DIVISION OF RATEPAYER ADVOCATES

Dana Appling, Director

California Public Utilities Commission

Audit Report

PG&E's Expenditures related to Political Activities
To Oppose Yolo Annexation By SMUD

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DEFINITIONS

Above The Line – Expenses on the utility's (PG&E) income statement that are appropriately charged to and paid in rates by its utility customers are referred to as being "Above The Line," or Above The Line of reasonableness for providing utility service.

Base – The costs that are considered to be a reasonable beginning point when projecting future costs in a General Rate Case.

Base Year – The Base Year is typically the most recent year for which recorded data is available to use as the beginning point for projecting future costs in a General Rate Case.

Below The Line - Expenses on the utility's (PG&E) income statement that are <u>not</u> appropriately charged to and paid in rates by its utility customers are referred to as being "Below The Line," or Below The Line of reasonableness for providing utility service.

California Public Utilities Commission or CPUC – The state commission charged with the responsibility to regulate the service and rates of investor-owned public utilities in California.

Coalition for Reliable and Affordable Electricity or CRAE – A non-profit entity established by PG&E to oppose the annexation of its Yolo County service territory by the Sacramento Municipal Utility District.

Division of Ratepayer Advocates or DRA – An independent division within the California Public Utilities Commission statutorily mandated to advocate for and represent the interest of customers of CPUC regulated public utilities with the primary goal to obtain the lowest possible rates for service consistent with safe and reliable service levels.

General Rate Case – The administrative proceeding conducted at the CPUC addressing the application of a public utility to establish a "Revenue Requirement" which forms the basis upon which rates are determined after CPUC approval.

Historical Data – Recorded data from prior years that is typically used to determine what is reasonable for future rates. Historical costs are adjusted to remove non-recurring items or to add known items that have not occurred in the past.

DEFINITIONS
(Continued)

Internal Costs – Costs of services or goods provided or produced by PG&E employees or for the use of Utility Facilities.

Measure H (Sacramento County) – A measure on the June 2006 ballot of Sacramento County that would require the Sacramento Municipal Utilities District to obtain the opinion of its current voters, through a non-binding advisory vote, on proposals pertaining to expansion of the boundaries of the district by annexation. This measure passed with 61.84 percent (120,940) yes votes.

Measure L (Sacramento County) – A measure on the November 2006 ballot of Sacramento County asking voters if SMUD should annex portions of Yolo County into its electric service territory. This measure failed with 61.43 percent (206,345) no votes.

Measure H (Yolo County) – A measure on the November 2006 ballot of Yolo County asking voters if SMUD shall annex into its service territory the Cities of West Sacramento, Davis and Woodland and the contiguous unincorporated area of Yolo County for the purpose of providing electric service, subject to the terms and conditions specified in the order adopted by the Sacramento Local Agency Formation Commission (LAFCo) on June 7, 2006, ordering such annexation. This measure passed with 50.99 percent (24,021) yes vote.

Measure I (Yolo County) – A measure on the November 2006 ballot of Yolo County asking voters if SMUD shall replace PG&E as the electric service provider for the territories described in Measure H (Yolo County). This measure failed by 10 votes (23,627 no).

Outside Costs – Costs for services or goods provided or produced by individuals or entities not employed by PG&E; typically contractors or vendors under contract to PG&E.

Pacific Gas & Electric or PG&E – An investor owned public utility subject to the jurisdiction of the CPUC. PG&E provides both gas and electric services in northern California.

Rates – The rates charged by PG&E to its utility customers for gas or electricity. These rates must be approved by the CPUC before PG&E is allowed to charge them to its customers.

DEFINITIONS
(Continued)

Revenue Requirement – The total amount of revenue needed by a CPUC regulated utility (PG&E) to recover its cost of providing service to its customers plus a reasonable return on its investment in the Utility Facilities used to provide those services. The Revenue Requirement amount is determined in a General Rate Case (described above). The CPUC must determine if this amount is reasonable.

Test Year – The year for which rates and revenues are being established in a General Rate Case.

Sacramento Municipal Utilities District or SMUD – A publicly-owned electric utility located in the Sacramento area, regulated by its Board of Directors and governed by the Municipal Utility Act in the Public Utilities Code.

Utility Facilities – Plant and equipment owned by PG&E that is used for providing services to PG&E's utility customers.

EXECUTIVE SUMMARY

The Division of Ratepayer Advocates[1] (DRA) conducted this audit at the request of California Public Utilities Commission (CPUC) President Michael Peevey to "verify what the source of funding has been for PG&E's recent political activities."[2] Pacific Gas and Electric Company (PG&E) spent approximately $12.6 million on political campaigns opposing the annexation of portions of PG&E's service territory in Yolo County by the Sacramento Municipal Utility District (SMUD). DRA's review encompassed PG&E's activities on four ballot measures: Measure H in Yolo County in the June 2006 elections; and, Measure L in Sacramento County and Measures H and I in Yolo County in the November 2006 elections.

This audit addresses two basic questions:

1. Are PG&E's campaign expenditures considered utility expenses that may be recovered from its customers? If not, how will the CPUC ensure that the expenditures are not recovered in rates?

2. How has PG&E funded its campaign to defeat the Yolo annexation ballot measures, including the bill insert and customer service message?

In answer to the first question, based on a review of the CPUC proceedings that determine the amount of revenue PG&E may collect in rates from its customers covering a period from 2000 through 2011, DRA concludes that:

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[1] DRA is an independent division within the CPUC and is statutorily mandated to advocate for and represent the interest of customers of regulated public utilities with a goal to obtain the lowest possible rates for service consistent with safe and reliable service levels.

- PG&E's campaign expenditures are <u>not</u> utility expenses that may be recovered from its customers in rates.

- DRA's upcoming review of PG&E's costs and expenses in the normal CPUC General Rate Case process will ensure that unauthorized expenditures are not recovered from customers in the future. DRA will apply heightened vigilance to ensure that PG&E's campaign expenditures will not be recovered in future rates.

Answering the second question, of how PG&E funded its campaign to defeat the Yolo annexation ballot measures, DRA's investigative audit of PG&E books and records revealed the following:

- PG&E incorporated a legal entity, The Coalition for Reliable and Affordable Electricity (CRAE), and fully funded it using shareholder money to oppose the annexation of its Yolo territory. To that end, CRAE funded the bulk of campaign activities at a cost of $11.5 million.

- PG&E incurred other expenses, including approximately $700,000 of Internal Costs for: employee time, internal labor and related expenses, postage for a campaign-related bill insert, use of PG&E's West Sacramento Office, use of call centers; and, approximately $400,000 of Outside Costs paid by PG&E to vendors and contractors. All of these expenses were reviewed and traced to shareholder funded accounts.

As a result of this audit, DRA concludes that the $12.6 million expended by PG&E to defeat the annexation of its Yolo territory was properly recorded in accounts funded by PG&E shareholders, and <u>not</u> charged to accounts funded by PG&E ratepayers. However, DRA does believe that there are areas in which PG&E could improve its record keeping and accounting of similar types of activities in the future. Accordingly, DRA makes the following recommendations:

- **<u>Recommendation 1</u>: Employee time and expenditures spent on campaign activities should be tracked using the time reporting system agreed to by DRA and PG&E in the settlement adopted in CPUC Decision 07-03-044, which requires written tracking on a daily basis. In addition, employees who are not covered by that**

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[2] Letter dated Nov. 9, 2006 from President Peevey to Senator Christine Kehoe and Assembly member Lloyd Levine.

agreement should also be required to track their time in writing on a daily basis when they spend time on political campaigns.

- **<u>Recommendation 2</u>: For future political campaign efforts, costs for the use of existing Utility Facilities, such as call centers, offices and monthly bills, should be allocated to shareholders based on the full fixed and incremental costs of those facilities, rather than just the incremental costs as was done by PG&E. Alternatively, these costs could be treated the same as utility affiliate costs, or at a minimum shared 50-50 between shareholders and ratepayers.**

- **<u>Recommendation 3</u>: Establish a one-way tracking account that would require that the costs allocated to the utility shareholders are credited back to ratepayers regardless of whether or not these credits appear in the Historic Data for setting future rates in the utility's next rate case.**

- **<u>Recommendation 4</u>: For future political campaign efforts, all Outside Costs should be paid for using a separate entity such as CRAE, rather than being paid directly by PG&E, to provide greater clarity on the sources and uses of funds expended on campaigns.**

Chapter 1

Introduction

A) Background

Pacific Gas & Electric Company (PG&E) spent approximately $12.6 million on four ballot measures in the June and November 2006 elections to oppose annexation of portions of its service territory located in Yolo County by the Sacramento Municipal Utility District (SMUD). Measure H on the June 2006 ballot in Sacramento County, which passed, required that future SMUD annexation proposals be put to a vote of the electorate. On the November 2006 ballots were Measure L in Sacramento County and Measures H and I in Yolo County.

The passage of all three November ballot measures would have provided voter approval for the annexation to proceed. Measure L in Sacramento provided existing SMUD customers an opportunity to approve of the proposed annexation, and Measures H and I in Yolo County afforded existing PG&E customers an opportunity to approve of their annexation to SMUD. Measure H (Yolo) passed, but Measures L (Sacramento) and I (Yolo) were defeated.

Concern was formally expressed about the propriety of PG&E's use of customer funded "Utility Facilities" in its campaign to oppose the November ballot measures in letters to CPUC President Michael Peevey from Jan Schori, SMUD General Manager,[3] dated October 20, 2006 and from Senator Christine Kehoe,[4]

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[3] Ms. Schori requested the CPUC to "expeditiously investigate and take appropriate action to require Pacific Gas and Electric Company (PG&E) to immediately cease and desist using its customer service

dated November 2, 2006. (Both letters are attached hereto as Exhibits 1 and 2). President Peevey responded to Ms. Schori by letter dated November 9, 2006 and to Senator Kehoe by letter dated November 9, 2006. (Both responsive letters attached hereto as Exhibits 3 and 4). In addition to responding to specific questions posed to President Peevey by Senator Kehoe, President's Peevey's letter stated: "I have directed the Commission staff to audit PG&E's expenditures so that we can verify what the source of funding has been for PG&E's recent political activities. We will report to you the results of our audit when completed."[5] President Peevey thereafter directed DRA to perform this audit.

B) Identified Issues

DRA's report addresses two main issues that reflect two of the questions raised by Senator Kehoe in her letter to CPUC President Peevey, as follows:

1. Are PG&E's campaign expenditures considered utility expenses that may be recovered from its customers. If not, how will the CPUC ensure that the expenditures are not recovered in rates?

2. How has PG&E funded its campaign to defeat the Yolo annexation ballot measures, including the bill inserts and customer service message?

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telephone line to force SMUD electric customers who are also PG&E gas customers to listen to a political message about the Yolo County annexation ballot measure."

[4] At that time Senator Christine Kehoe was Chair Designate of the Senate Energy, Utilities and Communications Committee. Attached to Senator Kehoe's letter was a letter addressed to the Honorable Senator Martha Escutia, Chair of the Senate Energy, Utilities and Communications Committee at the time, and to the Honorable Lloyd Levine, Chair of the Assembly Committee on Utilities and Commerce, signed by Assembly Members Dave Jones and Lois Wolk and by Senator Deborah Ortiz, expressing similar concerns regarding PG&E campaign activities and practices and requesting answers.

[5] Letter dated Nov. 9, 2006 from President Peevey to Senator Christine Kehoe and Assembly Member Lloyd Levine.

Chapter 2

CPUC Rate Treatment of Campaign Costs

Issue 1 -- Are PG&E's campaign expenditures considered utility expenses that may be recovered from its customers. If not, how will the CPUC ensure that the expenditures are not recovered in rates?

PG&E's campaign expenditures are not considered utility expenses that may be recovered from its customers. The following explanation of the CPUC's ratemaking process describes why campaign expenditures are not recoverable from ratepayers and how the CPUC and DRA review costs to assure that such expenditures will never be charged to consumers.[6]

A) General Ratemaking Overview

Generally, utilities, such as PG&E file an application with the CPUC every three to four years to establish, and typically increase, the amount of money that utility's are allowed to collect from ratepayers for the ensuing three to four years. This annual amount of money the utility is authorized to collect is referred to as the utility's Revenue Requirement, which is used to set the rates that are charged to customers. Only those utility expenses that the CPUC has determined are appropriate may be passed through to customers in rates charged by the utility. This administrative law procedure conducted at the CPUC is known as the utility's General Rate Case (GRC).

[6] Throughout this report, the terms "consumers", "customers" and "ratepayers" have the same meaning and may be used interchangeably.

During the processing of a GRC, the utility's Historical Data is utilized as one method of determining the proper level of the prospective Revenue Requirement and future rates. The Historical Data is adjusted to remove non-recurring costs and costs that should not be paid for by ratepayers, thereby setting a "Base" for the Revenue Requirement upon which rates for the designated period will be determined.

It is DRA's responsibility in each General Rate Case to review the utility's application to question, investigate, analyze, and verify all information and numbers presented by the utility, and where appropriate, to offer alternative proposals that will result in the lowest rates for customers, consistent with maintaining safe and reliable service. DRA also audits the utility's books and records to ensure that no costs that should be shareholder funded have made their way into costs charged to ratepayers.

B) Review of PG&E Rates

For this investigation, three different General Rate Case proceedings were considered.

- The GRC[7] that set rates for 2005 and 2006; the time period in which the campaign costs in question were expended.
- The GRC[8] approved by the Commission on March 15, 2007 which set rates for 2007, 2008, 2009 and 2010.
- The GRC which will set rates for 2011 and beyond.

[7] PG&E Application No. 02-11-017, filed November 8, 2002 and Commission Decision No. 04-05-055, dated May 27, 2004.
[8] PG&E Application No. 05-12-002, filed December 2, 2005 and Commission Decision No. 07-03-044, dated March 15, 2007.

1) 2003-2006 Rates

The General Rate Case that set rates for 2003, 2004, 2005 and 2006, utilized Historical Data from 2000 and prior years to determine the Base Revenue Requirement for setting 2003-2006 rates. There were no costs related to opposing the Yolo annexation in the 2000 and prior years Historic Data that were used to set the Revenue Requirement in this GRC. In addition, this GRC resulted in an all party settlement adopted by the CPUC in Decision (D.) 04-05-055. The settlement provided in pertinent part that there would be *"zero expense in the Account 912 Revenue Requirement for customer retention and economic development*".[9] Costs incurred by PG&E to oppose the Yolo annexation fall within the definition of "customer retention" as addressed in the adopted settlement.

Accordingly, there were no costs related to opposition of the Yolo annexation in the rates set in this GRC for 2005 and 2006 because (i) the costs were incurred after the Base Year of 2000, upon which 2005 and 2006 rates were determined; and (ii) the settlement which was used to set rates for 2005 and 2006 expressly excluded this type of cost.

[9] Motion of Pacific Gas and Electric Company, Office of Ratepayer Advocates, The Utility Reform Network, Aglet Consumer Alliance, Modesto Irrigation District, Natural Resources Defense Council and

2) 2007-2010 Rates

Historical Data from 2004 and prior years were used as the Base to set rates for 2007, 2008, 2009 and 2010. The Commission approved rates for the years 2007-2010 in D.07-03-044, adopted March 15, 2007. This GRC also resulted in a settlement which provides in pertinent part that there would be "*zero allocation in expenses for the "customer retention*" component of PG&E's Customer Retention and Economic Development Program." Similar to the prior GRC, the costs to oppose the Yolo annexation were not included in the Base used to set rates for 2007 through 2010 because (i) they were expended after the Base Year of 2004; and (ii) because the settlement used to set those rates expressly excluded this type of cost.

3) 2011 Rates and Beyond

For the next General Rate Case that will set rates for 2011 and beyond, Historical Data from 2008 and prior years (2005, 2006 and 2007) will be used as the Base. This is the GRC where PG&E's expenditures on the 2006 campaigns could be included inappropriately in the Historic Data, if PG&E incorrectly identifies them as costs paid by customers. However, in this audit DRA has determined that those costs were appropriately recorded by PG&E in an account that is not paid by customers, and therefore, should not be included in the Base used to set rates for 2011 and later.

Historical Data are either recorded in accounts that can be charged to ratepayers, commonly referred to as "Above The Line" accounts, or accounts that

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The Agricultural Energy Consumers Association for Approval of Settlement Agreement, September 15, 2003, page 23 and the Settlement Agreement, Section 3.3.3, page 14.

cannot be charged to ratepayers, commonly referred to as “Below The Line” accounts. The costs incurred by PG&E to oppose the Yolo annexation were recorded in Account 426.5[10], which is a Below The Line account funded by shareholder profits and therefore, will not be included in the Base when setting future rates for PG&E. DRA will apply heightened scrutiny to PG&E's submittal in its next GRC to ensure that the Historical Data presented by PG&E continues to correctly reflect these costs Below The Line.

[10] While Account 426.5, “Other deductions”, was used, Account 426.4, “Expenditures for certain civic, political, and related activities” would have been more appropriate. However, since both accounts are “Below The Line” this difference has no impact as neither account will be included in the base for costs in PG&E’s next GRC.

Chapter 3

Audit of PG&E Funding and Directly Incurred Costs

Issue 2 -- How has PG&E funded its campaign to defeat the Yolo annexation ballot measures, including the bill inserts and customer service message?

A) Audit Purpose and Findings Summary

The purpose of this chapter is to identify PG&E expenditures and sources of funds used to support the June 2006 ballot measure and defeat the November 2006 measures. In conducting the audit, DRA segregated PG&E's expenditures[11] into three categories as noted below:

Table 3-1
PG&E Expenditures by Category

Expenditure Category	**Amount (in 000's)**
Contributions to Coalition for Reliable and Affordable Electricity (CRAE)	$11,515
PG&E Incurred Internal Costs	$665
PG&E Incurred Outside Costs	$401
Total	$12,581

Based upon DRA's audit the following was noted:

PG&E Contributions to CRAE[12]:

- $11.5 million of the $12.6 million spent on the campaign was funded by CRAE with money it was given by PG&E. The money given to CRAE by PG&E came from shareholders and was properly recorded Below The Line.

[11] Providing funds to CRAE is an expenditure of PG&E.
[12] See explanation for Coalition For Reliable and Affordable Electricity (CRAE) in paragraph B below.

PG&E Internal Costs:

- PG&E employees were not consistent in the method used to track their time. This decreases the reliability of the accuracy of the time reported. However, DRA discovered no evidence to indicate that significant amounts of time were not reported.

- PG&E's original report of employee time was understated by $7,560 but was subsequently corrected.

- For including a campaign insert with monthly utility bills, PG&E recorded to a shareholder funded account a proportional share of 8% of the first class postage rate, approximately $14,000. PG&E's use of 8% of the postage costs was based on the campaign insert representing approximately 8% of the material sent in the customers' bills.

PG&E Outside Costs:

- $401,020 of Outside Costs for contractor and vendor services were paid for directly by PG&E, rather than through CRAE, with shareholder money and were properly recorded Below The Line.

B) CRAE Cost Audit Procedures

B.1) CRAE Background

The Coalition for Reliable and Affordable Electricity (CRAE) was incorporated by PG&E in July 2005 (see attached incorporation documentation, Exhibit 5), with the stated purpose "to advocate and educate the public about the benefits to be conferred on the citizens of a stable source of electricity generated and supplied by publicly regulated private utility firms." PG&E indicated that CRAE was fully funded to accomplish its goal to defeat the annexation of its Yolo territory.

To that end, CRAE used money it received from PG&E shareholders to in turn fund television broadcast advertising, radio broadcast advertising, campaign paraphernalia, canvassing, consulting, direct mail, focus groups, food for walkers, legal services, literature, payroll taxes, polling, print ads, signature gathering, slate mailer, travel, and other smaller items.

B.2) Testing of PG&E's Contributions to CRAE

Procedure 1 - Contribution Testing

The following table highlights contributions made by PG&E to CRAE.

Table 3-2
2005/2006 PG&E Contributions to CRAE

Date	Amount (in 000's)
08/03/2005	$ 50
10/20/2005	500
11/18/2005	50
12/20/2005	100
Total 2005	$ 700
01/26/2006	$ 285
02/07/2006	240
03/08/2006	200
03/22/2006	2,000
04/19/2006	200
05/19/2006	400
07/12/2006	4,000
08/10/2006	300
08/30/2006	950
09/11/2006	750
10/04/2006	750
10/24/2006	740
Total 2006	$ 10,815
Total	$ 11,515

Rather than just reviewing a sample of these contributions, DRA performed 100% testing to determine whether such contributions were properly recorded Below The Line (to be funded by shareholder profit). For each contribution, DRA performed the following:

- Reviewed a copy of the check and/or wire transfers noting propriety of amount, payee and payer;
- Reviewed proper debit/credit posting in PG&E's accounting system (SAP);
- Reviewed proper recording in account 426.5[13] (Below The Line account);
- Reviewed the Request for Check.

Procedure 2 – Review of CRAE Tax Return

DRA reviewed CRAE's 2005 tax return reconciling the total PG&E contributions to the amount recorded on the return. Further, DRA reviewed a CRAE expenditure listing to reconcile the amount listed to the proper line item on the tax return. DRA was not able to review the 2006 tax return given the timing of the audit.[14] Reviewing the tax return is a test that can identify unrecorded contributions in the event the amount recorded by PG&E does not match the tax return.

Procedure 3 – Review of CRAE Invoices

DRA reviewed a sample of CRAE invoices. This test is performed to determine whether costs noted on the expenditure listing are correct. This test

[13] While Account 426.5, "Other deductions", was used, Account 426.4, "Expenditures for certain civic, political, and related activities" would have been more appropriate. However, since both accounts are "Below The Line" this difference has no impact as neither account will be included in the base for costs in PG&E's next GRC.

[14] The 2006 tax returns for not for profit entities such as CRAE are not due until May 15, 2007. DRA will review the 2006 tax return after it is filed to ensure that it reconciles with the total PG&E contributions and will supplement this report if discrepancies are found.

also works to determine whether any costs typically related to a political campaign were absent from CRAE's expenditure listing; thereby, representing an unrecorded amount.

B.3) Results of Contribution Testing

Based on the procedures performed, DRA concluded that contributions provided by PG&E to CRAE were properly recorded Below The Line, and that the amounts are consistent with what CRAE spent on the campaign.

C) PG&E's Internal Costs

During 2005 and 2006, PG&E incurred costs related to its opposition to the Yolo annexation. As summarized above and in total, PG&E expended approximately $12.6 million for its efforts related to the annexation ballot measures. Of the total expenditures of $12.6 million, $11.5 million was paid to CRAE, leaving a balance of approximately $1 million, which represented Internal Costs of PG&E employees and use of utility facilities, and Outside Costs paid by PG&E to contractors and vendors, as illustrated in the table below:

Table 3-3
Internal PG&E Costs and Outside Vendor Costs for SMUD Campaign

Type of Cost	**Amount**
PG&E Internal Costs	$664,977
Outside Vendor Costs	401,325
Total Internal and Outside Costs	$1,066,302

The above stated Internal Costs of $664,977 were originally reported as $628,869 by PG&E. During the course of the audit, PG&E added $36,107 to its Internal Costs resulting in total Internal Costs of $664,977. The subsequently added $36,107 was attributed to the following three factors:

1.	In-house labor charges:	$ 7,560
2.	PG&E corporate officer time:	27,141
3.	One additional employee's time:	1,406
	Total Difference	$ 36,107

DRA performed the following procedures with respect to the updated Internal Costs of $664,977:

- Reviewed a list of 47 employees, and the percentage of their overall time spent on the campaign related to the ballot measures;
- Traced the updated Internal Costs of $664,977 to the Below The Line account 426.5, through the respective journal entries. The method of calculation was also critically reviewed for accuracy and reasonableness;
- Analyzed PG&E's spread sheet detailing total in house labor charges and selected a sample of 12 employees to interview;
- Conducted extensive interviews of the 12 selected employees, including PG&E's general counsel;
- Reviewed calculations for accuracy and reasonableness for other incurred costs, including: call center, West Sacramento office, and bill insert postage charges;
- Compared selected employees' expenses to the payroll records for consistency and;
- Traced the Outside Costs of $401,325 to proper invoices, journal entries, and applicable calculations.

C.1) Discussion of Internal PG&E Employee Costs

Employees holding the following positions were interviewed by DRA auditors:

1. Director of Service Analysis
2. Business Customer Field Representative
3. Principal Strategic Planner
4. Senior Regulatory Analyst
5. Supervisor of Account Services
6. Director of State Governmental Relations
7. Director of Government Relations
8. Supervisor in Account Services
9. Senior Governmental Relations Representative
10. News Manager
11. Governmental Relations Representative
12. General Counsel

$487,981 of the updated Internal Costs of $664,977 are for labor costs (excluding corporate officer time of $27,141)[15], associated with all of the PG&E employees who worked on the campaign. The 12 interviewed employees represent charges of $315,800 of the total in-house labor charged of $487,981, or a sample of 65%.

DRA's questions to the interviewees were extensive and included: relevance of job function to campaign, duties during the campaign, internal control and proper allocation of time spent on campaign, and method(s) of charging time spent on the campaign.

Based on these interviews, PG&E employees who devoted their labor time to the campaign performed lobbying, community outreach, and analyses of the effects of the annexation on both Yolo and Sacramento County customers. DRA

[15] During the course of the audit, PG&E reported to DRA that it incurred $27,141 in Corporate Officer time pertinent to the SMUD campaign.

examined the propriety of the recording and allocation of employee time spent on the campaign to the proper accounts to assure that no campaign costs are reflected in Above The Line accounts which are subject to rate recovery. DRA discovered that employees recorded their time largely through a process of estimation that occurred sometimes several weeks after the fact. Very few employees used a time card, which would have provided more accurate time reporting.

Paragraph 35 of the settlement of PG&E's GRC adopted by the CPUC in Decision 07-03-044 on March 15, 2007 states in pertinent part that "PG&E shall, within 90 days of a final decision in this case, adopt a time reporting system to track time and expenditures of those public policy and governmental affairs organizations that have a mixture of Below The Line activities in addition to activities for which PG&E seeks cost recovery from the CPUC." It further states that PG&E will "…have this reporting system implemented and in place by no later than January 1, 2008." Implementation of this reporting system will correct most of the time reporting problem found in this audit. Unfortunately, employees who do not work in the public policy and governmental affairs organizations are not covered by this settlement agreement and time reporting system and are therefore, not required to track their time in writing on a daily basis when they spend time on political campaigns.

Pursuant to the above described interviews, DRA has determined that the recorded labor costs for campaign activities performed by PG&E employees were properly charged Below The Line. However, to rectify problems with reporting and tracking employee time and costs, DRA recommends the following:

> **<u>Recommendation 1</u>: Employee time and expenditures spent on campaign activities should be tracked using the time reporting system agreed to by DRA and PG&E in the settlement adopted in CPUC Decision 07-03-044, which requires written tracking on a daily basis. In addition, employees who are not covered by that agreement should also be required to track their time in writing on a daily basis when they spend time on political campaigns.**

C.2) Other Internal Costs

In addition to the above described PG&E employee costs of $487,981, PG&E incurred other Internal Costs in the amount of $151,260, which fell into the following categories:

Employee time for handling of bill insert:	$ 7,570
Employee time and expenses for campaign efforts	91,843
Call Center Charges	15,400
West Sacramento Office Usage	9,020
Postage Fees Allocated from bill inserts	14,020
VMR Call Center Costs	6,265
Other Miscellaneous Expenses:	7,142
Total	$151,260

The amount of $7,570 for handling bill inserts represented 5 employees' time who worked on the bill insert. The employee time and expenses amount of $91,843 was charged to the campaign expenses as part of the Internal Costs, and represents the salaries of 2 employees.

DRA analyzed the call center charges of $15,400, which equated to a charge of $550 per night for 28 nights of phone bank facility usage. The VMR call center cost of $6,265 was for inbound and outbound calls associated with the campaign related messages. PG&E derived this amount by assigning costs of 3 cents per call for special menu presentation calls, 15 cents per call that listened to the special message, and 1.1 cents per call for outbound calls made from the Sacramento Call Center SMUD Campaign phone bank. The $15,400 and $6,265 represent the incremental cost of PG&E's use of existing Utility Facilities for its political activities. PG&E's allocation of these incremental costs to PG&E shareholders for the call center services appears reasonable.

PG&E derived the $14,020 postage fee charge by allocating to shareholders an incremental portion of the postage costs of mailing monthly bills which included a campaign-related insert. As the campaign insert was one thirteenth of the material sent in the bill, PG&E allocated one thirteenth of the cost of the postage, approximately 8%, to shareholders. The $14,020 amount represents approximately 8% of 500,000 bills at 37 cents per envelope.

Discussion

DRA traced the above Internal Costs to the respective journal entries, and found they were appropriately charged to “Below The Line” accounts. Although this audit did not find substantial errors in PG&E's accounting of these Internal Costs under current ratemaking principles, DRA recommends consideration of a different approach for requiring the utility’s shareholders to pay their fair share of all of the fixed and incremental costs of mass mailings, call centers and/or any other use of Utility Facilities used to support the utility's political messages, which in this instance totaled under $50,000.

Instead of having the shareholders pay for merely the incremental or proportional costs for the utility's use of Utility Facilities to deliver its political messages (e.g., PG&E's basic approach found in this audit), the utility shareholders could pay for all of the fixed and incremental costs of the mass mailing, call center or any other Utility Facilities on a stand-alone basis (e.g., as if the utility were not otherwise going to incur costs for the mass mailings of bills or have a call center).[16] Certainly other entities with different political views than the utility would have to set up and pay for the entire costs of a call center, incur all of the costs of a mass mailing, or contract for such services. Therefore, when the utility uses its property to promote its political views, the utility should charge its shareholders for the complete costs of the use of its property.

Alternatively, the utility's use of its property for its shareholders' political needs could be treated like the utility's transfer of goods and services to its affiliates, which are not charged on an incremental cost basis. Under Rule V. H. 2. of the Commission's Affiliate Transaction Rules Applicable to Large California Energy Utilities, transfers from the utility to its affiliates of goods and services for sale on the open market by the utility must be priced at fair market value, and under Rule V. H. 5. of these Rules, such transfers from the utility to its affiliates of goods and services not for sale on the open market must be priced at fully

[16] For example, the fixed and incremental costs for mailing the bills and political messages in envelopes would include not only costs of the postage, envelopes and bill inserts, it would also include the costs for the equipment and labor used to stuff the envelopes and mail them and include overhead, such as a fair

loaded costs plus 5% of direct labor cost. *See* Commission Decision 06-12-029, Appendix A-3, Rules V. H. 2. & 5.

Because the property used for political messages (e.g. the billing envelope) is not solely used for the shareholders, a 50-50 split may be more appropriate. The main point is that not just incremental costs should be allocated to the shareholders. At a minimum, the utility's shareholders should split 50-50 these costs with its ratepayers, so that neither the utility nor its ratepayers receive a free ride or a heavily subsidized use of the utility's property.

<u>Recommendation 2</u>: For future political campaign efforts, costs for the use of existing Utility Facilities, such as call centers, offices and monthly bills, should be allocated to shareholders based on the full fixed and incremental costs of those facilities, rather than just the incremental costs as was done by PG&E. Alternatively, these costs could be treated the same as utility affiliate costs, or at a minimum shared 50-50 between shareholders and ratepayers. [17]

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allocation of the costs of the computer equipment maintaining the pertinent mailing lists and the buildings rented or owned by the utility in which the equipment is located.

[17] An attempt by the Legislature or the Commission to prevent the utility from using regulated, utility property to set forth its political views, would likely violate the First Amendment rights of the utility. *See Consolidated Edison Co.* v. *Public Serv. Comm'n.* (1980) 447 U.S. 530 ("*Consolidated Edison Co.*"). However, the Legislature and the CPUC do have jurisdiction to set appropriate ratemaking treatment and cost allocation regarding the shareholders' use of utility property, such as requiring 50-50 sharing of such costs.

The order of the New York Public Service Commission ("NYPSC"), on remand from *Consolidated Edison Co.*, which addressed the ratemaking issues and was affirmed by the Court of Appeals of New York, provides some insight into this issue. As the Court of Appeals of New York explained, on remand the NYPSC ruled that if utilities enclosed political messages with billing statements, "50% of many fixed costs associated with preparation and mailing of those statements would be allocated to the utility shareholders." *See In the Matter of Consolidated Edison Company of New York, Inc. v. Public Serv. Comm'n of the State of New York* (1985) 66 N.Y.2d 369, 371-372, 488 N.E.2d 83, 84-85, 1985 N.Y. LEXIS 17612. The Court of Appeals of New York upheld the NYPSC's ruling and found that it was reasonable and within the discretion of the NYPSC to exclude from the rates an allocation of either marginal costs or fixed costs that are properly chargeable to shareholders, because "nothing in the Constitution requires that the shareholders get a free ride on the backs of the ratepayers." *Id.* , 66 N.Y.2d at 372-373, 488 N.E.2d at 85-86, 1985 N.Y. LEXIS 17612.

Consolidated Edison Company of New York subsequently appealed the decision of the Court of Appeals of New York, but this time the United States Supreme Court dismissed the appeal for want of substantial federal question. *See Consolidated Edison Co.* v. *Public Serv. Comm'n* (1986) 475 U.S. 1114. Therefore, this approach is not unconstitutional.

An additional measure should be considered to further ensure that ratepayers are reimbursed for the shareholders' use of utility assets. A one way tracking account for these Internal Costs would ensure that the costs associated with the use of utility property by shareholders is refunded or credited by the shareholders to the utility ratepayers to offset current costs.

Recommendation 3: Establish a one-way tracking account that would require that the costs allocated to the utility shareholders are credited back to ratepayers regardless of whether or not these credits appear in the Historic Data for setting future rates in the utility's next rate case.

D) Outside Costs

As stated above, PG&E incurred Outside Costs of $401,325 during the campaign period. These costs represented expenses associated with an outside legal firm, printing costs, use of grassroots representatives, and other invoiced expenses. PG&E indicated that $321,380 of the Outside Costs of $401,325 were directly charged Below The Line, to a shareholder funded account. For the balance of vendor payments of $79,945 not initially recorded in shareholder funded accounts charged Below The Line, PG&E's staff was instructed to transfer those costs to a "Below The Line" work order #3009098. DRA traced this order to the account it was charged to, which was the Below The Line account, 426.5. This is shown as follows:

Outside Costs Initially Charged to Account 426.5	$321,380
Outside Costs Charged to Order #3009098	79,945
Total	$401,325

Upon redirection of certain Outside Costs to the "Below The Line" account, DRA finds that Outside Costs were booked in accounts that would not be charged to ratepayers. However, PG&E's direct payment of Outside Costs, rather than having all such costs flow through CRAE, makes reviewing these costs more complex. To rectify this problem, DRA recommends the following:

> **Recommendation 4: For future political campaign efforts, all Outside Costs should be paid for using a separate entity such as CRAE, rather than being paid directly by PG&E, to provide greater clarity on the sources and uses of funds expended on campaigns.**

Chapter 4

Conclusion and Recommendations

The costs incurred by PG&E to oppose the Yolo annexation have not been nor should they ever be charged to ratepayers. The CPUC-approved 2003 and 2007 GRC rates did not include any costs related to customer retention activities opposing the Yolo annexation. In addition, DRA has determined that PG&E properly recorded its campaign costs to accounts which are funded by PG&E shareholders, so these costs should not become part of the Historical Data used for setting rates in future GRCs.

DRA has no control over how PG&E will present these costs in future proceedings before the CPUC. Therefore, DRA will exercise heightened vigilance to ensure that expenditures related to customer retention are not included inappropriately in the Base for setting rates.

While DRA did not discover any unreasonable charges or actions made by PG&E, there are areas in which PG&E could improve its record keeping and accounting of similar types of activities in the future. Accordingly, DRA makes the following recommendations:

- **<u>Recommendation 1</u>: Employee time and expenditures spent on campaign activities should be tracked using the time reporting system agreed to by DRA and PG&E in the settlement adopted in CPUC Decision 07-03-044, which requires written tracking on a daily basis. In addition, employees who are not covered by that agreement should also be required to track their time in writing on a daily basis when they spend time on political campaigns.**

- **<u>Recommendation 2</u>: For future political campaign efforts, costs for the use of existing Utility Facilities, such as call centers, offices and**

monthly bills, should be allocated to shareholders based on the full fixed and incremental costs of those facilities, rather than just the incremental costs as was done by PG&E. Alternatively, these costs could be treated the same as utility affiliate costs, or at a minimum shared 50-50 between shareholders and ratepayers.

- **<u>Recommendation 3</u>: Establish a one-way tracking account that would require that the costs allocated to the utility shareholders are credited back to ratepayers regardless of whether or not these credits appear in the Historic Data for setting future rates in the utility's next rate case.**

- **<u>Recommendation 4</u>: For future political campaign efforts, all Outside Costs should be paid for using a separate entity such as CRAE, rather than being paid directly by PG&E, to provide greater clarity on the sources and uses of funds expended on campaigns.**