BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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| 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<br>(Filed January 12, 2012)<br><br>(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<br>(Filed February 24, 2011)<br><br>(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<br>(Filed November 10, 2011)<br><br>(Not Consolidated) |

**THE CONSUMER PROTECTION AND SAFETY DIVISION REPLY TO PG&E'S AMENDED 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 this Reply to PG&E's Amended Responses to Section 4 of the Administrative Law Judges' (ALJs') July 30, 2013, Ruling Requesting Additional Comments. PG&E served amended Responses on October 11, 2013, pursuant to the ALJs' Ruling on October 9 that struck portions of PG&E's original Responses as non-responsive and outside the evidence in the record. CPSD's Reply is limited to the unredacted portions of the amended PG&E Responses.

## I. INTRODUCTION

PG&E's introduction to its Amended Response once again improperly argues that CPSD's penalty recommendation equals $4.0 billion, which is obviously incorrect in its basic arithmetic. As discussed previously, CPSD's recommendation is $2.25 billion, of which PG&E may claim credit for approximately $400 million previously spent on PSEP costs. Included in that recommendation is $300 million to the State's General Fund as a payment, which PG&E claims "would not be used to improve gas safety."[2] The rest would be spent to improve gas safety.

First, CPSD does not agree with the claim that $300 million in fines does nothing for gas safety. PG&E repeatedly violated, over many decades, federal gas safety provisions, emphasizing corporate profits at the expense of gas safety compliance. A substantial monetary penalty serves to enforce that utilities have a legal obligation to comply with the law, and deters future violations. This component of CPSD's recommendation is of equal importance to the other provisions, as PG&E has demonstrated that historically it has given compliance with gas safety a low priority, or

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[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] PG&E Amended Response, page 2.



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sometimes not at all. If PG&E merely spends money fixing problems it created in the first place and pays no additional fine, there is little incentive to comply in the future.

In addition, CPSD notes that PG&E's attempt to characterize the penalty as $4.0 billion rests on the assumption that PG&E should receive credit for $1.8 billion it has not yet spent, including $500 million for a right-of-way "encroachment issue" which has not been fully investigated, no evidence for it exists in the record, and PG&E has not yet begun to remedy and has not provided any evidence to support the alleged costs. PG&E also seeks to receive credit for money it spent years ago as part of the Gas Accord V settlement, which was signed in August 2010 and approved in April 2011.[3]

PG&E's introduction also raises the falsely dire scenario that PG&E and its customers could be "harmed" if PG&E cannot get credit for outside-the-record costs, under the guise that Overland's analysis requires it. However, Overland's analysis does not require it, because the analysis shows that the level of fines and penalties recommended by CPSD does not outstrip PG&E's ability to issue equity in the near future. In addition, Gas Accord V costs have been already been included in Overland's analysis. Overland's Report (Joint Exhibit 51) showed that so long as the fines and penalties do not exceed $2.25 billion, PG&E's creditworthiness will be unharmed and PG&E will remain financially healthy. Additionally, due to the potential tax implications, and because CPSD gives PG&E credit for recent disallowed PSEP expenditures, its effective recommendation is actually below that range.

PG&E further states that it will be unable to raise "enormous"[4] amounts of equity in the future, arguing that CPSD incorrectly believes PG&E has "access to a limitless supply of equity capital" for future expenditures.[5] However, CPSD does not believe this to be true. CPSD's position is that, as proven by Overland's analysis, PG&E can issue

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[3] D.11-04-031

[4] PG&E Amended Response, page 3.

[5] PG&E Amended Response, page 16.

sufficient equity to pay the recommended fines and penalties without suffering undue damage to its creditworthiness; and that PG&E's ability to issue equity for other future expenditures will be unaffected so long as PG&E can put those expenditures into rate base and earn a return.

PG&E's dire predictions that access to capital for future safety expenditures might "dry up"[6], even if those expenditures are allowed into rate base and earn a return, is wrong and illogical. In reality, such expenditures do not cause any increase in PG&E's costs of capital. The parties' financial experts unanimously agree that expenditures that are allowed into rate base and earn a return actually increase PG&E's ability to raise equity.[7]

## 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)

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[6] PG&E Amended Response, page 3, page 26.

[7] Joint Exhibit 67, page 23. Mr. Fornell states: "A use of proceeds that provides a return to investors will serve to expand an issuer's capacity to raise equity…"

> 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 reply to PG&E response to 1(a):**

PG&E's response to Question 1(a) fails to answer the question, instead saying that creating any methodology "would be very difficult as a practical matter."[8]

In addition, PG&E states that it "strongly opposes the use of potential tax deductions to increase the amount of any penalties."[9] However, CPSD's amended penalty proposal adopted a conservative (indeed, the most conservative) approach to adjusting for potential tax benefits of disallowed costs: it did not adjust for them. Therefore, the adoption of CPSD's amended penalty proposal does not require the Commission to make any specific adjustment for the impact of taxes. However, if PG&E realizes tax benefits from disallowed costs, such benefits may be significant.

With this in mind, CPSD's "effective" penalty recommendation may in fact be far lower than $2.25 billion, because the actual impact on PG&E of the disallowances may be alleviated substantially by the tax benefits.[10] As noted by PG&E's witness Mr.

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[8] PG&E Amended Response, page 8.

[9] PG&E Amended Response, page 7.

[10] PG&E wrongly contends that the "effective" penalty recommendation is $4.0 billion. (PG&E Amended Response, page 2 and page 14.) In that figure PG&E is including costs of $1.75 billion from the Gas Accord V settlement, a case which was settled in 2011 and includes alleged costs that are not in the record as a result of the ALJs' Ruling Granting CPSD's Motion to Strike in a June 3, 2013, e-mail. Moreover, Overland's analysis was based on PG&E's own projections of its financial condition as of the date Overland issued the report in August 2012, and Overland focused on incremental capital, not historical costs. (Reporters Transcript, page 1366.) PG&E is also including $500 million for right-of-way encroachments, a figure which is not in the record in these proceedings and is the subject of an ongoing investigation by CPSD. Neither CPSD nor PG&E can verify this amount at this time. These alleged costs are also not in the record as a result of the ALJs' Ruling Granting CPSD's Motion to Strike in a June 3, 2013, e-mail.

Fornell, there is "clearly a distinction between those penalties which are tax deductible and those that are not."[11]

CPSD previously provided an illustration that showed that a $2.25 billion penalty comprised of $1.95 billion in cost disallowances and a $300 million fine could result in an after-tax impact on PG&E of $1.529 billion. This represents a material reduction of roughly $720 million from the nominal amount of the penalty.[12] For purposes of this illustration, CPSD adopted the simplifying assumption offered by PG&E Witness Fornell regarding the tax impacts of cost disallowances that such tax benefits on disallowed costs would be "about 37% of the costs."[13] The tax benefits, however, need not be precisely at the level assumed by Mr. Fornell to have a material impact on PG&E. For instance, if the above illustration was modified by making a conservative assumption that PG&E ultimately receives only one-half of the tax benefits assumed by Mr. Fornell, PG&E would still receive $60 million more in tax benefits than it would pay in its fine to the State General Fund.[14]

**CPSD reply to PG&E response to 1(b):**

Regarding the impact on rates of accelerated depreciation for disallowed investments, PG&E stated that it will expense all disallowed capital expenditures when incurred.[15] As such, there will be no GAAP or regulatory depreciation and no deferred tax reserve for the difference between accelerated and straight line depreciation. Subsequently, as PG&E notes, "neither these expenditures nor any of the tax

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[11] Joint Hearing Transcript, p. 1590.

[12] The $720 million estimate was derived from the following calculation: $2.25 billion less $1.529 billion = $721 million. While all parties agree that PG&E would not receive a tax benefit from a fine, the assumption of most parties is that PG&E would receive a tax benefit from the disallowance, but this assumption is not certain.

[13] Joint Hearing Transcript, p. 1491.

[14] The $60 million figure was calculated as follows: $720 million * 50% = $360 million tax in benefits less $300 million fine = $60 million tax benefits in excess of fine.

[15] PG&E Amended Response, page 9.

consequences of these expenditures will impact customer rates."[16] PG&E's anticipated treatment of accounting for its disallowed capital investments appears reasonable.

**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 reply to PG&E response to Question 2.**

Although the ALJs' question was focused on the timing of expenses and tax effects, PG&E's response did not respond to the question. PG&E merely reiterated that no adjustment should be made for tax benefits, and that it will be "difficult" for PG&E to issue future equity for non-income generating assets.[17]

With regards to alleged "difficulty" raising equity, Overland's analysis was designed to assure the Commission, the public, and the investment community that fines and penalties which do not exceed $2.25 billion will not affect PG&E's creditworthiness. In fact, CPSD's effective recommendation is below that range, thus PG&E should not be financially harmed by raising equity to fund the recommended amounts. For future expenditures, capital investments that are approved by the Commission and allowed into rate base would, by definition, be earning a return and, in the words of Mr. Fornell,

[16] PG&E Amended Response, page 10.

[17] PG&E Amended Response, page 11.

"serve to expand" PG&E's ability to raise equity.[18] PG&E has not presented compelling evidence that it will have any difficulty issuing sufficient future equity for future expenditures.

**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 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 reply to PG&E response to 3(a).**

In its Response to Question 3, PG&E failed to adequately respond to the ALJs' question. Instead, PG&E's response digresses into alleged costs from past proceedings, investors' perceptions of the regulatory risk in California, concerns about a ratings downgrade, concerns that the supply of equity is limited, etc. None of this is in the record. Given PG&E's large proposed capital investment program over the next few years, the ALJs' Question 3 is asking a vital question that deserves a meaningful, direct response.

The ALJs' question focused on the impacts of any disallowed capital expenditures on incremental equity; that is, above and beyond the recommended disallowances by CPSD. CPSD's clear response was: *No adjustment is necessary to reflect the amount of*

[18] Joint Exhibit 67, Wells Fargo Report, p. 23.

*equity that PG&E would have otherwise issued to fund capital expenditures.* Equity issued for expenditures that provide a return increases PG&E's ability to raise capital. As discussed above, capital investments that are approved by the Commission and allowed into rate base would, by definition, be earning a return and, in the words of Mr. Fornell, "serve to expand" PG&E's ability to raise equity.[19]

To make a conservative estimate of PG&E's ability to raise capital (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." 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 would be effectively removed.

**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 Reply to PG&E response to Question 4.**

PG&E's response to Question 4 refers back to its previous answers.

[19] Joint Exhibit 67, Wells Fargo Report, p. 23.



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**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 Reply to PG&E response to Question 5(a).**

In its response to the ALJs' Question 5, PG&E stated that whether equity is issued all at once or over a number of years the total amount of equity that PG&E could issue "would not change."[20] The evidence in the record contradicts this claim.

PG&E's own witness testified that issuing equity over a number of years would increase PG&E's ability to raise equity capital. Under cross-examination, Mr. Fornell was asked whether issuing equity capital "over time" would be "beneficial."[21] Mr. Fornell responded by stating that there would be three factors that would impact PG&E's ability to issue equity for a fine/penalty: liquidity, scale of the penalty, investors' expectations/risk assessment.[22] Mr. Fornell concluded his response by stating that PG&E could "deal with the liquidity issue" by issuing equity over a number of years.[23] The effect of spreading the equity issuance over a period of time was also alluded to by CPSD's expert witness who testified that PG&E would make large equity issuances in tranches, not in a "single day."[24] PG&E's contention that no such effect exists is incorrect.

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[20] PG&E Amended Response, page 22.

[21] Joint Hearing Transcript, p. 1590.

[22] Joint Hearing Transcript, p. 1589 to 1591.

[23] Joint Hearing Transcript, p. 1593.

[24] Joint Hearing Transcript, p. 1384.

As described in CPSD's response to Question 5, and based on the evidence in the record and corroborated by PG&E's own witness, PG&E's capacity to raise equity capital would be enhanced if it were to issue this equity over a number of years rather than all at once.

**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 Reply to PG&E response to Question 6.**

PG&E's response merely refers back to Question 1.

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

**CPSD reply to PG&E response to Question 7(a) and (b).**

In response to Question 7 PG&E restated its answer to Question 3, that the Commission should not use any method that incorporates potential tax deductions. Again, while no tax adjustments are necessary to adopt CPSD's amended penalty proposal, the evidence in the record indicates that PG&E could receive tax benefits if it is allowed to deduct disallowed expenditures. See CPSD's reply to Question 1 above for additional discussion regarding this issue.

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

**CPSD reply to PG&E response to Question 8.**

PG&E's response to this Question was "Not applicable."

**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 reply to PG&E response to Question 9.**

This Question asked parties to provide comments regarding how fines and disallowances "should be compared to each other" and to comment on "how they differently affect PG&E's need for additional capital."

Instead, PG&E's response is irrelevant to the question. PG&E's concerns, such as the constitutionality of the proposed penalty, that PG&E should be given credit for past expenses in unrelated proceedings (i.e., Gas Accord V), and that PG&E should not be deprived of the potential tax benefits, are non-responsive to this question.

Respectfully submitted,

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