

Comments on “Infrastructure Financing Alternatives”

The Company appreciates this opportunity to provide comments to the Policy and Planning Division staff on “utility infrastructure financing alternatives” described in a briefing paper released in August 2012. The Company agrees that California investor-owned utilities face a significant challenge in raising substantial amounts of capital necessary to finance infrastructure investment over the next decade; moreover, the company agrees that projected rate of growth in infrastructure assets and rate base additions is likely to create upward pressure on energy utility rates for California energy consumers. In this context, the company agrees that it is appropriate to hold discussions concerning alternatives for financing infrastructure investments; however, these financing structures and potential to create unintended costs and consequences which should be fully vetted before any of the California utilities proceed to implement them.

The three alternatives described in the briefing paper include publicly traded real estate investment trusts (“REITS”), publicly traded master limited partnerships (“MLP’s), and utility debt securitization financings. The first two structures have the theoretical potential to reduce financing costs by mitigating if not eliminating the double taxation of corporate operating income that occurs when a tax paying Corporation distributes cash to its owners in the form of dividends, which are then taxable again to the individual investor. In theory, customers can benefit a reduction of this double taxation if the relative cost of equity capital declines for equity securities issued under a REIT or MLP structure compared to traditional utility equity, or if the tax-deductibility of distributions to owners reduces the tax component of the utility revenue requirements, as envisioned under the REIT structure. The company has significant concerns with the proposed financing alternatives described in the rating paper:

- Tax benefits to California utility customers of pass through entities are largely conjectural;
- The briefing paper does not address a number of potential costs to be incurred associated with these alternative financing structures. Under some conditions, energy consumers could end up paying higher rates as a result of restructuring the ownership and operation of utility service.
- With the partial exception of securitization described below, these alternative financing structures do not affect either the basic opportunity cost of money required by all investors when providing capital for either debt or equity capital, or the risk premiums

charged for the level of business and regulatory risk associated with operating a utility and recovering its full cost of service in a timely manner. The following paragraphs elaborate on these points.

Tax benefits of "pass-through" entities are conjectural

The analysis presented in the briefing paper reflects the federal Internal Revenue Code as of mid- 2012. Tax laws and regulations are not immutable. Indeed, The President's "Framework for Business Tax Reform" includes a proposal of establishing greater parity between large corporation and large non-corporate counterparts. In effect, taxing pass-throughs as corporations.¹ This would certainly affect the comparative advantages if any, of a master limited partnership structure over financing by a traditional C Corporation.

A second constraint on evaluating the net benefits of the REIT and MLP is that it is in fact difficult to determine the tax characteristics of utility shareholders, without making very general assumptions that may have little bearing on the economic incentives of marginal investors who determine the trading characteristics and the cost of common stocks.

Approximately 70% of PG&E Corporation shares are held by institutional investors. Some of these institutions, such as life insurance companies private equity funds, or even mutual funds may incur taxes on dividend income received from utility stock investments, other institutions, such as pension funds or 401(k) plans effectively defer income and associated taxes on such dividends until retiring beneficiaries receive their retirement income.

Unintended consequences and costs

The proposed structures may cause California utilities to incur significant costs which would offset the hypothetical tax reduction benefits of these financing structures. Three examples illustrate the degree to which the costs of these structures have not been fully evaluated:

¹ the "President's framework for business tax reform-a joint report by the White House Department of the Treasury", February 2012. The framework notes "Business may be organized under a variety of different forms, including C-corporations, S-corporations, partnerships and sole-proprietorships. These organizational forms offer varying legal regulatory and tax treatments. The ability of large pass-through entities to take advantage of the preferential tax treatment has placed businesses organized as C-corporations at a disadvantage by allowing large pass-through entities preferential treatment, the tax code distorts choices of organizational form, which can lead to losses and economic efficiency; business managers should make choices about organizational form based on criteria other than tax treatment." (see page 7.)

1) The briefing paper does not address the potential impact on the credit risk profiles of California utilities, aside from a general assertion that utilities will prefer traditional rate base financing in order to protect their credit ratings (see page 3). This dismissal of the potential effect of alternative financing structures on utility credit ratings is shortsighted. If regulated utilities (however organized and funded) are to retain the obligation to serve retail customers not just with energy delivery services, but with energy procured through long-term and short-term contracts, they must have access to trade credit and financial credit to meet these obligations. Utility credit quality supports more than access to bond markets to finance infrastructure. PG&E's electric and gas procurement functions alone require access to trade credit or short-term financial credit upwards of \$1 billion. Moreover, developers of independent power facilities rely upon the credit of California investor-owned utilities *as a foundation* for raising their own capital to finance construction of power generation facilities. Any reasoned consideration of the costs and benefits of alternative infrastructure financing approaches must address the potential effects, positive or negative, on utility credit risk. Aside from the general comment referred to above, the briefing paper is silent on this issue.

2) The description of real estate investment trust structure contemplates splitting existing utility functions into two parts: an asset management-operating company and an asset ownership company which leases the assets to the operating company. The briefing paper does not address the operating and legal challenges of splitting utility functions into two entities. For example, the literature does not address the disposition and treatment of franchises, easements, and other permits necessary to operate the assets that provide utility service. Given the perilous state of public finance in many California municipalities (four cities or counties have sought bankruptcy protection), this does not appear to be a propitious environment for California investor-owned utilities to renegotiate their local franchises and permits. Cities and counties would look upon the refinancing of utility assets with a REIT or MLP structure as an opportunity to demand higher franchise fees, and could conceivably threaten to block an entire transaction without some kind of compensation. This would hardly meet the objective of reducing the cost to California utility customers of energy infrastructure investment financing. Also, splitting utilities into separate operating and asset ownership organizations will create significant distraction of management time and attention until separation issues are resolved, and new reporting relationships established. Management will also have to develop brand-new investor communications relationships with an entirely new set

of owners, those who hold shares of the REIT. PG&E is currently focusing its managerial attention on strengthening its operations and molding its organizational culture to enhance its ability to provide reliable and safe service to customers and the public large. Redesigning the utility's corporate form and financing structure potentially will distract management and employees from these imperatives. Although the company recognizes the value to its customers in California at large of providing affordable service, providing service that is reliable and safe are also critical objectives, even if not easily quantified in the economic analysis of these financing alternatives.

3) the description of securitization financing in the briefing paper is oddly silent on the potential costs and benefits savings under this structure. Utility securitization financings generally been treated as "risk neutral" for utility credit risk purposes. As result, securitization financings have enabled utilities to replace a traditional mix of common equity and debt bond financing with securitization bonds. Superficially, this made securitization financing appear to be a deal almost too good to be true: replace traditional financing carrying a weighted average pre-tax cost of approximately 13% with bond financing carrying a pretax cost of 4-5%. California utilities have successfully used securitization financing to finance the transition to competitive electric markets during electric industry restructuring, as well as to refinance PG&E's bankruptcy reorganization plan regulatory asset. In fact, securitization financing has limits and costs.

- A utility cannot indefinitely use securitization financing without affecting its credit ratings and access to other credit. Credit rating agencies have held securitization financings to be credit risk neutral only if several conditions hold: these conditions include a constraint on the portion of customer bills to include securitization charges total securitization charges must remain approximately 15 to 20% of retail customers' energy bills. As a result, an entire utility cannot be refinanced using securitization, only a portion of its assets ; financing must be channeled through a bankruptcy remote separate entity; also, the state must pledge, preferably through legislation, to respect right of the bondholders to collect the utility revenues necessary to pay interest and principal on the securitization bonds. Indeed, of the three alternative financing structures discussed the briefing paper, this aspect of securitization financing, which reduces risk of regulatory confiscation is the only tangible risk reduction attribute.

- Securitization bonds carry low interest rates, but require faster recovery of capital investment, potentially increasing near term costs
- The high credit ratings and low interest rates on utility securitization financings also incorporate risk reduction benefits of a state pledge not interfere of collection of revenues necessary to pay debt service on bonds, the bankruptcy remote financing structure, dedicated tariffs with true up mechanisms that synchronize collection of revenue from customers, amortization of the underlying assets being refinanced, and payment of interest and principal to investors. The longest maturities of utility securitization financings utility securitization financings have been 12 to 15 years. Hence the amortization of the underlying assets and corresponding revenue requirement recovery time horizon are significantly faster than the typical depreciation schedule of 30 years or more associated with a utility infrastructure asset. The experience of California utilities' securitization financings demonstrate even faster recovery periods, of 5 to 7 years.