commission review these guidelines in Phase 2. PG&E issued its parent company's Affiliate Company Transactions Procedures in August 1997. ORA reviewed these guidelines and made many recommendations for revision.

PG&E Corporation's policy and guidelines will incorporate the conditions which the Commission adopts in this decision, as well as the Interim Opinion's conditions. Therefore, PG&E and ORA agree that the most efficient approach is to address these policies and procedures after the Commission addresses ORA's proposals in this decision. The parties do not object to PG&E filing these policies and procedures as a compliance filing, provided they preserve their ability to bring disputes to the Commission.

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[8] Rule II.I of the Affiliate Transaction Rules states: "These Rules should be interpreted broadly, to effectuate our stated objectives of fostering competition and protecting consumer interests. If any provision of these Rules, or the application thereof to any person, company, or circumstance, is held invalid, the remainder of the Rules, or the application of such provision to other persons, companies, or circumstances, shall not be affected thereby."

We agree that it is most efficient for PG&E Corporation to finalize its policies and procedures after we have ruled on the broader proposed conditions, because the parties' disputes surrounding the policies and procedures would likely mirror the disputes presented in Phase 2, if PG&E Corporation were to finalize its policies and procedures prior to our rendering this decision. We therefore direct that, no later than 90 days after the effective date of this proceeding, PG&E Corporation shall implement its proposed parent company Policy and Guidelines for Affiliate Company Transactions as modified by (1) the Commission in the Interim Opinion and this decision; (2) the Affiliate Transaction Rules, adopted in D.97-12-088, as modified by D.98-08-035; and (3) other pertinent Commission decisions. PG&E shall initially make this filing as an Advice Letter, which PG&E should serve on the service list of this proceeding. If there are disputes, they can be dealt with in the Advice Letter process, as determined by the Energy Division, or a party may petition the Commission to reopen this proceeding for such limited purpose. We anticipate that the parties will be able to reach agreement on these procedures, and direct PG&E to meet and confer with ORA before filing the Advice Letter.

8. Conditions Recommended To Achieve Appropriate Separation Between the Utility and Affiliates

8.1. Restriction on Dual Officers and Directors

ORA proposes that the Commission adopt the following condition:

> **Restriction on Dual Officers and Directors.** No more than three PG&E officers may also serve as officers of PG&E corporation or nonutility affiliates. No more than three members of PG&E's Board of Directors can serve on PG&E Corporation's Board of Directors.

Some PG&E officers and directors have dual assignments and serve, for example, both the utility and either the holding company or a nonregulated affiliate. ORA argues that this dual assignment may result in harm to the ratepayers if and when the interests of the affiliate or company as a whole conflict with the interests of the utility alone. ORA believes that dual PG&E and PG&E Corporation officers and directors have a fiduciary duty to subordinate the interests of PG&E if doing so increases PG&E Corporation's shareholder value. According to ORA, PG&E Corporation has an economic incentive to subordinate the interests of PG&E, and the increasing size of PG&E Corporation's other business units will increase both the incentive and the opportunity to subordinate PG&E's interests to the interests of its affiliates. Finally, ORA argues that shared officers and directors will make it more difficult to prevent the sharing of improper or confidential information. ORA therefore recommends the above condition in order to address these problems.

PG&E does not believe the Commission should adopt this proposed condition. PG&E disagrees that the dual status of some of its officers and directors will harm the utility's interests. PG&E asserts that the utility's financial performance is, and is likely to be for the foreseeable future, the primary basis for the value of the parent company stock. PG&E points out that the Audit Report does not provide evidence showing that dual officers or directors neglect their duties at the utility in favor of other business units. PG&E further argues that the Commission's Affiliate Transaction Rules, D.97-12-088, as modified by D.98-08 035, allow limited sharing of officers and directors between the utility and the holding company.

We decline to adopt ORA's recommended condition at this time. While it may be true that the growth of the nonutility portion of the company, relative to the utility, may become problematical and require review by the

Commission in the future, we do not believe that this restriction on dual officers and directors is appropriate. This is so, because we have recently adopted Affiliate Transaction Rules which address the sharing of directors and officers, and believe it is inappropriate based upon this record to superimpose another set of restrictions at this time, before we know whether or not the current rules provide for adequate separation.

8.2. Employee Benefit Plans

ORA proposes that the Commission adopt the following condition:

> **Separation of Employment and Employee Benefit Plans.** To the extent permitted by law, all transfers of employees between PG&E and affiliates shall be implemented as a resignation from one company and the acceptance of employment from the other company on the same terms as customarily apply to resignations to accept employment with a nonaffiliate. Employees of PG&E's affiliates will not participate in PG&E's employee benefit plans. PG&E employees will not participate in the benefit plans of PG&E Corporation or other affiliates.

PG&E and its affiliates do not share participation in their respective benefit plans. However, PG&E Corporation policy is to allow its employees to transfer within the PG&E Corporation, and to recognize service across lines of business within the entire company for benefits purposes. According to PG&E's testimony, "this PG&E Corporation policy provides that service credit is recognized across subsidiaries and the holding company for purposes of health, welfare, and retirement benefit plans....The intent of the employment and benefit policies within PG&E Corporation is to make employees indifferent to transfer between the holding company and its lines of business from a benefits perspective." (Exhibit 201 at p. 16-2.)

ORA recommends this condition in order to discourage the transfer of experienced utility managers to affiliates, and to reduce the risks of cross-subsidization and unreported transfers of confidential utility information to affiliates by prohibiting PG&E and its affiliates from jointly employing the same employee. In the hearings, ORA's witness narrowed the proposed condition to (1) incorporate and permit PG&E's policy of grandfathering participation in utility employee benefit plans for utility employees transferring to PG&E Corporation before December 31, 1999, until or unless such employee subsequently moves to another unregulated affiliate, and (b) permit PG&E Corporation to recognize continuity of service and other coordination to the extent required by law (i.e., by the federal Employee Retirement Income Security Act).

PG&E argues that the record does not show that this condition is necessary or would be effective. PG&E also argues that the Commission's Affiliate Transaction Rules provide several disincentives for employee transfers, and ORA has not shown that the safeguards implemented in the Affiliate Transaction Rules are insufficient to protect ratepayers and competitive markets.

We decline to adopt ORA's recommended condition at this time. The Affiliate Transaction Rules impose costs on affiliates that receive employees transferred from the utility. The Rules also impose several restrictions on transferring confidential information. We have recently adopted the Affiliate Transaction Rules, and have not yet received the results of the audit performed pursuant to those Rules. We therefore do not believe the record here supports superimposing another set of restrictions at this time, before we know whether or not the current Rules provide for adequate separation and address our cross-subsidization and confidentiality concerns.

8.3. Compensation for the "Benefits of Association"

ORA proposes that the Commission adopt the following condition:

> **Compensation for the Benefits of Association and Risk of Self-Dealing.** PG&E's affiliates selling products and services within PG&E's service territory will make payments to compensate PG&E and its ratepayers for: (1) the benefits accruing to the affiliate from its association with the local franchised distribution utility; and (2) the risk PG&E's cost of service will increase as a result of preferential treatment given to affiliates by PG&E. The payment will reflect a Commission determined percentage of the revenues received by the affiliate from the sale of products and services within PG&E's service territory. The Commission will determine the percentage of revenues to be paid to PG&E in PG&E's General Rate Cases.

ORA asserts that the affiliates within PG&E's service territory should compensate PG&E for the benefits of association accruing to them, and for the alleged preferential treatment the utility may give these affiliates. According to ORA, this benefit is separate from any benefit which may accrue through name recognition, and includes the benefits that affiliates within PG&E's service territory may receive from their association with "the host monopoly distribution services provider." (ORA Opening Brief at p. 89.) According to ORA, the benefits of association accruing to PG&E Energy Services within PG&E's service territory are largely a product of electric industry restructuring and PG&E's ratepayer-funded utility infrastructure. ORA does not specify the amount of compensation here, but says it should be determined by the Commission during PG&E general rate cases, after PG&E has conducted studies to determine if any benefits actually exist and the extent of these benefits.

PG&E disagrees with ORA and believes that the Commission's Affiliate Transaction Rules address separation issues between the utility and the affiliate, and that it is not appropriate for ORA to seek a modification of those Rules in this proceeding.

We do not adopt this condition at this time. The justification for ORA's proposed condition results from the conditions imposed by electric industry restructuring, and is not peculiar to PG&E alone. We have adopted rules addressing separation between the utility and certain affiliates in our Affiliate Transaction proceeding. If ORA believes those Rules are inadequate, it may request that we modify them in that proceeding for all utilities. Also, we do not rule out adopting this, or a similar recommendation, in the event PG&E, or any other utility, is found to have violated our Affiliate Transaction Rules regarding separation. However, we disagree with ORA that we need to adopt this condition as a placeholder to preserve our ability to impose it in the future should conditions warrant.

8.4. Transfer Pricing and 10% Adder

ORA proposes that the Commission adopt the following condition:

> **Transfer Pricing.** All transfers of assets, goods, services, confidential utility information, and other items of value from PG&E to affiliates will be priced at the higher of fully allocated cost or fair market value. Fully allocated cost will include a 10% premium on fully allocated cost excluding the premium. All transfers of assets, goods, services and items of value from affiliates to PG&E will be priced at the lower of fully allocated cost or fair market value. The 10% premium on fully allocated cost will not apply to transfers from affiliates to PG&E.

ORA's recommended condition contains two components. The first is that all transfers of assets, goods, and services from PG&E to affiliates should be priced at the higher of fully allocated cost or fair market value, and that all such transfers between affiliate and PG&E be priced at the lower of fully allocated cost or fair market value. ORA notes that its recommendation here is similar to the transfer pricing guidelines which the Commission adopted in its recent approval of the merger between Pacific Enterprises and Enova Corporation in D.98-03-073. ORA's recommendations are not consistent with the Affiliate Transaction Rules. However, ORA argues that the Commission should adopt its recommendations for transactions between the utility and holding company, which are not covered by the Affiliate Transaction Rules, as the Commission did in D.98-03-073.

ORA also recommends a 10% premium on the fully loaded cost of the utility service charged to the affiliate. This is to (1) compensate the utility for developing and maintaining the capacity to provide these services; and (2) adjust for anticipated accounting errors which the utility may make when it charges the affiliates for its services. ORA believes that the 5% markup on direct labor costs is not sufficient to protect ratepayers from the high error rate that Overland discovered in its audit.

PG&E believes that the Commission should not deviate from the transfer pricing rules set forth in the Affiliate Transaction decision because to do so would promote confusion. PG&E also opposes the imposition of a 10% adder, stating that it would cause PG&E to pay much more for these services than other energy utilities who are only bound by the Affiliate Transaction Rules. PG&E also believes that the claims of inaccuracy in the audit are insufficient to justify the imposition of this condition, and ORA has not demonstrated that in light of

all the changes PG&E has made since the audit the errors which occurred are likely to be repeated.

Rule V.H of the Affiliate Transaction Rules sets forth transfer pricing rules for affiliates covered by the Rules. Rule V.H was developed, for the most part, through consensus of the parties in the Affiliate Transaction proceeding in order to prevent cross-subsidization. Because we have not yet had the first audit pursuant to the Affiliate Transaction Rules, we do not have evidence that those adopted Rules will fail in this purpose, and therefore decline to modify them in this decision at this time, based on the current record. However, parties may request modification of our Affiliate Transaction Rules if circumstances so warrant.

Further, PG&E's transfer pricing rules for transactions between the utility and holding company are set forth in its proposed Policy and Guidelines for Affiliate Company Transactions, which is not yet adopted by the Commission. (See Section 7.5.) We will review PG&E's proposed transfer pricing rules for transactions between the utility and holding company in that context. Since we do not address transfer pricing rules between the utility and holding company in this decision, we do not reject ORA's proposal in this context.

We also do not adopt ORA's recommended 10% adder on transfer pricing. Our Affiliate Transaction Rules impose a 5% adder on certain direct labor costs. (See Rule V.H.5.) They further provide for a 10% or 15% adder on direct labor costs associated with the temporary assignment of personnel not involved in marketing. (See Rule V.G.2.e.i.) Although the Audit Report demonstrated that PG&E has made some accounting errors, we address these errors through the further conditions we impose on internal controls. Also, the

audit period occurred before PG&E's implementation of our Affiliate Transaction Rules. ORA has not demonstrated to our satisfaction that the errors made in the documentation of the utility's transactions with its affiliates are large and systematic enough to warrant imposing the 10% adder that ORA proposes, especially when the other utilities are not subject to this condition.

8.5. Pricing Studies

ORA proposes that the Commission adopt the following condition:

> **Pricing Studies.** PG&E shall prepare an annual study of the market value of all assets, goods and non-tariffed services it provides to affiliates, including corporate services and transfers of confidential utility information. Immaterial transactions may be excluded from the study except that the combined total fully allocated cost of all transactions excluded from the study cannot exceed $100,000. PG&E shall be required to demonstrate it has determined fair market value through a method appropriate to the asset, good, or non-tariffed service. Such methods may include independent appraisals using the market or income approach; prices charged by alternative service providers, e.g., outsourcing; the application of hourly billing rates charged by contractors or consulting firms for similar work; or a combination of methods adequately documented for audit purposes. The pricing studies will include an estimate of the affiliates' cost of obtaining equivalent assets, goods or services internally or from a nonaffiliated party. PG&E's affiliates shall provide PG&E with all information necessary to prepare the pricing study.

ORA argues that these studies are needed to monitor and assess the transfer pricing rules adopted in our Affiliate Transaction Rules, and to require PG&E "to identify the nature of the services it provides to affiliates and track the cost of the services by type of service." (ORA Opening Brief at p. 103.) ORA also argues it is similar to the condition the Commission adopted in the *Roseville Telephone Co. Decision*. PG&E does not believe the evidence supports this

recommendation, and that it would be unfair to impose this requirement on it to the exclusion of the other utilities.

Rule IV.F of the Affiliate Transaction Rules requires the utility to maintain records of all tariffed and nontariffed transactions with its affiliates. Rule VI.C requires an annual audit to verify compliance with our Rules. Our Affiliate Reporting Requirement Rules (see 48 CPUC2d 163) also require, inter alia, that the utility calculate transfer pricing. If the requirements of these Rules are unsatisfactory, the Commission may consider additional requirements. Also, any party may request modification of the Affiliate Transaction Rules or our Reporting Requirement Rules if conditions warrant. We therefore do not adopt ORA's proposed condition solely for PG&E at this time.[9]

8.6. Prohibition Against Affiliates Implying Favorable Treatment

ORA proposes that the Commission adopt the following condition:

> **Prohibition Against Implying Favorable Treatment.** PG&E Corporation, PG&E and their affiliates are prohibited from implying the purchase of products from affiliates will result in favorable treatment from PG&E in utility transactions.

Rule V.F.2 of the Affiliate Transaction Rules prevents the utilities from stating or implying that, as a result of the affiliation with the utility, its affiliates will receive any different treatment from other service providers.

[9] The condition we adopted for Roseville Telephone Company is not the same condition that ORA proposes here. In D.96-07-059, the Commission required that for utility transfers to or from the affiliate that involve more than $100,000, Roseville demonstrate that it has determined fair market value through a method appropriate to the asset, good, or non-tariffed service. The condition sets forth various available methods, including independent appraisals, published closing prices, market surveys, or a combination of methods adequately documented for audit purposes. Moreover, the parties agreed to this condition. (See D.96-07-059, *slip op.* at p. 36 and 58, Ordering Paragraph 27.)

Further, the Affiliate Transaction Rules provide that the utility shall not use the holding company as a vehicle to circumvent the Rules. ORA wants the Commission to prevent the affiliates themselves from making such claims or implications, and believes that this recommendation is not addressed by existing rules.

PG&E argues that the Commission has, in fact, intervened when the affiliates violated the Rules. For example, PG&E argues that the Commission imposed a penalty on PG&E for its affiliate's violation of Rule V.F.1, the requirement that the affiliate using the utility's name and logo to do so in conjunction with a specified disclaimer. Further, PG&E argues that if an affiliate falsely advertises, it could be subject to prosecution in California under, inter alia, § 17200 and § 17500 of the Business and Professions Code.

In the Affiliate Transaction proceeding, inter alia, we addressed customer confusion about the difference between the utility and its affiliate, coupled with the ability of the affiliates to use this confusion to capture market share. ORA has not demonstrated on this record that the rules promulgated in D.97-12-088, as modified by D.98-08-035, are inadequate to address the problems raised by ORA at this time. If ORA or another party believes the Rules are inadequate, it should request modification of the Affiliate Transaction Rules.

8.7. Record of Joint Negotiations

ORA proposes that the Commission adopt the following condition:

> **Record of Joint Negotiations.** If (1) affiliate personnel (or representatives) attend or participate in negotiations between PG&E and nonaffiliates, or (2) PG&E personnel (or representative) attend or participate in negotiations between an affiliate and a nonaffilaite, or (3) PG&E and an affiliate jointly negotiate with a nonaffiliate; the utility shall create a record of the negotiations and make the record available to the

> Commission on request. The record shall contain the following information: (1) the date of the negotiation; (2) the name and employer of each person attending or participating in the negotiation; (3) the subject matter of the negotiation; (4) all non-public utility information made available to the affiliate during or in connection with the negotiation; (5) the specific Affiliate Transaction Rules relied upon to permit the exchange of non-public information and the factual basis for determining the exchange of information was permitted under the rule; (6) a description of all other transactions, if any, entered into by the utility or the affiliate with the nonaffiliated participant as a result of the negotiation; (7) a description of all other transactions entered into by the utility and the nonaffiliated participant within 90 days of the negotiation; and (8) the title of all documents created in conjunction with the negotiations including but not limited to written proposals, correspondence, agendas and notes. The utility will maintain a copy of all documents created in conjunction with the negotiations for at least three years.

ORA proposes this condition to resolve what it perceives as weaknesses in the reporting requirements of our Affiliate Transaction Rules. For instance, ORA does not believe that Rule IV.F of the Rules, which requires that a utility maintain contemporaneous records documenting all tariffed and nontariffed transactions with its affiliates, is duplicative with its proposal because its proposed condition would require documentation of meetings which did not result in a transaction and contains detailed documentation requirements.

PG&E asserts that ORA's condition duplicates Rule IV.F of the Affiliate Transaction Rules. PG&E interprets Rule IV.F to require that "detailed records of any affiliate transaction - whether it is a joint negotiation or any type of transaction - be maintained by the utility, and for such records to be available to the Commission (or any other party) upon request and 3 days notice." (PG&E Opening Brief at p. 98.) PG&E also points out that its procedures already include

record keeping that will result in a trail leading to joint negotiations, whether or not they are consummated. (PG&E Reply Brief at p. 52.)

Rule IV.F states in relevant part:

> **Record-Keeping:** A utility shall maintain contemporaneous records documenting all tariffed and nontariffed transactions with its affiliates, including but not limited to, all waivers of tariff or contract provisions and all discounts. A utility shall maintain such records for a minimum of three years and longer if this Commission or another government agency so requires. The utility shall maintain such records for a minimum of three years and longer if this Commission or another government agency so requires. A utility shall make such records available for third party review upon 72 hours' notice, or at a time mutually agreeable to the utility and third party.

We agree with PG&E that Rule IV.F should be interpreted broadly. This Rule does not limit the type of affiliate transaction which the utility should document and archive. We agree with PG&E that negotiations of any sort which include the utility and its affiliates are covered by this Rule, whether or not they are consummated. Because ORA's proposed condition is duplicative of Rule IV.F, we do not adopt ORA's proposed condition on this issue.

9. Audit Results

9.1. Overview

This section addresses the Audit Report's specific findings which are in dispute and must be resolved because of their relationship to the Audit Report's proposed conditions, principally regarding PG&E's accounting practices and affiliate transaction transfer pricing. The Audit Report issued in November 1997 was critical of PG&E's affiliate transaction controls and compliance, alleging that about $35 million that should have been charged to affiliates was incorrectly charged to ratepayer accounts during the 1994-1996

audit period. PG&E has conceded certain mischarges, and states it has corrected them, and Overland has revised some of its own findings of misallocation downward after reviewing PG&E's response to the Audit Report. However, the parties still dispute many of the facts and allegations in the Audit Report. PG&E claims that ORA has not shown that the actual or alleged mischarges have affected PG&E's rates, and indeed, ORA is not seeking any disallowance or penalties for the alleged mischarges.

PG&E states that, whatever merit the findings of mischarges during the audit period have, the additional conditions which ORA proposes are not necessary because: (1) Overland conducted its audit when the holding company was still in the process of formation and its staffing plans had not yet been completed (since the Audit Report, the holding company has been staffed in a manner which provides significantly more structural separation between utility and affiliate activities, and affiliate transaction policies and accounting procedures have been enhanced); (2) the Commission's recently promulgated Affiliate Transaction Rules addressed many of the policy issues affecting affiliate transactions jointly for all energy utilities and there is no need to revisit that decision; and (3) the Audit covered a period during which the Commission's policies were in flux, and PG&E's changes made as a result of forming and staffing the holding company should enhance compliance with former as well as newly adopted rules.

We address disputed Audit Report findings and the need for further conditions below. However, we reiterate that PG&E's argument that changed circumstances have overtaken the Audit Report and its recommendations, supports our requirement that another audit should occur within three years, in order to verify that PG&E Corporation's new corporate structure and controls properly implement this Commission's required conditions.

9.2. Ratemaking Effect of the Audit Findings

PG&E emphasizes that, although it recognizes that the types of errors that Overland finds and any resulting cross-subsidies which might occur are problems that should be avoided, none of the errors alleged by the audit had, or will have, any effect on rates or cause any harm to ratepayers, because it has addressed these alleged errors in its 1999 General Rate Case testimony, either by adjusting its estimate or using a different year's recorded costs as a base year. Neither PG&E nor ORA believes it is necessary for the Commission to make any adjustment to rates or to require a refund to ratepayers in this decision.

We will determine PG&E's revenue requirement in our decision in its 1999 General Rate Case. However, we agree with ORA that regulatory audits and existing safeguards may not be sufficient to ensure that future misallocations will not be incorporated into rates. Audits may miss significant misallocations, especially in instances where the paper trail is difficult to follow, or is in summary form. Also, we agree that an incentive exists for a utility to cross-subsidize its affiliates. Indeed, our Affiliate Transaction Rules were adopted, in part, to attempt to address cross-subsidization issues. To the extent we determine that PG&E has unique auditing problems as a result of this Audit Report, it is in the public interest to impose additional conditions in order to create an environment where this type of ratepayer harm is unlikely to occur in the future.

9.3. Internal Controls

9.3.1. General Principles

Generally accepted auditing standards describe internal control as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial

reporting; (b) effectiveness and efficiency of operations; and (c) compliance with applicable laws and regulations. (See PG&E Opening Brief at p. 103.) Internal controls consist of activities such as accounting, time-keeping, and time-recording, and other systems needed to ensure accuracy and accountability. So long as the utility is part of the same company that has unregulated affiliates and subsidiaries, the existence of adequate internal controls is important to this Commission because it is through examination of the material generated by the internal controls that we can be sure that PG&E maintains appropriate separation between the regulated and unregulated portions of its business, and that ratepayers are not subsidizing PG&E Corporation's unregulated activities.

The Audit Report found PG&E's system of internal controls inadequate and proposes many detailed conditions in order to rectify these perceived problems. PG&E disputes many of these findings, and states that recent improvements and planned "enhancements" to its internal controls rectify many of the perceived problems. PG&E also argues that this Commission should not micromanage PG&E by imposing detailed and specific internal controls through audit conditions because such detailed controls may prove to be inflexible as the company evolves into the future. PG&E believes that this issue is less important today than it was during the audit period, since as a result of the corporate reorganization and movement to the holding company of many of the functional areas providing corporate support services to the corporate family, fewer utility employees are involved in affiliate transactions than have been in the past. PG&E further argues that at the holding company level, the kinds of timekeeping concerns the audit noted during the audit period are diminished because much of the employees' time is allocated according to formulae and not directly charged.

We believe the issue of adequate internal controls continues to be relevant in PG&E's new corporate structure, because the regulated utility is still a part of PG&E Corporation, and the potential for cross-subsidization still exists. In this new competitive environment, cross-subsidization issues are not only important because of this Commission's obligation to ensure that rates are just and reasonable, but also to ensure that there is fair competition. Also, adequate internal controls will assist the Commission in verifying PG&E's claims that the company maintains separation between regulated and nonregulated activities. The fact that holding company costs are allocated to the utility or other affiliates through a formula does not diminish the need for adequate recordkeeping because it is still necessary to determine the specific nature of the transaction, notwithstanding the method used for cost allocation.

The Audit Report addressed many activities, and we address here the report's main findings which are necessary for us to review in order to support the further conditions we impose. We agree with PG&E that the conditions imposed should be of a more general rather than specific nature, so that PG&E can have some flexibility to adjust to changing circumstances. However, we do not agree with PG&E that no additional conditions are necessary in order to provide for adequate internal controls. We cannot find based on this record that PG&E's newly established structure and "enhancements" provide adequate internal controls to assure us that PG&E Corporation is maintaining appropriate separation of its regulated and unregulated businesses, largely because the information obtained as a result of these new controls was not audited, and some controls are still in the process of being implemented. To the extent, as PG&E argues, that PG&E's "enhanced"

system provides for adequate internal controls, PG&E should not oppose the conditions we adopt.

9.3.2. Timekeeping

There is no dispute that effective timekeeping controls are necessary to ensure that employee services provided by PG&E to other affiliates, and provided by the holding company to PG&E, are properly identified, recorded, and charged. However, the parties dispute the adequacy of PG&E's timekeeping procedures.

The Audit Report found that PG&E prepares inadequate timesheets for work done for affiliates, especially with respect to the detail recorded. For example, some timesheets will list "administrative services" or "legal work," which descriptions do not allow auditors or other company personnel to understand the specific nature of the services rendered. As another example, an invoice from PG&E Corporation to PG&E for administrative services contained a bill for approximately $17 million but failed to break down the specific nature of the services rendered or who provided these services. The Audit Report also found that PG&E's timesheet instructions are inadequate, as they are not part of a formal process and the instructions are abstract and confusing. Proper instructions are important so that employees will understand where and how to record their time expenditure.

We agree that PG&E's timekeeping procedures in place during the audit period should be improved, especially to clearly set forth the nature of the work the employee has performed, whether in the context of recording the time or billing the time. Further, it is critical to provide training to employees regarding these new procedures to ensure that they are in fact being implemented.

PG&E argues that improvements it has made to its timekeeping system since the conclusion of the audit period, and planned enhancements, make it unnecessary for the Commission to adopt additional conditions. For example, it highlights the fact that it has implemented an SAP accounting system which facilitates information management and will allow for greater efficiency in internal and external audits. PG&E states that management reports showing "who" worked on "what," "when," and for "how long" can be and are prepared from the raw data. ORA disputes the fact that the SAP system, as implemented by PG&E, is adequate to meet its concerns and continues to offer detailed recommendations discussed more fully in Section 10.

We agree that the SAP system, at least as implemented by PG&E as set forth in ORA's rebuttal testimony at Exhibit 2-2, attached to Exhibit 104, does not provide the detail necessary to understand the nature of the transaction. For example, this exhibit does not contain any information about the nature of affiliate transactions, such as a description of the service that a holding company employee is charging to the utility. Although we modify ORA's recommended conditions to give PG&E more flexibility in their implementation, we believe that additional conditions are necessary to ensure that PG&E records sufficient information, and anticipate that PG&E will modify its implementation of its SAP process in order to meet the conditions we set forth in Section 10. Further, the system should be able to record and report information concerning the affiliate involved, the project or type of service, and the nature of the employee's specific activity in one document, so that future auditors, or others at the company in need of this information, do not have to compile it by piecing together various source documents (i.e., desk calendars to ascertain the nature of the employee's activity).

9.3.3. Budgeting

We find that PG&E's system of budgeting during the audit period and shortly thereafter should be improved. For example, its 1997 Annual Budget for Affiliate Planning Orders (which budget falls outside of and is more recent than the audit period) contains such general information (i.e. legal services or safety and health administration) that we cannot understand the specific nature of or reasonableness of the expenditures. (See Exhibit C101, Exhibit 12-1). Although PG&E has presented a detailed showing of its recently implemented procedures and planned enhancements, it is unclear without another audit which of these procedures will address this specific problem. For instance, PG&E plans to develop a more comprehensive budget process beginning in 1999.

PG&E argues that requiring more specificity is unwieldy, because it would be virtually impossible to forecast every specific affiliate service at the level of detail ORA recommends, and that many projects are not anticipated when the budgets are prepared. We recognize that it may be impossible to anticipate and budget each activity in great detail, and the budget could allow for such contingencies. However, the fact that such contingencies exist should not relieve PG&E from the duty to provide more budget detail in most instances when the projects can in fact be anticipated.

9.3.4. Analysis Between Planned and Actual Expenditures

The Audit Report also found that during the audit period, P&GE did not have an established procedure for analyzing variances between planned and actual expenditures. We believe such an established procedure is useful in that it will provide the company the information to analyze the reasons for the variance, and to determine whether the method for determining planned expenditures can be improved. We therefore direct PG&E to establish and maintain such procedure with respect to affiliate expenditures, and for PG&E

Corporation to establish and maintain such procedure with respect to expenditures it plans on making on behalf of PG&E. PG&E and PG&E Corporation can determine whether its newly implemented procedures meet this condition, or whether further enhancements are necessary. We discuss this condition more fully in Section 10.

9.3.5. Authorization Documents

The Audit Report found that PG&E failed to create and maintain documents showing the nature, scope, and price of services that PG&E provides to affiliates. ORA states that these documents are necessary, because they provide an audit trail and increase the likelihood that transactions will be correctly recorded and minimize the likelihood of billing disputes. ORA found that during the audit period, PG&E did not prepare a single "request for service" form, which was the mechanism it at that time had in place for authorizing specific affiliate work.

We agree that PG&E's implementation of authorization documents during the audit period needs improvement in order to provide greater specificity, and therefore adopt the conditions set forth in Section 10. For example, a Continuing Service Agreement, a mechanism for written authorization for the provision of goods and services to affiliates, in and of itself, does not provide specific support for a specific transaction, but is more general in nature. Also, PG&E's Daily Transaction Reports do not cover utility charges originating at the holding company.

Although PG&E claims that its currently existing (as opposed to that existing during the audit period) affiliate cost categorization system utilizing orders, cost elements, and other such indicators is generally appropriate, PG&E states that it is considering certain enhancements that will

make the system a better management tool and simultaneously facilitate external reviews. Primarily, PG&E will improve its training to clarify the situations in which either the provider or receiver of a service will want to establish an order to track in more detail the services provided. PG&E also plans to shift responsibility for creating and monitoring the use of orders for affiliate transactions to the Affiliate Transactions Section in the utility's Corporate Accounting Department. The future audit we require can insure that PG&E has improved this system.

9.3.6. Record of Inter-Company Payables

The Audit Report lists several instances where PG&E failed to record significant payments to affiliates in its inter-office payables account. (See ORA Opening Brief at p. 116 for a summary of this list.) We agree with ORA that this problem may be a symptom of other control problems, such as timekeeping problems, and additional internal controls should be established that would ensure more complete recording of these payments. We therefore adopt the applicable conditions set forth in Section 10.

9.4. Corporate Services

The Audit Report reviewed PG&E's Corporate Service Unit, which provided services for utility departments, affiliates, and the corporation as a whole during the audit period. Of the $35 million cross-subsidies which the Audit Report alleges occurred, approximately $15 million relate to common corporate costs. Over the course of this proceeding, ORA reduced its estimate to about $12.5 million. PG&E believes that about $2.4 million was improperly allocated and disputes approximately $10.5 million of ORA's allegations.

ORA's testimony shows that PG&E and ORA are litigating the issue of the correct corporate common cost allocation for ratemaking purposes in

PG&E's 1999 general rate case. Steps are also being taken in PG&E's general rate case to address the possibility that the failure to have taken common corporate costs into account in the past should not taint the forecast of the adopted revenue requirement on a going-forward basis. Therefore, it is not necessary for us to resolve the dispute of the precise monetary figure that was improperly allocated during the audit period. However, the existence of some reporting errors, even as acknowledged by PG&E, supports the further conditions we adopt in Section 10 below.

9.5. Corporate Development

PG&E explains that the Corporate Development Organization (CDO) was a joint activity of the utility and affiliate employees, the purpose of which was to provide a systematic method for developing new products and services, and for identifying new business opportunities to be pursued by either the utility or its unregulated affiliates. PG&E terminated the CDO in 1995, after about a year in operation.

The Audit Report alleges that all costs associated with designing and implementing the CDO should have been charged to the affiliates, and to the extent they were not, to shareholder-funded below-the-line accounts. The Audit Report also believes that PG&E underbilled its affiliates for work performed on the CDO. ORA states that PG&E billed PG&E Enterprises $153,430 of the $573,048 corporate development costs which PG&E incurred. ORA also believes that, regardless of the specific affiliate rules in place at the time, PG&E should have charged its affiliates market-based rates for the services provided, for a total of $799,000.

PG&E believes that some costs of the project, such as those associated with designing the process itself, were properly chargeable to the

utility. PG&E points out that the CDO provided a means to quickly halt further utility work on new business opportunities that were outside the scope of utility core business (such as ground penetration radar) and to identify new products related to the utility business (such as gas pipe liner technology). PG&E states that because the Commission had not set firm policies for treatment of costs and revenues associated with the pursuit of unregulated business opportunities, PG&E met with Commission advisory staff to discuss the CDO and PG&E's interim cost allocation approach. PG&E states that staff did not endorse PG&E's proposals, but also did not raise any general or specific cost allocation concerns. PG&E also admits to some timekeeping mistakes (it now believes it failed to charge about $54,000), but disputes ORA's allegations that it should have charged even more hours to the affiliates. PG&E also disputes the allegation that it should have charged market-based rates, since that was not Commission policy at that time.

The charging errors did not affect rates during the audit period, and PG&E is moving much of the company's unregulated business planning function to the holding company. Also, the Commission's Affiliate Transaction Rules establish rules on new products and services for the affiliates covered by the rules. Therefore, it is not necessary for us to make detailed findings here on exactly how much PG&E undercharged its affiliates for the CDO.[10] However, even PG&E admits that it undercharged its affiliates. Also, we find that this project primarily benefited shareholders, since PG&E was only able to identify one utility development project which was terminated and one project that went

[10] We clarify here that PG&E's presentation to Commission staff of its cost allocation approach, and staff's failure to point out any perceived deficiencies, is not a defense as to the procedure's reasonableness in a later Commission review.

on to the utility line of business. Yet, PG&E's cost allocations are not in keeping with this division. For instance, PG&E initially did not charge CDO for the cost of establishing regulatory and legal policy for the CDO project.

This project demonstrates the need for further separation between the regulated and unregulated activities, and the need for a much better cost allocation policy and implementation of that policy in order to ensure that ratepayers do not finance competitive activities. The future audit we order today can aid us in this determination. This project also demonstrates the need for clearer, and more detailed timekeeping policies, procedures, and training thereon, which is addressed by the conditions we adopt in Section 10.

9.6. Power Quality

Power quality as a term used to describe various products and services offered to customers in order to mitigate problems associated with sustained or momentary power disturbances. The Audit Report states that PG&E transferred its entire power quality business line to PG&E Energy Services without receiving proper compensation. The Audit Report states that the business line cost $2.2 million to develop, and had a market value of $8.5 million. PG&E disputes that it transferred the entire business line, and states it only transferred the service orders for five static transfer switches to PG&E Energy Services and appropriately billed it for PG&E's costs of $315,216.

ORA is not asking for penalties or refunds in this case, but uses the power quality example to demonstrate the need for additional conditions to ensure separation and to guard against anticompetitive behavior. For this reason, we do not make detailed findings on this issue of the appropriate dollar amount transferred to PG&E Energy Services, since ratepayers did not pay any of the static transfer switch development costs. The 1996 general rate case used a

base year of 1993. These disputed costs were charged to Account 912 beginning in 1994. Moreover, the Commission denied PG&E's request for funding for Account 912 in PG&E's 1996 general rate case. Further, we will determine the appropriate rates going forward in PG&E's 1999 general rate case, and to the extent this issue is currently relevant, we can address it in that decision.

We recognize that a similar transfer of the static transfer switches, or other elements of PG&E's power quality business would not be permitted today under the Affiliate Transaction Rules. For example, the rules clearly delineate that the utility cannot provide the affiliate with preferential treatment regarding services provided by the utility, and that transactions between a utility and its affiliates shall generally be limited to tariffed products and services, or services made available to all participants through an open competitive bidding process. (See, e.g., Rules III.A and III.B.)

We do not find that PG&E transferred its entire power quality business line to PG&E Energy Services, since PG&E still provides some power quality consultation for its customers. However, we find that it transferred, either directly or indirectly, a very large portion of this business line to PG&E Energy Services at the same time that it transferred the purchase orders for the five static transfer switches. Initially, PG&E's power quality business line had five different product lines. Two (Fermata and Terrier) were discontinued in 1995, one (Starfish) exists at PG&E in another name today, and another (Darwin), which consists of power quality consulting, is also offered by PG&E today on a more limited basis than in the past. The fifth product line, Orca, was focused on the power quality needs of large industrial customers. The static transfer switches and static voltage regulators were significant power quality solutions in this section. PG&E selected its affiliate to exclusively market the static transfer

switches and static voltage regulators, and instructed its utility to stop marketing these solutions.

PG&E Energy Services' power quality business was developed, in part, by utility personnel, who either transferred to the affiliate or who were on rotational assignment. Also, prior to the transfer of the static transfer switches, PG&E's RD&D department conducted initial research and studies regarding power quality issues which lead to the formulation of the idea to create Orca and the product solutions offered therein.

Although we do not believe that PG&E transferred its entire power quality business line business line, PG&E transferred more than just five purchase orders to PG&E Energy Services, either directly or indirectly. Thus, this demonstrates the need for the separation rules adopted as part of the Affiliate Transaction Rules, as well as the need for a verification audit to ensure that any future transfers of this type are properly conducted and accounted for.

9.7. Energy Marketing and Tiger Project

The Tiger Project was an effort undertaken in 1994 to determine the feasibility of creating an energy marketing company. The project involved employees from both PG&E and its unregulated subsidiary, PG&E Enterprises. PG&E agrees that all utility employee costs of the Tiger Project should have been charged to nonutility accounts, and instructed utility employees to bill their time to PG&E Enterprises. PG&E admits that not all costs were correctly tracked and recorded. However, PG&E and ORA differ on the amount of costs that were incorrectly tracked and recorded, with PG&E claiming only minor errors and ORA claiming that the Tiger Project's charges were understated by about 50%.

Again, because any errors which may have occurred did not affect rates during the audit period, it is not necessary for us to resolve the specific

differences between PG&E and ORA here. However, even PG&E admits that some of its employees did not appropriately track and record their time, despite receiving instructions thereon. It is clear that these errors were significant. For instance, in 1994, PG&E's controller took the initiative to audit employee records after a meeting on the Tiger Project. He found that the system did not work, and that of the 26 PG&E employees attending the meeting, as few as nine had, at that point, correctly billed their time to PG&E Enterprises. Also, the cost of the Learning Center where the meeting was held was incorrectly billed to PG&E.

Although PG&E states that timekeeping has been improved, and the holding company structure should prevent this type of problem from recurring, it is important for holding company personnel to correctly charge their time to the affiliate at the holding company level. The fact that these timekeeping errors existed in the past supports the further internal controls which we impose in Section 10 of this decision. It also reinforces the need for a verification audit to monitor whether the changed circumstances in fact result in better tracking and recording of employee time, and appropriate separation between the utility and affiliates.

9.8. Acquisitions

PG&E and PG&E Enterprises pursued corporate acquisitions during the audit period, and various utility employees performed due diligence activities on potential acquisition projects. The Audit Report alleges that PG&E did not accurately track the costs to it of working on these projects, and failed to bill its affiliates or shareholders with a price reflecting the fair market value of the services. PG&E disputes the report's conclusions, stating that at most, minor errors occurred. PG&E also points out that none of the alleged errors impacted rates during the audit period, and the formation of the holding company reduces the risk of similar errors affecting utility costs in the future.

A potential reason for the dispute here is the method by which PG&E's salaried employees, particularly corporate executives, billed their time. These PG&E employees are instructed to charge on the basis of an eight hour day, under the assumption that the hours spent after work on particular topics or activities (i.e., if an employee works longer than eight hours on a particular day) are proportional to time spent on those topics or activities during the regular eight hour work day. PG&E explains that, under this assumption, the rate per hour used to charge salaried employees' time to affiliates is much higher than it would be if all the hours spent were in fact recorded.

Again, we do not need to resolve the specific factual dispute on the number of hours that should have been billed in this instance because ORA is not requesting a rate adjustment or a penalty. However, we agree with ORA that this dispute exists, in part, because of the inadequacy of the authorizing, timekeeping, and accounting documents underlying these transactions. We therefore adopt the conditions discussed in Section 10 to improve PG&E's internal control system.

Furthermore, PG&E's "8-hour day" timekeeping system would only be accurate if affiliates were billed on a cost rather than fair market value basis, and PG&E's assumptions regarding proportionality are in fact accurate. We therefore direct that if PG&E continues to use this timekeeping and billing system, PG&E test its system to verify that its assumption that the "8-hour day" timekeeping and billing system adequately and proportionately reflects work actually performed.

9.9. Mission Trail Insurance

Mission Trail Insurance is a wholly owned subsidiary of PG&E Corporation, which PG&E owned until recently. It is a captive insurer, providing

property and general liability insurance only to the utility. Mission Trail was formed in 1985, was essentially inactive from 1988 to 1991, and stopped writing new policies in April 1997. PG&E created Mission Trail at a time when PG&E states it was difficult to obtain insurance at rates it considered reasonable. However, PG&E Corporation has determined that the insurance market has become more competitive and that it can obtain the required coverage through commercial insurers. For this reason, PG&E states that it decided in June 1998 to liquidate Mission Trail, and expects the liquidation process to be completed by early 1999.

Since its establishment in 1985 as a wholly owned subsidiary of PG&E, Mission Trail has been used for two primary purposes: to obtain reinsurance from commercial insurers and to underwrite directly PG&E's and PG&E's subsidiaries' insurance needs. With respect to reinsurance, PG&E purchased about $46 million limits of reinsurance from Mission Trails, about $26 million of which Mission Trails passed on to PG&E at its cost. Mission Trail received a ceding commission of $36,000 from one reinsurer for $20 million of coverage, but did not pass this benefit on to PG&E. Mission Trails charged PG&E retail prices for the insurance Mission Trails underwrote for PG&E.

ORA does not propose any rate adjustment or penalty in this proceeding. ORA states that Mission Trails should not have added a markup in its reinsurance efforts for PG&E, and should have provided insurance to PG&E at cost, and not at market price. While ORA argues that many of its recommendations are made moot if PG&E permanently ends affiliated company insurance transactions, it argues that if Mission Trail is reactivated, or if PG&E Corporation forms another affiliate to sell insurance coverage to the utility, the Commission should prohibit the utility from paying a price which is higher than cost. ORA also recommends that the Commission prohibit PG&E from using

PG&E Corporation or an affiliate as a direct insurer of the utility to meet future insurance requirements.

PG&E believes that its plans to dissolve Mission Trail moots ORA's concerns. PG&E also states that, with respect to the reinsurance, it only failed to pass on to PG&E a $36,000 savings, which is incidental in dollar amount as well as percentage of earned premium. PG&E also believes that since shareholders bear the cost of running Mission Trails, it would be fair to allow the ceding commission to offset the cost of running Mission Trail. PG&E also states that it was appropriate for the affiliate to charge market price for its underwriting activities, and believes it was able to use the existence of Mission Trail as leverage to negotiate lower premiums with other insurers. PG&E also asserts that the ratepayers underpaid Mission Trail for insurance, since payments for losses which the utility suffered exceeded premiums which the utility paid.

The parties do not dispute the fact that ratepayers benefited overall from the reinsurance transactions that took place between 1991 and 1996. However, PG&E's argument that ratepayers benefited from Mission Trail's ability to underwrite insurance and charge market rates is not necessarily correct. If the utility paid the market rate, the utility could have bought insurance from a commercial carrier at that same rate. The ratepayers were indifferent between using Mission Trail and using a third-party carrier, and were thus neither harmed nor benefited by the use of Mission Trail for this purpose.

There is insufficient evidence in the record to support ORA's claim that ratepayers are harmed by the utility's decision to self-insure in all instances. This is a business decision which is fact intensive and is adopted by many successful companies. However, we direct PG&E to price such services appropriately. PG&E's affiliate transaction transfer pricing rules which governed

during the audit period required that the sale by an affiliate to the utility of goods and services not produced for sale to third parties be priced at fully loaded cost, not fair market value. If Mission Trail is reactivated as an affiliate, or if another business unit within the holding company begins selling insurance to the utility, PG&E should follow the transfer pricing rules set forth in Rule V.H of our Affiliate Transaction Rules.

PG&E states that it plans to liquidate Mission Trail by early 1999, but as of this writing the company still exists. No later than 15 days after the effective date of this decision, we direct PG&E to inform the Commission's Energy Division by letter of the status of Mission Trail and PG&E's plans regarding Mission Trail. This letter should be sent to all parties to this proceeding. In the event Mission Trail is not liquidated at the time of PG&E's first letter, PG&E should provide follow-up letters each 30 days thereafter until Mission Trail is liquidated. The follow-up letters should also be sent to all parties to this proceeding.

Based on ORA's review of Mission Trails, PG&E should inform us if PG&E Corporation forms an insurance affiliate in the future. Therefore, we direct PG&E to comply with the requirements of Affiliate Transaction Rule VI.B, and notify the Energy Division by advice letter if and when an affiliate is created to sell insurance to the utility, and whether or not the affiliate plans to sell such insurance to third parties as well. We require PG&E to so notify the Commission, whether or not it believes the new insurance affiliate is covered by the Affiliate Transaction Rules. (See Rule VI.B.) However, if PG&E does not believe the new affiliate is covered by the Rules, it need not demonstrate how the new affiliate

will comply with the Rules. However, PG&E should demonstrate in its Advice Letter why the affiliate is not covered by the Rules.

9.10. Other

9.10.1. PGT Pension Allocation

Effective January 1, 1996, PG&E made a formal allocation of assets held within the PG&E Retirement Master Trust for the benefit of both PGT and PG&E employees. ORA initially questioned the valuation method, but ultimately concluded it to be reasonable. The only remaining outstanding issue is whether PG&E violated Commission asset transfer reporting rules by failing to report the pension allocation in the 1996 Annual Report on Significant Utility-Affiliate Transactions. We agree with PG&E that it did not violate this requirement because no assets were transferred out of the trust. PG&E is bound by the minimum reporting requirements. However we encourage PG&E to report in its annual report significant utility-affiliate transactions which comply with the spirit of the reporting requirements and can add clarity to the Commission's ability to understand utility-affiliate transactions.

9.10.2. Reporting Requirements

ORA believes that PG&E failed to comply with several reporting requirements for the Annual Report on Significant Utility-Affiliate Transactions, which report is required by D.93-02-019, 48 CPUC2d 163. ORA also recommends further conditions to supplement the requirements set forth in D.93-02-019.

ORA recommends that PG&E fully disclose the basis for its transfer pricing in Sections E and F of its annual report filed pursuant to D.93-02-019. Although PG&E believes it is in compliance with reporting requirements, PG&E recognizes that it can make improvements and agrees to

add clarifying language in future annual reports. We adopt this recommendation as agreed to by the parties.

ORA also found that PG&E failed to explain why it omitted financial statements for unconsolidated subsidiaries from its annual report, since D.93-02-019, 48 CPUC2d 163, 179 (Section II.G.7 of the Reporting Requirements) requires financial statements from all non-consolidated subsidiaries of the controlling corporation, unless the company is legally precluded from providing them. PG&E states that the reason for such absences in the past is that the financial statements have not been available in time to include in the report, and that its position as a minority owner in such subsidiaries constrains its ability to demand that the statements be issued earlier. However, PG&E agrees to supplement its report in the future once the statements become available. We think PG&E's approach is reasonable, provided that it notify the Commission in the report which statements are missing, why they are missing, and approximately when PG&E anticipates supplementing the report.

ORA also requests that we require the following specific disclosures in the portion of PG&E's future annual affiliate reports responsive to section G of the Reporting Requirements: (1) Annual affiliate reports must include consolidating worksheets for both PG&E Corporation and PG&E, the utility; (2) Financial information for each consolidated subsidiary must be shown separately on the consolidating worksheet (instead of combining consolidated subsidiaries into a column entitled "other"); and (3) All information necessary to achieve a basic understanding of each subsidiary's or affiliate's financial results must be disclosed on the consolidating worksheet.

We believe that item (1) above is covered by the Affiliate Reporting Requirements, which require quarterly and annual financial

statements of the utility's controlling corporation, including consolidating workpapers of the controlling corporation (in this case, PG&E Corporation) and its subsidiaries (both regulated and unregulated). The definition of "subsidiaries" should include PG&E. (See 48 CPUC2d at 173, Rule I.G.d.) Therefore, we do not adopt ORA's first recommendation because it duplicates existing requirements. We believe ORA's remaining recommendations above are reasonable and therefore adopt them.

ORA also makes several recommendations to improve the quality of the CPUC annual affiliate reports. Since these are generic recommendations to the Affiliate Reporting Requirement, we reject them without prejudice to ORA making a request to modify these rules generically in the appropriate forum. By this determination, we do not preclude PG&E or any other utility from voluntarily providing more information in order to aid in developing a more useful and meaningful annual affiliate report.

9.10.3. Modification of D.91-12-057

As a result of ORA's inquiry, PG&E has proposed that the Commission reduce the $500 million credit support for its subsidiaries which the Commission authorized in D.91-12-057 to an aggregate of $50 million.

PG&E explains that it is currently committed to approximately $26 million of capital support pursuant to this authorization. In light of the formation of the holding company, the existing commitments of approximately $26 million under the existing authorization, and the desirability for PG&E to have some flexibility to provide limited future credit support for utility-related affiliates and subsidiaries, PG&E believes its recommended reduction from $500 million to $50 million is reasonable. ORA does not oppose this request.

We adopt this recommendation and modify Ordering Paragraph 1 of D.91-12-057 so that the $500 million of capital support which we authorized is reduced to $50 million.

10. Audit Recommendations

10.1. Overview

ORA makes three general sets of recommendations with respect to the issues discussed in Section 9 above. These recommendations can be classified as (1) recommendations PG&E has implemented and which Overland has verified; (2) recommendations with which PG&E has not disagreed, but which Overland has not been able to verify as implemented; and (3) recommendations with which PG&E disagrees or states it will not voluntarily implement.

ORA recommends that PG&E move functions that are predominately corporate in nature to the holding company. PG&E satisfied this recommendation during the first half of 1998. Therefore, ORA does not believe that the Commission needs to take any further action on this recommendation at this time, and we do not.

10.2. Recommendations That Are Largely Undisputed

ORA also lists recommendations with which PG&E has not disagreed but which have not been verified. The main issue of controversy on these recommendations is where compliance with them should be audited. We address the audit issue in Section 7.3 above. We therefore direct that PG&E comply with the recommendations it has not disputed and that compliance therewith should be reviewed in the verification audit. In order to ensure that PG&E implements these recommendations promptly, we also direct that no later than 180 days from the effective date of this decision, PG&E send a letter, verified by the head of either PG&E Corporation's or PG&E's internal audit department,

that PG&E Corporation and PG&E have implemented the conditions set forth below. The verified letter should briefly describe the steps PG&E has taken to fulfill these conditions and verify their implementation. If PG&E Corporation or PG&E has been unable to fully implement the recommendations, the letter should state the reasons therefore, and a target date for full implementation. PG&E Corporation or PG&E shall send a supplemental letter or letters every two months thereafter, as necessary, until full implementation has occurred. These letters should be sent to Executive Director, and also served on all Commissioners, the assigned ALJ, and the service list of this proceeding.

PG&E should:

1. Establish accountability for affiliate accounting and record-keeping in a single utility accounting manager.

2. Provide authorizing documents in advance of providing services between affiliates.

3. Redesign the existing system of associated company (affiliate) accounts payable and receivable. For this item, PG&E should (a) eliminate unnecessary sub-accounts; (b) appropriately use notes and accounts payable accounts; (c) standardize accounting for inter-company (affiliate) income tax transactions; (d) develop a mechanism to flag improperly recorded payables transactions; and (e) improve the documentation supporting recorded transactions.

4. Establish written agreements for all recurring transactions.

5. Improve the documentation of the transfer pricing basis and the nature and scope of goods and services provided.

6. Utilize requests for services that have been required by continuing service agreements.

7. Conduct a complete review of existing written agreements and implement revisions or execute new agreements, as necessary, to reflect transfers of responsibility from the utility to the holding company.

8. Ensure that all utility accounting with affiliates is recorded in inter-company receivables and payables accounts, and develop a simplified set of inter-company accounts with meaningful titles.

9. Simplify inter-company accounting procedures and update account documentation.

10.3. Disputed Recommendations

As a result of the Audit Report's findings on PG&E's internal controls, as discussed more fully in Section 9 above, ORA makes detailed recommendations regarding affiliate services classifications, timekeeping procedures, and budgeting. Specifically, ORA recommends that PG&E (a) develop a hierarchical classification system to track services between affiliates; (b) develop an affiliate time-keeping procedure with clear instructions and a meaningful categorization of affiliate costs, including a code or description which identifies the entity being billed, the type of service being provided, and the specific job or activity being performed, and develop a timekeeping procedure describing the documentation requirements set forth above and providing guidance on correct timekeeping, with details on exactly what this procedure should include; (c) establish budgets for charges by the utility and the holding company to affiliates and subsidiaries, with costs delineated according to the affiliate to be charged, project or type of service to be provided, and if known, the specific job or nature of work; (d) conduct a budget-to-actual variance analysis at

least quarterly to provide a means to investigate significant deviations from planned charges; and (e) improve the documentation supporting recorded affiliate transactions (i.e., the holding company's bill to the utility) to include at least the following: (i) a summary of the bill; (ii) SAP order detail at the project level, and if possible, the job or activity level, which totals to an amount which can be tied to the invoice total; (iii) for common allocated holding company costs, support for the allocation factors used to distribute the cost to the utility and other affiliates; (iv) a reference indicating from whom and from where more detailed supporting data, such as time sheets documenting the efforts and service request authorization forms, can be obtained; and (v) retain timesheets (especially holding company time sheets), service authorizations, vouchers for materials and outside services, and other source document support for affiliate billings in a logical system that permits the invoice support to be traced to the source documents without difficulty.

PG&E objects to the details in these recommendations, and believes that its current system, with planned enhancements, will rectify any existing problems, and that no further conditions are necessary. For example, PG&E believes that its present timekeeping system provides the hierarchical information, but is nonetheless enhancing its system to increase its usability and effectiveness. PG&E also objects to such detailed conditions because circumstances may change in the future, and it believes that the conditions should not be ridged in details, but should give the company the ability to respond to changing circumstances.

As discussed in detail in Section 9.3 above, we found problems with PG&E's system of internal controls which we cannot verify have been effectively addressed by PG&E today, either as implemented or through its planned enhancements. However, we also recognize the difficulty in imposing extremely

detailed requirements on our approval of a holding company structure, because these requirements might preclude management from implementing even more beneficial internal controls than the parties or the Commission could anticipate today.

In response to our discussion in this section and in Section 9.3 above, we impose the following additional requirements on PG&E. We require that PG&E implement and maintain the following internal control systems for transactions between the utility and its affiliates and subsidiaries and between the parent and the utility: (a) tracking; approval and authorization; (b) timekeeping; (c) billing; and (d) budgeting, which systems will each contain specific descriptions of the services to be rendered, or the services that are anticipated to be rendered. These specific descriptions should include, but are not limited to, a description of the entity billed, the type of service provided, and the specific job or activity performed. For common allocated holding company costs, there should be support for the allocation factors used to distribute the cost to the utility and other affiliates. PG&E and the holding company shall also develop and maintain a timekeeping procedure describing the documentation requirements set forth above and providing guidance on correct timekeeping.

PG&E and the holding company shall also conduct a budget-to-actual variance analysis at least quarterly to provide a means to investigate significant deviations from planned charges. We also require PG&E and the holding company to maintain the internal reports and all detailed underlying documentation used to generate them until completion of the verification audit ordered by this decision. While we do not mandate the specific documentation to be kept at all levels, it should be detailed and include such items as timesheets, service authorizations, and vouchers for materials and outside services. With respect to its internal control system, PG&E and the holding company should

also include a reference indicating from whom and from where more detailed supporting data can be obtained.

As in Section 10.2 above, we want to ensure that PG&E implements these recommendations promptly. Therefore, we also direct that no later than 180 days from the effective date of this decision, PG&E send a letter, verified by the head of either PG&E Corporation's or PG&E's internal audit department, that PG&E Corporation and PG&E have implemented the additional conditions set forth above. The verified letter should briefly describe the steps PG&E has taken to fulfill these conditions and to verify their implementation. If either PG&E Corporation or PG&E has been unable to fully implement the recommendation, the letter should state the reasons why and a target date for full implementation. PG&E Corporation or PG&E shall send a supplemental letter or letters every two months thereafter, as necessary, until full implementation has occurred. These letters should be sent to the Executive Director, and also served on all Commissioners, the assigned ALJ, and the service list of this proceeding.

11. Comments to the Proposed Decision and Alternate

The proposed decision of ALJ Econome was mailed to the parties on February 23, 1999, in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. The following parties filed comments or replies: PG&E, ORA, Sempra Energy, and Southern California Edison Company. In response to the parties' comments, we have made changes to the proposed decision to improve the discussion, add case citations or references to the record, and correct typographical errors.

- In Section 6, we provide that parties who believe it necessary to raise the need for further financial conditions on all electric and gas utilities within our jurisdiction, either as proposed by ORA in this proceeding, or other appropriate financial conditions, may raise this issue when the Commission reviews

the Affiliate Transaction Rules as provided for in D.97-12-088, *slip op*. at p. 99, Ordering Paragraph 10.) This is in lieu of the recommendation set forth in the proposed decision that the Commission staff prepare a new generic proceeding on these issues for our consideration. Ordering Paragraph 10 is also deleted, since the recommendation for a generic proceeding is deleted.

- In Section 7.5, we clarify that we address the parent company guidelines, not PG&E's guidelines.
- In Section 8.4, we state the Commission will review PG&E's proposed transfer pricing rules for transactions between the utility and holding company when it review PG&E's proposed Policy and Guidelines for Affiliate Company Transactions, which review is discussed in more detail in Section 7.5.
- In Section 9.10, we clarify that although PG&E is bound by the minimum reporting requirements, we nevertheless encourage PG&E to report in its annual report significant utility-affiliate transactions which comply with the spirit of the reporting requirements and add clarity to the Commission's ability to understand utility-affiliate transactions.
- In Sections 10.2 and 10.3, we require the letter PG&E sends to the Commission verifying that it has implemented the listed recommendations should also briefly describe the steps PG&E had taken to fulfill these recommendations and to verify their implementation.
- In Ordering Paragraph 5, we clarify the timing and period for the audit, as well as the audit procedures.

Alternate pages of Commissioner Neeper were mailed on April 7, 1999. Comments were received from ORA on April 16, 1999. We do not change the alternate pages in response to comments.

Findings of Fact

1. This is the second decision in PG&E's application for authorization to form a holding company structure. A February 15, 1996 ALJ ruling determined that ORA should conduct an audit in this proceeding of all of PG&E's significant

utility/affiliate transactions from the 1994 reporting period through the present. The Commission later affirmed this ruling in D. 96-11-017, the Interim Opinion.

2. After the formation of the holding company, PG&E Corporation became the parent of PG&E and PG&E's affiliates. Prior to the formation of the holding company, PG&E's investments in non-utility businesses were held through PG&E Enterprises, which was a wholly owned subsidiary of the utility.

3. The Audit Report covered the period between 1994 and 1996 (the audit period). The Audit Report also included a review of all of PG&E's affiliate transactions during the audit period, and a review of the current business plans of PG&E affiliates.

4. Two subsequent events occurred after the end of the audit period which the parties argue, to various degrees, affect this decision. First, the Commission enacted the Affiliate Transaction Rules in D.97-12-088, as modified by D.98-08-035. Second, PG&E continued staffing and developing the infrastructure for the holding company.

5. Although PG&E Corporation is planning to engage in newly competitive businesses through its affiliates, the record does not demonstrate that the risks are greater for PG&E than they are for any other California investor-owned energy utility.

6. Several companies are pursuing a national energy strategy, and only a small number of those are expected to be successful in continuing to pursue such a strategy.

7. Although we decided several other holding company or energy utility merger decisions after the advent of electric industry restructuring, we did not examine a comprehensive set of financial conditions similar to what ORA proposes here in those cases, nor have we recently examined the appropriateness

of these, or similar conditions, to be applied to all of the energy utilities within our jurisdiction in a uniform manner.

8. Under the PUHCA, 15 U.S.C. §§ 79 et seq., in order to obtain an exemption from the Act, a Commission such as ours, that has jurisdiction over a public utility company that is an associate or affiliate company of a foreign utility company, must certify to the SEC that we have the authority and resources to protect ratepayers subject to our jurisdiction and that we intend to exercise our authority. The Commission may impose additional conditions to the SEC on a prospective basis.

9. We have conditioned our current certification on the utility's compliance with the requirements set forth in D.95-12-007, 62 CPUC2d 517, 529-532. However, we issued this decision prior to the enactment and implementation of Assembly Bill 1890 concerning electric industry restructuring, and before the recent turmoil in the overseas financial markets.

10. Rule VII of the Affiliate Transaction Rules, significantly modified in D.98-08-035, provides detailed rules and procedures for utilities to follow to offer nontariffed products and services, including an Advice Letter process requiring a detailed showing. The Commission is also reviewing PG&E's application to adopt a revenue sharing mechanism for nontariffed products and services, A.98-05-007. An additional layer of regulation as proposed by ORA with respect to assignment of business opportunities is not necessary to adopt at this time.

11. The Commission has multiple tools available to protect ratepayers from unreasonable contracts. Contrary to ORA's assertions, we do not concede here that our authority is limited to disallowances, or that the Commission cannot implement the remedy suggested by ORA in Section 7.2 without our adopting the proposed condition.

12. The benefit of ORA's current audit has been somewhat eclipsed by the passage of time and intervening circumstances. The audit period covered affiliate transactions from 1994 to 1996. After the conclusion of the audit period, (1) PG&E changed its corporate structure to a holding company structure; (2) the Commission adopted the Affiliate Transaction Rules, which cover some, but not all, of PG&E's affiliates; and (3) PG&E instituted procedures to attempt compliance with these rules.

13. PG&E has used the defense of the passage of time and intervening events to oppose many of the conditions proposed by ORA. ORA has withdrawn some of its proposed conditions based on the Commission's adoption of the Affiliate Transaction Rules and PG&E's formation of a holding company structure, and we have been judicious in adopting further conditions in this decision in light of these, and other, intervening events.

14. PG&E's statements that the holding company structure and attendant safeguards which it has in place are sufficient to protect ratepayers have, as yet, not been tested.

15. The verification audit we direct will give the Commission an opportunity to verify if PG&E's implementation of its new corporate structure, and the conditions adopted in this decision as well as other Commission decisions, are sufficient to protect ratepayers.

16. The audits we have ordered in the Affiliate Transaction proceeding do not make this audit redundant. Although there may be some overlap between the Affiliate Transaction audits and this audit, the auditors hired as a result of this decision should review the earlier audits, which should streamline the process.

17. We do not wish to resolve detailed questions in this proceeding about the scope or content of the audit mandated by the Affiliate Transaction Rules, which are applicable to many energy utilities, not just PG&E.

18. PG&E must comply with the Affiliate Transaction Rules under the terms of the decisions which adopted the rules. Adding a condition that PG&E comply with the Affiliate Transaction Rules in this decision would not enhance that requirement.

19. In the unlikely event that a court of last resort were to find a portion of the Affiliate Transaction Rules invalid, we would address that event if and when it occurs.

20. It is most efficient for PG&E Corporation to finalize its parent company Policy and Guidelines for Affiliate Company Transactions after we have ruled on the broader proposed conditions in this Phase 2 decision. The parties' disputes surrounding the policies and procedures would likely mirror the disputes presented in Phase 2, if PG&E Corporation were to finalize its policies and procedures prior to our rendering this decision.

21. The Affiliate Transaction Rules address the sharing of directors and officers. We do not superimpose another set of restrictions addressing such sharing at this time, before we know whether or not the current rules provide for adequate separation.

22. The Affiliate Transaction Rules impose costs on affiliates that receive employees transferred from the utility and restrictions on transferring confidential information. We do not superimpose another set of restrictions addressing separation of benefit plans at this time, before we know whether or not the current rules provide for adequate separation and address our cross-subsidization and confidentiality concerns.

23. The justification for ORA's proposed condition regarding the benefits of association results from the conditions imposed by electric industry restructuring, and is not peculiar to PG&E alone. We do not need to adopt this condition as a placeholder in this decision to preserve our ability to impose it in the future either on a generic, or utility specific basis, should conditions warrant.

24. Rule V.H of the Affiliate Transaction Rules sets forth transfer pricing rules for affiliates covered by the Rules.

25. PG&E's transfer pricing rules for transactions between the utility and holding company are set forth in its proposed Policy and Guidelines for Affiliate Company Transactions, which is not yet adopted by the Commission. (See Section 7.5.) We will review PG&E's proposed transfer pricing rules for transactions between the utility and holding company in that context.

26. Although the Audit Report demonstrated that PG&E has made some accounting errors, we address these errors through the further conditions we impose on internal controls. ORA has not demonstrated to our satisfaction that the efforts made in the documentation of the utility's transactions with its affiliates are large and systematic enough to warrant imposing the proposed 10% adder.

27. Rule IV.F of the Affiliate Transaction Rules requires the utility to maintain records of all tariffed and nontariffed transactions with its affiliates. Rule VI.C requires an annual audit to verify compliance with our Rules. Our Affiliate Reporting Requirement Rules (see 48 CPUC2d 163) also require, inter alia, that the utility calculate transfer pricing.

28. Rule IV.F of the Affiliate Transaction Rules should be interpreted broadly. This Rule does not limit the type of affiliate transactions which the utility should document and archive. Negotiations of any sort which include the utility and its affiliate are covered by this Rule, whether or not they are consummated.

29. PG&E's argument that changed circumstances have overtaken the Audit Report and its recommendations supports our requirement that the verification audit should occur in three years, in order to verify that PG&E Corporation's new corporate structure and controls properly implement this Commission's required conditions.

30. ORA is not requesting a rate adjustment or penalty as a result of the errors alleged in the Audit Report, because the errors did not affect past rates, and the parties are recommending the appropriate future revenue requirement for PG&E in its 1999 general rate case in light of, inter alia, the Audit Report.

31. Generally accepted auditing standards describe internal control as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting; (b) effectiveness and efficiency of operations; and (c) compliance with applicable laws and regulations. Internal controls consist of activities such as accounting, timekeeping, and time-recording, and other systems needed to ensure accuracy and accountability.

32. So long as the utility is part of the same company that has unregulated affiliates and subsidiaries, the existence of adequate internal controls is important to this Commission because it is through examination of the material generated by the internal controls that we can be sure that PG&E maintains appropriate separation between the regulated and unregulated portions of its business, and that ratepayers are not subsidizing PG&E Corporation's unregulated activities.

33. The issue of adequate internal controls continues to be relevant in PG&E's new corporate structure, since the regulated utility is still a part of PG&E Corporation, and the potential for cross-subsidization still exists. Adequate internal controls will assist the Commission in verifying that PG&E's claims that the company maintains adequate separation between regulated and nonregulated activities.

34. We cannot find based on this record that PG&E's newly established structure and "enhancements" provide adequate internal controls in order to assure us that PG&E Corporation is maintaining appropriate separation of its regulated and unregulated businesses, largely because the information obtained as a result of these new controls was not audited, and some controls are still in the process of being implemented.

35. PG&E's timekeeping procedures which it had in place during the audit period should be improved, especially to clearly set forth the nature of the work the employee has performed, whether in the context of recording the time or billing the time. It is also critical to provide training to employees regarding these new procedures to ensure that they are in fact being implemented.

36. The SAP system, at least as implemented by PG&E as set forth in ORA's rebuttal testimony at Exhibit 2-2, attached to Exhibit 104, does not provide the detail necessary to understand the nature of the transaction. The system should be able to record and report information concerning the affiliate involved, the project or type of service, and the nature of the employee's specific activity in one document, so that future auditors, or others at the company in need of this information, do not have to compile it by piecing together various source documents (i.e., desk calendars to ascertain the nature of the employee's activity).

37. PG&E's system of budgeting during the audit period and shortly thereafter should be improved. For example, its 1997 Annual Budget for Affiliate Planning Orders (which budget falls outside of and is more recent than the audit period) contains such general information (i.e., legal services or safety and health administration) that we cannot understand the specific nature or reasonableness of the expenditures.

38. An established procedure for analyzing variance between planned and actual expenditures is useful in that it will provide the company the information to analyze the reasons for the variance, and to determine whether the method for determining planned expenditures can be improved.

39. PG&E's implementation of authorization documents during the audit period needs improvement in order to contain greater specificity. For example, a Continuing Service Agreement, a mechanism for written authorization for the provision of goods and services to affiliates, in and of itself, does not provide specific support for a specific transaction, but is more general in nature. Also, PG&E's Daily Transaction Reports do not cover utility charges originating at the holding company.

40. PG&E's failure in several instances to record significant payments to affiliates in its inter-office payables account may be a symptom of other control problems, such as timekeeping problems, and additional controls should be established which would ensure more complete recording of these payments.

41. The existence of some reporting errors with respect to corporate services, in part, supports the further conditions on internal controls.

42. The CDO project demonstrates the need for further separation between the regulated and unregulated activities, and the need for a much better cost allocation policy and implementation of that policy in order to ensure that

ratepayers do not finance competitive activities. The future audit we order today can aid us in this determination. The CDO project also demonstrates the need for clearer, and more detailed timekeeping policies, procedures, and training thereon, which is addressed by the further conditions we adopt on internal controls.

43. Although PG&E did not transfer its entire power quality business line to PG&E Energy Services, PG&E transferred more than just five purchase orders to PG&E Energy Services, either directly or indirectly.

44. The fact that timekeeping errors existed in the past with respect to the Tiger Project supports the further internal controls conditions which we impose. It also reinforces the need for a verification audit to monitor whether the changed circumstances in fact result in better tracking and recording of employee time, and appropriate separation between the utility and affiliates.

45. PG&E's "8-hour day" timekeeping system would only be accurate if affiliates were billed on a cost, rather than fair market value basis, and PG&E's assumptions regarding proportionality are in fact accurate.

46. PG&E did not violate Commission asset transfer reporting rules by failing to report the pension allocation in the 1996 Annual report on Significant Utility-Affiliate Transactions, because no assets were transferred out of the trust. PG&E is bound by the minimum reporting requirements. However, we encourage PG&E to report in its annual report significant utility-affiliate transactions which comply with the spirit of the reporting requirements, and can add clarity to the Commission's ability to understand utility-affiliate transactions.

47. PG&E is currently committed to approximately $26 million under the existing credit support authorized by D.91-12-057. PG&E desires to have some flexibility to provide limited future credit support for utility-related affiliates and

subsidiaries. PG&E recommends reducing the $500 million credit support authorized by D.91-12-057 to $50 million. ORA does not oppose this request.

Conclusions of Law

1. The Interim Opinion's holding that PG&E's proposed reorganization into a holding company structure should not be classified as an acquisition activity subject to Pub.Util. Code § 854 should not be changed.

2. As applicant, PG&E has the burden of proof to demonstrate that its requested relief is reasonable under our adopted standard of ratepayer indifference for approving holding company applications. PG&E therefore has the burden of proof to demonstrate that (1) a valid business purpose exists, and (2) the reorganization may be accomplished and future operations conducted pursuant to conditions that will be adequate to protect the public interest. To the extent that PG&E fails to meet this burden, we may add further conditions in order to protect the public interest, or reject the application.

3. ORA has the burden of producing evidence in support of its affirmative recommendations.

4. Ordering Paragraph 17 of D.96-11-017 should be modified to read as follows: "The capital requirements of PG&E, as determined to be necessary and prudent to meet the obligation to serve or to operate the utility in a prudent and efficient manner, shall be given first priority by PG&E Corporation's Board of Directors."

5. PG&E should not be subject to the proposed financial restrictions while other California investor-owned energy utilities are not, because PG&E is not unique vis-a-vis other such California energy utilities in this regard, and we do not wish to place PG&E at a competitive disadvantage with respect to other such California energy utilities.

6. When we review the Affiliate Transaction Rules, the Commission may examine whether it is necessary to impose additional financial conditions on the energy utilities with respect to their holding company operations.

7. Parties who believe it is necessary to raise the need for further financial conditions on all electric and gas utilities within our jurisdiction, either as proposed by ORA in this proceeding, or other appropriate financial conditions, may raise this issue when the Commission reviews the Affiliate Transaction Rules as provided in D.97-12-088, *slip op,* at p. 99, Ordering Paragraph 10.

8. ORA's recommended condition discussed in Section 7.1 regarding assignment of business opportunities should not be adopted.

9. ORA's recommended condition discussed in Section 7.2 regarding conforming affiliate agreements should not be adopted.

10. Within three years after the date of this decision, the Commission should conduct an audit of PG&E Corporation, PG&E, and controlled affiliates, at the expense of shareholders of PG&E Corporation, to determine compliance with the conditions adopted in this proceeding, PG&E Corporation's Policies and Guidelines for Affiliate Transactions, and other applicable Commission orders and regulations, as more specifically described in the Ordering Paragraphs of this decision. (Verification Audit.) PG&E, PG&E Corporation, and all controlled affiliates should retain until the completion of the verification audit (i) all internal and external correspondence between PG&E and affiliates; (ii) to the extent prepared in the normal course of business, desk calendars, meeting summaries, phone call summaries, or logs and E-mail correspondence between PG&E officers and department heads and affiliates; and (iii) marketing materials, proposals to customers, and business and strategic plans.

11. ORA's request that the Commission provide the auditors of audits conducted pursuant to our direction in the Affiliate Transaction Rules with explicit direction in this proceeding concerning review of Rule V.E transactions should be denied.

12. If ORA or any other party requests that the Commission generically modify or clarify the Affiliate Transaction Rules, it should do so by an appropriate procedure in the Affiliate Transaction proceeding.

13. ORA's recommended condition discussed in Section 7.4 regarding PG&E's acceptance of the Affiliate Transaction Rules as holding company conditions should be denied.

14. No later than 90 days after the effective date of this proceeding, PG&E Corporation should implement its proposed parent company Policy and Guidelines for Affiliate Company Transactions as modified by (1) the Commission in the Interim Opinion and this decision; (2) the Affiliate Transaction Rules, adopted in D.97-12-088, as modified by D.98-08-035; and (3) other pertinent Commission decisions. PG&E shall initially make this filing as an Advice Letter, which PG&E should serve on the service list of this proceeding. If there are disputes, they can be dealt with in the Advice Letter process, as determined by the Energy Division, or a party may petition the Commission to reopen this proceeding for such limited purpose. We direct PG&E to meet and confer with ORA before filing the Advice Letter.

15. ORA's recommended condition discussed in Section 8.1 regarding restrictions on dual officers and directors should be denied.

16. ORA's recommended condition discussed in Section 8.2 regarding separation of employment and employee benefit plans should be denied.

17. ORA's recommended condition discussed in Section 8.3 regarding compensation for the "benefits of association" should be denied.

18. ORA's recommended condition discussed in Section 8.4 regarding transfer pricing and the 10% adder should be denied, except with respect to transfer pricing between the utility and holding company, where we do not decide the issue here. We will review PG&E's proposed transfer pricing rules between the utility and holding company when we review PG&E's proposed Policy and Guidelines for Affiliate Company Transactions.

19. ORA's recommended condition discussed in Section 8.5 regarding pricing studies should be denied.

20. ORA's recommended condition discussed in Section 8.6 regarding prohibition against implying favorable treatment should be denied.

21. ORA's recommended condition discussed in Section 8.7 regarding a record of joint negotiations should be denied.

22. If PG&E continues to use its "8-hour day" timekeeping and billing system, PG&E should test this system to verify that its assumption that the "8-hour day" timekeeping and billing system adequately and proportionately reflects work actually performed.

23. PG&E should inform the Commission if PG&E Corporation forms an insurance affiliate in the future. PG&E should comply with the requirements of Affiliate Transaction Rule VI.B, and notify the Energy Division by advice letter if and when an affiliate is created to sell insurance to the utility, and whether or not the affiliate plans to sell such insurance to third parties as well. PG&E should so

notify the Commission whether or not it believes the new insurance affiliate is covered by the Affiliate Transaction Rules. However, if PG&E does not believe the new affiliate is covered by the Rules, it need not demonstrate how the new affiliate will comply with the Rules. PG&E should, however, demonstrate in its Advice Letter why the affiliate is not covered by the Rules.

24. In the future, PG&E should fully disclose the basis for its transfer pricing in Sections E and F of its annual report filled pursuant to D.93-02-019.

25. In the future, if PG&E omits financial statements for unconsolidated subsidiaries from its annual report filed pursuant to D.93-02-019, 48 CPUC2d 163, 179, PG&E should notify the Commission in the report which statements are missing, why they are missing, and approximately when PG&E anticipates supplementing the report.

26. In the future, PG&E's annual affiliate reports responsive to Section G of the Reporting Requirements at 48 CPUC2d at 179-180 should include the following: (1) Financial information for each consolidated subsidiary shown separately on the consolidating worksheet (instead of combining consolidated subsidiaries into a column entitled "other"); and (2) All information necessary to achieve a basic understanding of each subsidiary's or affiliate's financial results.

27. Ordering Paragraph 1 of D.91-12-057 should be modified so that the $500 million of capital support which we authorized is reduced to $50 million.

28. PG&E should comply with the following recommendations which it has not disputed. PG&E should: (a) Establish accountability for affiliate accounting and record-keeping in a single utility accounting manager; (b) Provide authorizing documents in advance of providing services between affiliates; (c) Redesign the existing system of associated company (affiliate) accounts payable and receivable. (For this item, PG&E should (i) eliminate unnecessary

sub-accounts; (ii) appropriately use notes and accounts payable accounts; (iii) standardize accounting for inter-company (affiliate) income tax transactions); (iv) develop a mechanism to flag improperly recorded payables transactions; and (v) improve the documentation supporting recorded transactions); (d) Establish written agreements for all recurring transactions; (e) Improve the documentation of the transfer pricing basis and the nature and scope of goods and services provided; (f) Utilize requests for services that have been required by continuing service agreements; (g) Conduct a complete review of existing written agreements and implement revisions or execute new agreements, as necessary, to reflect transfers of responsibility from the utility to the holding company; (h) Ensure that all utility accounting with affiliates is recorded in inter-company receivables and payables accounts, and develop a simplified set of inter-company accounts with meaningful titles; and (i) Simplify inter-company accounting procedures and update account documentation.

29. PG&E should implement and maintain the following internal control systems for transactions between the utility and its affiliates and subsidiaries and between the parent and the utility: (a) tracking; approval and authorization; (b) timekeeping; (c) billing; and (d) budgeting, which systems each contain specific descriptions of the services to be rendered, or the services that are anticipated to be rendered. These specific descriptions should include, but are not limited to, a description of the entity billed, the type of service provided, and the specific job or activity performed. For common allocated holding company costs, there should be support for the allocation factors used to distribute the cost to the utility and other affiliates. PG&E and the holding company should also develop and maintain a timekeeping procedure describing the documentation requirements set forth above and providing guidance on correct timekeeping. PG&E and the holding company should also conduct a budget-to-actual variance

analysis at least quarterly to provide a means to investigate significant deviations from planned charges. PG&E and the holding company should maintain the internal reports and all detailed underlying documentation used to generate them until completion of the verification audit ordered by this decision. With respect to its internal control system, PG&E and the holding company should also include a reference indicating from whom and from where more detailed supporting data can be obtained.

30. In order to ensure that PG&E implements the recommendations set forth in Conclusions of Law paragraphs 28 and 29 promptly, we direct that no later than 180 days from the effective date of this decision, PG&E should send a letter, verified by the head of either PG&E Corporation's or PG&E's internal audit department, that PG&E Corporation and PG&E have implemented the conditions set forth. The verified letter should briefly describe the steps PG&E has taken to fulfill these conditions and to verify their implementation. If either PG&E Corporation or PG&E has been unable to fully implement the recommendation, the letter should state the reasons why, and a target date for full implementation. PG&E Corporation or PG&E should send a supplemental letter or letters every two months thereafter, as necessary, until full implementation has occurred. These letters should be sent to the Executive Director, and also served on all Commissioners, the assigned ALJ, and the service list of this proceeding.

ORDER

IT IS ORDERED that:

1. The application for Pacific Gas and Electric Company (PG&E) for authority pursuant to Public Utilities Code § 818 for issuance of stock by PG&E Parent Co., Inc. and PG&E Merger Company is granted, subject to the conditions set forth in Decision (D.) 96-11-017, and subject to the following conditions set forth in Ordering Paragraphs 2 through 7 inclusive.

2. PG&E shall comply with the following recommendations which it has not disputed. PG&E shall: (a) Establish accountability for affiliate accounting and record-keeping in a single utility accounting manager; (b) Provide authorizing documents in advance of providing services between affiliates; (c) Redesign the existing system of associated company (affiliate) accounts payable and receivable. (For this item, PG&E shall (i) eliminate unnecessary sub-accounts; (ii) appropriately use notes and accounts payable accounts; (iii) standardize accounting for inter-company (affiliate) income tax transactions; (iv) develop a mechanism to flag improperly recorded payables transactions; and (v) improve the documentation supporting recorded transactions); (d) Establish written agreements for all recurring transactions; (e) Improve the documentation of the transfer pricing basis and the nature and scope of goods and services provided; (f) Utilize requests for services that have been required by continuing service agreements; (g) Conduct a complete review of existing written agreements and implement revisions or execute new agreements, as necessary, to reflect transfers of responsibility from the utility to the holding company; (h) Ensure that all utility accounting with affiliates is recorded in inter-company receivables and payables accounts, and develop a simplified set of inter-company accounts with

meaningful titles; and (i) Simplify inter-company accounting procedures and update account documentation.

3. PG&E shall implement and maintain the following internal control systems for transactions between the utility and its affiliates and subsidiaries and between the parent and the utility: (a) tracking; approval and authorization; (b) timekeeping; (c) billing; and (d) budgeting, which systems shall each contain specific descriptions of the services to be rendered or the services that are anticipated to be rendered. These specific descriptions shall include, but are not limited to, a description of the entity billed, the type of service provided, and the specific job or activity performed. For common allocated holding company costs, there shall be support for the allocation factors used to distribute the cost to the utility and other affiliates. PG&E and the holding company shall also develop and maintain a timekeeping procedure describing the documentation requirements set forth above and providing guidance on correct timekeeping. PG&E and the holding company shall also conduct a budget-to-actual variance analysis at least quarterly to provide a means to investigate significant deviations from planned charges. PG&E and the holding company shall maintain the internal reports and all detailed underlying documentation used to generate them until completion of the verification audit ordered by this decision. With respect to its internal control system, PG&E and the holding company shall also include a reference indicating from whom and from where more detailed supporting data can be obtained.

4. In order to ensure that PG&E implements the recommendations set forth in Ordering Paragraphs 2 and 3 promptly, we direct that no later than 180 days from the effective date of this decision, PG&E shall send a letter, verified by the head of either PG&E Corporation's or PG&E's internal audit department, that PG&E Corporation and PG&E have implemented the conditions set forth. The

verified letter should briefly describe the steps PG&E has taken to fulfill these conditions and to verify their implementation. If either PG&E Corporation or PG&E has been unable to fully implement the recommendation, the letter should state the reasons why and a target date for full implementation. PG&E Corporation or PG&E shall send a supplemental letter or letters every two months thereafter, as necessary, until full implementation has occurred. These letters shall be sent to the Executive Director, and also served on all Commissioners, the assigned Administrative Law Judge (ALJ), and the service list of this proceeding.

5. Within three years after the date of this decision, the Executive Director shall make staff assignments as necessary to conduct an audit of PG&E Corporation, PG&E, and controlled affiliates, at the expense of shareholders of PG&E Corporation, to determine compliance with the conditions adopted in this proceeding, PG&E Corporation's Policies and Guidelines for Affiliate Transactions, and other applicable Commission orders and regulations. (Verification Audit.) The verification audit period should cover the period from January 1, 2000 through December 31, 2001. However, nothing in this order prevents the auditors from reviewing transactions prior to the audit period, and particularly during the transition period to a holding company structure, if the auditors believe it is necessary to determine PG&E's compliance. The Commission's Energy Division shall be the designated staff organization having responsibility for the audit unless the Executive Director determines that the needs of the Commission dictate otherwise. PG&E Corporation shall reimburse the Commission for the costs of the audit, including the fees and expenses of an outside auditor or consultant and Energy Division's incremental travel costs, if any. Energy Division may contract with the outside auditor or consultant and shall have the ultimate responsibility for selection, direction, monitoring and

supervision of the contractor. Prior to the selection of an outside auditor or consultant, Energy Division should consult with PG&E and ORA regarding the identity of potential contractors. PG&E, PG&E Corporation, and all controlled affiliates shall retain until the completion of the verification audit (i) all internal and external correspondence between PG&E and affiliates; (ii) to the extent prepared in the normal course of business, desk calendars, meeting summaries, phone call summaries, or logs and E-mail correspondence between PG&E officers and department heads and affiliates; and (iii) marketing materials, proposals to customers, and business and strategic plans. The auditor's report shall then be sent by Energy Division to the Executive Director of the Commission, and shall be served on the service list of this application. The Commission may then determine whether further public proceedings regarding the audit are necessary.

6. No later than 90 days after the effective date of this proceeding, PG&E Corporation shall implement its proposed parent company Policy and Guidelines for Affiliate Company Transactions as modified by (1) the Commission in the Interim Opinion and this decision; (2) the Affiliate Transaction Rules, adopted in D. 97-12-088, as modified by D.98-08-035; and (3) other pertinent Commission decisions. PG&E shall initially make this filing as an Advice Letter, which PG&E shall serve on the service list of this proceeding. If there are disputes, they can be dealt with in the Advice Letter process, as determined by the Energy Division, or a party may petition the Commission to reopen this proceeding for such limited purpose. We direct PG&E to meet and confer with ORA before filing the Advice Letter.

7. PG&E shall inform us if PG&E Corporation forms an insurance affiliate in the future. PG&E shall comply with the requirements of Affiliate Transaction Rule VI.B, and notify the Energy Division by advice letter if and when an affiliate is created to sell insurance to the utility, and whether or not the affiliate plans to sell such insurance to third parties as well. PG&E shall so notify the Commission, whether or not it believes the new insurance affiliate is covered by the Affiliate Transaction Rules. However, if PG&E does not believe the new affiliate is covered by the Rules, it need not demonstrate how the new affiliate will comply with the Rules. PG&E shall, however, demonstrate in its Advice Letter why the affiliate is not covered by the Rules.

8. Ordering Paragraph 17 of D.96-11-017 is modified to read as follows: "The capital requirements of PG&E, as determined to be necessary and prudent to meet the obligation to serve or to operate the utility in a prudent and efficient manner, shall be given first priority by PG&E Corporation's Board of Directors."

9. Parties who believe it necessary to raise the need for further financial conditions on all electric and gas utilities within our jurisdiction, either as proposed by ORA in this proceeding or other appropriate financial conditions, may raise this issue when the Commission reviews the Affiliate Transaction Rules as provided for in D.97-12-088, *slip op.* at p. 99, Ordering Paragraph 10.

10. Ordering Paragraph 1 of D.91-12-057 should be modified so that PG&E's aggregate limit of $500 million in capital support to PG&E's regulated and unregulated subsidiaries or affiliates is reduced to $50 million. Ordering Paragraph 1 of D.91-12-057 shall now read as follows: "Pacific Gas and Electric Company (PG&E), on or after the effective date of this order, is authorized to provide up to an aggregate limit of $50,000,000 in capital support to PG&E's

regulated and unregulated subsidiaries or affiliates upon terms and conditions substantially consistent with those set forth or contemplated by the application."

11. This proceeding is closed.

This order is effective today.

Dated April 22, 1999, at San Francisco, California.

RICHARD A. BILAS
President
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

APPENDIX A

COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
Access to Capital on Reasonable Terms			
1. **Restriction on Lines of Business**. The total capitalization (debt and equity) of PG&E's non-energy related business lines shall not exceed 20% of PG&E's capitalization. Energy related business lines include fuel supply, energy conversion, storage, transmission, distribution, marketing, power quality, energy management, energy efficiency and associated technologies.	Not addressed in OIR.	Utility-specific rule.	Outside scope of OIR.
2. **Restriction on Total Investment**. The total capitalization of PG&E Corporation's business units other than PG&E shall not exceed PG&E's capitalization. PG&E Corporation will adjust the investment and dividend policies of its business units as necessary to satisfy this condition.	Not addressed in OIR.	Utility-specific rule.	Outside scope of OIR
3. **Prohibition Against Parent Company Senior Securities and Pledging PG&E Stock**. All financings other than short-term debt and the sale of PG&E Corporation common stock shall occur at the subsidiary level. PG&E Corporation will not issue any preferred stock or any debt with a maturity greater than 12 months. PG&E Corporation will not pledge its PG&E stock as security for	Not addressed in OIR.	Utility-specific rule.	Outside scope of OIR

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COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule PG&E	Overland/ORA
debt or make any other commitments impairing its ability to distribute PG&E's common stock to PG&E Corporation shareholders through a spin-off.			
4. **Capital Requirements**. The capital requirements of PG&E, as determined to be necessary and prudent to meet the obligation to serve or to operate the utility in a prudent and efficient manner, shall be given first priority by PG&E Corporation's Board of Directors.	Not addressed in OIR - Revises Existing Holding Company Condition 12. The capital requirements of PG&E, as determined to be necessary to meet its obligation to serve, shall be given first priority by the Board of Directors of PG&E's parent holding company and PG&E.*	Utility-specific rule.	Outside scope of OIR
Maintain the Commission's Ability to Respond to Changing Circumstances			
5. **Utility Divestiture**. The Commission may order PG&E Corporation to divest PG&E through a distribution of PG&E common stock to PG&E Corporation's shareholders (i.e. a spin-off) if the Commission determines PG&E's affiliation with PG&E Corporation has caused or is likely to cause material harm to PG&E or its ratepayers. PG&E's affiliates will notify their creditors the Commission has the authority to order the	Not addressed in OIR.	Utility-specific rule.	Outside scope of OIR

* PG&E has agreed to this revised language.

APPENDIX A

COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
divestiture of PG&E under certain circumstances.			
6. **Assignment of Business Opportunities**. Any business activities the Commission finds to be necessary, reasonably incidental or economically appropriate to utility operations will remain with PG&E.	**VII. Utility Products & Services** **A. General Rule:** Except as provided for in these Rules, new products and services shall be offered through affiliates. **III. Nondiscrimination** **B. Affiliate Transactions:** Transactions between a utility and its affiliates shall be limited to tariffed products and services, the sale or purchase of goods, property, products or services made generally available by the utility or affiliate to all market participants through an open, competitive bidding process, or as provided for in Sections V D and V E (joint purchases and corporate support) and Section VII (new products and services) below, provided the transactions provided for in Section VII comply with all of the other adopted Rules. **E. Business Development and Customer Relations:** Except as otherwise provided by these Rules, a utility shall not: 1. Provide leads to its affiliates; 2: solicit business on behalf of its affiliates; 3. Acquire information on behalf of or to	Conflicts with OIR Rule VII (for new products and service) and OIR Rule III (for existing utility products or services).	Outside scope of OIR because the proposed condition restricts the activities of affiliates. Does not conflict with Rule VII because Rule VII allows the utility to provide non-tariffed goods and services in specified circumstances. ORA agrees that the affiliate transaction rules govern transfers of goods, property, products and services to affiliates.

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COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
	provide to its affiliates; 4. share market analysis reports or any other types of proprietary or non-publicly available reports, including but not limited to market, forecast, planning or strategic reports, with its affiliates. ***		
7. **Agreements with Affiliates to Conform with Commission Findings**. All transactions between PG&E and affiliates shall be subject to written "affiliate agreements". Affiliate agreements, by definition, are not the product of arms-length negotiation. All PG&E affiliate agreements shall include a "regulatory out" clause allowing PG&E to terminate or modify the contract to conform with Commission findings if the Commission determines the terms of the agreement are unfair to PG&E or its ratepayers. PG&E will cause its affiliate agreements to be terminated or modified consistent with Commission findings.	**III.B.1. Provision of Supply, Capacity, Services or Information:** Except as provided for in Sections V D, V E, and VII, provided the transactions provided for in Section VII comply with all of the other adopted Rules, a utility shall provide access to utility information, services, and unused capacity or supply on the same terms for all similarly situated market participants. If a utility provides supply, capacity, services, or information to its affiliate(s), it shall contemporaneously make the offering available to all similarly situated market participants, which include all competitors serving the same market as the utility's affiliates. **3. Tariff Discretion:** If a tariff provision allows for discretion in its application, a utility shall apply that tariff provision in the same manner to its affiliates and other market participants and their respective customers.	Utility-specific rule	Outside scope of OIR Rules III.B.1, 3 and 4 and Rule IV. G are not directly relevant to the proposed condition.

APPENDIX A

COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
	4. No Tariff Discretion: If a utility has no discretion in the application of a tariff provision, the utility shall strictly enforce that tariff provision.		
	IV. Disclosure and Information **G. Maintenance of Affiliate Contracts and Related Bids:** A utility shall maintain a record of all contracts and related bids for the provision of work, products or services to and from the utility to its affiliates for no less than a period of three years, and longer if this Commission or another government agency so requires.		
8. **Audit**. Within three to six years after the date of this Decision, the Commission will conduct an audit of PG&E Corporation, PG&E, and controlled affiliates, at the expense of shareholders of PG&E Corporation, to determine compliance with the conditions adopted in this proceeding, PG&E Corporation's Policies and Guidelines For Affiliate Transactions, and other applicable Commission orders and regulations ("Verification Audit"). PG&E, PG&E Corporation, and all controlled affiliates shall retain until the completion of the verification audit (i) all internal and	**VI. Regulatory Oversight** **C. Affiliate Audit:** No later than December 31, 1998, and every year thereafter, the utility shall have audits performed by independent auditors that cover the calendar year which ends on December 31, and that verify that the utility is in compliance with the Rules set forth herein. The utilities shall file the independent auditor's report with the Commission's Energy Division beginning no later than May 1, 1999, and serve it on all parties to this proceeding. The audits shall be at shareholder expense.	Utility-specific rule.	Outside scope of OIR because (1) the proposed condition requires the cooperation of affiliates, and (2) the scope of the audit goes beyond compliance with the affiliate transactions rules adopted in the OIR.

APPENDIX A

COMPARISON EXHIBIT - EXHIBIT 124

Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
external correspondence between PG&E and affiliates, (ii) to the extent prepared in the normal course of business, desk calendars, meeting summaries, phone call summaries, or logs and E-mail correspondence between PG&E officers and department heads and affiliates, and (iii) marketing materials, proposals to customers, and business and strategic plans.			
Separate Utility and Nonutility Activities			
9. **Restriction on Dual Officers and Directors**. No more than three PG&E officers may also serve as officers of PG&E Corporation or nonutility affiliates. No more than three members of PG&E's Board of Directors can serve on PG&E Corporation's Board of Directors.	**V. Separation** **G. Employees:** 1. Except as permitted in Section V E (corporate support), a utility and its affiliates shall not jointly employ the same employees. This Rule prohibiting joint employees also applies to Board Directors and corporate officers, except for the following circumstances: In instances when this Rule is applicable to holding companies, any board member or corporate officer may serve on the holding company and with either the utility or affiliate (but not both). Where the utility is a multi-state utility, is not a member of a holding company structure, and assumes the corporate governance functions for the affiliates, the prohibition against any board	Conflicts with clarification on limits of dual officers issued in Decision 98-08-035.	Consistent with Rule V.G. with regards to affiliates. Outside scope of OIR with regard to PG&E Corporation because PG&E Corporation is not an affiliate for purposes of the affiliate transaction rules.

APPENDIX A

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Overland Proposed Conditions	Related Affiliate OII/OIR Rules	Relationship Between Proposed Condition and Rule: PG&E	Relationship Between Proposed Condition and Rule: Overland/ORA
	member or corporate officer of the utility also serving as a board member or corporate officer of an affiliate shall only apply to affiliates that operate within California. In the case of shared directors and officers, a corporate officer from the utility and holding company shall verify in the utility's compliance plan the adequacy of the specific mechanisms and procedures in place to ensure that the utility is not utilizing shared officers and directors as a conduit to circumvent any of these Rules. [Text regarding compliance plan showing omitted.]		
13. **Separation of Employment and Employee Benefit Plans**. To the extent permitted by law, all transfers of employees between PG&E and affiliates shall be implemented as a resignation from one company and the acceptance of employment from the other company on the same terms as customarily apply to resignations to accept employment with a nonaffiliate. Employees of PG&E's affiliates will not participate in PG&E's employee benefit plans. PG&E employees will not participate in the benefit plans of PG&E Corporation or other affiliates. Temporary assignments of utility employees to affiliates, including	**V. Separation** **G. Employees:** 1. Except as permitted in Section V E (corporate support), a utility and its affiliates shall not jointly employ the same employees. This Rule prohibiting joint employees also applies to Board Directors and corporate officers, except for the following circumstances: In instances when this Rule is applicable to holding companies, any board member or corporate officer may serve on the holding company and with either the utility or affiliate (but not both). Where the utility is a multi-state utility, is not a member of a holding company structure, and assumes the corporate	Conflicts - Affiliate OII/OIR does not prohibit employees from participating in benefit plans of other affiliates and it permits rotations and temporary assignments of utility employees to all but marketing affiliates.	The Affiliate Transaction Rules do not specifically permit or prohibit affiliate employees to participate in utility benefit plans. However, the proposed condition is consistent with the prohibition against joint employment contained in Rule V.G. D.98-08-035 does allow temporary assignments of employees with strict limits. Rules V.G.2 (c) and (d) and Rule V.E. are not directly relevant to the proposed condition.

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rotational assignments, are prohibited.	governance functions for the affiliates, the prohibition against any board member or corporate officer of the utility also serving as a board member or corporate officer of an affiliate shall only apply to affiliates that operate within California. In the case of shared directors and officers, a corporate officer from the utility and holding company shall verify in the utility's compliance plan the adequacy of the specific mechanisms and procedures in place to ensure that the utility is not utilizing shared officers and directors as a conduit to circumvent any of these Rules. [Text regarding compliance plan showing omitted.] 2. All employee movement between a utility and its affiliates shall be consistent with the following provisions: a. A utility shall track and report to the Commission all employee movement between the utility and affiliates. The utility shall report this information annually pursuant to our Affiliate Transaction Reporting Decision, D.93-02-016, 48 CPUC2d 163, 171-172 and		

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	180 (Appendix A, Section I and Section II H.). b. Once an employee of a utility becomes an employee of an affiliate, the employee may not return to the utility for a period of one year. This Rule is inapplicable if the affiliate to which the employee transfers goes out of business during the one-year period. In the event that such an employee returns to the utility, such employee cannot be retransferred, reassigned, or otherwise employed by the affiliate for a period of two years. Employees transferring from the utility to the affiliate are expressly prohibited from using information gained from the utility in a discriminatory or exclusive fashion, to the benefit of the affiliate or to the detriment of other unaffiliated service providers. c. When an employee of a utility is transferred, assigned, or otherwise employed by the affiliate, the affiliate shall make a one-time payment to the utility in an amount equivalent to 25% of the employee's base annual compensation, unless the utility can		

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	demonstrate that some lesser percentage (equal to at least 15%) is appropriate for the class of employee included. In the limited case where a rank-and-file (non-executive) employee's position is eliminated as a result of electric industry restructuring, a utility may demonstrate that no fee or a lesser percentage than 15% is appropriate. The Board of Directors must vote to classify these employees as "impacted" by electric restructuring and these employees must be transferred no later than December 31, 1998, except for the transfer of employees working at divested plants. In that instance, the Board of Directors must vote to classify these employees as "impacted" by electric restructuring and these employees must be transferred no later than within 60 days after the end of the O&M contract with the new plant owners. All such fees paid to the utility shall be accounted for in a separate memorandum account to track them for future ratemaking treatment (i.e. credited to the Electric Revenue Adjustment Account or the Core and Non-core Gas Fixed Cost Accounts, or other ratemaking treatment, as appropriate), on an annual		

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	basis, or as otherwise necessary to ensure that the utility's ratepayers receive the fees. This transfer payment provision will not apply to clerical workers. Nor will it apply to the initial transfer of employees to the utility's holding company to perform corporate support functions or to a separate affiliate performing corporate support functions, provided that that transfer is made during the initial implementation period of these rules or pursuant to a § 851 application or other Commission proceeding. However, the rule will apply to any subsequent transfers or assignments between a utility and its affiliates of all covered employees at a later time.		
	d. Any utility employee hired by an affiliate shall not remove or otherwise provide information to the affiliate which the affiliate would otherwise be precluded from having pursuant to these Rules.		
	e. A utility shall not make temporary or intermittent assignments, or rotations to its energy marketing affiliates. Utility employees not involved in marketing may be used on a temporary basis (less		

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	than 30% of an employee's chargeable time in any calendar year) by affiliates not engaged in energy marketing only if: (i) All such use is documented, priced and reported in accordance with these Rules and existing Commission reporting requirements, except that when the affiliate obtains the services of a non-executive employee, compensation to the utility should be priced at a minimum of the greater of fully loaded cost plus 10% of direct labor cost, or fair market value. When the affiliate obtains the services of an executive employee, compensation to the utility should be priced at a minimum of the greater of fully loaded cost plus 15% of direct labor cost, or fair market value. (ii) Utility needs for utility employees always take priority over any affiliate requests; (iii) No more than 5% of full time equivalent utility employees		

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	may be on loan at a given time; (iv) Utility employees agree, in writing, that they will abide by these Affiliate Transaction Rules; and (v) Affiliate use of utility employees must be conducted pursuant to a written agreement approved by appropriate utility and affiliate officers. **V. Separation** **E. Corporate Support:** As a general principle, a utility, its parent holding company, or a separate affiliate created solely to perform corporate support services may share with its affiliates joint corporate oversight, governance, support systems and personnel. Any shared support shall be priced, reported and conducted in accordance with the Separation and Information Standards set forth herein, as well as other applicable Commission pricing and reporting requirements. As a general principle, such joint utilization shall not allow or provide a means for the transfer of confidential information from		

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	the utility to the affiliate, create the opportunity for preferential treatment or unfair competitive advantage, lead to customer confusion, or create significant opportunities for cross-subsidization of affiliates. In the compliance plan, a corporate officer from the utility and holding company shall verify the adequacy of the specific mechanisms and procedures in place to ensure the utility follows the mandates of this paragraph, and to ensure the utility is not utilizing joint corporate support services as a conduit to circumvent these Rules. Examples of services that may be shared include: payroll, taxes, shareholder services, insurance, financial reporting, financial planning and analysis, corporate accounting, corporate security, human resources (compensation, benefits, employment policies), employee records, regulatory affairs, lobbying, legal, and pension management. Examples of services that may not be shared include: employee recruiting, engineering, hedging and financial derivatives and arbitrage services, gas and electric purchasing for resale, purchasing of gas transportation and storage capacity,		

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	purchasing of electric transmission, system operations, and marketing.		
16. **Compensation for Benefits of Association and Risks of Self-Dealing.** PG&E's affiliates selling products and services within PG&E's service territory will make payments to compensate PG&E and its ratepayers for: (1) the benefits accruing to the affiliate from its association with the local franchised distribution utility; and (2) the risk PG&E's cost of service will increase as a result of preferential treatment given to the affiliate by PG&E. The payment will reflect a Commission determined percentage of the revenues received by the Affiliate from the sale of products and services within PG&E's service territory. The Commission will determine the percentage of revenues to be paid to PG&E in PG&E's General Rate Cases.	**V. Separation** **F. Corporate Identification and Advertising:** 1. A utility shall not trade upon, promote, or advertise its affiliate's affiliation with the utility, nor allow the utility name or logo to be used by the affiliate or in any material circulated by the affiliate, unless it discloses in plain legible or audible language, on the first page or at the first point where the utility name or logo appears that: a. the affiliate "is not the same company as [i.e. PG&E, Edison, the Gas Company, etc.], the utility,"; b. the affiliate is not regulated by the California Public Utilities Commission; and c. "you do not have to buy [the affiliate's] products in order to continue to receive quality regulated services from the utility." The application of the name/logo disclaimer is limited to the use of the name or logo in California.	Conflicts - Affiliate OII/OIR rules allow use of corporate logo with appropriate disclaimer and without payment. Conflicts with Affiliate OIR/OIR Rules that eliminate benefits of association because it assumes violations of the rules and ignores existence of penalty docket designed to evaluate penalties appropriate for violation of affiliate rules.	Not addressed in OIR. Proposed condition does not require payment for use of utility name or logo.

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17. **Transfer Pricing**. All transfers of assets, goods, services, confidential utility information, and other items of value from PG&E to affiliates will be priced at the higher of fully allocated cost or fair market value. Fully allocated cost will include a 10% premium on fully allocated cost excluding the premium. All transfers of assets, goods, services and items of value from affiliates to PG&E will be priced at the lower of fully allocated cost or fair market value. The 10 % premium on fully allocated cost will not apply to transfers from affiliates to PG&E.	**V. Separation** **H. Transfer of Goods and Services:** To the extent that these Rules do not prohibit transfers of goods and services between a utility and its affiliates, and except for as provided by Rule V.G.2.e, all such transfers shall be subject to the following pricing provisions: 1. Transfers from the utility to its affiliates of goods and services produced, purchased or developed for sale on the open market by the utility will be priced at fair market value. 2. Transfers from an affiliate to the utility of goods and services produced, purchased or developed for sale on the open market by the affiliate shall be priced at no more than fair market value. 3. For goods or services for which the price is regulated by a state or federal agency, that price shall be deemed to be the fair market value, except that in cases where more than one state commission regulates the price of goods or services, this Commission's pricing provisions govern. 4. Goods and services produced, purchased	Conflicts with Phase I on asset transfers. Affiliate rules provide for fully loaded cost transfer pricing for specific categories. The adder is 5% and not 10%.	Outside scope of OIR with regard to non-energy affiliates and PG&E Corporation. Utility specific rule proposed to apply 10% adder to energy affiliates.

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	or developed for sale on the open market by the utility will be provided to its affiliates and unaffiliated companies on a nondiscriminatory basis, except as otherwise required or permitted by these Rules or applicable law. 5. Transfers from the utility to its affiliates of goods and services not produced, purchased or developed for sale by the utility will be priced at fully loaded cost plus 5% of direct labor cost. 6. Transfers from an affiliate to the utility of goods and services not produced, purchased or developed for sale by the affiliate will be priced at the lower of fully loaded cost or fair market value.		
18. **Pricing Studies**. PG&E shall prepare an annual study of the market value of all assets, goods and non-tariffed services it provides to affiliates, including corporate services and transfers of confidential utility information. Immaterial transactions may be excluded from the study except that the combined total fully allocated cost of all transactions excluded from the study except that the combined total fully allocated cost of all transactions excluded from the study cannot exceed $100,000. PG&E shall be	**V. Separation** **H. Transfer of Goods and Services:** To the extent that these Rules do not prohibit transfers of goods and services between a utility and its affiliates, and except for as provided by Rule V.G.2.e, all such transfers shall be subject to the following pricing provisions: 1. Transfers from the utility to its affiliates of goods and services produced, purchased or developed for sale on the open market by the utility will be priced at fair market	Utility-specific rule.	Not addressed in OIR. Proposed condition is outside of scope of OIR to the extent it requires cooperation of affiliates and applies to non-energy affiliates. The proposed condition is needed to monitor and assess the transfer pricing policy adopted in the affiliate transaction rules.

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required to demonstrate it has determined fair market value through a method appropriate to the asset, good, or non-tariffed service. Such methods may include independent appraisals using the market or income approach; prices charged by alternative service providers, e.g. outsourcing; the application of hourly billing rates charged by contractors or consulting firms for similar work; or a combination of methods adequately documented for audit purposes. The pricing studies will include an estimate of the affiliates' cost of obtaining equivalent assets, goods or services internally or from a nonaffiliated party. PG&E's affiliates shall provide PG&E with all information necessary to prepare the pricing study.	value. 2. Transfers from an affiliate to the utility of goods and services produced, purchased or developed for sale on the open market by the affiliate shall be priced at no more than fair market value. 3. For goods or services for which the price is regulated by a state or federal agency, that price shall be deemed to be the fair market value, except that in cases where more than one state commission regulates the price of goods or services, this Commission's pricing provisions govern. 4. Goods and services produced, purchased or developed for sale on the open market by the utility will be provided to its affiliates and unaffiliated companies on a nondiscriminatory basis, except as otherwise required or permitted by these Rules or applicable law. 5. Transfers from the utility to its affiliates of goods and services not produced, purchased or developed for sale by the utility will be priced at fully loaded cost plus 5% of direct labor cost. 6. Transfers from an affiliate to the utility		

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	of goods and services not produced, purchased or developed for sale by the affiliate will be priced at the lower of fully loaded cost or fair market value.		
20. **Prohibition Against Implying Favorable Treatment**. PG&E Corporation, PG&E and their affiliates are prohibited from implying the purchase of products from affiliates will result in favorable treatment from PG&E in utility transactions.	**III. Nondiscrimination** **A. No Preferential Treatment Regarding Services Provided by the Utility:** Unless otherwise authorized by the Commission or the FERC, or permitted by these Rules, a utility shall not: 1. represent that, as a result of the affiliation with the utility, its affiliates or customers of its affiliates will receive any different treatment by the utility than the treatment the utility provides to other, unaffiliated companies or their customers; or 2. provide its affiliates, or customers of its affiliates, any preference (including but not limited to terms and conditions, pricing, or timing) over non-affiliated suppliers or their customers in the provision of services provided by the utility. **B.2. Offering of Discounts:** Except when made generally available by the utility through an open, competitive bidding process, if a utility offers a discount or waives all or any part of any other charge or	Utility-specific rule.	Outside of scope of OIR because the proposed condition restricts the activities of affiliates. The proposed condition is consistent with the affiliate transaction rules with regards to the activities of the utility.

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	fee to its affiliates, or offers a discount or waiver for a transaction in which its affiliates are involved, the utility shall contemporaneously make such discount or waiver available to all similarly situated market participants. The utilities should not use the "similarly situated" qualification to create such a unique discount arrangement with their affiliates such that no competitor could be considered similarly situated. All competitors serving the same market as the utility's affiliates should be offered the same discount as the discount received by the affiliates. A utility shall document the cost differential underlying the discount to its affiliates in the affiliate discount report described in rule III F 7 below.		
	B.3. Tariff Discretion: If a tariff provision allows for discretion in its application, a utility shall apply that tariff provision in the same manner to its affiliates and other market participants and their respective customers.		
	B.4. No Tariff Discretion: If a utility has no discretion in the application of a tariff provision, the utility shall strictly enforce that tariff provision.		

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	E.7. Business Development and Customer Relations: Except as otherwise provided by these Rules, a utility shall not: *** give any appearance that the affiliate speaks on behalf of the utility.		
23. **Record of Joint Negotiations.** If (1) affiliate personnel (or representatives) attend or participate in negotiations between PG&E and nonaffiliates, or (2) PG&E personnel (or representatives) attend or participate in negotiations between an affiliate and a nonaffiliate, or (3) PG&E and an affiliate jointly negotiate with a nonaffiliate; the utility shall create a record of the negotiations and make the record available to the Commission on request. The record shall contain the following information: (1) the date of the negotiation (2) the names and employer of each person attending or participating in the negotiation (3) the subject matter of the negotiation (4) all non-public utility information made available to the affiliate during or in connection with the negotiation (5) the specific Affiliate Transactions Rules relied upon to permit the exchange of non-public information and the factual basis for determining the exchange of information was permitted under the rule; (6) a description of all other transactions, if any, entered into by the	**V. Separation** **D. Joint Purchases:** To the extent not precluded by any other Rule, the utilities and their affiliates may make joint purchases of good and services, but not those associated with the traditional utility merchant function. For purpose of these Rules, to the extent that a utility is engaged in the marketing of the commodity of electricity or natural gas to customers, as opposed to the marketing of transmission and distribution services, it is engaging in merchant functions. Examples of permissible joint purchases include joint purchases of office supplies and telephone services. Examples of joint purchases not permitted include gas and electric purchasing for resale, purchasing of gas transportation and storage capacity, purchasing of electric transmission, systems operations, and marketing. The utility must insure that all joint purchases are priced, reported, and conducted in a manner that permits clear identification of the utility and affiliate portions of such purchases, and in accordance with applicable Commission	Utility-specific rule.	Utility specific affiliate transaction rule.

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utility or the affiliate with the nonaffiliated participant as a result of the negotiation; (7) a description of all other transactions entered into by the utility and the nonaffiliated participant within 90 days of the negotiation; and (8) the title of all of documents created in conjunction with the negotiations including but not limited to written proposals, correspondence, agendas and notes. The utility will maintain a copy of all the documents created in conjunction with the negotiations for at least three years.	allocation and reporting rules. **V. Separation** **F. Corporate Identification and Advertising:** 4. A utility shall not participate in joint advertising or joint marketing with its affiliates. This prohibition means that utilities may not engage in activities which include, but are not limited to the following: a. A utility shall not participate with its affiliates in joint sales calls, through joint call centers or otherwise, or joint proposals (including responses to requests for proposals (RFPs)) to existing or potential customers. At a customer's unsolicited request, a utility may participate, on a nondiscriminatory basis, in non-sales meetings with its affiliates or any other market participant to discuss technical or operational subjects regarding the utility's provision of transportation service to the customer; b. Except as otherwise provided for by these Rules, a utility shall not participate in any joint activity with its affiliates. The term "joint activities" includes, but is not limited to, advertising, sales, marketing,		

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	communications and correspondence with any existing or potential customer; c. A utility shall not participate with its affiliates in trade shows, conferences, or other information or marketing events held in California.		
24. **Affiliate Transactions Rules Accepted as Holding Company Conditions.** PG&E, PG&E Corporation and PG&E's affiliates hereby grant the Commission the authority to enforce all of the Affiliate Transactions Rules adopted in D.97-12-088 and this decision, even if the rules are subsequently determined to be invalid. In the event some portion of the Affiliate Transactions Rules are determined to be invalid, PG&E, PG&E Corporation and PG&E's affiliates agree to continue to abide by the portion of the Affiliate Transactions Rules determined to be invalid, unless directed to do otherwise by the Commission.	Not Addressed in OIR.	Conflict because Holding Company is not covered by Affiliate OII/OIR rules. If found to be invalid, condition would then be in conflict with Affiliate OII/OIR.	Outside of scope of OIR. The proposed condition strengthens rather than conflicts with the affiliate transaction rules.