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)

THE CONSUMER PROTECTION AND SAFETY DIVISION RESPONSES TO QUESTIONS IN SECTION 4 OF THE ADMINISTRATIVE LAW JUDGE'S (ALJ) JULY 30, 2013, RULING REQUESTING ADDITIONAL COMMENT

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The Consumer Protection and Safety Division (CPSD)[1] submits these Responses to Section 4 of the Administrative Law Judge's (ALJ's) July 30, 2013, Ruling Requesting Additional Comments.

I. INTRODUCTION

The ALJ Ruling Requesting Additional Comment issued on July 30, 2013, requested all parties to respond to a series of questions related to whether, and to what extent, the nominal dollar amounts disallowed should be adjusted to reflect the following:

- tax benefits accruing to PG&E;
- the time value of money;
- the amount of equity that PG&E would have issued to fund capital expenditures regardless of any disallowance;
- any other factors.[2]

Given the potentially differing viewpoints of the responding parties, it is important to keep in mind some general principles regarding these adjustments. First, the potential impact of tax deductible disallowed costs would represent a benefit to PG&E that is not represented in the nominal costs of penalty values, unless there is a specific mechanism to collect tax benefits from PG&E. However, given that the Internal Revenue Code and its interpretation can change, both PG&E and CPSD recognize that a deduction for disallowed costs for tax purposes is not certain.[3] If it is, a penalty comprised of disallowed capital expenditures/expenses that PG&E is able to deduct for tax purposes clearly represents less of a burden on an after-tax basis than the nominal dollar amount of that penalty. PG&E's Witness Mr. Fornell estimated that the tax benefit on disallowed

[1] On January 1, 2013, CPSD officially changed its name to the Safety and Enforcement Division (SED). However, in light of all of the references to CPSD in the previous rulings by the Commission and the Administrative Law Judges (ALJs), pleadings, exhibits, testimony and cross-examination of witnesses and corresponding transcript references, to avoid confusion we will continue to refer to SED as "CPSD" in this brief and through the remainder of this proceeding.

[2] ALJ Ruling, pages 4-7.

[3] PG&E currently believes that it will be allowed to deduct disallowed costs for income tax purposes, although it is not certain. As stated on page 3 of PG&E's Response to ALJ Questions, Section 3, PG&E believes that "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".

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costs would be "about 37% of the costs."[4] Assuming favorable tax treatment, to calculate the net impact on the Company, nominal amounts of disallowed costs should therefore be reduced to 63%.[5]

Second, the impact of the time value of money would necessarily decrease the present value of any nominal penalty amount that was to be incurred in the future (e.g., disallowed costs related to expenditures in future years). While an adjustment related to the time value of money of disallowed costs to be incurred in future years is dependent on a variety of assumptions (some of which have not been established in the record), it is clear that the present value (or, "actual") impact on PG&E is reduced. Costs that are incurred by PG&E in future years are paid with *future* dollars, not *today's* dollars. Future dollars are assumed to be worth less than present dollars.[6] As such, any nominal dollar amounts that are related to disallowed future expenditures are overstated in present value terms.

CPSD's amended penalty proposal adopts a conservative approach regarding both time value of money and tax benefits. Namely, it did not adjust for them in its calculation. However, the Commission could adopt certain methodologies to account for these effects if it chose to do so, as discussed below. Both the impact of the time value of money, as well as financial savings resulting from tax deductible expenditures, would increase the capacity of PG&E to absorb what would otherwise be implied by the nominal amount of CPSD's proposed penalty.

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[4] Joint Hearing Transcript, p. 1491.

[5] To place the significance of potential tax benefits into context, CPSD's nominal penalty amount of $2.25 billion consists of $1.95 billion of cost disallowances and a fine of $300 million. Assuming Mr. Fornell's estimate regarding the tax benefits of disallowed costs, the after-tax impact of CPSD's proposed penalty would be reduced to 1.529 billion. This is calculated as follows: [$1,950 million * (1-37%) = 1,229 million] + $300 million = $1,529 million.

[6] In finance, "future dollars" are assumed to be worth less than "present dollars" due to loss of purchasing power through inflation, among other factors.

II. RESPONSE TO QUESTIONS IN THE ALJ RULING SECTION 4

1. 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.

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.

CPSD response to 1(a):

The tax deductibility of PG&E's disallowed expenditures will significantly affect the net impact of these expenditures on PG&E and its capital requirements. This issue was first introduced in this proceeding over one year ago on page 14 of Overland's August 2012 report when Overland stated that the CPUC should, "remain cognizant of the possibility that cost disallowances may have more favorable tax treatment for the company than fines."[7]

The methodology necessary to adjust cost disallowances to their after-tax (net) impact is relatively straightforward. Tax deductible expenses decrease taxable income which in turn decreases the income tax expense that PG&E must pay. This methodology

[7] Joint Exhibit 51, page 13.

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is best demonstrated through an example. Assuming a 37% tax rate, a $100 pre-tax disallowed expense would result in a post-tax expense of $63, calculated as follows:

*Pre Tax Cost Disallowance * (1 – PG&E Tax Rate) = Post Tax Impact of Cost Disallowance*

*$100 * (1-37%) = $63· Post Tax Impact of $100 Cost Disallowance.*

The "post-tax" reduction in the penalty amount would have a corresponding effect on the amount of capital that PG&E would need to raise related to the expense. In the previous example, PG&E would only need to raise the after-tax expense of $63, *not* the full cost disallowance amount of $100.

CPSD response to 1(a) i. and ii.

In regards to whether, and to what degree, the suggested methodology should distinguish between costs, any methodology that incorporates the impact of taxes should distinguish between disallowed costs (both capital expenditures and expenses) and fines paid to the California General Fund. Any fines paid to the California General Fund, unlike cost disallowances, are not tax deductible. As PG&E's witness Mr. Fornell stated during cross-examination, the distinction between cost disallowances and fines is significant because "one has tax consequences and the other does not."[8]

In the example provided in subpart (a) above, a $100 pre-tax cost disallowance was shown to have an after-tax (net) impact of $63 on PG&E. A $100 fine, however, would not be tax deductible. As such, a $100 fine would cost PG&E the full $100 on an after-tax basis, or $37 *more* than the cost disallowance. Thus a distinction between disallowed costs and fines is appropriate to reflect the differences in tax deductibility.

However, a further distinction between disallowed capital expenditures and disallowed expenses is not recommended. A procedure to distinguish between disallowed capital expenditures and disallowed expenses would make estimating the net impact of a penalty on PG&E much more complex and necessarily rely on highly unreliable and, in some cases, subjective assumptions.

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[8] Joint Hearing Transcript, p. 1491.

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As stated on page 4 of PG&E's Response to ALJ Questions, Section 3, PG&E currently believes that it is entitled to expense for income tax purposes disallowed non-capital expenditures when incurred, and it is entitled to depreciate over a 20 year timeframe disallowed capital expenditures. Assuming the Company's beliefs hold true, there would be a time lag between when PG&E would incur its capital expenditures and when it would realize the corresponding tax benefit via depreciation. Attempting to quantify this impact would require assumptions about the amount, timing, and depreciation rates of all disallowed capital expenditures. It would then require assumptions regarding discount rate(s) to use in order to discount future tax benefits to present value. Such a discount rate has not been established in the record.

Furthermore, this distinction is not necessary to assess CPSD's proposed recommendation. CPSD made the conservative assumption when calculating its proposed penalty that none of the disallowed costs would be tax deductible. As such, if PG&E may deduct disallowed costs for tax purposes, even if these costs are not immediately realized, it would be a shift downward from CPSD's nominal penalty amount of $2.25 billion. Furthermore, PG&E's utilization of accelerated depreciation would mitigate any timing impact by shifting the majority of the depreciation related to the asset to the beginning of the asset's life.

CPSD response to 1(b).

Given PG&E's statement on page 4 of PG&E's Response to ALJ Questions, Section 3, this issue appears to be irrelevant. PG&E currently anticipates expensing any disallowed capital expenditures when such expenditures are incurred. Since these expenditures will be written off for both GAAP and regulatory purposes, there will be no deferred tax reserve related to the difference between straight line and accelerated depreciation, nor any deferred tax reserve for ratemaking purposes.

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2. ***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. The answer to this question can be included the answers to Question 1.a. above.***

CPSD response to 2(a) i. and ii.

CPSD does not recommend that a specific methodology be utilized to adjust nominal penalty amounts with regard to the timing of future/historic expenses and tax benefits. As discussed in Question 1, such a methodology would require assumptions about the timing of future disallowed capital expenditures and expenses and would also require the development of an appropriate rate at which to discount the future expenditures. Such a discount rate has not been established in the record. However, as discussed above, incorporating the time value of money when addressing future expenditures would decrease the present value impact on PG&E.

CPSD response to 2(b).

See response to Question 1.

3. ***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."***

   a. ***In order to understand the impact of any disallowed capital expenditures on PG&E's need for incremental equity, should there***

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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?

CPSD response to 3(a).

No, there should be no adjustment to incorporate the impact of equity that PG&E would have issued to fund capital expenditures without regard to disallowance. As Overland stated on page 9 of its Rebuttal Testimony (Joint Exhibit 53), Overland made the assumption when performing its threshold level of equity analysis that the additional equity would produce a 0% return and "zero incremental earnings." Consistent with these assumptions, Overland held PG&E's market capitalization constant. Consequently, the additional equity issued in Overland's analysis diluted the shareholder base.

If Overland instead assumed that the equity being issued for capital investments will earn a return, as would be the case for any non-disallowed investments, the restrictions on the level of equity that PG&E could issue are effectively removed. Stated another way, capital investments that earn a fair return would not dilute the shareholder base, it would expand it. As Mr. Fornell stated on page 23 of the Wells Fargo report (Joint Exhibit 66), "A use of proceeds that provides a return to investors will serve to expand an issuer's capacity to raise equity…"

4. 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).

CPSD Response to Question 4.

No additional comment.

5. 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.

a. If so, how could this additional amount of equity be calculated?

CPSD Response to Question 5.

Yes, if PG&E were to issue equity over a number of years there would be some increase in the amount of equity that PG&E would be able to raise.

CPSD Response to Question 5(a).

The enhanced ability of PG&E to raise capital in multiple tranches was alluded to by Mr. Fornell during the evidentiary hearing of this proceeding. When asked under cross-examination what his response would be if PG&E's CEO questioned Wells Fargo about issuing $2 billion in equity, Mr. Fornell's first piece of advice was to not "do it all at once."[9] Similarly, CPSD's witness Mr. Lubow stated that the Company would issue $2.25 billion of equity not in a "single day", but would instead do it in "tranches" over the period of a year or less.[10] As such, the opinions of both financial expert witnesses appear to be in agreement that issuing equity over a longer period of time increases the capacity of the issuer. However, an attempt to quantify this impact would be highly speculative and not recommended.

6. 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?

CPSD Response to Question 6.

[9] Joint Hearing Transcript, p. 1587.

[10] Joint Hearing Transcript, p. 1384.

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Adopting a methodology wherein tax benefits accrued by PG&E related to disallowed expenditures will be returned to taxpayers is a possible ratemaking tool that the CPUC could employ to address the limitations of the incomplete information that now exists. One advantage to utilizing such a mechanism would be that it would enable the CPUC to focus on what it deemed to be an appropriate nominal penalty without requiring some sort of "gross up" to incorporate the effect of potential tax benefits.

Although PG&E currently believes that it will be able to deduct disallowed costs for tax purposes, it adds qualifying language that "this [tax] treatment may ultimately not be sustained."[11] Additionally, given that the Internal Revenue Code often changes, cost disallowances that will be incurred in future years are subject to the additional risk that the tax code itself will change.

To guard against these contingencies the CPUC may deem it prudent to adopt a procedure to track costs that it deems non-recoverable and require PG&E to provide regular filings regarding the tax treatment of these costs. An adjustment to the nominal value of the penalty for potential tax benefits (as described in response to Question 1) or a mechanism to return accrued tax benefits to ratepayers (as discussed above in response to Question 6) is appropriate, but not both. Otherwise, the effect of PG&E's tax benefits would be counted twice.

7. 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***

[11] Page 4 of PG&E's Response to ALJ Questions, Section 3.

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methodology will need to be applied after the conclusion of these proceedings.

CPSD response to Question 7(a) and (b).

Several methodologies are available to the Commission.

Application of Tax Benefits Adjustment Methodology (Question 1) – Assuming a schedule of future disallowances can be reasonably assumed, one method to incorporate this effect is to utilize PG&E Witness Fornell's estimate that the tax benefit on disallowed costs would be "about 37% of the costs."[12] To determine the net impact on PG&E would require that the CPUC simply assume a level of disallowed expenditures and multiply this amount by 63%.[13] However, it should be noted that to employ this methodology the CPUC would need to assume the amount of future disallowed costs and the corresponding tax rate.

Application of Time Value of Money Adjustment Methodology (Question 2) – As discussed in response to Question 2 above, a methodology for adjusting the impact of the time value of money on the nominal amounts to be disallowed in the future relies on a variety of assumptions, some that have not been established in the record. However, as stated above, a time value of money adjustment to the nominal level of future cost disallowances would necessarily *decrease* the present value of these costs and, consequently, mitigate any negative impact on PG&E.

Application of Other Equity Issuance Adjustment Methodology (Question 3) – As described in response to Question 3, no adjustment is necessary regarding this issue.

Application of Equity Issuance Over a Number of Years Methodology (Question 5) – As discussed in response to Question 5, both financial experts in this hearing agree that the capacity of a company to issue equity does increase somewhat when the equity

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[12] Joint Hearing Transcript, p. 1491.

[13] This figure is calculated as follows: Post Tax Impact of Disallowed Cost = (Nominal Value of Disallowed Costs) * (1-Assumed Tax Rate).

issuances are spread over a long period rather than a short timeframe; however, any attempt to quantify such an adjustment would likely be highly speculative.

Application of Ratepayer Refund Methodology (Question 6) – Adopting a methodology to return tax benefits derived from disallowed expenditures to ratepayers is a method that could be implemented by the CPUC. This approach is discussed in response to Question 6. Two advantages include limiting the number of future assumptions the CPUC must make regarding tax implications of penalties and also allowing the CPUC to focus on the nominal amount of the penalty.

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

CPSD response to Question 8.

PG&E's claims regarding the potential impact on PG&E's cost of capital are exaggerated and not supported by record evidence.

PG&E claims that PG&E's debt ratings would "be under pressure and could be downgraded."[14] Not only is this assertion overstated, it is directly contradictory to evidence in the record. As noted on page 6 of Overland's Rebuttal Testimony (Joint Exhibit 53), the rating agencies have assumed that the penalties at PG&E would be substantial. Even so, both S&P and Moody's have maintained their ratings on PG&E despite this anticipation of a substantial fine.

On page 17 of Overland's Rebuttal Testimony, it states "…[Overland does] not anticipate [PG&E's] cost of capital being significantly impacted by a penalty, so long as it falls within the range of [Overland's] analysis." The Company has cited no evidence (in the record) to refute Overland's assertion that PG&E's cost of capital would not be negatively impacted.

[14] PG&E's Response to ALJ Questions, Section 3, page 6.

9. 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.

CPSD response to Question 9.

No additional comment.

Respectfully submitted,

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