**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>(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>(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>(Not Consolidated) |

**REPLY COMMENTS OF THE UTILITY REFORM NETWORK**

**IN RESPONSE TO SECTION 4 QUESTIONS**

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## REPLY COMMENTS OF THE UTILITY REFORM NETWORK IN RESPONSE TO SECTION 4 QUESTIONS

Pursuant to the directions in the Administrative Law Judges' Ruling Requesting Additional Comment ("Ruling"), issued on July 30, 2013, The Utility Reform Network ("TURN") provides the following reply comments to the Amended Responses of Pacific Gas and Electric Company ("PG&E") to the Questions posed in Section 4 of the Ruling ("PG&E Amended Responses").[1] TURN previously filed its own opening comments on the Section 4 Questions on September 20, 2013.[2]

### 1. Reply to Question 1 Comments

#### a. The Calculation of Tax Benefits for Purposes of Comparing Financial Consequences on PG&E Does Not Violate OII 24

PG&E argues that using assumed tax deductions to increase disallowances or other penalties would constitute an "unwarranted departure" from precedent.[3] PG&E relies on language from OII 24 for the proposition that "if shareholders pay a cost, they are entitled to the related tax effects." PG&E's reliance on OII 24 is misplaced; moreover, even if PG&E's interpretation is

[1] By Ruling dated October 9, 2013, PG&E was required to amend its original Responses to remove substantial text and footnotes that were unresponsive to the ALJs' Section 4 questions.

[2] 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.

[3] PG&E Amended Responses, p. 8.



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correct, the point of calculating the tax impact of a disallowance in these proceedings is not to reduce the tax expense component of the revenue requirement, but to properly compare different types of financial consequences.

Decision 84-05-036 in OII 24 does not stand for the proposition that PG&E is entitled to all tax benefits from disallowed costs. Rather, that decision adopted a policy that shareholders should get the benefit of tax impacts due to voluntary shareholder spending on **below-the-line activities**. The Commission addressed the question of whether the tax expense for revenue requirements should be adjusted due to voluntary below the line "expenses [such as] donations, dues, and contributions …."[4] Indeed, while the Commission discussed disallowed expenses, it made clear that by "disallowance" it meant a reduction to the utility cost estimate, based on a more reasonable cost forecast.[5] In other words, the Commission expected that the utility could perform the identified activity at a lower cost without any shareholder impact. This is entirely different from the notion of a "disallowance" of costs based on the expectation that shareholders will have to cover a portion of the cost forecast, such as the disallowance of pipeline testing costs imposed in the PSIP decision.

The intent of D.84-05-036 was to ensure that if shareholders funded a below-the-line activity (such as a political contribution) that created tax benefits, the shareholders should get those benefits, particularly since the tax benefits

[4] D.84-05-036, 15 CPUC 2d 42, 47-48.

[5] D.84-05-036, 15 CPUC 2d 42, 48 ("The term 'disallow' is itself a bit misleading, which may contribute to any controversy over this point. Ratemaking is better understood as a matter of constructing an overall revenue requirement, based on estimates of reasonable costs, than as a matter of disallowing unreasonable expenses.")



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partly motivated the spending. The Commission sought to ensure that shareholders would not "suffer an unjustified loss of net income equal to the full amount of the disallowed tax deduction, while ratepayers would receive an unjustified windfall arising from rates based on tax benefits that did not belong to them."[6] But in this case, the calculation of the tax deduction has nothing to do with setting a tax expense amount for revenue requirements; and it is not related to providing shareholders with the benefit of a tax impact due to voluntary spending on below-the-line activities.

Moreover, PG&E is incorrect that the policy of OII 24 concerning the calculation of tax expenses in rate cases is applicable to the situation at hand. The purpose of calculating the tax consequences of potential disallowances in these proceedings is *not* to capture the tax benefits that normally flow to shareholders. Rather, the goal is to calculate the "financial consequences" of a disallowance on PG&E shareholders for the purpose of comparing the impact of a penalty versus a disallowance. The underlying goal is to ensure that the "financial consequences" imposed upon PG&E can be compared to the $2.25 billion threshold calculated by Overland.

There is no dispute among the parties that the financial consequences to PG&E of a penalty and a disallowance are different due to the tax deductibility of disallowed costs. In order to determine an appropriate set of financial consequences – including any disallowances, penalties or other Commission-imposed remedies – the Commission should compare apples-to-apples. The goal

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[6] *Id.*



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of calculating the tax benefits due to disallowed costs is to fairly craft a total package of financial consequences that is commensurate with PG&E's serious and numerous violations and is within PG&E's ability to issue new equity.

The Commission could in theory order PG&E to pay $2.25 billion as a penalty to the General Fund.[7] But there is broad consensus among all the parties – including TURN, DRA, and CPSD, as well as PG&E – that it is appropriate for PG&E to pay for some of the costs of repairing the gas transmission system.[8] In other words, parties agree that a disallowance is an appropriate remedy in this case. However, if the Commission imposed (for example) a $2.25 billion disallowance, the impact on PG&E shareholders would be substantially less, more on the order of $1.42 billion.[9] The whole point of the "tax adjustment" is to ensure that the actual financial consequences imposed on PG&E add up to the amount that the Commission believes should be paid by PG&E shareholders. Whether the "additional" amount is credited to ratepayers, or credited to taxpayers as a penalty, is an entirely separate decision to be made by the Commission.

#### b. The Tax Impact Can be Practically Incorporated into a Remedy

PG&E also argues that determining how to factor in tax deductions "would be very difficult as a practical matter" due to uncertainties in whether PG&E can deduct disallowed costs, and the timing of potential tax savings.[10] TURN agrees

[7] For purposes of this example TURN uses $2.25 billion as an illustrative figure, without attempting to credit prior disallowances.

[8] See, for example, PG&E Coordinated Remedies Brief, June 5, 2013, pp. 8-9; PG&E Amended Responses, p. 25.

[9] Using the 37% tax impact. 14 Jt. RT 1491:7 (PG&E/Fornell).

[10] PG&E Amended Responses, p. 8.



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that some forecast uncertainties exist.[11] However, the goal is not to precisely calculate future tax impacts, but to adjust the financial consequences on a forecast basis in a manner that results in a fair and equitable outcome. TURN proposed a conservative means of forecasting the tax deductions based on separate gross-up factors for capital and expense.[12] The Commission could take other steps to ensure any forecast is sufficiently conservative, such as reducing the gross-up factor or tracking actual tax impacts. However, TURN suggests that tracking actual tax impacts simply delays final resolution of these proceedings and is not necessary for a proper resolution.

#### c. Tax Normalization

TURN has no reply comments, as there appears to be general agreement that PG&E would not create a deferred tax reserve account to track depreciation differences for any disallowed costs.

### 2. Reply to Question 2 Comments

Although disagreeing with PG&E's discussion, TURN agrees with PG&E's conclusion that it is not advisable to adjust the financial consequences to account for any timing differences.[13]

The CPSD notes that there is no appropriate discount rate in the record to calculate timing impacts. However, TURN did provide a gross-up figure for capital expenditures that is based on an accelerated 20-year depreciation

[11] TURN Response to Section 4 Questions, September 20, 2013, p. 5-6.

[12] PG&E notes that "expenditures relating to capitalized amounts will be recovered over 20 years," and are thus worth less than a current expense. However, TURN's lower gross-up factor of 1.30 for capital takes into account the accelerated depreciation over 20 years.

[13] *See* TURN Responses to Section 4 Questions, pp. 5-6.



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schedule discounted at the utility's cost of capital (consistent with the treatment of the tax gross-up for Contributions in Aid of Construction).[14]

### 3. Reply to Question 3 Comments

Under the guise of providing context, even PG&E's amended response to Question 3 (reflecting the stricken text) reiterates arguments from prior pleadings, particularly the argument that Overland's approach "must take into account the full extent of costs borne by PG&E's shareholders.[15] Accordingly, PG&E's response does not advance the Commission's consideration of the financial consequences issues. Nevertheless, TURN will respond (again) to PG&E's recycled arguments.

#### a. Overland's Threshold Analysis Properly Includes Extraordinary Shareholder Costs Related to the San Bruno Proceeding, Not the Full Panoply of Costs PG&E Advocates

PG&E argues that Overland included "all shareholder costs, not just fines and penalties," in its calculation of what counts toward the $2.25 billion threshold.[16] Overland did agree that certain shareholder costs, that are for sure not included in rates, could be credited towards the $2.25 billion. And in fact, TURN conservatively (i.e., in PG&E's favor) credited PG&E with almost $784 million in spending.[17] However, PG&E ignores certain specific limitations explained by Overland; and PG&E's conception of shareholder costs that should

[14] TURN Opening Brief on Fines and Penalties, May 6, 2013, p. 9; TURN Response to Section 4 Questions, September 20, 2013, p. 2-3 and fn. 4.

[15] PG&E Amended Responses, p. 12.

[16] PG&E Amended Responses, pp. 12-13 and fn. 23-26.

[17] TURN Opening Brief on Fines and Remedies, p. 46. TURN notes that this number was inadvertently transcribed to $748 million in TURN's Reply Brief, at 36-37.



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be credited, including forecast future costs, are completely beyond the costs which Overland considered as properly within the threshold amount.

PG&E cites to Overland's testimony for the proposition that "all shareholder costs" are included in the $2.25 billion.[18] However, there is nothing in the cited pages of Overland's testimony to support this assertion. PG&E then claims that Overland's oral testimony stands for the proposition that not only "costs that are being incurred for Commission–approved activities but not allowed into rates," but also "other costs that the company has incurred and is continuing to incur that are above and beyond whatever was in rates"[19] all count towards the threshold. But PG&E's quotation is actually from *a question asked by counsel for PG&E*,[20] and Mr. Lubow's responses to cross examination questions do not support the notion that "any and all costs" should count toward the threshold.

In fact, Mr. Lubow explained that "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."[21] Mr. Lubow clarified that "unrecovered costs" would be considered relevant only if they were "directly related to fines and penalties."[22] In other words, Mr. Lubow explained that while there is an entire third category of "unrecovered costs," those costs are part of the threshold amount only if they are associated

[18] PG&E Amended Responses, p. 12, fn. 23.
[19] PG&E Amended Responses, p. 13, quoting from 14 Jt. RT 1370-1371.
[20] 14 RT 1370:21 – 1371:6 (PG&E/Malkin).
[21] 14 RT 1370:11-16 (CSPD/Lubow). See, also 14 RT 1369:16- 1370:5 (CPSD/Lubow).
[22] 14 RT 1373:4-6 (CPSD/Lubow).



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with specific Commission disallowances. This explanation is entirely consistent with Overland's written testimony, which explained that the purpose of the analysis was to benchmark "the financial capacity of PG&E to absorb potential fines or penalties *associated with the outcome of proceedings arising from the San Bruno incident.*"[23]

**b. PG&E Should Not Be Given Credit for Normal Costs of Fulfilling Its Obligations as a Gas Operator**

Contrary to PG&E's repetitive arguments,[24] Overland's limitation is appropriate. Costs that shareholders may have to absorb in the normal course of operations or requested cost recovery that the Commission found to be excessive (such as the Pipeline Safety Implementation Plan ("PSIP") contingency[25]) are costs of doing business as a gas operator and should not be considered in the same category as extraordinary disallowances or penalties. To the extent that PG&E seeks credit for such normal business costs, it is attempting to nullify the impact of any adverse financial consequences. A "penalty" that is fully offset by costs that PG&E shareholders would otherwise be required to absorb is no penalty at all.

Similarly, PG&E's planned equity issuances[26] are not a reason to moderate the financial consequences. As TURN and CPSD have previously

[23] Ex. Jt. 53, p. 3:1-3 (emphasis added)

[24] PG&E Amended Responses, pp. 14-15, 19-20.

[25] See TURN Reply Brief on Fines and Remedies, June 7, 2013, p. 40-41 (discussing why the contingency was a forecast cost reduction, not a disallowance). See also 14 RT 1425:7-16 (CPSD/Lubow).

[26] PG&E Amended Responses, pp. 16-17. In addition, although most of PG&E's attempt to exaggerate the impact of CPSD's penalty proposal was properly stricken by the ALJs' October 9, 2013 Ruling, PG&E's Amended



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explained, no adjustment is necessary, because Overland's analysis explicitly took into consideration PG&E's need for "incremental equity" to fund planned capital expenditures.[27]

In footnote 61, PG&E claims that TURN's argument that only costs which had been "expressly approved" by the Commission should count towards the threshold "makes no sense." PG&E explains that if costs had been previously approved, they would not be "paid by shareholders." PG&E misrepresents TURN's argument. By "approved costs" TURN meant exactly the same thing as PG&E and Overland. PG&E itself asked Overland whether the threshold included "costs incurred for Commission-approved activities *but not allowed in rates*."[28] This is exactly what TURN meant by "approved" costs that are, nevertheless, disallowed and paid for by shareholders. These include certain PSIP pipe testing costs, which the Commission approved but did not allow in rates.

**4. Reply to Questions 4 through 9**

PG&E does not provide any additional substantive information in its responses to these questions, and accordingly TURN has no comments.

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Responses (p. 2) include the naked assertion that CPSD's recommendation would cause PG&E to incur $4 billion in unrecovered costs. This figure finds absolutely no support in the record and is nothing more than an arbitrary dart-board number. The fact that PG&E keeps repeating it makes it no more real.

[27] TURN Opening Brief on Fines and Remedies, p. 31-33; TURN Reply Brief on Fines and Remedies, p. 47-49.

[28] PG&E Amended Responses, p. 13, quoting 14 Jt. RT 1370 (CPSD/Lubow).



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Respectfully submitted,

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