Application	:	A.05-12-002
Exhibit Number	:	DRA-18
Commissioner	:	Bohn
Admin. Law Judges	:	Kenney, Econome
Witness	:	Tang

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Report on the Results of Operations Electric and Gas Distribution Electric Generation for Pacific Gas and Electric Company

General Rate Case
Test Year 2007

Business Transformation and Earnings Sharing Mechanism

San Francisco, California
April 14, 2006

BUSINESS TRANSFORMATION AND EARNINGS SHARING MECHANISM

I. INTRODUCTION

This exhibit presents DRA's analysis and recommendations regarding PG&E's Business Transformation Program and the proposed earnings sharing mechanism. Essentially, Business Transformation is PG&E's effort to evaluate its core business processes and to identify areas for improvement and restructuring in order to improve operating efficiency and customer service.

PG&E commits to reducing the 2008 and 2009 attrition year revenue requirements by $41.1 million and $97.1 million, respectively, to capture estimated net savings from Business Transformation. In addition to the 2-year cumulative total of $138.2 million of committed dollar reductions for 2008-2009, PG&E proposes an earnings sharing mechanism for 2007-2009 that is intended to allow ratepayers and shareholders to share in the benefits of Business Transformation.

II. SUMMARY OF RECOMMENDATIONS

The following summarizes DRA's recommendations:

- For the purposes of this proceeding, DRA does not take issue with PG&E's net savings estimates from Business Transformation for this GRC cycle. As discussed in Exhibit DRA-19, when filing its attrition advice letters for 2008 and 2009, PG&E should be directed to:
  - incorporate the $138.2 million in committed savings from Business Transformation to the attrition mechanism that is adopted; and
  - apply the Business Transformation savings to each functional area—electric distribution, gas distribution, and electric generation.
- The Commission should adopt an earnings sharing mechanism (for 2007-2009) where there is sharing between ratepayers and shareholders on the upside but not on the downside. This is consistent with traditional GRC ratemaking and past Performance Based Ratemaking (PBR) mechanisms.
- The Commission should order PG&E to submit testimony in its next GRC that provides updated information on the status of Business Transformation.

Table 18-1 compares DRA's recommended with PG&E's proposed estimates:

Table 18-1
Estimated Net Savings from Business Transformation for 2008-2009
(in Thousands of Dollars)

Description (a)	DRA Recommended (b)	PG&E Proposed (c)	Difference PG&E>DRA (d=c-b)	Percentage PG&E>DRA (e=d/b)
Net Savings for 2008	$41,095	$41,095	$0	0.0%
Net Savings for 2009	$97,059	$97,059	$0	0.0%
Total	$138,154	$138,154	$0	0.0%

III. DISCUSSION

Sections A through C below present PG&E's proposals associated with Business Transformation and an earnings sharing mechanism. Sections D through F present DRA's review and recommendations regarding those issues.

A. Business Transformation is Designed to Improve PG&E's Operating Efficiency and Customer Service

The Business Transformation Program (BTP) evolved from PG&E's effort to evaluate its core business processes to identify areas for improvement and restructuring in order to improve operating efficiency and customer service. PG&E says that the BTP is a major undertaking to restructure its business operations model, and not merely a series of process improvements strung together. According to PG&E, the three primary underpinnings to this effort are: (1) new technology to facilitate operational improvements; (2) integration across different lines of business to achieve performance improvement and cost-efficiencies; and (3) culture change to ensure better performance and to encourage innovation for the benefit of customers and employees.

The program focuses on certain areas of PG&E's business: energy delivery/asset management; supply chain/corporate real estate/fleet; and customer management. Improvements in PG&E's information technology are supposed to support the company's operations in general and Transformation initiatives specifically, since many of the initiatives require new investments in information systems and technology.

In its testimony, PG&E states that Business Transformation "…is a risky venture with uncertainty over the timing and magnitude of costs and benefits." [1] PG&E also states that it "…has not requested rate recovery of the costs of Transformation incurred in the 2004 to 2006 timeframe."[2]

Since Business Transformation is still in its early stages, PG&E claims that implementation details are still preliminary. PG&E has therefore presented two scenarios (to indicate potential low and high forecasts of costs and savings) for estimated expense and capital expenditures for Business Transformation.[3] PG&E's conservative estimate initially—in the NOI—yielded net savings equal to $41.1 million and $97.1 million in revenue requirement for 2008 and 2009, respectively. Even though those estimates were subsequently, in the Application, lower than initially forecasted, PG&E still commits to the higher net savings figures as proposed in the NOI.[4]

PG&E also assumes that, for 2007, "…the Transformation effort may cost more than it saves, due to the need to fund early stages in order to realize future benefits. PG&E is not, for the purposes of this application, seeking such costs for 2007, nor is it assuming that savings may materialize which will offset such costs."[5] However, as discussed in Exhibit DRA-10, Chapter 10-C, there are some costs related to Business Transformation in PG&E's Legal Department. According to PG&E,

[1] Exhibit PG&E-10, page 6-2, lines 8-9.
[2] Exhibit PG&E-1, page 1-16, lines 30-32.
[3] Exhibit PG&E-10, Table 5-1 and Table 5-2.
[4] Exhibit PG&E-10, page 5-1, lines 19-30.
[5] Exhibit PG&E-10, page 5-1, lines 15-18.

those legal costs are not incremental costs for Transformation initiatives,[6] but are costs that will be incurred within the Legal Department in dealing with Transformation. Hence, those legal costs are not addressed here, but are addressed in Exhibit DRA-10, Chapter 10-C.

B. Net Savings from Business Transformation Will Reduce PG&E's Request for Post Test Year Ratemaking Revenue Requirement Increases

As discussed in Exhibit DRA-19, PG&E is seeking Commission authorization to file advice letters to implement Post Test Year Ratemaking (PTYR) adjustments for the 2008 and 2009 attrition years. PG&E is seeking revenue requirement increases of $186.0 million in 2008 and $248.8 million in 2009; PG&E commits to reducing the 2008 and 2009 attrition year revenue requirements by $41.1 million and $97.1 million, respectively, to capture estimated net savings from Business Transformation. The breakdown appears in Table 18-2 below:

Table 18-2
PG&E is Seeking Nearly $429 Million in Attrition Year Revenue Requirement Increases, but Net Savings from Business Transformation Would Reduce that by $138 Million
(in Thousands of Dollars)

Year (a)	Electric Distribution Attrition Increase (b)	Gas Distribution Attrition Increase (c)	Electric Generation Attrition Increase (d)	Total Attrition Increase (e=b+c+d)	Net Savings from Business Transformation (f)	Total Attrition Increase Net of Transformation Savings (g=e+f)
2008	$87,906	$32,581	$65,507	$185,994	($41,095)	$144,899
2009	108,419	33,822	100,591	242,832	(97,059)	145,773
Total	$196,325	$66,403	$166,098	$428,826	($138,154)	$290,672

C. PG&E Proposes an Earnings Sharing Mechanism as a Means of Capturing Greater-than-Expected Net Savings from Business Transformation

In addition to the $138.2 million of committed dollar reductions over the 2-year period of 2008-2009, PG&E proposes an earnings sharing mechanism for ratepayers and shareholders to share in the benefits of Business Transformation if net

[6] PG&E's response to Data Request ORA-210, Question 4.

cost savings are greater than the levels incorporated in the attrition proposal and which exceed a dead band. The earnings sharing mechanism would be in place during the period between this GRC and the next GRC, from 2007-2009.

PG&E proposes thresholds for customer and shareholder sharing, relative to its authorized return on equity (ROE) for CPUC jurisdictional operations. PG&E's testimony used the 2005 authorized ROE, equal to 11.22%, to illustrate its proposal:

Table 18-3
Illustration of PG&E's Proposed Earnings Sharing Mechanism Relative to its 2005 Authorized Return on Equity (ROE)

Line No.	ROE	Customer	Shareholder
1	Below 10.72%	50%	50%
2	10.72% - 11.72%	0%	100%
3	11.73% - 14.22%	50%	50%
4	Above 14.22%	100%	0%

PG&E proposes a +/- 50 basis point dead band centered on the authorized ROE, a 50/50 split of earnings results outside the dead band (upside or downside), and an earnings cap but no floor. PG&E's testimony also discusses other considerations in the sharing mechanism, including below-the-line exclusions, other exclusions (e.g., removing incentive earnings and adjusting revenues and expenses to account for the impact of Rate Reduction Bond and Energy Recovery Bond financings), using recorded rate base and authorized capital structure, and the tax treatment of shared earnings.

PG&E indicates that, "[a]ll earnings to be shared will be treated as a one-time adjustment to base revenues, grossed up for income taxes, franchise fees, and uncollectibles, and credited to the appropriate balancing accounts to return to customers."[7] PG&E also states that the earnings sharing mechanism, "…will retain the 50/50 sharing up to 300 basis points above the authorized ROE. Earnings above that level will be returned 100 percent to customers…The probability that the

[7] Exhibit PG&E-10, page 6-8, lines 14-17.

Company would achieve this level of performance during this rate case cycle is remote."[8]

D. DRA does not Oppose PG&E's Estimated Net Savings from Business Transformation for this GRC Cycle

DRA reviewed PG&E's testimony and workpapers regarding estimated net savings from Business Transformation, and discussed them with PG&E's witness. It is important for PG&E to seek cost-effective methods to become more efficient and to attain cost savings that will benefit ratepayers. Hence, for the purposes of this proceeding, DRA does not: (1) impute net savings from Business Transformation in 2007; nor (2) take exception to PG&E's net savings estimates for 2008-2009. The amount of savings to which PG&E commits for 2008-2009 lean toward the conservative end based on its analysis. However, an earnings sharing mechanism could still allow ratepayers to benefit from a higher level of savings, should they materialize.

In response to a DRA data request,[9] PG&E provided a breakdown of the Business Transformation savings for the functional areas:

Table 18-4
Net Savings from Business Transformation Will Reduce 2008-2009 PTYR Increases for Electric Distribution by $69 Million, for Gas Distribution by $40 Million, and for Electric Generation by $29 Million
(in Thousands of Dollars)

Description (a)	2008 (b)	2009 (c)	Cumulative (d=b+c)
Electric Distribution	$15,014	$54,061	$69,075
Gas Distribution	12,561	27,623	40,184
Electric Generation	13,521	15,374	28,895
Total	$41,095	$97,059	$138,154

8 Exhibit PG&E-10, page 6-8, lines 26-31.

9 Data Request ORA-052, Question 1.

As discussed in Exhibit DRA-19, when filing its attrition advice letters for 2008 and 2009, PG&E should be directed to:

- incorporate the $138.2 million in committed savings from Business Transformation to the attrition mechanism that is adopted; and
- apply the Business Transformation savings to each functional area—electric distribution, gas distribution, and electric generation.

E. DRA does not Oppose the Concept of an Earnings Sharing Mechanism, but Recommends a Different Sharing Formula

DRA reviewed PG&E's testimony regarding the proposed earnings sharing mechanism, and discussed the matter with PG&E's witness. DRA believes it is important for PG&E to seek cost-effective methods to become more efficient and to attain cost savings that will benefit ratepayers. Hence, for the purposes of this proceeding, DRA does not take issue with the concept of sharing earnings between ratepayers and shareholders for 2007-2009. However, DRA recommends a modified mechanism, as described below.

1. PG&E's Proposed Mechanism is Tied to Authorized ROE

PG&E's proposed mechanism can be illustrated formulaically, in terms of identifying thresholds by the number of basis points below or above the authorized ROE, as shown in Table 18-5:

Table 18-5
PG&E's Proposed Earnings Sharing Mechanism is Tied to its Authorized Return on Equity (ROE)

Line No.	Sharing Band (Basis Points) Below or Above Authorized Return On Equity (ROE)	Customer	Shareholder
1	Less than -50	50%	50%
2	-50 to 50 (deadband)	0%	100%
3	51- 300	50%	50%
4	More than 300	100%	0%

The numerical percentage thresholds for the earnings sharing mechanism can change from year-to-year, depending on the authorized ROE. However, the sharing bands would remain unchanged. For instance, using PG&E's 2006 authorized ROE of 11.35% yields the following:

Table 18-6
Illustration of PG&E's Proposed Earnings Sharing Mechanism Relative to its 2006 Authorized Return on Equity

Line No.	ROE	Customer	Shareholder
1	Below 10.85%	50%	50%
2	10.85% - 11.85%	0%	100%
3	11.86% - 14.35%	50%	50%
4	Above 14.35%	100%	0%

2. DRA Opposes any Mechanism that Puts Ratepayers at Risk for Subsidizing Performance that Results in a Utility Earning Lower-than-Authorized Returns

DRA opposes the aspect of PG&E's proposed mechanism that exposes ratepayers to sharing on the downside should PG&E's actual ROE fall below the lower end of the proposed dead band, at 50 basis points below authorized ROE. There is no basis for ratepayers to cover the utility's inability to achieve its authorized ROE or compensate shareholders if the utility's ROE falls below a given range, as suggested by PG&E in its proposal. The proposal is inconsistent with past Commission precedent.

In GRCs, utilities are provided an opportunity to earn their authorized rate of return (ROR) and associated ROE; however, earning the authorized return is not a guarantee. In past cases, the Commission has adopted sharing mechanisms should the utility achieve a return above authorized, but ratepayers have not been required to make up for a utility's inability to achieve its authorized return.[10]

For example, in D.99-05-030, the Commission adopted an asymmetric progressive sharing mechanism for San Diego Gas and Electric Company (SDG&E) where ratepayers did not share in any earnings deficiency below the authorized ROR. In that decision, the Commission stated that, "[t]his progressive sharing mechanism

[10] Such a policy provides the utility with an incentive to achieve cost savings, while acknowledging that the utility is afforded the ability to operate and manage its system in the manner it deems appropriate.

creates a 'win-win' for both shareholders and ratepayers."[11] The adopted sharing mechanism is shown below in Table 18-7:

Table 18-7
The Performance Based Ratemaking Sharing Framework
Adopted by the Commission for SDG&E in D.99-05-030
was Asymmetric and Tied to Rate of Return (ROR) Above Authorized

Bands	Sharing Band (Basis Points) Above Authorized Rate of Return (ROR)	Customer	Shareholder
Inner	0 – 25	0%	100%
1	25 – 75	75%	25%
2	75 – 100	65%	35%
3	100 – 125	55%	45%
4	125 – 150	45%	55%
5	150 – 175	35%	65%
6	175 – 200	25%	75%
7	200 – 250	15%	85%
8	250 – 300	5%	95%
Outer	Above 300	0%	100%

More recently, the Commission adopted a base margin sharing mechanism for SDG&E and Southern California Gas (SoCalGas) in D.05-03-023, where there is earnings sharing between ratepayers and shareholders on the upside but not on the downside. In that decision, the Commission stated, "[t]here would be no sharing in the event of earned ROR falling below authorized ROR for either of the two utilities individually."[12]

[11] D.99-05-030, page 57.

[12] D.05-03-023, page 23.

The adopted mechanism is shown below in Table 18-8:

Table 18-8
The Base Margin Sharing Mechanism Adopted by the Commission for SDG&E and SoCalGas in D.05-03-023 Excludes Sharing if the Earned Rate of Return (ROR) Falls Below Authorized ROR

Bands	Sharing Band (Basis Points) Above Authorized Rate of Return (ROR)	Customer	Shareholder
Inner	0 - 50	0%	100%
1	51- 100	75%	25%
2	101 – 125	65%	35%
3	126 – 150	55%	45%
4	151 – 175	45%	55%
5	176 – 200	35%	65%
6	201 – 300	25%	75%
Outer	More than 300		Suspend

In both of these instances, the Commission has shown that: (1) a sharing mechanism is not a backstop to protect the utility ROR; (2) downside sharing would essentially subsidize poor performance; and (3) the utility should be fully at risk for all earnings below authorized levels.

Thus, DRA recommends a mechanism that is consistent with PG&E's proposal but with greater initial ratepayer sharing, similar to those mechanisms adopted for SDG&E and SoCalGas:

Table 18-9
DRA's Proposed Earnings Sharing Mechanism is Tied to Protects Ratepayers on the Downside and Provides Shareholders with Opportunities to Benefit on the Upside

Bands	Sharing Band (Basis Points) Above Authorized Return On Equity (ROE)	Customer	Shareholder
Inner	0 – 50	0%	100%
1	51 – 150	75%	25%
Outer	More than 150	50%	50%

DRA's proposed sharing mechanism includes a reasonable trade-off which offers PG&E's shareholders an opportunity to benefit from greater-than-expected earnings in exchange for protecting ratepayers on the downside (no sharing of earnings deficiency).

Applying DRA's recommended mechanism to PG&E's 2006 authorized ROE yields the following:

Table 18-10
Illustration of DRA's Proposed Earnings Sharing Mechanism
Relative to PG&E's 2006 Authorized Return on Equity of 11.35%

Bands	ROE	Customer	Shareholder
Inner	11.35% 11.85%	0%	100%
1	11.86% - 12.85%	75%	25%
Outer	Above 12.85%	50%	50%

DRA does not take issue with what PG&E proposes regarding how to account for below-the-line exclusions, other exclusions, using recorded rate base and authorized capital structure, and the tax treatment of shared earnings as part of the mechanics behind calculating the ROE and implementing the earnings sharing mechanism.

F. In its Next GRC, PG&E Should Provide Updated Information on the Status of Business Transformation

PG&E should submit testimony in its next GRC that provides details about the Business Transformation initiatives, costs, benefits, and earnings sharing based on actual experience. In particular, PG&E should identify any initiatives that either fell short of or exceeded expectations, and explain what occurred and why. PG&E should also discuss the prospects of Business Transformation going forward, provide updated cost and benefit estimates, identify updated net savings projections, revisit the earnings sharing mechanism, and discuss how the initiatives have become, or will become, the norm as part of PG&E's operations.