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 High Population Density.	I.11-11-009 (Filed November 10, 2011) (Not Consolidated)

SECOND REBUTTAL BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES REGARDING FINES AND REMEDIES

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August 28, 2013

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I. INTRODUCTION

The Division of Ratepayer Advocates (DRA) files this Second Rebuttal Brief in response to both the "Amended Reply Brief of the Consumer Protection and Safety Division on Fines and Remedies" filed July 16, 2013 (CPSD Amended Reply Brief), and "Pacific Gas and Electric Company's Response to Consumer Protection and Safety Division's Amended Reply Brief on Fines and Remedies" filed August 21, 2013 (PG&E Response).

In sum, DRA supports the general thrust of CPSD's revised fines and remedies proposal, but urges that it be clarified or expanded to address two important ratemaking issues overlooked in CPSD's Amended Reply Brief. These two issues are discussed in Section III below.

DRA focuses its comments primarily on PG&E's Reply, which argues that CPSD's proposal has no legal basis. As discussed in detail in Section II below, PG&E's arguments have no merit and should be summarily rejected by this Commission. Further, in support of these arguments, PG&E makes a number of blatant misrepresentations, including statements regarding the Commission's conclusions in the Pipeline Safety Enhancement Program (PSEP) Decision, D.12-12-030. PG&E's willingness to misrepresent basic facts and legal conclusions throughout these proceedings continues to perplex DRA. It may well be appropriate for a comprehensive Order to Show Cause regarding Rule 1.1 violations contained in PG&E's briefs (some of which have been noted in the briefs of intervenors in these proceedings)[1] to follow the final decisions on the substance of these proceedings.

II. THERE IS A SOLID LEGAL FOUNDATION FOR CPSD'S PROPOSED DISALLOWANCES

A. The Issue Has Already Been Fully Briefed

PG&E argues that "CPSD fails to identify a valid legal basis for [its] 'disallowance.'"[2] That argument is utterly without merit. The Commission's legal authority to impose disallowances has been fully briefed in these proceedings and it is clear that the Commission has authority to order disallowances, among other remedies that it may find appropriate in these cases. Thus, CPSD had no need to brief this issue in its Amended Reply Brief, particularly given the limited scope of the brief and the 10 page limit. As DRA has previously explained,[3] the

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[1] *See, e.g.,* DRA Opening Brief on Fines and Remedies (F&R), May 6, 2013, pp. 22-23.

[2] PG&E Reply, p. 1.

[3] DRA Opening Brief on F&R, May 6, 2013, pp. 14-16.

Commission has equitable authority to order refunds or disallow utility expenses so long as the remedies are designed to redress the harm committed by the violation and they are "cognate and germane" to the Commission's existing authority.[4] This authority is well-established in both statute and case law. Because DRA's prior brief fully explains the legal bases for this authority,[5] we will not repeat those arguments here, except to note that the Commission that it has relied upon its ratemaking and equitable authority on many occasions, and on Public Utilities Code § 463 in particular, to disallow costs resulting from unreasonable utility errors and omissions, and should do so here.

B. The PSEP Decision Did Not Find That PG&E's PSEP Costs "Were Not Caused By Prior Imprudent And Unreasonable Conduct"

PG&E claims that the ratemaking treatment for PSEP costs has been resolved in the PSEP Decision (D.12-12-030) and there is no legal foundation for CPSD's proposed disallowance of PSEP costs in these proceedings. Specifically, PG&E asserts that the reasonableness of its Phase I PSEP costs was litigated in R.11-02-019 and that the Commission "found [that PG&E's PSEP costs] were not caused by prior imprudent and unreasonable conduct." These assertions are completely false.[6]

As PG&E well knows, the most compelling facts regarding PG&E's mismanagement of its gas transmission system were scoped for litigation in the three separate San Bruno Investigations, I.11-02-016 (the Recordkeeping Investigation), I.11-11-009 (the Class Location Investigation), and I.12-01-007 (the San Bruno Explosion Investigation). In light of the extensive record of PG&E malfeasance being developed in those Investigations, The Utility Reform Network (TURN) and DRA proposed disallowance of nearly all of PG&E's proposed PSEP costs in the PSEP Rulemaking Proceeding. While the PSEP Decision did not grant the full extent of TURN and DRA's disallowance requests, it *never* found that PG&E's PSEP costs

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[4] Consumers Lobby Against Monopolies v. CPUC, 25 Cal. 3d 891, 905-906 (1979).

[5] See DRA Opening Brief on F&R, May 6, 2013, pp. 14-16, and especially footnote 58 in that pleading.

[6] PG&E Response, p. 1. PG&E repeats this claims at p. 4: "…[T]he Commission ruled unanimously that PG&E's PSEP is reasonable, and authorized recovery of other PSEP Phase 1 costs because those costs did not result from unreasonable and imprudent conduct." PG&E's citations to D.12-12-030 - which broadly cite to most of the PSEP decision and provide no pin-point cites in support - do not provide any support for PG&E's claim that D.12-12-030 determined that its "approved" PSEP costs "were not caused by prior imprudent and unreasonable conduct." PG&E cites to the Lexis version of D.12-12-030 at * 26-27, 105-88, and 198-218.

"were not caused by prior imprudent and unreasonable conduct."[7] The PSEP Decision's determination to make the approved PSEP rates "subject to refund" pending findings made in the San Bruno Investigations confirms the very opposite. It expressly held:

> Our upcoming decisions in [the San Bruno] Investigations (I.) 11-02-016, I.11-11-009, and I.12-01-007 will address potential penalties for PG&E's actions under investigation. We do not foreclose the possibility that further ratemaking adjustments may be adopted in those investigations; thus, all ratemaking recovery authorized in today's decision is subject to refund.[8]

While the Commission may have originally intended to have the findings in the San Bruno Investigations inform rate determinations in the PSEP Proceeding, when the PSEP Decision was issued, these Investigations were still pending, and the Commission explicitly stated that it would consider *in the Investigations* whether further PSEP disallowances were justified as a result of the conclusions reached in those Investigations.[9]

Notwithstanding this clear Commission determination that *the Investigations* may consider ratemaking adjustments, PG&E cobbles together two additional arguments to challenge the legality of CPSD's proposed disallowances. First, PG&E argues that these proceedings are not the appropriate forum for CPSD to propose disallowances, and that it should have argued for them in the PSEP Proceeding.[10] Second, PG&E argues that CPSD's proposed $2.25 billion in

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[7] D.12-12-030 only found that various PG&E cost forecasts, which were extensively litigated, were "reasonable" for purposes of setting cost caps and provisionally authorizing partial rate recovery for those costs (subject to refund based on the findings in the Investigations). *See, e.g.,* D.12-12-030, p. 118, Findings of Fact 19 and 23. To the extent D.12-12-030 commented on PG&E's imprudent and unreasonable conduct, Conclusion of Law 13, p. 122 states: "It is reasonable for PG&E's shareholders to absorb the portion of the [PSEP] costs which were caused by imprudent management." See also, *id.,* p. 53 ("It is beyond dispute that the Commission has the authority to disallow ratemaking recovery for costs imprudently incurred by California's public utilities.") and pp. 119-120, Findings of Fact 36, and 38.

[8] D.12-12-030, p. 4 (*emphases added*); see also p. 126, Ordering Paragraph 3 ("All increases in revenue requirement authorized in Ordering Paragraph 2 are subject to refund pending further Commission decisions in Investigation (I.) 11-02-016, I.11-11-009, and I.12-01-007. ").

[9] It appears from the Orders Instituting Investigations (OIIs) that the Commission may have originally intended that the PSEP Proceeding consider the findings from the San Bruno Investigations in rendering its ratemaking determinations. *See, e.g.*, OII in the Recordkeeping Investigation, I.11-02-016, February 24, 2011, p. 15 ("We also place PG&E on notice that in the [PSEP] rulemaking the Commission may take note of the record evidence in this investigation.") and OII in the San Bruno Explosion Investigation, I.12-01-007, January 12, 2012, p. 11 (same). However, given the need to address funding for PG&E's ongoing PSEP work, the PSEP Proceeding moved ahead of the San Bruno Investigations, and therefore lacked the record needed to fully evaluate whether PG&E malfeasance required further PSEP disallowances. To remedy this timing dilemma, the PSEP Decision made the PSEP rates subject to refund in the San Bruno Investigations. *See, e.g.,* D.12-12-030, p. 4 and p. 126, Ordering Paragraph 3.

[10] PG&E Response, pp. 1-5.

disallowances are inconsistent with the Overland Financial Analysis. Both of these arguments are without merit, as discussed below.[11]

1. CPSD Has Properly Proposed Disallowances At This Stage In The Proceedings

PG&E states that "[u]ntil its Amended Reply Brief [in the Fines and Remedies portion of the San Bruno Investigations], CPSD did not allege, let alone attempt to prove, that PG&E's Commission-approved PSEP Phase 1 costs should be disallowed due to 'unreasonable and imprudent conduct.'"[12] PG&E states that the "blanket ratemaking disallowance CPSD now advocates has no legal basis in these OIIs, and amounts to a backdoor attempt to modify the PSEP decision and disallow costs a unanimous Commission found reasonable just eight months ago."[13]

The record does not support this argument. Among other things, PG&E's argument begs the question of why the Commission's PSEP Decision would make PSEP rates "subject to refund" and subsequent "ratemaking adjustments" in these Investigations if it found those rates "reasonable just eight months ago." The simple answer is that it did not find those rates reasonable eight months ago. It found some of PG&E's PSEP cost forecasts reasonable,[14] but declined to make a final ruling on the allocation of PSEP costs between ratepayers and shareholders by making the rates "subject to refund" and "adjustment" in the Investigations.[15] Further, nothing prevents CPSD from requesting the disallowances now, and nothing compelled it to advocate for them previously. Among other things, CPSD was not a party to the PSEP proceeding, and the procedural schedule for the San Bruno Investigations expressly reserved arguments regarding "Fines and Remedies" to this phase.[16] Thus, to the extent that CPSD is now advocating for disallowances based on the record in these Investigations of PG&E's "unreasonable and imprudent conduct in neglecting to repair and replace its aging

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[11] PG&E Response, pp. 6-7.

[12] PG&E Response, p. 1.

[13] PG&E Response, p. 2.

[14] *See* footnote 7, above.

[15] D.12-12-030, p. 4 and p. 126, Ordering Paragraph 3.

[16] See, e.g., Administrative Law Judges' Ruling Adopting Revised Schedule And Common Briefing Outlines, issued in these proceedings on February 4, 2013, Attachment 1.

infrastructure,"[17] this is the place and time expressly contemplated for these arguments by the Commission. CPSD had no affirmative obligations to make any such arguments previously.

2. CPSD's Disallowance Proposal Is Consistent With The Overland Financial Analysis

PG&E claims CPSD's proposal is legally flawed because it is inconsistent with the Overland Financial Analysis.[18] PG&E claims that its shareholder share of PSEP costs now exceeds $4 billion and that this far exceeds the "threshold level" identified by Overland.[19] PG&E concludes: "…[A]ll shareholder costs funded with new equity must count toward Overland's 'threshold level.'"[20]

PG&E's arguments are baseless and appallingly misleading. Among other things, PG&E misrepresents Overland and significantly overstates shareholder contributions to the PSEP.

Overland clarified on cross examination that the financial consequences to PG&E from San Bruno fell into three buckets – fines paid to the general fund, penalties or disallowances, and "unrecovered costs" "incurred … during a period of existing authorized rates."[21] Overland anticipated that the first two buckets – fines and disallowances – would be paid through the issuance of incremental equity. Overland described the third bucket of "unrecovered costs" as costs that may not have been specifically considered in a prior rate case, but would nevertheless be covered by authorized rates for the relevant period so long as revenues were sufficient.[22] Overland did not necessarily intend that these costs would count towards the "threshold level."[23] Nevertheless, PG&E sweeps claimed "third bucket" costs into a much broader category of its own making that it calls "Shareholder costs," and asserts that all of these costs should be included in the "threshold level."

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[17] CPSD Amended Reply Brief, p. 2.

[18] PG&E Response, p. 2.

[19] PG&E Response, p. 2.

[20] PG&E Response, p. 8.

[21] Jt. RT 14:1368-1370, PG&E/Lubow-Malko.

[22] Jt. RT 14:1368-1370, PG&E/Lubow-Malko.

[23] Jt. RT 14:1370, lines 11-16, PG&E/Lubow-Malko ("So in my opinion historic, quote, unrecovered costs, costs that were not specifically considered in a previous proceeding, may or may not be appropriately identified or earmarked in what we are talking about today as penalties.") and Jt. RT 14:1371, lines 8-9 ("And the Commission will sort this out ultimately.").

PG&E's claim makes no sense from a ratemaking perspective. For example, should PG&E's San Bruno-related costs incurred before 2011 be deemed a "penalty" that counts toward its "credit" even though PG&E never requested rate recovery for these costs in the PSEP Proceeding, and its authorized rates for 2011 provided revenues to cover those costs? Similarly, should the $380 million in PSEP contingency costs – which the PSEP Decision found unnecessary given the "generous" base cost forecasts for the PSEP work[24] – be treated as part of PG&E's penalty? The answers to these questions are clearly "no," yet PG&E appears to argue that these types of costs should be included in Overland's $2.25 billion "threshold level" or otherwise credited toward the CPSD disallowance.[25]

PG&E also implies that Overland's $2.25 "threshold level" was developed in a vacuum that did not take into account PG&E's need to raise equity for other purposes. This too is misleading. The record is clear that Overland's "threshold level" of $2.25 billion was incremental to equity already raised by PG&E, and equity that PG&E would need to raise for other purposes. Overland's "threshold level" estimate focused on 2012 and found that PG&E could raise an additional $2.25 billion in that year to address San Bruno-related issues, assuming that it also raised as much as $750 million for other purposes in that same year.[26] Implicit in this assumption is that PG&E will continue to issue similar amounts of equity in later years to fund other projects. Further, to arrive at this "threshold level" of equity, Overland assumed highly conservative constraints: PG&E's stock price should remain above its book equity value and the dividend payout ratio should remain unchanged.[27]

Approximately six months later, in February 2013, the Overland Rebuttal reevaluated its conclusions in response to the Wells Fargo Report[28] and using the most recent quarterly information and updated financial forecasts provided by PG&E.[29] Even with this new information, Overland explained that its estimated threshold level of $2.25 billion did not change

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[24] D.12-12-030, p. 100.

[25] While the specifics of PG&E's $4-5 billion "estimate" of unrecovered Shareholder costs are not fully understood, the first page of Jt. Ex. 59 provides some insight into how PG&E has arrived at this number.

[26] Jt. Ex. 51, Overland Report (confidential version), p. 10 and Table 10 on p. 12. See also Jt. RT 14:1366, lines 27-28, PG&E/Lubow-Malko ("incremental new equity") and 1367, lines 1-13 ("nonrevenue producing in nature").

[27] Jt. Ex. 51, Overland Report (confidential version), p. 10.

[28] Jt. Ex. 67, Wells Report (public version).

[29] Jt. Ex. 54, Overland Rebuttal (public version), pp. 22-26.

because it was based on highly conservative assumptions.[30] Overland compared its own results to another equity analyst's results and found that its own estimates were more conservative. The International Strategy & Investment (ISI) analysis assumed a post-tax exposure of $2.24 billion for San Bruno financial consequences, slightly less than Overland's "threshold level" of $2.25 billion, and calculates that PG&E's resulting share price would be $2 to $10 higher than Overland's estimated shared price, based on different levels of authorized ROE.[31] Overland concludes that while PG&E has criticized its analysis because it "does not use standard equity capital markets industry practices," its more conservative results reflect that those inconsistencies – assuming they are inconsistent with standard industry practices – "appear to be in [PG&E's] favor."[32]

C. PG&E's Constitutional Claims Have No Merit

PG&E claims that CPSD's recommendation violates the Excessive Fines Clause of the California Constitution.[33] As set forth in DRA's Rebuttal Brief, PG&E's constitutional claims have no merit.[34] Those arguments will not be repeated here.

III. CPSD'S REVISED PROPOSAL IS MUCH IMPROVED BUT FAILS TO ADDRESS SOME CRITICAL ISSUES

A. CPSD Properly Imposes A Fine On PG&E And Limits Future PG&E "Credits" To PSEP Work

CPSD's revised recommendation provides total financial consequences to PG&E of $2.45 million, comprised of $200 million in equity already accrued by PG&E to pay fines plus $2.25 billion in additional capital that PG&E may raise going forward to cover its San Bruno-related fines and other obligations. This total financial package is comprised of:

- A minimum fine of $300 million payable to the General Fund;

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[30] Jt. Ex. 54, Overland Rebuttal (public version), p. 24 ("Q. Have you revised your "threshold" level based on your updated analysis? A. No, we have not. As stated in our August 2012 report, we believe that our threshold level of equity issuance is a conservative estimate. By assuming that the market will fully dilute PCG's share price with each share of new equity, we are making the highly conservative assumption that the market has not priced in any incremental equity issuance related to a CPUC imposed fine. Furthermore, PCG's metrics, as explained in our previous answer, were largely unaffected from our initial analysis.")

[31] Jt. Ex. 54, Overland Rebuttal (public version), pp. 25-26.

[32] Jt. Ex. 54, Overland Rebuttal (public version), pp. 25-26.

[33] PG&E Reply, pp. 8-10.

[34] DRA Rebuttal Brief on F&R, July 7, 2013, pp. 13-14.

- A "credit" of $634.5 million for disallowed Phase I PSEP costs, reduced by $200 million in equity already raised by PG&E for purposes of paying penalties associated with San Bruno, for a total credit of $435 million;[35] and
- All remaining moneys – approximately $1.515 billion – to be applied to offset ratepayer costs associated with PSEP Phases I and II.[36]

This CPSD proposal is a significant step in the right direction. It properly recognizes that Overland's $2.25 billion estimate was incremental to the $200 in equity already raised by PG&E. It takes this additional $200 million in equity into account by subtracting it from the $635.5 million initial credit that PG&E receives for its disallowed PSEP costs. The CPSD proposal also properly limits any further PG&E credits to the Commission-approved "ratepayers' share" of Phase I and II PSEP costs.[37]

DRA supports the spirit of the CPSD proposal, but urges that it be clarified or expanded to address two important ratemaking issues overlooked by CPSD: (1) PG&E "credits" against its total financial exposure should be adjusted to reflect PG&E's after-tax cost of the PSEP work; and (2) with the exception of the credit for Phase I PSEP costs expressly disallowed by D.12-12-030,[38] the Commission should clarify that all other credits will only be for *authorized costs for capital expenditures that ratepayers would otherwise have to pay.*[39]

B. Ratemaking Clarifications Are Critical To Bring Finality To The San Bruno Proceedings

These ratemaking clarifications are critical to bringing finality to the San Bruno proceedings and to ensuring that ratepayers get the full value of the financial consequences imposed on PG&E as a result of the San Bruno explosion. Absent clarity on the tax issues, PG&E will receive a windfall in tax benefits. Absent clarification that future credits may only be applied to authorized capital expenditures, PG&E will seek to minimize the ratepayer value of the credits by using them to offset cost overruns, unauthorized expenditures, and/or expenses for

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[35] CPSD Amended Reply Brief, p. 4.

[36] $2.25 billion – ($435 million + $300 million) = $1.515 billion

[37] CPSD Amended Reply Brief, p. 4.

[38] D.12-12-030 expressly disallowed costs allocated to recordkeeping and database upgrades, and testing of pipelines installed after 1955. *See, e.g.,* D.12-12-030, p. 56.

[39] Thus, for example, the $380 million contingency adder that the Commission found unreasonable in the PSEP Decision, or other similar costs, would not be counted as a disallowance that would count toward the credit.

activities that would not be added to rate base (thus keeping as much in rate base earning a rate of return as possible).

1. Credits Should Be Tax Adjusted To Reflect PG&E's Actual Costs

As explained in DRA's Rebuttal Brief, PG&E has agreed that the tax benefit of costs that it can deduct - such as PSEP expenses - is 37%.[40] In sum, PG&E avoids 37 cents in taxes for every PSEP dollar it spends. Thus, while PG&E is authorized to spend $1.169 billion of ratepayer monies in Phase I of PSEP, the after tax consequences mean that spending $1.169 billion will only cost PG&E $736.5 million ($1.169 billion x .63). Thus, PG&E's "credit" for the authorized PSEP work should only be $736.5 million – the actual cost to PG&E, not the $1.169 billion it is authorized to spend. As also explained in DRA's Rebuttal Brief, this treatment is consistent with the Overland Financial Analysis, which assumes that the $2.25 billion "threshold level" is post-tax.[41]

In sum, the method for calculating tax benefits has not been disputed, is assumed in all of the applicable financial analyses in the record, and should be applied here to ensure ratepayers receive the full benefit of the disallowances. If any disallowances are not considered tax deductible at some later date,[42] PG&E can file a petition to modify the decision on these matters.[43]

2. Credits Should Only Apply To Authorized Capital Expenditures

Any PG&E credit for Phase I and II PSEP work should be limited to authorized capital expenditures. Absent such a limitation, PG&E will seek to apply the credits to expenses that do not go into rate base, thus minimizing the ratemaking impact of the credits. Using credits to pay

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[40] DRA Rebuttal Brief on F&R, pp. 6-8. Among other things, PG&E used a 37% tax rate for purposes of calculating its post-tax San Bruno liability for its 2012 Annual Report. *See, e.g.,* the first page of Jt. Ex. 59 ("Tax Benefit Savings (@ 37%)").

[41] DRA Rebuttal Brief on F&R, pp. 6-8.

[42] *See, e.g.*, Pacific Gas And Electric Company's Responses To Questions In Section 3 Of Administrative Law Judges' July 30, 2013 Ruling Requesting Additional Comment, filed in these proceedings on August 21, 2013, p. 4 ("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.")

[43] Note also that the Commission should characterize the disallowances to support tax deductibility.

for authorized capital expenses is analogous to paying down a home mortgage – you not only pay for your home (or the utility asset), you ultimately pay less interest to the bank (and less in revenue requirement to PG&E). By applying the credits only to authorized capital expenses that would otherwise go into rate base, ratepayers are saved the annual cost of paying PG&E revenue requirement on those capital investments.

IV. CONCLUSION

For all the reasons set forth herein, the Commission should adopt the recommendations set forth in DRA's Rebuttal Brief filed June 7, 2013 in these proceedings.

Respectfully submitted,

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August 28, 2013