BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Adopt New Safety and Reliability Regulations for Natural Gas Transmission and Distribution Pipelines and Related Ratemaking Mechanisms	Rulemaking 11-02-019

OPENING TESTIMONY OF DAVID MARCUS ON BEHALF OF THE COALITION OF CALIFORNIA UTILITY EMPLOYEES

January 31, 2012

1011-797v

I. Introduction

In his November 2, 2011 Scoping Memo in this proceeding, Commissioner Florio identified the very first issue to be addressed in ratemaking testimony as "revenue requirements," and explained that, "[a]ny recommendations that utility shareholders bear a portion of the costs of future safety-related expenses and investments must be well-supported, and address the safety implications of the proposed ratemaking treatment."[1] This testimony explains why safety-related costs imposed on utility shareholders should be based on past behavior, and not tied to future expenses and investments.

The general issue here arises from the distinction between future costs and sunk costs, and between penalties and incentives. CUE, the Commission and the public have a strong desire for a safe gas delivery system, and in providing incentives to make sure utility shareholders feel the same way. Since shareholders are generally believed to respond better to financial incentives than to simple exhortations, those incentives have to be at least partially financial, either rewarding desired behavior or penalizing undesired behavior.

PG&E's past management of its gas delivery system was inadequate, a conclusion with which PG&E now agrees. CUE and many others believe that ratepayers should not have to pay PG&E twice for work it failed to do in the

[1] R.11-02-019, Amended Scoping Memo and Ruling of the Assigned Commissioner, 11/2/11, p. 3.

past. CUE also strongly supports, and believes all other parties do as well, the need for PG&E (and the other California gas utilities) to make substantial investments to improve the safety of their gas systems. But there is a real risk that in trying to achieve one goal (don't pay twice for the same work), the other goal (get the needed work done) will be undermined. This testimony addresses ways to achieve both goals without the pursuit of one compromising attainment of the other. Ultimately, the Commission can impose penalties for past errors without unintentionally providing incentives for PG&E to avoid doing all of the needed future work.

II. What should be done, or not done, now?

In the current situation, there is strong reason to believe that PG&E at least, and possibly other California gas utilities, have not built or operated a sufficiently safe gas system. The gas plans the Commission is now starting to evaluate are a response to that belief, and are intended to make the existing system much safer. The issue which the Scoping Memo anticipates arising is, if not enough money was spent in the past on gas safety, should shareholders be held to account by requiring them to pay some "portion of the future safety-related expenses and investments" needed to make up for past under spending?

CUE's answer is "no." Identifying expenditures and investments that need to be made in the future, but refusing to reimburse utilities for making them, provides exactly the wrong incentive. If utilities know they will recover less than 100 percent of their investments, they will have a direct and strong financial incentive to resist making the investment in the first place, since the more they spend, the more they will lose. Also, if they are told they will only be reimbursed up to X dollars for investments that ought to cost more than X, with shareholders making up the difference, they will have a direct and strong financial incentive to cut corners in order to keep the total investment as close to X as possible.

As CUE previously wrote regarding proposals to have PG&E shareholders pay for part of the future costs of gas pipeline safety,

> CUE believes that the Proposed Decision's requirement that PG&E, and only PG&E, allocate the costs of testing and replacing pipeline between ratepayers and shareholders is misplaced. The requirement intertwines assessing PG&E's culpability for its past failure with future costs for improving the safety of California's gas system. Moreover, the requirement gives shareholders a disincentive to undertake the necessary work to ensure a safe system. Instead, the Commission should determine PG&E's fault and appropriate penalty for its past failure separately from assessing the cost of future work required to achieve a safe gas system for Californians.[2]

CUE expanded those comments, explaining that,

> by requiring shareholders to pay for upgrading PG&E's gas system, the Commission would be undercutting shareholders' incentives to quickly perform the necessary work. CUE understands the impulse to penalize PG&E, and CUE is not opposed to the sentiment per se, but the Commission must think carefully about how best to implement a penalty. The Commission has an important goal here – to get California's gas systems up to standards. But, the potentially undesirable effect of requiring shareholders to pay for the work for which they will see no return is that there is less incentive for shareholders to provide the money to do the work.
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> If the Commission is steadfast on punishing PG&E for the San Bruno rupture in this proceeding, the Commission should consider a system whereby PG&E is penalized up front, but not on the margin.

[2] CUE, 5/31/11 comments on Bushey PD in R.11-02-019.

> For example, for the first million dollars of capital investment, the return on equity ("ROE") would be zero, but for each million dollars of capital investment after that, the ROE would be 12 percent. Such a system would achieve the desired effect of punishing PG&E, but would eliminate the negative side effect of discouraging investment. In fact, it would provide shareholders with an incentive to supply the capital quickly in order to get some return on their investment.[3]

Alternatively, PG&E's own proposal to have shareholders pay for 2011 costs to survey and remediate parts of the gas transmission system fits into the rubric set out above. Since 2011 costs are now sunk, and not subject to incentives to underspend, there is no incentive problem with making them into shareholder costs. Going forward, PG&E's shareholders should bear responsibility for past misdeeds through a penalty proceeding, but not by giving counterproductive incentives to avoid doing the work needed to provide safe gas service.

III. Conclusion

At his confirmation hearing, Commissioner Florio said that if money was diverted from safety expenditures in the past, ratepayers should not have to pay that money again. He said the tricky part is deciding what should have been done in the past based on past funding and what is a result of changing the standards. CUE agrees. But here again, even beyond deciding what the utility should have done in the past but didn't do, there is the question of how to impose a consequence for past behavior. In order to get the incentives for future behavior right, the Commission should distinguish between the consequences for past behavior and the desired

[3] Ibid.

future behavior. Where money was inappropriately underspent in the past, the underspending should be recouped from shareholders via some sort of penalty. But that penalty should be clearly linked to the past misbehavior, and not imposed on future investments. Otherwise, the Commission will be trying to use two wrongs to make a right, underfunding future work to offset PG&E's underspending on past work.

Underfunding future work by requiring shareholders to pay for part of it is wrong because it gives PG&E an incentive to either cut corners on the future work (in order to control costs) or to endeavor not to do it at all (to avoid shareholder losses). The Commission doesn't want shoddy work, and it shouldn't want to have to fight a recalcitrant PG&E to get PG&E to do what needs to be done. The Commission can, and should, have it both ways. It should reassure PG&E that it will fully fund future work that the Commission finds is needed for safety, so that there is no extra incentive for PG&E to avoid doing that work, or to do it on the cheap. But it should also penalize PG&E for past work that was either promised and not done, or should have been done pursuant to then-existing safety requirements, but was not done. And it should also make clear to PG&E, in case there is any doubt, that it is prepared to impose further penalties in the future, if PG&E doesn't do the right thing this time around.