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Scott Murtishaw
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Dear Mr. Murtishaw:

PG&E would like to respond to a letter you received dated December 17, 2010 from Mr. Finkelstein, Legal Director for TURN, concerning the ratemaking treatment of PG&E's retired electromechanical meters. PG&E believes that letter (and an earlier Ex Parte notice) includes several inaccurate assertions regarding Commission policy and the so-called "used and useful" principle.

Most notable among these inaccuracies is TURN's flawed claim that previous Commission decisions stand for the principle that utilities should not fully recover their costs of equipment replaced before the end of their useful life on account of technological change and to implement Commission policies. To the contrary, PG&E has explained in its reply brief that TURN's flawed claim is undermined by the Commission's treatment of Pacific Bell in an analogous circumstance involving group accounting rules and the ratemaking treatment of assets being retired due to technological change. For the reasons stated below, TURN has failed to adequately distinguish in its letter between the PacBell decision and PG&E's current situation.

A. The Pacific Bell Decision distinguishes between assets that were retired early on account of technological change (rate of return allowed) and assets that were retired on account of a marketing strategy (rate of return disallowed).

TURN's letter raises a false distinction between assets that were retired on account of technological change and assets that were retired on account of a migration strategy. TURN's letter admits that the assets removed due to the marketing strategy were no longer "used and useful." Yet, it fails to take the logical next step to conclude that the assets retired on account of technological change similarly were no longer "used and useful."

TURN's letter makes a feeble effort to distinguish between assets retired on account of Pac Bell's marketing activities and assets retired on account of technological change:

> In D.83-08-081, the Commission followed up on the issues first discussed in D.93367. As PG&E noted in its reply brief, only costs that were attributable to the premature retirements associated with the success of the migration strategy were removed from rate base. *However, this is because the other costs were associated with the*

> *remaining physical plant that continued to serve customers of the regulated utility*. Here, of course, PG&E's SmartMeter program is premised on prematurely retiring its entire investment in electromechanical meters, such that none of those meters will be "necessary to serve" or, to put it another way, "used and useful." (TURN letter, pp. 2-3, emphasis added).

TURN's letter, however, never explains why PG&E should be denied a return on its retired metering equipment, even while acknowledging that Pac Bell was allowed a return on their retired equipment because the "other costs" [i.e., stranded investment from early retirement] "*were associated with the remaining physical plant that continued to serve customers of the regulated utility*." Like Pac Bell, which had new equipment replacing older equipment, PG&E also has "remaining physical plant that continued to serve customers of the regulated utility," including the newly installed Smart Meters. Thus, the treatment of PG&E and Pac Bell should be the same.

In fact, the Pac Bell decision specifically recognizes that retired assets, whether by marketing or technological change, both involved stranded investment. This is made clear by that Decision's explanation of the issues set for hearing by the Commission:

> a. An appropriate method for allocating to the proper user ***any net stranded investment*** as a result of Pacific's migration strategy and the establishment of nonregulated operations on March 1, 1982, as required by the FCC Computer Inquiry II decision.
>
> * * *
>
> c. Studies by Pacific and the staff to determine the kinds of equipment which may have been retired prior to being fully depreciated, the associated amount of undepreciated or stranded investment, and a method for recovering fairly ***any stranded investment***.
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> * * *
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> f. Depreciation rates used for ratemaking.[1]

Thus, TURN's letter fails in any reasonable way to distinguish the Pac Bell case from the facts involving PG&E.

Moreover, the entire context of the Pac Bell decision reveals just how flawed TURN's theories are in the context of rate of return, cost of service ratemaking There are undoubtedly a great many situations where utility assets (whether previously in the telephone industry, or other

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[1] D. 83-08-031, 1983 Cal. PUC LEXIS 1071, at *1; 12 CPUC 2d 150 (emphasis added).

utility activities) are replaced earlier than expected due to technological improvement. Ordinarily, this is accomplished through the rules of group accounting by treating the retirements with equal and offsetting entries to plant and the depreciation reserve (with no net change to rate base) and/or shortening the depreciable life of the group. The fact that TURN has failed to identify a single "used and useful" case where groups (or subsets) of distribution-type assets are retired early on account of technological change, and where rate base treatment is denied, is telling and shows just how out of the mainstream TURN's flawed application of the used and useful principle is. In fact, in the Pac Bell decision, the intervenors did not even contest full recovery of assets retired due to technological change, only those replaced due to affirmative marketing practices. Given the Pac Bell decision and TURN's failure to cite any analogous precedent supporting extension of the "used and useful" principle to the facts presented here, the Commission should summarily reject TURN's ill-advised modifications to standard ratemaking practice and group accounting rules.

B. TURN's letter fails to address the unintended consequences of denying utilities full cost recovery when assets are replaced early on account of technological change.

TURN seems to suggest (at p. 3) that the utilities should be denied recovery because *all* of the old meters are being replaced, not just a substantial portion. PG&E knows of no policy reason for reasonably distinguishing between replacement of a subset, a substantial portion, or virtually all of a group of assets with a technologically more advanced piece of equipment. TURN's suggestion should be rejected for the following additional reasons:

- PG&E will have replaced only around 70% of its electromechancial meters by the end of 2010. (Exhibit PG&E-4, pp. 13-23.) If TURN is seeking to distinguish (and apply the used and useful principle) only to those situations when *all* equipment has been replaced, then the Commission should note that PG&E continues to retain a substantial investment in operable electro-mechanical meters in the test year. If the Commission chooses to adopt TURN's suggested standard, which appears to require replacement of *all* meters before invoking the used and useful principle, then PG&E should be allowed (even under the TURN rationale) a full rate of return at least for this rate cycle, since a substantial portion of the meters will remain used and useful in the test year.

- Had the Commission adopted TURN's proposed cost recovery rules prior to PG&E's installation of Smart Meters, PG&E could have recommended retention of a significant portion of the old equipment (*e.g.,* in coastal regions), thereby potentially avoiding the loss that TURN seeks to now impose. Because TURN failed to request these rules in a timely fashion (*i.e.,* in the AMI and Upgrade proceedings), TURN – and, if adopted, the Commission – has deprived PG&E of the opportunity to avoid such loss. In the future, should the Commission adopt a punitive policy in this situation, utilities will be loath to fully replace a group of assets.

- Similarly, had TURN requested these unprecedented cost recovery rules in a timely fashion, PG&E could have proposed cost recovery over four to six years in 2005 when it first proposed SmartMeter, thereby allowing it to receive a full return as the assets would have been depreciated as they were being retired. Again, having failed to take timely action, TURN now asks the Commission to change the rules and deny PG&E the opportunity for full recovery over the accelerated period. If the Commission adopts TURN's proposal in this GRC, utilities will be forced to more rapidly depreciate plant when it appears that technological change could lead to replacement of an asset group. This will lead to increased litigation (as explained in the last bullet, below).

- It is unfair and fundamentally bad public policy for the Commission to adopt policies that will have the effect of placing utilities at financial risk when groups of assets have a shorter life than their estimated depreciable life. A great many groups of assets have had a service life much longer than estimated, while some have had a shorter service life. Given that ratepayers reap the benefit when groups of assets last for longer than their depreciable lives, it is unfair to place utilities at financial risk for groups of assets that have a useful life that falls below the mean on account of technological change or Commission policy. If the Commission undertakes such unfair policies utilities will be incentivized to estimate shorter useful lives.

- If the Commission adopts TURN's proposal here, the utilities will be forced to closely scrutinize their assets for possible technological change (*e.g.,* assets subject to Smart Grid replacement) and shorten the estimated lives of assets subject to change so there will be fewer stranded costs. This will almost certainly result in increased regulatory litigation and, ultimately, higher costs for customers.

The concerns described above raise serious questions of public policy and fundamental fairness. TURN's proposal, if adopted, will have long-lasting and deleterious consequences by incentivizing utilities in perverse ways and unfairly punishing shareholders for investing in technological change. These are good reasons why the Commission should continue the current ratemaking practice of not extending the "used and useful" principle to asset groups, especially in situations where the utility is expected to invest in replacement utility assets to implement Commission policy and accommodate changes in technology.

C. TURN's complaints about PG&E making arguments for the first time in reply brief are unwarranted.

TURN also complains that PG&E challenged TURN's proposal to use the 18-year amortization period and raised the Pacific Bell Decision for the first time in its reply brief. Neither complaint has any merit.

First, PG&E had no reason to address TURN's 18-year amortization period argument prior to reply brief because PG&E believed that the ratemaking treatment of the retired meters had been previously resolved in the Smart Meter proceedings. Specifically, PG&E's opening brief showed that PG&E had made ratemaking proposals in both SmartMeter proceedings to recover the costs

of the retired meters as if they were an ordinary retirement (status quo ratemaking with inclusion in rate base). These proposals were either adopted explicitly by the Smart Meter decisions or implicitly presumed as part of the adopted ratemaking. PG&E had proposed the 18-year life consistent with the incremental cost analysis in the SmartMeter proceedings; that is PG&E sought a status quo ratemaking treatment for the retired meters *that resulted in no incremental cost or benefit to customers*. Had PG&E proposed a different amortization period, there would have been an incremental cost or benefit/rate impact that would have needed to be considered in the SmartMeter decisions. PG&E had no reason in its opening brief to suggest an alternative to the status quo treatment of the old meters that it previously proposed in the SmartMeter proceedings and reasonably believed had been adopted explicitly or implicitly.[2]

Second, because TURN had previously provided neither legal nor any other support for its unprecedented extension of the used and useful theory, PG&E had no basis to rebut TURN's position prior to reply brief. In its opening brief, however, TURN attempted to draw analogies between PG&E's situation with the retired electromechanical meters and other cases that were clearly distinguishable on their facts. The only cases cited by TURN that denied a return based on the used and useful principle involved (1) projects that never went into service and were abandoned or (2) individual power plants that were prematurely shut-down because they could no longer be operated economically. Under the circumstances, it was entirely appropriate for PG&E to point out in its reply brief the factual differences between TURN's cited authority and the meter replacement situation (*i.e.,* the old meters functioned exactly as intended and could have continued to perform, but were replaced due to technological change and to implement Commission policy). It was also appropriate for PG&E to distinguish the authorities cited by TURN by identifying the Pac Bell decision that recognized in group assets situations that technological change is not a reason for denying utilities full cost recovery.

D. TURN fails to explain why PG&E's shareholders should be penalized and treated worse here than in cases of project abandonments, especially when the Commission has specifically determined that ratepayers would benefit on an incremental basis, assuming full recovery of the stranded electromechanical meter costs.

TURN suggests that an 18-year amortization period for the electromechanical meter costs is reasonable given the economy and project delays. However, TURN never addresses why PG&E's shareholders should be treated worse here, where PG&E acted in compliance with the Commission's directives to pursue AMI technology as a necessary predicate to demand-response programs, than in cases of project abandonments. This is especially the case when the record evidence in the SmartMeter proceedings shows that ratepayers were to benefit on an incremental

[2] Having participated actively in the SmartMeter proceeding, TURN's current efforts to retain an 18-year amortization period without any return should be viewed by the Commission as nothing more than "sandbagging" -- an "after the fact" effort to revisit the economics upon which PG&E obtained project approvals. Had TURN's proposal been made *before* implementation of Smart Meter, PG&E would have argued – and PG&E believes the Commission would have agreed – that TURN's proposal should be rejected as inconsistent with the economics that the utilities were requesting as a condition for implementing the AMI program.

basis, even assuming full recovery (including a return) of the retired meters.

Moreover, TURN has no basis for determining how the project benefits and costs may have changed since the implementing decisions. While delays, if any, may have deferred benefits, they also likely would have deferred costs as well. It is pure speculation to say how benefits and costs of Smart Meter have been impacted, especially since increasing deployment of alternative energy projects is likely to enhance the benefits of demand-side management capabilities with the new metering systems. Certainly, there is no record in this case – or in any case – to support TURN's allegation of changed project benefits and costs.

Finally, the most important issue from the standpoint of the investor is the return it receives while its capital remains invested. The period of amortization for any single group of assets does not impact the return that is reasonable for the Company as a whole. Regardless of whether the Commission ultimately adopts a shorter amortization period, investors should continue to be compensated for the full rate of return deemed reasonable for PG&E's overall base of assets. Stated otherwise, PG&E believes it highly inadvisable for the Commission to undertake efforts to piecemeal the rates of return for individual investments based on their depreciable life or their period of amortization.

Please let me know if you have any questions or would like to further discuss these issues.

Sincerely,

Brian Cherry

cc: ALJ David Fukutome
Service List for A.09-12-020 and OII 10-07-027