BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Investigation on the Commission's Own Motion into the Operations and Practices of Pacific Gas and Electric Company to Determine Violations of Public Utilities Code Section 451, General Order 112, and Other Applicable Standards, Laws, Rules and Regulations in Connection with the San Bruno Explosion and Fire on September 9, 2010.	I.12-01-007 (Filed January 12, 2012) (Not Consolidated)
Order Instituting Investigation on the Commission's Own Motion into the Operations and Practices of Pacific Gas and Electric Company with Respect to Facilities Records for its Natural Gas Transmission System Pipelines.	I.11-02-016 (Filed February 24, 2011) (Not Consolidated)
Order Instituting Investigation on the Commission's Own Motion into the Operations and Practices of Pacific Gas and Electric Company's Natural Gas Transmission Pipeline System in Locations with Higher Population Density.	I.11-11-009 (Filed November 10, 2011) (Not Consolidated)

PACIFIC GAS AND ELECTRIC COMPANY'S RESPONSES TO QUESTIONS IN SECTION 3 OF ADMINISTRATIVE LAW JUDGES' JULY 30, 2013 RULING REQUESTING ADDITIONAL COMMENT

MICHELLE L. WILSON
Pacific Gas and Electric Company
77 Beale Street
San Francisco, CA 94105
Telephone: (415) 973-6655
Facsimile: (415) 973-0516
E-Mail: MLW3@pge.com

JOSEPH M. MALKIN
Orrick, Herrington & Sutcliffe LLP
405 Howard Street
San Francisco, CA 94105
Telephone: (415) 773-5505
Facsimile: (415) 773-5759
E-Mail: jmalkin@orrick.com

Attorneys for
PACIFIC GAS AND ELECTRIC COMPANY

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The ALJs asked that parties respond to questions on the financing of fines and disallowances. The first set of these questions was directed to PG&E. On August 13 2013, the ALJs limited the information that PG&E could provide in response to these questions, thereby granting in part a motion that TURN filed the previous day. They ordered:

[1] Pursuant to *England v. Louisiana State Board of Medical Examiners*, 375 U.S. 411 (1964), PG&E expressly reserves its federal constitutional and any other federal claims and reserves its right to litigate such claims in federal court following any decision by the Commission, if necessary.

> PG&E and other parties responding to the July 30 Ruling may not introduce new evidence that would circumvent the August 1, 2013 ruling denying PG&E's motion to reopen the record. More broadly, we seek further *briefing* with comments based on the existing record of these proceedings; no new facts are to be introduced.[2]

The ALJs' questions on their face ask for information that is not in the record.[3] Therefore, PG&E cannot fully and fairly respond to the questions posed without providing additional facts that would run afoul of the ALJs' ruling. Nonetheless, PG&E provides the following responses to these questions in order to comply with both the ALJs' request for additional information and their August 13 ruling.

SECTION 3, QUESTION 1

Does PG&E plan to issue equity (i.e. PCG stock) to fund: (1) any fines, (2) any disallowed capital expenditures, (3) any disallowed expenditures that are not capitalized? If PG&E does not plan to fund all of such items with additional equity, please explain which items, or portions of items, would be funded by other means, and what those other means likely would be.

PG&E Corporation plans to issue equity (PCG stock)[4] to fund any fine or penalty in these proceedings including any disallowed costs. The Utility has no choice but to raise equity because the Commission's Holding Company decision requires that PG&E maintain the minimum equity ratio set by the Commission in PG&E's Cost of Capital proceedings.[5] Under the current Cost of Capital decision, this means that PG&E must maintain a minimum 52% equity ratio.[6] Any fine or penalty will be a charge to income, which in turn will reduce PG&E's equity. As a result, PG&E will need to raise additional equity to maintain the required capital structure.

[2] ALJs' Ruling of August 13, 2013 (underlined emphasis added).

[3] For example, the information requested in Question 2 regarding how PG&E would expense or depreciate fines or penalties is not in the record.

[4] And, if necessary under certain conditions, equity-like securities such as a mandatory convertible.

[5] D.96-11-017 (mimeo), Ordering Paragraph 14, at 48; D.06-12-029 (mimeo), Appendix A-3, Section IX, B, at 32.

[6] D.12-12-034 (mimeo), Ordering Paragraph 4, at 53.

Saying that PG&E must raise equity to fund any fine or penalty, however, does not necessarily mean that sufficient PCG stock can be issued to fund any fines or penalties on top of PG&E's existing equity needs to fund planned capital expenditures. Ultimately, the ability to issue equity to fund fines and penalties and planned capital expenditures will depend on the reaction of investors, equity analysts and the rating agencies to the Commission's decision.[7] If the final decision imposes fines and penalties that are too extreme, it may not be feasible to raise sufficient equity.

<u>SECTION 3, QUESTION 2</u>

For income tax purposes will PG&E: (1) expense any fines when imposed; (2) take accelerated depreciation on any disallowed capital expenditures (and take straight line depreciation only if accelerated depreciation is not available for the particular kind of property involved); (3) expense any disallowed expenditures that are not capitalized when the expenses are incurred? If not, please explain how PG&E will account for these three kinds of items for income tax purposes.

PG&E will follow normal practice under applicable income tax law, which is independent of CPUC regulatory treatment, in determining the tax treatment for these expenditures. Under income tax law, a company cannot expense for tax purposes any fine or similar penalty paid to a government for the violation of any law. This includes an amount paid as a civil penalty imposed by state law and would include any fine imposed by the Commission in this case. PG&E will not expense amounts the Commission imposes as a fine.

The law with respect to what constitutes a fine or similar penalty is complex and its application depends on the facts and circumstances of the particular case. In this matter, those facts will include future determinations not yet known. The tax authorities have broadly applied the prohibition against any deduction for fines or similar penalties to include payments in lieu of a fine or similar penalty. Therefore, some expenditures made by PG&E for disallowed capital and non-capital items, which are not paid to a government, may not be eligible to be expensed, through depreciation or otherwise.

[7] *See generally* Ex. Joint-66 (PG&E/Fornell).

Although PG&E believes, on the basis of the facts as they are currently known and without the influence of any future facts, that it is entitled to expense for income tax purposes any non-capital expenditure and to take accelerated depreciation over 20 years on any capital expenditure disallowed by the Commission, other than an explicit fine paid to the state, this treatment may ultimately not be sustained.

SECTION 3, QUESTION 3

For regulatory accounting purposes will PG&E (1) expense any fines when imposed; (2) take straight line depreciation on any disallowed capital expenditures and establish a deferred tax reserve to take account of the difference between accelerated and straight line depreciation; and (3) expense any disallowed expenditure that are not capitalized when the expenses are incurred? If not, please explain how PG&E will account for these three kinds of items for regulatory accounting purposes.

For regulatory and GAAP purposes, PG&E will expense disallowed expenses as incurred. Fines are recorded as below the line costs when imposed and do not affect PG&E's regulatory accounts.

For regulatory and GAAP purposes, PG&E will expense disallowed capital expenditures when incurred (i.e., expenditures are not capitalized or added to rate base). Therefore, there is no regulatory or GAAP depreciation. As a result, there will not be a deferred tax reserve related to the difference between accelerated and straight line depreciation. PG&E will not be collecting revenues from customers to pay for income taxes, so there is also no deferred tax reserve for ratemaking purposes.

The accounting described above is based on the information available as of the date of this filing. Changes in facts and substance as of the final decision could result in a change to the accounting.

SECTION 3, QUESTION 4

Will any straight line depreciation taken on PG&E's regulatory books for disallowed capital expenditures be reflected in PG&E's tax expense as computed for regulatory purposes? Explain.

If capital expenditures are disallowed, no depreciation is included in PG&E's regulatory books or rate filings nor will any book or tax depreciation be included in the calculation of tax expense for regulatory books or rate filings.

SECTION 3, QUESTION 5

In the event that any disallowed expenditures are not incurred for some time and that straight line depreciation on any disallowed capitalized expenditures would be taken over the course of many years, what would be the impact of issuing additional equity, as described in answer to Question 1 above, on PG&E's actual capital structure when that is considered in a CPUC Cost of Capital proceeding? If there would be an increase in the percentage of equity in PG&E's actual capital structure for a period of time, what impact could that have on rates? Would PG&E's plan to issue equity to finance any fines and disallowances have any other impact on rates?

Disallowed costs would be charged to net income in the period incurred. As explained in response to Question 1 above, a charge to net income reduces the equity component of the capital structure by the after-tax amount of the charge. PG&E will need to raise additional equity to bring the company back into line with its authorized capital structure.

PG&E's capital structure is determined by the Commission in the Cost of Capital proceeding and is based on what the Commission determines is the appropriate capital structure to maintain credit quality, attract capital and minimize customer rates. The Utility's actual capital structure has no direct impact on the Cost of Capital proceeding. PG&E's need to raise equity to fund any excessive fines or penalties could have other impacts on rates, however, as discussed below.

If PG&E's equity ratio is greater than the minimum amount, which is currently 52%, for any period of time, shareholders would pay the additional cost of capital, but there would be no impact to customers or rates. Absent a waiver from the Commission's capital structure condition, PG&E must maintain, on average, an equity ratio of at least 52%.

The ALJs' question asks whether PG&E's plan to issue equity to finance any fines and disallowances would have any other impacts on rates. Penalties such as those recommended by CPSD and Intervenors could have many negative effects, including increasing PG&E's cost of financing. Mr. Fornell of Wells Fargo testified that if the Commission imposes a penalty that is significantly larger than expected and is perceived to be excessive, investors will reassess their perception of the regulatory environment in California and the risk of investing in PG&E.[8] Before any fines or penalties in the OIIs, PG&E projects capital expenditures in excess of $5 billion annually from 2013 through 2016.[9] A large portion of these capital expenditures will need to be financed externally through both equity and debt.[10] PG&E would have to try to raise billions of dollars of equity capital for authorized capital expenditures on top of the equity it would need for fines and penalties in this negative environment.

Even if PG&E were able to raise the equity it needs, it most likely would have to pay more for the equity.[11] PG&E's debt ratings also would be under pressure and could be downgraded.[12] Any downgrade would have significant negative ramifications for PG&E, including higher borrowing costs, the potential loss of access to debt markets, and incremental collateral obligations.[13] While customers' rates would not reflect the higher cost of equity and long-term debt in the current Cost of Capital period (absent some form

[8] Ex. Joint-66 at 19, 21-22 (PG&E/Fornell); Joint R.T. 1448-49 (PG&E/Fornell).

[9] Ex. Joint-57 at 6, 11; Ex. Joint-66 at 17 (Figure 7) (PG&E/Fornell).

[10] PG&E projects equity issuances of $1 to $1.2 billion in 2013 and very large additional equity issuances each year through 2016. Ex. Joint -57 at 9; Ex. Joint -66 at 17 (Figure 9) (PG&E/Fornell). Just as PG&E needs large amounts of equity to fund planned capital improvements, it is also forecasting very substantial debt issuances each year from 2013 through 2016. Ex. Joint-66 at 17 (Figure 8) (PG&E/Fornell).

[11] There is no dispute that "[t]he perceived quality of the regulatory environment in which a utility operates is among the most important factors affecting the utility's ability to attract capital at reasonable rates." Ex. Joint-60.

[12] According to Standard & Poor's, "regulatory risk is perhaps the most important factor" in assessing a utility's overall business risk." Ex. Joint -66 at 10 (PG&E/Fornell) (citing Standard & Poor's "Assessing U.S. Utility Regulatory Environments," Todd A. Shipment, p. 2, Nov. 7, 2007). The regulatory environment and the utility's ability to recover costs determine 50% of Moody's ratings. Ex. Joint -66 at 10-11 & Figure 5 (PG&E/Fornell).

[13] *See* Ex. Joint-66 at 12-14 (PG&E/Fornell).

of unusual relief from the Commission), PG&E's increased costs of financing would be passed on to customers in the next Cost of Capital proceeding. PG&E estimates that its annual revenue requirement could increase by $800 million due to increases in its cost of capital and other costs.[14] This would correspond to roughly a 4% increase in the average residential gas and electric bill. More immediately, customer rates could be increased through PG&E's annual ERRA proceedings to reflect higher short-term borrowing costs, higher procurement costs, and higher collateral costs.[15] By changing investors' perception of the regulatory environment in California, a decision by the Commission to impose excessive fines or penalties on PG&E also could raise the cost of capital of other California utilities and lead to higher rates for their customers.[16]

Respectfully submitted,

By: */s/ Michelle L. Wilson*	By: */s/ Joseph M. Malkin*
MICHELLE L. WILSON	JOSEPH M. MALKIN
Pacific Gas and Electric Company	Orrick, Herrington & Sutcliffe LLP
77 Beale Street	405 Howard Street
San Francisco, CA 94105	San Francisco, CA 94105
Telephone: (415) 973-6655	Telephone: (415) 773-5505
Facsimile: (415) 973-5520	Facsimile: (415) 773-5759
E-Mail: **mlw3@pge.com**	E-Mail: **jmalkin@orrick.com**

Attorneys for
PACIFIC GAS AND ELECTRIC COMPANY

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[14] This assumes a 200 basis point return on equity increase (10.4% to 12.4%) and a 78 basis point authorized cost of debt increase (5.52% to 6.30%) on PG&E's rate base at the midpoint of guidance for 2014 (i.e., $28.75 billion). The $800 million annual revenue requirement increase includes $150 million in short term borrowing, procurement and collateral costs.

[15] *See* Ex. Joint-66 at 13-14 (PG&E/Fornell) (discussing collateral obligations to support purchase commitments).

[16] As Mr. Fornell testified, "[a] penalty above expectations also would potentially harm investors' opinion of the business and regulatory prospects for the other California state utilities." Ex. Joint-66 at 16 (PG&E/Fornell). And, as noted above, Overland agrees that "[t]he perceived quality of the regulatory environment in which a utility operates is among the most important factors affecting the utility's ability to attract capital at reasonable rates." Ex. Joint-60; *see also* Ex. Joint-66 at 10-14 (PG&E/Fornell).

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