Application	:	A.05-12-002
Exhibit Number	:	DRA-20
Commissioner	:	Bohn
Admin. Law Judges	:	Kenney, Econome
Witnesses	:	Bower, Waterworth

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Report on the Results of Examination for Pacific Gas and Electric Company

General Rate Case
Test Year 2007

San Francisco, California
April 14, 2006

DIVISION OF RATEPAYER ADVOCATES
REPORT ON THE RESULTS OF EXAMINATION
FOR PACIFIC GAS AND ELECTRIC COMPANY
TEST YEAR 2007 GENERAL RATE CASE

TABLE OF CONTENTS

CHAPTER 1

EXECUTIVE SUMMARY

I. INTRODUCTION

The purpose of this report is to present to the California Public Utilities Commission (Commission) and other interested parties the results of the Division of Ratepayer Advocates' (DRA) examination of the financial and accounting records of Pacific Gas and Electric Company (PG&E). This examination was performed in response to PG&E's Application (A.) 05-12-002, filed with the Commission, December 2, 2005, for authority to increase its revenue requirement by $849 million.

PG&E's financial and accounting records were last examined by the Office of Ratepayer Advocates (DRA's predecessor) in connection with A. 02-11-017, filed November 2002. DRA's current examination covered the years 2003 through 2004. DRA focused primarily on the 2004 calendar year recorded revenues and expenses because PG&E used 2004 recorded adjusted data to forecast and estimate its operating revenues and expenses for the 2007 test year.

DRA's review of historic financial information consisted principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial accounting matters. The scope of DRA's review is different from an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, DRA does not express an opinion as to PG&E's financial statements.

II. DISCUSSION

In determining the scope of the examination, DRA took into consideration the fact that PG&E's accounting records are audited by independent Certified Public Accountants, PG&E's internal auditors, and by various other state and federal auditors. DRA reviewed PG&E's internal audit reports to determine the scope of the audits conducted and the nature of any exceptions.

DRA directed its attention primarily towards determining PG&E's compliance with prior Commission decisions and reviewing selected areas of PG&E's financial and accounting records for compliance with the Federal Energy Regulatory Commission (FERC), Uniform System of Accounts (USOA), and Generally Accepted Accounting Principles (GAAP). In the examination of PG&E's financial and accounting records, DRA's procedures included, but were not limited to reviewing and examining:

- PG&E's application and workpapers;
- prior Commission decisions;
- prior Commission reports and workpapers;
- independent auditors' workpapers;
- internal audit reports and workpapers;
- Board of Director's and Committee meeting minutes; and,
- Supporting documentation for selected account samples.

III. RECOMMENDATIONS

DRA makes the following recommendations:

1. No adjustments be made to the Electric and Gas Credit Facilities Fees Tracking Accounts;
2. No adjustments be made to the Operation and Maintenance Expenses;
3. That Account 921, recorded 2004, should be reduced by $409,899 for unreasonable reimbursable expenses but given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account

921, a separate adjustment has not been made for this amount in the Results of Operation;

4. That PG&E be ordered to perform an audit of reimbursable expenses for each of the three years leading up to its next general rate case;

5. That Account 923, recorded 2004, should be reduced by $422,743 for settled discrimination cases;

6. That Account 923, recorded 2004, should be reduced by $4,700,470 for litigation costs associated with the Chromium lawsuit;

7. That Account 926, recorded 2004, should be reduced by $1,036,000 for service awards; but given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account 926, a separate adjustment has not been made for this amount in the Results of Operation;

8. That recorded 2004 expenses should be reduced by $3,298,337 for bonuses, awards, and recognition costs that are not reasonable for ratepayers to pay for but, given that the DRA analyst has made similar adjustments for such items in the functional analyses of various accounts, a separate adjustment has not been made for this amount in the Results of Operation;

9. That a potential audit adjustment of $48,779,786 might be recommended to Administrative and General Accounts based on the lack of supporting documentation; and,

10. No adjustments be made to the Utility Plant.

CHAPTER 2

ECFFTA and GCFFTA

I. INTRODUCTION

This chapter presents the results of DRA's examination of PG&E's Electric and Gas Credit Facilities Fees Tracking Accounts (ECFFTA and GCFFTA).

II. RECOMMENDATIONS

DRA has no recommended adjustments.

III. DISCUSSION

In 2004, PG&E implemented its bankruptcy Exit Financing which included $1.5 billion of working capital facilities. The Exit Financing was completed consistent with Decisions (D.) 02-11-030, 03-09-020, 03-12-035, and 04-01-024. Although most of the Exit Financing costs are recovered through PG&E's annual authorized cost of capital proceedings, a portion of the working capital facilities includes general working capital, which is typically recovered as part of A&G bank fees. Therefore, the general capitals portion of the Exit Financing costs was not included in PG&E's cost of capital proceedings. In compliance with D. 03-12-035 and Resolution E-3862, PG&E established the ECFFTA and the GCFFTA to record the incremental costs of these general working capital facilities. PG&E will continue to track these costs and record them to the ECFFTA and GCFFTA until December 2006. These tracking accounts will continue to accrue interest until the balance is transferred or resolved.

PG&E entered into an agreement to secure an $850 million Bank Revolver which was divided into the following three working capital facilities: (1) $200 million – Cash Borrowing, (2) $550 million – Procurement, and (3) $100 million – Workers Compensation. DRA reviewed the recorded bank fees associated with these facilities and takes no exceptions.

CHAPTER 3

OPERATION AND MAINTENANCE EXPENSES

I. INTRODUCTION

Operation and Maintenance (O&M) expenses are costs that are directly charged to specific utility functions. They are broken down into three major categories. These include electric generation, electric distribution, and gas distribution. Accounts within electric generation are purchased power, miscellaneous nuclear power expenses, nuclear power maintenance, and nuclear power steam. For electric distribution the major accounts include overhead lines maintenance, miscellaneous distribution expenses, and distribution underground line expenses. For gas distribution the accounts include customer installation, and maintenance/service of mains.

DRA's review was performed on a total company basis. The process involves applying any adjustments to PG&E's total company recorded adjusted O&M expenses for the year 2004, and subsequently the numbers PG&E's Unbundled Cost Categories (UCCs) in DRA's Results of Operations Report.

II. RECOMMENDATIONS

DRA has no recommended adjustments.

III. DISCUSSION

DRA performed a limited review of the O&M expenses in this case. DRA considered this limited approach appropriate, given the results of an extensive review of both 2000 and 2001 numbers during PG&E's prior rate case. This extensive review resulted in $2.16 Million in recommended adjustments for year 2001 out of $301 Million in recorded costs and no recommended adjustments for year 2000 out of $378 Million in recorded costs. Given this low recommendation rate and historic level of recommendations resulting from prior utility O&M audits, DRA considered the risk of missing material recommendations as low.

CHAPTER 4

ADMINISTRATIVE AND GENERAL EXPENSES

I. INTRODUCTION

This chapter presents the analysis and recommendations of DRA regarding PG&E's administrative and general (A&G) expenses. DRA focused its examination of A&G expenses on the base year 2004. DRA's examination included, but was not limited to the following:

- Sampling of accounting entries and supporting documentation;
- Data Requests;
- Sampling of reimbursable expenses reports;
- Review of Internal and External audit reports and workpapers;
- Review of Board of Directors and Committee Minutes;
- Review of testimony and workpapers; and,
- Reviewing specific A&G Provider Cost Center's (PCCs) expense reports.

A&G expenses are costs of a general nature and are not directly charged to any specific utility function. These costs include general office labor and expenses such as insurance, casualty payments, consultant fees, professional and legal services, employee benefits, regulatory expenses, association dues, and stock and bond expenses.

DRA's review was performed on a total company basis and the recommended audit adjustments were applied to PG&E's total company recorded adjusted A&G expenses for the base year 2004. These numbers are then allocated to PG&E's Unbundled Cost Categories (UCC) in DRA's Results of Operations Report.

II. RECOMMENDATIONS

As a result of its review, DRA recommends:

1. That Account 921, recorded 2004, should be reduced by $409,899 for unreasonable reimbursable expenses but given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account 921, a separate adjustment has not been made for this amount in the Results of Operation;
2. That PG&E be ordered to perform an audit of reimbursable expenses for each of the three years leading up to its next general rate case;
3. That Account 923, recorded 2004, should be reduced by $422,743 for settled discrimination cases;
4. That Account 923, recorded 2004, should be reduced by $4,700,470 for litigation costs associated with the Chromium lawsuit;
5. That Account 926, recorded 2004, should be reduced by $1,036,000 for service awards, but given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account 926, a separate adjustment has not been made for this amount in the Results of Operation;
6. That recorded 2004 Administrative and General expenses should be reduced by $3,298,337 for bonuses, awards, and recognition costs that are not reasonable but given that the DRA analyst has made similar adjustments for such items in the functional analyses of various accounts, a separate adjustment has not been made for this amount in the Results of Operation; and
7. That a potential audit adjustment of $48,779,786 might be recommended to Administrative and General expense accounts based on lack of supporting documentation.

The following is the summary of DRA's audit adjustments:

Table 4-1

Summary of DRA Audit Adjustments

Account/Description	2004
921 Office Supplies and Expenses	
Reimbursable Expenses	$ 409,899
923 Outside Services	
Discrimination Suits-Settled	$ 422,743
Litigation Costs - Chromium	$ 4,700,470
926 Pensions & Benefits - Service Awards	$ 1,036,000
Various Accounts - Spot Bonuses, Awards, Recognition	$ 3,298,337
Total	$ 9,867,449

The following is the summary of DRA's potential audit adjustments based on outstanding data requests:

Table 4-2

Summary of DRA's Potential Audit Adjustments

Account/Description	2004
921 Office Supplies and Expenses	$ 28,046,110
923 Outside Services	$ 20,733,676
	$ 48,779,786

III. DISCUSSION

The result of DRA's audit was significantly impacted by PG&E's delays in responding to data requests, incomplete explanations of adjustments made to recorded 2004 expenses, and problems reconciling SAP and FERC dollars. DRA auditors sent PG&E approximately 59 data requests. All of DRA's audit data requests were sent electronically to PG&E and had a due date that was ten business days from the date of the data request. As a result of PG&E's delays in responding to data requests, including the fact that there are still, as of this writing, a number of outstanding follow-up data requests, DRA has not reviewed all responses. Table 4-2 above represents the potential additional adjustments that DRA recommends be made until PG&E responds to the outstanding data requests and DRA has had sufficient time to fully review and analyze all responses. Table 4-1 shows DRA's recommended adjustments.

A. Account 921 Office Supplies and Expenses

A.1 Reimbursable Expenses

This account includes office supplies and expenses incurred in connection with the general administration of the utility's operations which are assignable to specific administrative or general departments and are not specifically provided for in other accounts. PG&E is required to file with the Commission its General Order 77(L) listing of the compensation it pays its employees in excess of $75,000. PG&E provided the 2004 77(L) to DRA, which included the reimbursable expenses. PG&E's 77(L) related reimbursable expenses for 2004 totaled $1,789,125. DRA selected 19 employees whose reimbursable expenses totaled over $20,000 each for 2004 to review[1]. DRA sent data request ORA Audit 28 – DFB to PG&E electronically on October 13, 2005 with a due date of October 27, 2005. PG&E provided the requested information on March 9, 2006, over four months late. Five of the sampled employees' expense reports were missing supporting documentation. This missing documentation totaled $33,909. In addition, 14 of the sampled employees had questionable expenses totaling $114,997. These expense reports include costs for team building, appreciation, recognition lunches, holiday parties, retirement party, club dues, summer picnic, political issues, election dinners, hosting non PG&E customers (golf costs, Meals on Wheels and gifts), campaign 2004 Conference, republic leadership, entertainment, Cal Poly Golf tour, dinner hosted in Hawaii, leadership retreat and lodging, Starbucks team building, and a missed dental appointment.

In response to DRA's data request ORA Audit – DFB, Question 4, PG&E indicated that it has not performed an audit on the reimbursable expenses since 1997. Under PCC 10407 an employee spent over $8,900 and $19,000 on holiday parties in

[1] The Reimbursable expenses for 19 employees sampled totaled $649,419.

2004 and 2005, respectively. DRA recommends that PG&E be ordered to perform internal audits on its reimbursable expense reports for each employee whose annual total reimbursable expenses are $20,000 or more. With no internal audit being performed on the reimbursable expense reports, abuse of the company credit card can occur. Clearly, having no recent internal audit performed on expense reports leaves doubts as to the reasonableness of the expenses being claimed by PG&E employees and potentially being paid for with ratepayer funds.

DRA has calculated the error rate of DRA's sample of reimbursable expenses to be 22.9%. DRA based this calculation on the $148,906 ($33,909+$114,997) of the $649,419 of the reimbursable expenses. DRA believes this 22.9% of error on the sample is an indication that the total reimbursable expenses contain expenses that should not be borne by ratepayers. Applying the 22.9% error rate to the remaining reimbursable expenses that were not reviewed ($1,789,125 - $649,419 = $1,139,707) results in an additional adjustment of $260,993 ($1,139,707 * 22.9%) of reimbursable expenses that should not be borne by the ratepayers. Accordingly, DRA recommends that Account 921 be reduced by a total of $409,899($33,909+$114,997+$260,993) for reimbursable expenses. Given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account 921, a separate adjustment has not been made for this amount in the Results of Operation.

PG&E's Internal Audit Department has not performed any audits on reimbursable expenses since 1997. An audit of reimbursable expenses is, therefore long over due. PG&E should be ordered to perform an audit on reimbursable expenses for each of the three years leading up to PG&E's next GRC.

A.2 Audit Sample

DRA verbally requested and received from PG&E[2] a CD containing all detail accounting information for this account. PG&E recorded over 51,843 entries in this account during 2004, with a dollar value of $30,189,398. DRA took a stratified sample of this account which resulted in a sample selection of 69 entries totaling $13,039,658. DRA sent ORA Audit 40 – DFB to PG&E electronically on December 22, 2005 with a

[2] PG&E provided DRA with a CD dated November 30, 2005.

due date of January 9, 2006. PG&E provided the requested information on February 9, 2006. DRA questions 30 of the 69 sample items, as PG&E provided no explanation as to what the costs were for nor how these costs were determined. DRA questions 30 items which could result in a potential audit adjustment from $1,450,976 to $28,046,110.

B. Account 923 Outside Services

B.1 Audit Sample

This account includes fees and expenses of professional consultants and others for general services which are not applicable to a particular operating function or other accounts. DRA verbally requested and received from PG&E[3] a CD containing all detail accounting information for this account. PG&E had recorded over 6,869 entries in this account during 2004, with a dollar value of $140,819,401[4]. DRA took a stratified sample of this account which resulted in a sample selection of 175 entries totaling $127,959,245. DRA sent ORA Audit 41 – DFB to PG&E electronically on December 22, 2005 with a due date of January 9, 2006. PG&E finally provided the requested information on February 14, 2006, some 36 days late. DRA questions 46 of the 175 sample items, as PG&E provided (1) little or no explanation as what the costs were for, (2) how they were determined, or (3) the costs were unsupported. DRA's potential audit adjustment could be as high as $20,733,676.

B.2. Discrimination Litigation Costs

PG&E has included in Account 923 litigation costs of $422,743 for discrimination cases that were settled in 2004. When a discrimination case either results in a judgment against the utility or the utility chooses to settle such a case, the costs incurred by the utility should not be borne by the ratepayers. The FERC USOA specifically questions:

> "What is the proper accounting treatment for expenditures made by the utility, resulting from employment practices that were found to be discriminatory by a judicial or

[3] PG&E provided DRA with a CD dated November 30, 2005.

[4] The total debit entries for this account were approximately $153,193,956.85.

> administrative decree or that were the result of a compromise settlement or consent decree?"

The FERC Release AR-12 answers the question by stating:

> "The Uniform System of Accounts provides that all charges to utility operating expense accounts must be just and reasonable. Expenditures of the nature mentioned above that can be readily identified and quantified should not be considered as just and reasonable charges to utility operations and should be classified to the appropriate nonoperating expense accounts."

In D. 96-01-011, the Commission, in harmony with FERC Release AR-12, held that costs incurred in meritorious employment discrimination suits should not be charged to ratepayers as they are nonoperating expenses. The Commission has applied this rule to discrimination litigation costs[5]. As such, ratepayers should not bear costs incurred in PG&E's discrimination settlement. DRA recommends that Account 923 Outside Services be reduced by $422,743 before forecasting for the test year 2007.

B.3. Chromium Litigation Costs

PG&E incurred, in 2004, $4,700,470[6] in costs to defend itself in chromium litigation. The complaints in these chromium litigation cases include, among other things, allegations of negligence, false representations, fraud, and intentional destruction of evidence. The Public Utilities Code requires that:

> "All charges demanded or received by any public utility…shall be just and reasonable."[7]

Commission decisions are clear that ratepayers should not bear litigation or settlement costs where the utility has acted in bad faith or against public policy laws.[8] Thus litigation costs are subject to reasonableness review, and, as the Commission has

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[5] See D.92549 5 CPUC 2d 39, 65-66.

[6] Total costs from 2000 to 2004 were $25,798,633.

[7] Public Utility Code Section 451.

[8] *See* Application of Pacific Gas and Electric Company (1983) 1983 Cal. PUC LEXIS 1156*272, D.83-12-068; In the Matter of Pacific Bell (1986) 20 CPUC 3d 237, 1986 LEXIX 890*146, D.86-01-026.

stated in the past, "PG&E cannot assume that ratepayers are automatically obligated for PG&E's actions."[9] Over the years the Commission has disallowed various types of litigation expenses including those incurred in defending job discrimination class action lawsuits and anti-trust suits. Until the merits of the allegations of these lawsuits have been resolved, no costs should be attributed to ratepayers. In the case of anti-trust lawsuits, the Commission has held that a verdict against the utility:

> "…is prima facie evidence of corporate management's violating public policy laws and it would, in turn, be poor policy to have ratepayers fund even part of the defense costs. Having ratepayers contribute to the costs of defending such suits would be a form of partial remuneration to shareholders notwithstanding that the management which they elected had violated public policy laws. Shareholders should fully bear all the consequences of management's violations of such laws, including the costs of defending suits resulting in a guilty verdict.[10]

The same reasoning applies to these chromium litigation costs. Until there is a final disposition of the chromium litigation, the reasonableness of allowing any of the chromium litigation expenses in rates cannot be determined. In no event should ratepayers be held responsible for any costs associated with these cases until there has been a resolution of these cases and that resolution has been carefully examined. If the chromium litigation cases settle, the Commission should examine any out-of-court settlement to determine whether any ratepayer funding of the litigation costs is appropriate. Commission precedent supports such a course. In the case of Equal Employment Opportunity (EEO) litigation expenses, the Commission stated:

> "We will disallow all expenses where PG&E has had to pay punitive damages or where the court has found that PG&E acted in bad faith. Further, the reasonableness of out-of-court settlements will also be examined."[11]

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[9] D. 92-11-050 46 CPUC 2d 423.

[10] D. 86-01-026 20 CPUC 2d 237.

[11] D. 83-12-068 1983 Cal. PUC LEXIX 1156*272.

Thus, even if the courts determine that PG&E did not engage in fraudulent concealment or spoliation of evidence, PG&E should still be required to demonstrate here the reasonableness of its conduct before allowing PG&E to recover any litigation costs from ratepayers. Only after the cases have been finally resolved will the Commission be able to determine whether the litigation costs were reasonable. Lawsuit costs attributable to utility negligence, fraud and destruction of evidence should not be charged to ratepayers. These are the type of litigation costs that should not be borne by ratepayers. DRA recommends that Account 923 Outside Services be reduced by $4,700,470 for the chromium litigation costs before forecasting for the test year 2007. PG&E has indicated that these chromium litigation costs have already been removed from its request and that it will provide DRA with support. At the time of this printing, DRA has not had the opportunity to verify that these costs have been removed. If DRA is able to confirm that the chromium litigation costs have been removed, this recommendation will be changed.

C. <u>Account 926 Employee Pensions and Benefits</u>

This account includes pensions paid to or on behalf of retired employees, or accruals to provide for pensions, and expenses incurred in medical, educational or recreational activities for the benefit of employees, and administrative expenses in connection with employee pensions and benefits. In 2004, PG&E recorded $1,036,000 in this account for service awards. PG&E did not include service awards in its compensation study because they are not typical direct compensation. The Commission has addressed this issue in D. 04-07-022,[12] stating:

> "If it were shown that the Spot Bonus program does not result in employees receiving above-market compensation, and that the program does not produce outcomes that are contrary to ratepayer interests, we would be inclined to include the program costs in the authorized revenue requirements.
>
> …SCE state that 'SCE's total compensation includes a Spot Bonus program,' (SEC opening brief, p. 181), and that 'Spot Bonuses are an integral part of SCE's Total Compensation Program' (ID., p.

[12] Page 214 to 215.

> 184). However, even though SCE's total compensation package includes spot bonuses, for ratemaking purposes we are more concerned with the portion of total compensation that is measured in the SCE/ORA total compensation study. Since that study explicitly excludes spot bonuses (Exhibit 77, p. 12), we are in no position to conclude that the Spot Bonuses program does not result in SCE's overall total compensation being above market level. Accordingly, we cannot conclude that costs of Spot Bonus program are reasonable. The costs will be removed for recorded years 1999 and 2000 as proposed by ORA."

Like Southern California Edison Company's Spot Bonuses, PG&E's service awards were not a part of its 2007 test year GRC total compensation study. DRA believes that it is unreasonable to ask ratepayers to fund these service awards. Given that the DRA analyst has made similar adjustments for such items in the functional analyses of Account 926, a separate adjustment has not been made for this amount in the Results of Operation.

D. Bonuses and Awards

PG&E has a Rewards and Recognition Program which is designed to provide immediate recognition to individuals or teams or significant achievements or innovative suggestions through monetary or non-monetary awards[13]. PG&E was unable to provide DRA with the reasons for the awards/bonuses[14]. In addition, the Commission has had a history of denying utility requests for these types of benefits (D.93-12-043, 52 CPUC 2d, 513-514). The Commission has found that such awards fit the category of social activities and should not be funded by ratepayers. D. 93-12-043 states:

> "We are not as concerned as DRA or SoCalGas with the precedent associated with funding employee social activities. We are more concerned with the current economic circumstances. SoCalGas' employees have generous benefits included in their employment contracts. Disneyland trips and Christmas turkey checks may be reasonable employee benefits but ratepayers should not be required to pay for them. SoCalGas, of course, may continue to

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[13] ORA Audi 45, Question 2.

[14] ORA Audit 45, Question 2.

offer these benefits at shareholder expense. We deny funding in this account for employee social activities."

DRA recommends that the Commission adhere to its past precedent and policy and deny all costs for spot bonuses and awards. DRA recommends that various accounts be reduced by $3,298,337 costs that relate to bonuses and awards. Given that the DRA analysts have made similar adjustments for such items in the functional analyses of various accounts, a separate adjustment has not been made for this amount in the Results of Operation.

CHAPTER 5

UTILITY PLANT

I. INTRODUCTION

Rate base generally represents the amount of investment a company has in its utility plant. Rate base includes utility plant-in-service, working capital, certain deferrals and adjustments, less customer advances, accumulated depreciation, and accumulated deferred taxes. Return on investment is calculated by multiplying the authorized rate of return by a utility's reasonable rate base. DRA's limited review was performed with a focus on the recorded data from the year 2004.

II. RECOMMENDATIONS

As a result of this limited review, DRA has no recommendations.

III. DISCUSSION

DRA performed a limited review of Utility Plant in this case. DRA considered this limited approach appropriate, given the results of an extensive review of 2001 numbers during the prior rate case. The prior review resulted in no adjustments due to detail testing. As a result of prior the rate case extensive review and historic level of recommendations relative to detail testing, DRA considered the risk of missing material recommendations via detail testing as low.