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)

RESPONSE OF THE UTILITY REFORM NETWORK TO QUESTIONS IN SECTION 4 OF THE ALJ RULING

Thomas J. Long, Legal Director
Marcel Hawiger, Energy Attorney

THE UTILITY REFORM NETWORK
115 Sansome Street, Suite 900
San Francisco, CA 94104
(415) 929-8876 (office)
(415) 929-1132 (fax)
TLong@turn.org
Marcel@turn.org

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RESPONSE OF THE UTILITY REFORM NETWORK TO QUESTIONS IN SECTION 4 OF THE ALJ RULING

Pursuant to the directions in the "Administrative Law Judges' Ruling Requesting Additional Comment" ("Ruling"), issued on July 30, 2013, the Utility Reform Network provides the following responses to the Questions posed in Section 4 of the Ruling.

Q1.a. With regard to tax benefits:

a. What, if any, methodology should be used to adjust the amount of any disallowed expenditures to account for tax benefits and thus determine the actual impact of any disallowances on PG&E and/or the amount of capital that PG&E would need to raise?

i. Should this methodology treat capital investment different from other expenses?

ii. If so, please explain how.

TURN recommends that the Commission adjust any disallowed expenditures to account for tax benefits to PG&E by forecasting those tax benefits based on an imposed disallowance amount and appropriate gross-up factors, and increase the financial consequences[1] imposed on PG&E to account for those forecast tax benefits.

[1] Consistent with TURN's previous briefs on fines and remedies, TURN uses the following nomenclature: the terms "fine" and "penalty" are used synonymously to refer to the per offense fines and penalties authorized by Public Utilities Code Section 2100 *et seq* and that are typically paid to the state's General Fund; the term "remedies" refers to other actions or costs imposed upon PG&E pursuant to the Commission's equitable powers and includes disallowance of costs from rate recovery; the term "total financial consequences" (or similar phrases) refer to the cumulative financial impact on PG&E of: (1) fines / penalties and (2) disallowances and other remedies.

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The tax benefits to the utility of disallowed expenditures are calculated by using tax gross-up factors, based on the composite tax rate. The record in this proceeding contains discussion of the fact that PG&E's composite federal and state tax rate is approximately 37%, resulting in a gross-up factor for expenses of 1.587.[2]

TURN recommends that the Commission treat capital and expenses differently based on PG&E's response to Question 2 of Section 3 in its August 21 pleading. PG&E stated that:

> … on the basis of the facts as they are currently known and without the influence of any future facts, [PG&E believes] 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 ….[3]

This response indicates that, *for income tax purposes*, PG&E will immediately expense any disallowed expenditures, and that PG&E "is entitled" to take accelerated depreciation of disallowed *capital* expenditures with actual tax benefits accumulating over time.

This income tax accounting corresponds to the recommendation made by TURN in our Opening Brief on Fines and Penalties. TURN calculated tax benefits of disallowed expenditures by using a gross-up factor of 1.30 for capital and 1.68 for expenses.[4] TURN noted in our brief that PG&E should provide a more accurate gross-up factor, if there is one, in any implementing advice letter.

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[2] The tax gross up factor is equal to: 1 / (1-tax rate) = 1 / (.63) = 1.587.

[3] PG&E, August 21, 2013, p. 4. PG&E cautioned that this opinion was based on PG&E's belief about certain tax matters which are not completely known at this time.

[4] TURN Opening Brief on Fines and Remedies, p. 8-9 and fn. 25. TURN used 1.68 as the gross-up factor based on a more accurate gross-up factor of 1 / (1-.35-.0884*(1-.35)). The gross-up percentage for capital should be equivalent to the tax

It is unclear whether PG&E's use of the phrase "is entitled" reflects a possibility of other tax treatment. PG&E's responses to Questions 2-5 in Section 3 explain that PG&E would use different accounting for book, tax and regulatory purposes. PG&E indicates that for book purposes "disallowed costs would be charged to net income in the period incurred."[5] PG&E does not explain whether it could choose to deduct all disallowed expenditures (capital and expense) as an immediate write down for tax purposes. If PG&E did so the tax impact would be more accurately calculated by using the single gross-up factor of 1.68. TURN's recommendation to separately adjust disallowed capital and expense results in a smaller adjustment and is thus more conservative.

Q1.b. With regard to tax benefits:

b. If PG&E receives accelerated tax depreciation for some of its disallowed investment, do the tax normalization rules contained in Internal Revenue Code Section 168(f)(2) and (i)(9) require the use of a deferred tax reserve account to track any difference between straight-line and accelerated depreciation for the purpose of (i) understanding the impact of fines and disallowances on PG&E by stating the impact of fines and disallowances in equivalent terms or (ii) determining a maximum feasible amount of fines and disallowances that could be absorbed by PG&E?
Please explain your answer. Also please explain the effect, if any, on PG&E's ability to take accelerated depreciation for other capital investment if a deferred tax reserve is not used for these particular purposes.

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gross-up factor on contributions in aid of construction, which was in the range of 1.30 before adders due to recent federal bonus depreciation. See, Advice 2975-G/3372-E, effective January 1, 2009.Thus, 1.30 represents a conservative (low) figure. These gross-up factors result in a forecast tax benefit to PG&E of $256 million based on TURN's proposed disallowances.

[5] PG&E Response to Q 5, p. 5.

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Based on PG&E's responses there is no need to track the difference between straight-line and accelerated depreciation in a deferred tax reserve account for regulatory purposes.

PG&E's responses to the Section 3 questions indicate that:

- For tax purposes, PG&E will "follow normal practice under applicable income tax law, which is independent of CPUC regulatory treatment."[6] PG&E believes that it is entitled to take accelerated depreciation on disallowed capital expenditures.
- For regulatory purposes, PG&E will expense any disallowed expenditures (expense and capital), so there is no deferred tax reserve account or depreciation for regulatory purposes.[7]

Based on these responses, TURN expects that PG&E will, *for income tax purposes*, take any and all necessary accounting steps to comply with income tax rules and not violate tax normalization rules. There should thus be no problem with respect to other capital investments. If PG&E must set up a deferred tax reserve account for tax purposes, PG&E will presumably do so. Any such tax accounting is, as PG&E says, "independent of CPUC regulatory treatment" and will not impact regulatory accounting for disallowed expenditures.

For regulatory purposes there is no need for a deferred tax reserve account, as any disallowed capital costs will not be rate based or depreciated. Because there will be no deferred tax reserve for regulatory purposes, there are neither costs (taxes paid by ratepayers as if there were straight line depreciation)

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[6] PG&E Response to Sec. 3, Q. 2, p. 3.
[7] PG&E Response to Sec. 3, Q. 3, p. 4.

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nor benefits (from the reduction to rate base for accumulated deferred income taxes) to ratepayers due to tax normalization. This is entirely appropriate. The disallowed costs are not booked to rate base, so there is no reason for a normalization adjustment (reduction to rate base based on the deferred tax reserve) to account for accelerated depreciation.

Q2 With regard to the timing of expenses and tax benefits:

a. What, if any, methodology should be used to determine the actual impact on PG&E, and/or on the amount of capital that PG&E would need to raise

i. of capital expenditures or other expenses that will not be made until sometime in the future?

ii. of capital expenditures or other expenses that have already been made?

b. What, if any, methodology should be used to determine the actual impact on PG&E, and/or on the amount of capital that PG&E would need to raise, of tax benefits that will not be received until sometime in the future.

It is theoretically possible to track the actual tax impacts of disallowed costs in the future, based on amounts of costs, tax depreciable lives of disallowed capital investments, and tax rates. This would not be a calculation of a regulatory account such as a memorandum account, but would be usable to generally track the impacts of the Commission decision. Nevertheless, TURN suggests that there is little need to implement any such tracking.

Actual tax benefits over time may deviate from a forecast due to a difference in actual spending compared to forecast, any changes in tax rates, and any changes in depreciable lives of plants.

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TURN suggests that realistically the only significant risk is due to a difference between actual and forecast spending. For example, TURN's recommendation was to disallow the $1.00 billion in PSIP Phase 1 costs for pipeline testing and replacement based on the authorized forecast cost for testing and replacing a specified amount of pipeline. The Commission could track future actual costs and tax benefits. However, the Commission could eliminate this source of uncertainty by disallowing a specific fixed dollar amount of expenditures, regardless of whether those costs were for the PSIP Phase 1 replacement work or other work on the gas transmission system, such as PSIP Phase 2. Such a fixed-dollar disallowance would be entirely appropriate based on the records in these three enforcement proceedings.

In theory the Commission could require PG&E to track disallowed costs and resulting tax benefits to determine the "actual impact" on PG&E. However, the potential usefulness of such cost tracking may be limited, and cost tracking for any future adjustment would result in some continuing uncertainty concerning the financial consequences on PG&E.

The purpose of adjusting the financial consequences is *not* to capture the exact future tax benefits due to a disallowance. Federal tax regulations prohibit state commissions from requiring utilities to compensate ratepayers for the differences between straight-line depreciation for regulatory purposes and accelerated depreciation for tax purposes.[8] TURN does not propose that the Commission impose any requirements on PG&E that would violate this tax regulation. Thus, as long as the forecast tax benefit is conservative, there is not *a priori* rationale for monitoring exact impacts in the future.

[8] See, for example, Resolution L-411A, June 23, 2011, p. 2-3 and 9.

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Q3. The Overland Report states that "Currently, the company is assuming recovery of these PSEP capital costs and the company is financing these costs with its existing capital structure. However, if these costs are disallowed, the company plans to write these capital expenditures off to expense and issue additional equity to fill the equity gap." The Overland Report also contends that "the incremental external equity capital available to PCG is approximately $2.25 billion."[footnotes omitted]

> ***a. In order to understand the impact of any disallowed capital expenditures on PG&E's need for incremental equity, should there be an adjustment to reflect the amount of equity that PG&E would have issued to fund capital expenditures regardless of any disallowance?***
>
> ***b. If the answer above is "yes," what methodology should be used to make this adjustment?***

The Overland Report explained that its analysis "reflects the impact of *incremental equity* issued by PCG. This is equity beyond the amount already embedded in PCG's forecasts." Overland's financial analysis explicitly considered PCG's plan to issue $600 million in equity in 2012.[9]

Overland furthermore explained that "if we chose to ignore PG&E's ability to raise capital as required in the future, our threshold analysis would look considerably different."[10] Overland considered data concerning PG&E's planned capital expenditures for 2013-2016.

There should be no adjustment for equity PG&E "would have issued" to fund these future capital expenditures in 2013-2016. Such a number is impossible to forecast accurately. PG&E's forecast of capital expenditures for 2013-2016 are based on the unrealistic assumptions that its entire GRC capital request is authorized, its entire yet-to-be-requested 2015 GT&S capital request is authorized,

[9] Ex. 52, p. 10 (CPSD / Overland).
[10] Ex. 54, p. 17:12-18 (CPSD / Lubow and Malko).

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and its forecast electric transmission and certain generation capital requests are authorized.[11] There is no basis on which to assume that PG&E's forecast of future capital expenditures is accurate.

Q4. Are there any other factors that require adjustment of the nominal dollars of any disallowed expenditures so that the impact on PG&E of any disallowances can be directly compared to any fines payable to the State's General Fund that may be imposed on PG&E or to calculate the amount of capital that PG&E would need to raise? If so, identify those factors and the methodology that should be used to make the adjustment(s).

TURN has no additional comments on these issues at this time. TURN reiterates that there is not a need to develop an *exact* comparison between a disallowance, and its associated tax benefits, and a penalty to the General Fund. The range of potential financial consequences warranted by PG&E's past practices is quite large.

Q5 If PG&E were to issue equity over a period of years to fund any fines or disallowances, would that have the effect of increasing the amount of such equity that PG&E could raise without negatively affecting PG&E's ability to raise capital and otherwise remain financially viable? Please explain.

Both Overland and PG&E agreed that as a practical matter PG&E would likely raise equity over some period of time, rather than in a single issuance, to raise capital for fines or disallowances.[12] However, TURN does not recommend the Commission adjust its order in recognition of this practical reality. PG&E should have the flexibility to adjust its equity and debt issuances as needed in the future, subject to the Commission's existing orders concerning capital structure.

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[11] Ex. Jt. 76, p. 9-10; See, TURN Reply Brief on Fines and Remedies, June 7, 2013, p. 47-49.
[12] 14 Jt. RT 1384 (CPSD / Lubow) and 15 Jt. RT 1587 (PG&E / Fornell).

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Q6. ***Should the CPUC adopt a methodology for recovering for ratepayers tax benefits that PG&E will accrue from any disallowed expenditures? If so, what should this methodology be?***

The Commission should not adopt a methodology for "recovering" the exact "tax benefits" that PG&E will accrue over time; rather, the Commission should increase the financial consequences on PG&E by requiring PG&E to compensate ratepayers and / or taxpayers an amount based on the forecast tax benefits that PG&E will obtain in the future due to expense and capital disallowances imposed in these proceedings, so that PG&E is not made significantly better off as a result of repairing its system that if it had to pay a penalty to the General Fund.

The forecast tax benefits should be based on using separate gross-up factors of 1.68 for expense and 1.30 for capital.[13] Alternatively, the Commission could, based on the record in this proceeding, adopt one single gross-up factor of 1.58.[14] However, to be conservative, TURN recommends using the two separate gross-up factors. Indeed, the Commission could use a slightly lower capital gross-up factor of 1.25 to minimize any risk to PG&E of future tax rate changes.

TURN had recommended that the Commission disallow the remaining authorized amount for the pipeline modernization portion of the PSIP, forecast at

[13] See, *infra.* fn. 4.

[14] Mr. Fornell agreed on cross-examination that PG&E's tax rate was 37%. However, the record is not clear on whether Mr. Fornell's was taking into account the composite tax rate.

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$150 million in expenses and $852 million in capital.[15] PG&E's actual spending on the program may vary. As discussed above, the Commission could eliminate this potential variance by disallowing a set amount (for example, $1 billion) in capital costs, irrespective of the nature of the work done by PG&E.

Accounting for tax benefits by grossing-up a disallowance places the financial impact of a disallowance on a rough equivalence with the financial impact of a penalty that is not tax deductible. The calculation by itself is not complex.

Q7. *With regard to any methodology recommended in your response to Questions 1 – 6 above:*

a. How can this methodology be applied in this proceeding without waiting for all of any disallowed expenses to be incurred or all of the tax impacts to occur?

b. If the methodology cannot be applied in this proceeding to all disallowances, please explain what cannot be done in these proceedings and why. Also, please explain when and how the methodology will need to be applied after the conclusion of these proceedings.

There is no barrier to imposing a disallowance and increasing the financial consequences based on a conservative forecast of future tax benefits. This is analogous to normal utility ratemaking based on forecast costs. The Commission in its order needs to clearly specify the costs that are being disallowed; or, alternatively, the Commission should disallow a fixed amount during a specified time period.[16]

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[15] These are the amounts remaining for pipe testing and replacement after all disallowances in D.12-12-030. See, TURN Opening Brief on Fines and Remedies, May 6, 2013, p. 8-9.
[16] See Response to Q. 9 below.

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TURN reiterates that our proposal is that the Commission increase the financial consequences on PG&E so that the utility does not reap substantial tax benefits due to the imposition of a disallowance rather than a fine. The Commission could in theory create a memorandum account to track actual costs and tax benefits. However, for the reasons explained in response to Question 2 above, TURN does not propose that the tax impacts be tracked and accounted for to ensure exact equality between the impacts of a penalty and a disallowance.

Q8. *Provide any comments you may have on PG&E's response to Question 5 in Section 3 above.*

PG&E's response to Question 5 indicates that any change to the "actual capital structure" will have "no direct impact on the Cost of Capital proceeding."[17] Rather, PG&E focuses on the fact that it will need to issue additional equity to finance the penalty and remedies imposed in these proceedings (whether fines or disallowances), and that the need to issue additional equity would result in higher cost of equity capital. PG&E then speculates that its debt ratings would be "under pressure and could be downgraded" based on rating agency perceptions of "regulatory risk."[18] PG&E notes that any impacts of higher capital costs would not be reflected in current rates, but might be reflected in the "next Cost of Capital proceeding."[19]

PG&E's explanation of potential increases in capital costs is speculative and unsupported by record evidence. TURN does not disagree that there could

[17] PG&E Response to Sec. 3, p. 5.
[18] PG&E Response to Sec. 3, p. 6 and fn. 12.
[19] PG&E Response to Sec. 3, p. 7.

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be increased equity capital costs in the short term. However, those costs would be reflected in rates after the next Cost of Capital (Test Year 2016) proceeding only if the increased capital costs persisted long enough to affect forecasts for 2016 and beyond. As TURN explained previously, if the Commission issues a decision by the end of 2013, the impact on PG&E stock price would be felt in 2013-2014. There is no evidence that the impact on the actual cost of equity capital would persist long enough to affect forecasts of equity returns for 2016.[20]

Furthermore, there is little evidence that any penalty will result in higher debt costs. PG&E has stated unequivocally that it will finance any penalties with equity. The utility is quick to claim that any Commission decision that negatively impacts its short term finances will impact rating agencies' perception of "regulatory risk." In this case PG&E has consistently argued that any penalty above analyst forecasts or "investor expectations" will result in a negative market reaction and increased capital costs. TURN agrees that the Commission should take utility financial health into consideration, and, in fact, maintaining utility financial health was the principle constraining the Overland analysis. But the Commission should not be blackmailed by threats regarding investors' "perception of the regulatory environment in California."[21] Such threats are not supported in the record and should have no place in the decision-making process in these enforcement proceedings.

PG&E also speculates that rates will be increased by "short-term borrowing costs, higher procurement costs, and higher collateral costs. These increases are based entirely on the assumption that PG&E's debt ratings would

[20] See, TURN Opening Brief on Fines and Remedies, p. 42-43.
[21] PG&E Response to Question 5, p. 6.

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be downgraded, resulting in decreased access to debt markets.[22] Again, there is no basis for assuming any credit downgrade aside from the vague threat of a response by ratings agencies to a perception of increased regulatory risk.

Q9. *Provide any other comments you may have about how the impact of any fines and any disallowances imposed on PG&E should be compared to each other or how they differently affect PG&E's need for additional capital.*

Aside from the tax impacts, a disallowance of costs incurred over time may have a financial benefit as compared to a penalty payable at a fixed time. For this reason, the Commission should specify that the disallowed costs are to be accounted for over a certain time period, for example stretching over two to three years. Such a rule may be easier to implement if the disallowance is of a fixed cost, rather than a forecast cost for a program or project. The fixed cost could obviously be based on cost forecasts, such as the $1.00 billion for PSIP costs proposed for disallowance by TURN.

[22] PG&E cites to the section of Mr. Fornell's testimony that is entitled "debt investors" and discusses debt capital markets and credit ratings.

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Respectfully submitted,

By: ____/s/______________
Marcel Hawiger

Thomas J. Long, Legal Director
Marcel Hawiger, Energy Attorney

THE UTILITY REFORM NETWORK
115 Sansome Street, Suite 900
San Francisco, CA 94104
Phone: (415) 929-8876, ex. 311
Fax: (415) 929-1132
Email: marcel@turn.org