

PROPOSED DECISION

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Decision PROPOSED DECISION OF ALJ KERSTEN (Mailed 12/12/2013)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for the Recovery of Costs Associated with the Acquisition and Transfer of the Assets of the Hercules Municipal Utility (U39E).

Application 13-07-001
(Filed July 1, 2013)

PHASE 1 DECISION APPROVING THE ACQUISITION AND PURCHASE AGREEMENT BETWEEN PACIFIC GAS AND ELECTRIC COMPANY AND THE CITY OF HERCULES AND DENYING THE ASSOCIATED "NET BENEFITS" PROPOSAL

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**PHASE 1 DECISION APPROVING THE ACQUISITION AND
PURCHASE AGREEMENT BETWEEN PACIFIC GAS AND ELECTRIC
COMPANY AND THE CITY OF HERCULES AND DENYING THE
ASSOCIATED “NET BENEFITS” PROPOSAL**

1. Summary

In response to Pacific Gas and Electric Company's (PG&E) Application 13-07-001 dated July 1, 2013, this Phase 1 Decision approves the PG&E and City of Hercules Asset Purchase Agreement (APA) executed by PG&E and the City of Hercules on May 28, 2013 at a purchase price of \$9.5 million. This Phase 1 Decision approving the APA is effective immediately. Pacific Gas and Electric is directed to initiate the closing process for this transaction within 30 days of the issuance of this decision.

Once the transaction closes and PG&E assumes ownership of and daily operational responsibility for Hercules Municipal Utility (HMU) assets, the APA is subject to the following cost recovery conditions:

- 1) PG&E shall book the \$7.4 million book value of HMU assets to its rate base;
- 2) From a broad policy perspective, PG&E's proposed “net benefits” proposal is denied; and
- 3) Once this transaction closes, HMU customers who become new PG&E customers shall receive service according to the appropriate PG&E tariff and rate schedules in effect.

PG&E shall collect the revenue requirement that reflects the book value of \$7.4 million for HMU assets beginning on the effective date of this decision. The revenue requirement will be collected through the Distribution Revenue Adjustment Mechanism and incorporated in rates as part of the Annual Electric

True-Up advice filing, or as soon as practicable following the California Public Utilities Commission decision in this proceeding.

Phase 2 of this proceeding will address the reasonableness of capital expenditures that PG&E estimates will amount to \$3.6 million over three years (2014-2016), proposed distribution revenue requirements (including amounts and mechanics), and any other necessary direction.

2. Background

Hercules Municipal Utility (HMU) is a “local publicly owned electric utility” as defined in Section 224.3 of the California Public Utilities Code.¹ Therefore, the California Public Utilities Commission (Commission) does not regulate this public utility. The City of Hercules,² located in western Contra Costa County, owns and operates HMU and provides electric service to customers within a limited portion of the City of Hercules – less than one square mile mostly north of Highway 80. HMU is comprised of a 12,000 volt system which accepts electric power from the power grid via three interconnections with PG&E facilities. HMU provides electric service to approximately 800 residential and commercial customers through 825 meters within PG&E’s certificated territory. By contrast, the current population of the City of Hercules is approximately 24,000 with approximately 9,000 households.³

Currently PG&E serves approximately 8,000 residential electric customers and 460 commercial electric customers situated inside the City of Hercules but

¹ All statutory references are to the Public Utilities Code unless otherwise noted.

² Throughout this decision, the terms “City of Hercules,” “City,” and “Hercules” are used interchangeably.

³ PG&E Application at 3-4, 8.

outside the HMU service area. PG&E also serves natural gas to HMU customers. The City of Hercules approved both electric and gas franchises that allow PG&E to use public rights-of-way to install electric infrastructure necessary to furnish both electric and gas service to all customers within the City.

On July 1, 2013, PG&E filed Application (A.) 13-07-001, its *Application of Pacific Gas and Electric Company for the Recovery of Costs Associated with the Acquisition and Transfer of the Assets of the Hercules Municipal Utility* (Application). PG&E requests approval for the recovery of costs associated with the acquisition and transfer of assets of HMU and benefit sharing or “net benefits” proposal.

More specifically, according to its Application:

PG&E requests authorization to recover a total revenue requirement for the three-year period 2014-2016 of \$6.4 million in electric distribution rates associated with \$7.4 million for the book value of the HMU assets, \$3.6 million in capital expenditures for necessary safety and service enhancements, plus 50% of approximately \$5.3 million in benefits which will be created in the first 15 years as a direct result of PG&E’s acquisition and transfer.⁴

Also:

The transaction will initially result in a de minimis short-term increase in rates of approximately 0.03% for one year. The revenue from the existing HMU customers, once transitioned to PG&E service, is expected to partially recover the necessary requirement in the first year and exceed it in future years, resulting in a rate reduction in 2015.⁵

⁴ PG&E’s A.13-07-001, July 1, 2013 at 1.

⁵ PG&E Application at 24.

In its Application, PG&E proposes to collect the revenue requirements and its proposed share of other benefits produced as a result of the transaction beginning as early as January 1, 2014. PG&E proposes that the revenue requirement be collected through the Distribution Revenue Adjustment Mechanism (DRAM) and incorporated in rates as part of the Annual Electric True-up (AET) advice filing following a final Phase 2 Commission decision in this proceeding. PG&E also proposes that its ongoing revenue requirement would be managed with its other distribution assets in the next General Rate Case (GRC) for inclusion in rates. PG&E asserts that the rate impact of this revenue requirement is “de minimis” since the dollars associated with the transaction are relatively small.⁶

While Section 451 provides the primary statutory authority for the application,⁷ PG&E claims that a “benefit sharing” on a “50/50 basis” for savings related to “mergers” under Section 854 is appropriate to encourage this transaction.⁸ In its application, PG&E concludes “While a Section 854 application is not required by an investor-owned utility acquiring a municipal utility, nevertheless, the logic for benefit-sharing under Section 854 also applies here.”⁹

⁶ PG&E Application at 2.

⁷ Among other things, Section 451 ensures that, “Every public utility shall furnish and maintain such adequate, efficient, just, and reasonable service, instrumentalities, equipment and facilities, including telephone facilities, as defined in Section 54.1 of the Civil Code, as are necessary to promote the safety, health, comfort, and convenience of its patrons, employees, and the public.”

⁸ Section 854 (b)(2) allows the sharing of short-term and long-term benefits between customers and shareholders, as determined by the Commission; ratepayers shall not receive less than 50% of those benefits.

⁹ PG&E Application at 20.

(Please see Section 4.3 “Net Benefits” Proposal for a more thorough discussion of this topic).

In its Application, PG&E gives numerous reasons why the transaction should be pursued. Through this transaction, PG&E endeavors to not only ensure the continued safe service of reliable delivery of electricity and natural gas to residents of the City of Hercules, but also to create benefits for its existing and new customers through additional contribution to margin (revenues net of cost) and increased “economies of scale.”¹⁰ For example, PG&E notes that HMU had planned to build a substation to accommodate new growth in the area but abandoned the plan due to financial difficulties. PG&E’s nearby Franklin Substation can support projected growth without significant new investment. According to PG&E, this transaction aligns with PG&E’s goals to support communities during a time of difficulty, lessen customer confusion about utility service providers, and reinstate or establish conservation programs that benefit customers.¹¹

The City of Hercules has similar reliability goals but has fallen short of its objective to generate surplus revenue for the City’s general fund via the HMU. “Instead of generating the anticipated profit in almost 10 years of operation, HMU has consistently required annual subsidies from the City to continue operations.”¹² Currently, HMU revenues cannot support daily operations or related debt service for approximately \$13 million in outstanding bonds, which

¹⁰ PG&E Application at 4; for a more thorough discussion of short- and long-term benefits see pages 13-18.

¹¹ PG&E Application at 4.

¹² PG&E Application at 5.

were originally secured in part to construct an electric substation. Timely completion of the transaction will allow the City to retire the bonds and redirect monies from subsidization of HMU and payment of debt service to municipal services that benefit the entire community.¹³

Following a competitive solicitation process, negotiations between PG&E and HMU resulted in the Asset Purchase Agreement (APA), which was approved by local ballot measure (as required by law) and the Hercules City Council, and executed by City of Hercules and PG&E on May 28, 2013.¹⁴

Given the City of Hercules's dire financial situation and the opportunity to realize expected benefits from the transaction, PG&E requests an expedited Commission decision on its Application.

3. Procedural History

The Utility Reform Network (TURN) filed a protest to PG&E's Application on August 2, 2013. Both the City and County of San Francisco (CCSF) and the City of Hercules filed responses on August 5, 2013. PG&E filed a reply to the protests and responses on August 15, 2013. In essence, while parties did not object to PG&E's acquisition of the HMU and transfer of assets, both TURN and CCSF did not think that it was appropriate to shift any benefits of the transaction to shareholders. (Please see a more thorough discussion of positions contained in Section 4.3, "Net Benefits Proposal.")

On August 29, 2013 a prehearing conference (PHC) took place in San Francisco, California to establish the service list, discuss the scope based on parties' protests and responses to the Application, review categorization and

¹³ PG&E Application at 5, 6, 18.

¹⁴ PG&E Application at 5.

need for hearing, and develop a procedural timetable for the management of this proceeding. At the PHC, the assigned Administrative Law Judge (ALJ) granted party status to the Division of Ratepayer Advocates (now named Office of Ratepayer Advocates or ORA).¹⁵

On September 6, 2013 the assigned Commissioner issued a Scoping Memo setting forth the procedural schedule, assigning the presiding officers, and addressing the scope of this proceeding and other procedural matters following the PHC held on August 29, 2013.

According to the Scoping Memo, a first phase of this proceeding will examine whether PG&E's proposed acquisition of the HMU and benefit sharing proposal are reasonable including discussion of whether:

1. To authorize PG&E's request to acquire and transfer the assets of the HMU from the City of Hercules to PG&E;
2. The proposed purchase price of the acquisition of HMU by PG&E is reasonable;
3. To adopt a basic policy determination that PG&E's proposal 50% of the estimated "net benefits" to be credited to shareholders is just and reasonable;
4. California Environmental Quality Act (CEQA) review applies to this proposed acquisition and transfer; and
5. Potential acquisition and transfer of assets ensures safe and reliable delivery of energy to customers.

Also:

6. Should interim rates apply for the new PG&E (former HMU) customers (e.g., based on current HMU rates or the

¹⁵ The Division of Ratepayer Advocates was renamed the Office of Ratepayer Advocates effective September 26, 2013, pursuant to Senate Bill 96 (Budget Act of 2013: public resources), which was approved by the Governor on September 26, 2013.

- current PG&E customer rates) and should rates be subject to true-up from the date of any interim rate authority to the date of final ratemaking determinations?
7. Should the Commission address the ratemaking issues associated with the acquisition of HMU, including PG&E's additional expenditures proposed for maintaining and upgrading the HMU assets, in this proceeding or in PG&E's next GRC proceeding, expected for Test Year 2017?

If, in the first phase of this proceeding, the Commission determines that the ratemaking proposals associated with the proposed acquisition of HMU should be addressed in this proceeding, a second phase will then address all ratemaking issues in PG&E's application including:

8. If the shareholder benefit sharing is approved, calculation of and assumptions behind amount of proposed benefit sharing; and
9. Whether PG&E's other ratemaking proposals related to this application, including, but not limited to, proposed capital safety and service enhancements, proposed distribution revenue requirements, and related rate recovery (including amounts and mechanics), are just and reasonable.

On September 13, 2013 Merced Irrigation District (Merced ID) and Modesto Irrigation District (Modesto ID) filed a motion for Party Status in proceeding. On September 18, 2013 the ALJ granted party status to Merced ID and Modesto ID.

Responses to questions in the Scoping Memo were filed and served on September 26, 2013 by PG&E, City of Hercules, TURN, ORA, CCSF, Merced ID and Modesto ID. Replies to responses to questions in the Scoping Memo were filed and served on October 1, 2013 by PG&E, City of Hercules, TURN, Merced ID and Modesto ID, and ORA.

4. Issues before the Commission

The following summarizes parties' views pertaining to questions raised in the Scoping Memo. To the extent those areas were not the subject of dispute by parties, discussion is more limited.

4.1. Acquisition and Transfer

4.1.1. PG&E Position

PG&E states that it is seeking CPUC authorization to record the book value of the HMU assets and to recover in electric distribution rates the revenue requirement associated with those assets, the capital costs for reliability enhancements, and a share of future benefits. PG&E emphasizes that it requests Commission approval for specific cost recovery terms only and not the HMU asset acquisition itself.¹⁶

According to PG&E, it holds a franchise, issued by the Hercules City Council to own, operate, and maintain electric facilities in the City of Hercules now and in the future. Instead of installing new electric distribution facilities according to Tariff Rules 15 and 16, PG&E agreed to purchase the HMU distribution facilities that were already serving HMU customers.¹⁷

As stated in PG&E's Application, and reemphasized by PG&E and the City at the PHC, the acquisition is important to the City's financial health and will help eliminate the drain on municipal resources to fund annual HMU losses.¹⁸

¹⁶ PG&E Response to Scoping Memo at 2. PG&E bases its recommendation on the specific terms of a settlement agreement contained in Decision (D.) 99-10-064 (*OIR on the Commission's Own Motion to Set Rules and to Provide Guidelines for the Acquisition and Merger of Water Companies*) at 3.

¹⁷ PG&E Response to Scoping Memo at 2.

¹⁸ PG&E Application at 5-7, August 29, 2013 PHC Transcript at 20-22.

PG&E contends the transaction will help realize both short- and long-term benefits of the proposed transaction for PG&E's customers, current HMU customers, and the City of Hercules.

4.1.2. Parties' Position

The City of Hercules agrees with PG&E's position and states that the City of Hercules' ability to return and maintain financial stability depends on the timely completion of the sale of the HMU and concurrent retirement of the HMU bonds. The City of Hercules emphasizes that it cannot retire the bonds without the sale of HMU to PG&E and timely implementation.¹⁹

While PG&E does not think that it is necessary for the Commission to approve the acquisition itself, both TURN and ORA support the acquisition and transfer but subject to conditions adopted by the Commission, rather than those described in the Application. According to TURN, "The Commission can do so by approving the asset purchase agreement between the City of Hercules and PG&E."²⁰ However, they point out that the APA does not address the benefit-sharing proposal or the incremental capital expenditures that PG&E describes in general terms in its application. Therefore, the Commission should

¹⁹ City of Hercules Response to Scoping Memo at 4-5.

²⁰ TURN Response to Scoping Memo at 1. See PG&E Application (APA), Article 1-Definitions at 3. "CPUC approval" is defined as "the final and non-appealable order of the CPUC which approves this Agreement in its entirety including payments to be made by the Buyer and cost recovery of the Purchased Assets at the commencement of the Purchased Assets dedication to utility service, subject only to CPUC review with respect to reasonableness of the Buyer's payment of the Purchase Price and its administration of the Post-Closing Adjustment, and finds the Buyer's entry into and under the agreement to be reasonable."

authorize the acquisition and transfer according to the explicit terms of the APA.²¹

In response to the same question, ORA said, “Yes, with the caveat that PG&E’s request for \$2.7 million in transaction benefits is denied.”²² ORA thinks that the acquisition and transfer is advantageous because the City of Hercules will be able to retire significant debt and move towards more solid financial footing. The citizens of the City will have lower rates as compared to current rates of HMU. “PG&E will earn a return on book value of its investment and the additional service and safety enhancement capital investment in the system.”²³

4.1.3. Discussion

As PG&E notes in its Response to the Scoping Memo, “[N]one of the parties objects to PG&E’s acquisition of the HMU assets and transfer of the ownership and responsibility for ongoing operation and maintenance of the system and customer service.”²⁴ As PG&E and the City of Hercules have stated in public filings, such an acquisition is critical to the City’s financial health because the corresponding utility will be able to pay off HMU bonds. PG&E customers, HMU customers, the City of Hercules, and future customers will enjoy short-term and long-term benefits as listed in PG&E’s Application.

²¹ TURN Response to Scoping Memo at 2.

²² ORA Response to Scoping Memo at 1.

²³ ORA Response to Scoping Memo at 2.

²⁴ PG&E Response to Scoping Memo at 2.

ORA and TURN support the APA “as is” without the newly proposed cost recovery conditions that were made following the signing of the APA – namely approval of the “net benefits” proposal and approval of capital improvements that have not been publicly scrutinized as they would in any ongoing GRC.

In accordance with the Commission’s Section 451 statutory authority and for other reasons parties state above, we find it is reasonable to approve this acquisition and transfer of the HMU assets to PG&E, as defined in the APA. We do not believe it is prudent or necessary to be bound by the settlement terms of D.99-10-064 that do not require a privately owned utility to obtain authorization from the Commission before acquiring another “publicly owned utility.” This particular decision was negotiated over 10 years ago with a different set of market and regulatory conditions and financial terms unique to the water systems and water industry.

The APA, along with other cost recovery provisions, will allow the City of Hercules to return to financial health and HMU customers, PG&E customers, PG&E shareholders, and future customers will enjoy both short-term and long-term benefits from the transaction. Approval of the APA is subject to cost recovery conditions as discussed in the remainder of this decision. Even though we approve the transaction, we reserve to Phase 2 the question of the \$3.6 million for safety and reliability enhancements.

4.2. Proposed Purchase Price

4.2.1. PG&E Position

According to the buyer PG&E, the proposed purchase price of \$9.5 million is “just and reasonable” because the market price for the HMU assets was arrived via a competitive bid price. Further, PG&E knew that there were other bidders so a competitive bid would need to be based on a “reasonable estimate of the fair

market value of the assets.”²⁵ In its Application, PG&E proposes that the book value of the HMU assets at \$7.4 million be authorized for recovery during 2014-2016 (assuming the transaction closes by January 1, 2014).²⁶

4.2.2. Parties’ Position

According to the seller the City of Hercules, the purchase price is “just and reasonable” by any “market, regulatory, or other, standard.”²⁷ The City received three bid proposals, and determined that the bid proposal submitted by PG&E was “the highest and best” bid. Further, the PG&E bid was the only bid that offered a purchase price sufficient to enable Hercules to retire the outstanding HMU bond debt of approximately \$8.5 million.²⁸

ORA also said that the acquisition price is “just and reasonable “provided that only the book value of \$7.4 million will be included in PG&E’s rate base.”²⁹ ORA refers to many decisions that don’t approve the recovery of acquisition premiums including Commission decision (D.06-02-033)³⁰ that states, “We will adopt ORA’s proposal to prohibit the Applicant’s recovery of the acquisition

²⁵ PG&E Response to Scoping Memo at 2.

²⁶ PG&E Application at 1.

²⁷ City of Hercules Response to Scoping Memo at 6.

²⁸ City of Hercules Response to Scoping Memo at 6.

²⁹ ORA Response to Scoping Memo at 2.

³⁰ Application of PacificCorp and MidAmerican and MidAmerican Energy Holdings for Exemption under Section 853(b) from the Approval Requirements of Section 854(a) of the PC Code with Respect to the Acquisition of PacificCorp by MidAmerican (A.05-07-010); 2006 Cal. PUC LEXIS 49.

premium as ORA's proposal is consistent with long-standing Commission precedent."³¹

TURN concludes, "The approximately \$7.4 million that is the book value of the HMU assets appears to be reasonable." As for the \$2.7 million premium that PG&E chose to pay above the book value of the assets, TURN argues that the Commission need not and should not make any determination of reasonableness.³² TURN argues that the premium that PG&E agreed to pay in excess of book value was a "management decision" and should be presumed to reflect some cost-benefit analysis the utility performed in the course of deciding how much to bid for the HMU assets. TURN further points out that in its Application PG&E did not provide any "explanation or basis" for its decision to pay \$9.5 million to the City of Hercules for the HMU assets.³³

4.2.3. Discussion

In this decision, we approve the proposed purchase price of \$9.5 million. The market price was achieved as a result of a competitive bidding process. PG&E had full knowledge that there would likely be other competitors so it had an incentive to provide a reasonable bid that took into account all market variables. However, we will only authorize PG&E to recover the \$7.4 million in book value of these assets. We agree with ORA and TURN that it is not appropriate to include an "acquisition premium" into rate base. Such an action would depart from Commission policy and past precedents as demonstrated in

³¹ ORA Response to Scoping Memo at 2.

³² TURN Response to Scoping Memo at 2.

³³ TURN Response to Scoping Memo at 4.

D.06-02-033 and other Commission decisions. It is significant to note that PG&E made no showing regarding the breakdown of costs to support this premium.

As a matter of principle or ongoing practice, transferring ownership at a premium frustrates the application of any “original cost” standard. A seller would receive more than he is entitled, at the expense of ratepayers. The willingness of the purchaser to pay the premium would have “little significance” to a purchaser since it would not be bearing the burden of the transaction.³⁴

4.3. “Net Benefits” Proposal

4.3.1. PG&E Position

According to PG&E, the acquisition of HMU is forecasted to produce “net benefits” over the first 15 years with a net present value of approximately \$5.3 million. PG&E proposes to keep 50% of that figure as the utility’s share of “net benefits.”³⁵ PG&E estimates the benefits to existing PG&E customers by calculating the revenue generated by the HMU customers, less the costs PG&E will incur to serve those customers.

According to PG&E, “[T]he issue here is whether PG&E after evaluating the costs and benefits of acquiring HMU, and identifying material benefits that would result from the transaction should be barred from sharing in those benefits.³⁶ PG&E justifies benefits based on a number of cases such as the GTE/Contel merger (D.96-04-053) and cites factors the Commission considered in allocating benefits to shareholders:

³⁴ D.69490 (1965) 64 CPUC1st, 558, 564 (quoting D.68841).

³⁵ PG&E Application at 19-20, Exhibit L.

³⁶ PG&E Reply to Protests to Application at 4.

The Commission reasoned 1) shareholders undertake the negative effects of the merger and hence should be allowed to benefit from rewards of their decision as well; 2) shareholders face additional risk as a result of earnings dilution; 3) shareholders will decide in favor of mergers only if on balance the return on their investment is commensurate with the level of risk they are willing to assume; and 4) customers may receive additional benefits through incentive regulation and competition.³⁷

According to PG&E, “While a Section 854 application is not required by an investor-owned utility acquiring a municipal utility, nevertheless the logic for benefit-sharing under Section 854 also applies here.”³⁸ PG&E argues that the Commission has supported benefit sharing where utility acquisitions and mergers would realize “operational efficiencies and measurable benefits for utility customers.”³⁹ In the GTE/Contel merger, the Commission allocated half of the benefits to shareholders in order to incent those same shareholders to voluntarily bear the additional costs that result from seeking opportunities to create the economic benefits.⁴⁰ PG&E contends that a 50/50 allocation of 15-year economic benefits is especially reasonable in this case considering that in addition to economic benefits, current HMU customers will realize non-economic benefits as previously described in the PG&E application.”⁴¹ In its

³⁷ PG&E Application at 20-21, citing 65 CPUC2d 582, 586-588.

³⁸ PG&E Response to Scoping Memo at 5.

³⁹ PG&E Response to Scoping Memo at 5.

⁴⁰ PG&E Response to Scoping Memo at 6.

⁴¹ PG&E Response to Scoping Memo at 7. Some of the “non-economic” options include improved customer services with access to new payment options, combined electric and gas billing, 24-hour customer call service centers, etc. See PG&E Application at 16-18.

Reply to Responses to the Scoping Memo, PG&E also cites D.98-03-073, the merger of two regulated GRC-regulated entities Pacific Enterprises and Enova Corporation (Enova), who shared benefits between customers and shareholders.⁴²

PG&E notes that some parties express concerns that providing shareholder benefits in this case of HMU would create incentives for investor-owned utilities to undermine municipal utilities. PG&E claims that these concerns are unfounded. It argues that awarding of benefits should be evaluated on a case-by-case basis and that the modest benefit sharing that is proposed in the Application suggests a “win-win” situation for all parties involved in the transaction.⁴³

4.3.2. Parties’ Position

In both its original Protest and Response to Scoping Memo, TURN rejects PG&E’s “unprecedented” proposal to shift 50% of the estimated net benefits from ratepayers to shareholders. They argue that the GTE/Contel case is not an appropriate case to apply since it involves an incumbent telephone company GTE (now Verizon), operating under an incentive regulatory framework, which acquired a smaller incumbent telephone company, Contel of California. According to TURN, “PG&E does not cite any decision regarding an acquisition by a general rate case (GRC) regulated energy utility in which the energy utility was allowed to shift recovery of net benefits to shareholders.”⁴⁴ Under the

⁴² PG&E Reply to Responses to Scoping Memo at 3.

⁴³ PG&E Response to Scoping Memo at 7.

⁴⁴ TURN Protest to Application at 2.

incentive framework (called New Regulatory Framework or NRF), applicable to GTE in 1994, ratepayers were not subject to rate increases as a result of the transaction and were not responsible for other financial risks related to the merger. All of the costs and risks fell on shareholders. In this case, new PG&E customers, unlike customers of NRF telephone companies in the 1990s, could experience higher rates to pay for the authorized rate of return and depreciation on the assets added to the PG&E's rate base under the acquisition. "Reward should follow risk, and since PG&E ratepayers bear the risks, they should obtain any benefits from the acquisition."⁴⁵

In its Reply to Responses to Scoping Memo, TURN also criticizes PG&E's reference to the benefits sharing adopted as part of the merger approval for Enova and Pacific Enterprises. "PG&E's characterization of 'two GRC-regulated energy utilities' appears not to have looked carefully enough at the merger decision, which explained that in D.97-07-054 the Commission had adopted performance based ratemaking for the portion of SoCalGas's rates that recovers the costs of providing gas utility service that had been considered in a general rate case."⁴⁶ Therefore, TURN argues that benefit sharing was only approved in "non-cost based regulation settings," which can be distinguished from the backdrop of the PG&E acquisition here.

⁴⁵ TURN Protest to Application at 3.

⁴⁶ TURN Reply to Response to Scoping Memo at 10.

TURN provides three reasons why it does not support PG&E's "net benefits" proposal:⁴⁷

- 1) Any assessment of the allocation between PG&E and its customers of the "benefits" must include the benefit to PG&E from the authorized return on the additional rate base.

TURN points out the net benefits or 50% share would be in addition to the authorized return it expects to earn on the increased rate base resulting from the transaction. Further, PG&E does not explain why it chose a 15-year period for assessing the net benefits that should be subject to its sharing proposal. In the 2014 test year GRC, PG&E used a 10-year period to calculate net benefits associated with its proposed "customer retention activities." In the San Diego Gas & Electric Company/Southern California Gas Company merger, the Commission adopted a five-year period for calculating the utility's share of savings under Section 854. TURN complains that PG&E provides insufficient rationale for its assumptions and that cost of service ratemaking provides sufficient incentive for the utility without the additional "net benefits" inducement.⁴⁸

⁴⁷ See TURN Response to Scoping Memo at 4-11 and D.97-07-054 Order Instituting Rulemaking to Review the Time Schedules for the Rate Case Plan and Fuel Offset Proceedings, In the Matter of the Application of Southern California Gas Company to Adopt Performance Based Regulation (PBR) for Base Rates to Be Effective January 1, 1997.

⁴⁸ TURN Response to Scoping Memo at 7.

- 2) PG&E's argument for a share of net benefits as a means of recouping the costs of acquiring HMU is inconsistent with both the timeline of the transaction and the application, and the 'below the line' treatment of such acquisition costs.

PG&E's position is that without a strong incentive to overcome a direct loss in the range of several million dollars, stakeholders would not want to proceed with such a transaction. However, TURN claims that there are two problems with this. First, in the signed APA, entered into before the application was filed, there is no mention that PG&E was interested in a "net benefits" sharing outcome. Second, activities and expenses associated with mergers and acquisitions should traditionally be incurred solely by shareholders, not customers. Referring to PG&E testimony in its test year 2014 GRC, such "below-the-line," treatment should not be recovered in rates.⁴⁹ Therefore, TURN recommends that "[t]he Commission should reject such an outcome to offset or recover indirectly costs that are designated for below-the-line treatment."⁵⁰

- 3) As the Commission has recognized in the past, there may be policy reasons that support avoiding the creation of incentives for certain actions, even if those actions increase the contribution to margins.

TURN has suggested that the policy making aspects are not as "widespread" or "simple." "There are policy reasons that warrant either not encouraging or even discouraging increased sales [e.g. load growth], despite that potential ratepayer benefit."⁵¹

⁴⁹ TURN Response to Scoping Memo at 8-9.

⁵⁰ TURN Response to Scoping Memo at 8-9.

⁵¹ TURN Response to Scoping Memo at 9.

ORA also rejects the net benefits proposal and said that there is no precedence for the “net benefits” sharing mechanism. ORA agrees that the GTE/Contel merger involved phone companies that were under PBR at the time of the merger and not cost-of-service GRCs. Further, there is a difference between a merger which may be designed to maximize operational efficiencies and cut costs, but the current application involves an acquisition in which there are no immediate cost reductions.⁵² According to ORA, “PG&E requests that the Commission impute an immediate benefit of \$2.7 million and allocate this cost to its current ratepayers which they refer to as its ‘share’ of transaction benefits.” ORA maintains that PG&E is defraying the acquisition premium it agreed to pay to HMU by requesting an increase on current ratepayers. ORA also challenges the purported “net benefits” for 15 years into the future and considers these benefits “speculative” and a departure from “reasonable” ratemaking policy.⁵³

ORA states that there are sufficient incentives for the transaction without the “net benefits” proposal. As a result of newly acquired HMU facilities and any new investment in the future associated with the service territory, PG&E will generate sufficient returns on rate base for its shareholders. This reflects the traditional and acceptable method for ratemaking for GRC-regulated utilities.⁵⁴

Merced ID and Modesto ID also agree that PG&E shareholders do not need an added incentive to acquire a municipal utility. They argue that PG&E should not be compensated for the “risk” of such a transaction since there is no “unique risk” associated with the acquisition of a municipal utility totally

⁵² ORA Response to Scoping Memo at 3.

⁵³ ORA Response to Scoping Memo at 4.

⁵⁴ ORA Response to Scoping Memo at 4.

surrounded by PG&E territory.⁵⁵ “There is no need to provide further incentives to shareholders because PG&E has shown absolutely no hesitance in obstructing the creation, maintenance, and expansion of publicly-owned utilities, community choice aggregators, and any other threat to their share of the energy market.”⁵⁶

In response to the four factors supporting allocating benefits to shareholders, Merced ID and Modesto ID claim that PG&E fails to recognize that none of the four cited factors support allocating benefits to shareholders in this case or in the case of the acquisition of assets of a municipal utility generally:

First, PG&E cites no real “negative effects” of the acquisition of HMU’s assets. Instead, PG&E anticipates traditional ratemaking treatment for the acquired assets (Application, page 23), which means that PG&E’s operations in Hercules will be funded through rates at no risk to shareholders at all. Second, PG&E cites no “earnings dilution” that could result from this purchase of assets. In fact, there is no possibility that PG&E will experience any decrease in earnings per share since there is no evidence of the issuance of additional shares to finance the acquisition. Third, PG&E provides no evidence or explanation of whether or how shareholders may have weighed the potential return on investment from the Hercules asset purchase against the undefined “level of risk” of the purchase. Fourth, and finally, with respect to customer benefits from “incentive regulation and competition”, the District contends that the HMU acquisition harms competition by eliminating one of the few remaining competitors existing in PG&E’s service territory. Far from being competitively neutral, or providing benefits, the transaction harms

⁵⁵ Merced ID and Modesto ID Response to Scoping Memo at 4.

⁵⁶ Merced ID and Modesto ID Response to Scoping Memo at 4.

competition directly and to the direct benefit of PG&E's shareholders.⁵⁷

In both its Response to PG&E's Application and Response to Scoping Memo CCSF also states that "benefits sharing" proposal is not "just and reasonable" and should be rejected by the Commission. CCSF agrees with ORA and TURN that acquisition of a municipal utility should be funded "below the line." CCSF also agrees that the authorities PG&E cites in support of its proposal are "inapplicable." It also agrees that additional incentives are not necessary given PG&E's history of aggressive efforts to acquire municipal utilities without the existence of incentives. Without the "benefits sharing" proposal, PG&E will be adding customers to its customer base and facilities to its ratebase. "Simply put, PG&E will be enhancing its opportunity to make money and requires no added incentive to find and pursue its corporate interest."⁵⁸ CCSF believes that hearings are necessary to develop a record to evaluate factual assertions related to the 50/50 sharing proposal and other matters contained in the Application.⁵⁹

4.3.3. Discussion

In this decision, we agree with TURN, ORA, CCSF, Merced ID, and Modesto IDs who make compelling cases that the "benefits sharing" proposal is not fair or reasonable. The proposed relatively small acquisition is not a "cost-saving merger" where significant economies of scale or significant cost reductions can be achieved as described in D.96-04-053 (GTE/Contel merger) or D.98-03-078 (Pacific Enterprises/Enova Corporation merger). As PG&E explains

⁵⁷ Merced ID and Modesto ID Response to Scoping Memo at 7.

⁵⁸ CCSF Response to Scoping Memo at 2.

⁵⁹ CCSF Response to Scoping Memo at 1.

in its Application, the rate impact of this revenue is “de minimis” due to the small size of the HMU compared to the vast size of PG&E’s system. Further, PG&E is not subject to the same PBR that applies to the decisions it cites.

From a policy perspective, even if we were to consider the “four factors” that support allocating benefits 50/50 between shareholders and ratepayers, these factors don’t apply in this case. As Merced ID and Modesto ID point out, the application of traditional ratemaking for the acquired assets and daily operations suggests that there is minimal risk to shareholders. Acquiring a municipal utility surrounded by PG&E territory entails limited risk. Second, there is no evidence that PG&E will experience any decrease in earnings per share based on the impact of such a small transaction. Third, there is no real cost/benefit analysis which would show how shareholders weighted the potential return on investment of the acquisition versus some assumed “level of risk” of the purchase. Finally, this purchase doesn’t further the goals of “incentive regulation and competition” because one could argue that the transaction only serves to lessen competition to the benefit of shareholders rather than customers.

The Commission may have legal authority to apply frameworks outside of cost-based ratemaking; however, it has a long history of applying cost-based ratemaking and should not depart from this policy here. There is no reason why PG&E shareholders should be given a financial “bonus” up front (proposed after the execution of the original APA), when it is uncertain whether all of the projected benefits will be realized over time. PG&E ratepayers will absorb the risk of the acquisition, whether the benefits are realized or not.

Moreover, as parties have demonstrated, PG&E does not need incentives to either acquire or “take over” other municipalities on either a “friendly” or “hostile” basis. Commission history demonstrates that the Commission has been careful not to incent new “load growth” opportunities without careful consideration and review. If such “customer retention” or similar acquisition activities occur, then they should be funded “below the line,” as they have been accomplished in the past. PG&E will be adding customers and facilities to its ratebase, so both shareholders and customers will benefit from PG&E's ability to generate added returns on ratebase.

4.4. Application of CEQA

4.4.1. PG&E Position

As PG&E states in its Response to the Scoping Memo, “The acquisition and transfer of property, and funding of those activities, do not constitute a project within the meaning of the CEQA.”⁶⁰ A “project” under CEQA does not include government funding of fiscal activities “which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment.”⁶¹ In this case, PG&E does not seek approval to construct or improve the HMU “electric lines and appurtenances,” or to extend its territory. PG&E seeks approval to fund the acquisition of existing facilities so “That, in and of itself, is not a project cognizable under CEQA.”⁶²

⁶⁰ PG&E Response to Scoping memo at 8.

⁶¹ PG&E Response to Scoping memo at 8.

⁶² PG&E Response to Scoping Memo at 8.

4.4.2. Parties' Position

The City of Hercules states that the proposed acquisition and transfer of control is not a "project" within the meaning of the California Environmental Quality Act (CEQA). "As a result, CEQA does not apply to the application."⁶³ Both TURN and ORA said that they had no position on the question and CCSF and Merced ID and Modesto ID did not address this topic.

4.4.3. Discussion

In this decision, we agree with PG&E and the City of Hercules that the proposed acquisition and transfer of control, and proposed funding of those activities, do not constitute a "project" within definitions established by CEQA. Therefore, CEQA does not apply to this application. Before commencing any new infrastructure in the future, PG&E will have to comply with all applicable CEQA and other regulatory requirements.

4.5. Impact on Safety and Reliability**4.5.1. PG&E Position**

PG&E states that it has the expertise and resources to better ensure safe and reliable operations and maintenance of the current HMU system. Both current and future customers within the HMU service area will enjoy the same electrical services that other PG&E customers receive in the City of Hercules. If the City experiences load growth in following years, its existing Franklin Substation will be able to accommodate this growth. (The City of Hercules currently does not have the capability or needed financial stability to add a

⁶³ City of Hercules' Response to Scoping Memo at 7.

substation or other safety and reliability enhancements if load growth accelerates in the coming years.)

PG&E states that specific safety and service enhancements that PG&E proposes will further improve service to customers. As further detailed in the Application, these enhancements, at an estimated cost of \$3.6 million over the 2014-2016 periods, include:

- 1) Replacing SF switches with more standard oil-filled or vacuum switches;
- 2) Upgrading current HMU electric meters to PG&E SmartMeters to allow customers access to on-line electric usage and conservation information;
- 3) Installing new conductor and conduit to improve system reliability;
- 4) Extending additional distribution lines and feeders to new project developments and installing transformers, switches, and meters; and
- 5) Maintaining the serviceability of the equipment.⁶⁴

In addition to these added safety and service enhancements, PG&E points out that customers will enjoy the “safety and efficiency” from having a single city-wide electric provider. For example, if there is an emergency, first responders would only need to coordinate with one utility instead of two utilities. HMU customers would have access to PG&E online services to initiate service, report a problem, or schedule a service request.⁶⁵

⁶⁴ PG&E Response to Scoping Memo at 12.

⁶⁵ PG&E Response to Scoping Memo at 12.

4.5.2. Parties' Position

The City of Hercules states, "Hercules's financial challenges have challenged its long-term ability to maintain the HMU."⁶⁶ It further warns, "Hercules does not have, and cannot afford to hire, sufficient staff with the necessary skills and experience to ensure safe and reliable service to customers at the same level PG&E offers to its customers." They believe that PG&E will both maintain and improve upon the safety and reliability of service that HMU has provided to its customers.⁶⁷

TURN concludes that the potential acquisition and transfer of assets will likely not negatively impact the safe and reliable delivery of energy to customers presently served by HMU.⁶⁸ TURN quotes an HMU Operating Report from November 2012: "The HMU distribution system is in 'like new' condition and was designed and built utilizing current utility best practices, materials and operating criteria."⁶⁹ The same Operating Report indicates "excellent service levels" since 2004, with reliability metrics that place HMU system reliability in "top quartile performance."⁷⁰

At the same time, TURN notes that PG&E proposes to install new conductor and conduit to create a "redundant feed" that would "enhance reliability" at a cost of \$140,000. However, TURN argues that, "[u]ntil the utility presents testimony that substantiates the reasonableness of these incremental

⁶⁶ City of Hercules' Response to Scoping Memo at 8.

⁶⁷ City of Hercules' Response to Scoping Memo at 8.

⁶⁸ TURN Response to Scoping Memo at 12.

⁶⁹ TURN Response to Scoping Memo at 12.

⁷⁰ TURN Response to Scoping Memo at 13.

costs, and the purported reliability benefits, the Commission should not rely upon such an inadequately supported statement to reach any conclusion that there is a need for such a “redundant feed” or that the \$140,000 cost is a reasonable one given the increment of reliability improvement that might result from such a project.”⁷¹ Instead, TURN believes that such costs should be one of the ratemaking proposals that are considered in a second phase of this proceeding.

ORA argues that there is no evidence that the acquisition ensures safe and reliable service to customers.”⁷² However, they observe that the Application outlines a number of ways in which PG&E expects to improve the safety and reliability of service.

4.5.3. Discussion

Based on information provided in comments and recent HMU operating reports, it appears that HMU municipal facilities are able to provide ongoing safe and reliable service to its customers. The purchase transaction of PG&E application provides only the transfer of control of assets of HMU to PG&E and will not result in any change in the operation of the electric distribution facilities serving the HMU customers. Therefore, once the transaction closes, and PG&E assumes ownership and responsibility for daily operations, service will most likely continue at the same levels PG&E offers to its customers outside the HMU territory. PG&E plans to interconnect existing HMU facilities with PG&E’s existing Franklin Substation and distribution facilities.

⁷¹ TURN Response to Scoping Memo at 12.

⁷² ORA Response to Scoping Memo at 5.

PG&E proposes a number of safety enhancements as listed above, at an estimated cost of \$3.6 million over the 2014-2016 periods that will benefit customers long-term. Parties dispute the numbers and justification for these numbers and ask for the opportunity to vet these concerns via pleadings or evidentiary hearings. Therefore consideration of these proposed expenditures will be handled in an expedited Phase 2 of this proceeding which will commence immediately upon Commission approval of the Phase 1 Decision and close of the acquisition and transfer transaction. While the proposed capital expenditure dollars may be perceived to be relatively small, due process requires that parties have an opportunity to ask questions about whether proposed expenditures provide safe and reliable service at just and reasonable rates.

4.6. Rate Impacts on New PG&E Customers

4.6.1. PG&E Position

According to PG&E's Response to the Scoping Memo, "HMU will set its own rates until such time as the transaction closes and PG&E takes title to the assets."⁷³ After the transaction closes, HMU customers will be put on a new PG&E rate schedule, "just as any other new customer," so there is no need for interim rates. According to PG&E:

The transaction will initially result in a de minimis short term increase in rates of approximately 0.03% for one year. The revenue from the existing HMU customers, once transitioned to PG&E service, is expected to partially recover the necessary revenue requirement in the first year and exceed it in future years, resulting in a rate reductions starting in 2015.⁷⁴

⁷³ PG&E Response to Scoping Memo at 13.

⁷⁴ PG&E Application at 24.

However, PG&E further warns, “PG&E cannot make a decision to terminate or close the transaction until it receives the final decision in Phase 2 of this proceeding addressing the requested cost recovery.”⁷⁵

Despite this “de minimis” proposed short-term increase, PG&E maintains that it will be able to provide a lower-cost option to HMU customers who transition to PG&E service. Currently, “PG&E’s non-industrial rates are currently 17.9% lower on average than HMU’s rates, and include services beyond those provided by HMU.”⁷⁶ Therefore, completion of the transaction will further benefit current HMU customers by providing them lower rates and expanded service even if they incur a short-term increase as described above.

4.6.2. Parties’ Position

ORA points out that typically all new customers to PG&E pay the current rate in effect for that class of customers according to PG&E tariffs. Therefore, new HMU customers should enjoy the same treatment. The only exception is if the Commission decided to provide some financial benefit to PG&E due to its acquisition. For example, ORA states that if the Commission decides to impute transaction benefits, then it should allocate such costs only to former HMU customers for an interim time frame prior to transferring them to PG&E tariffs.⁷⁷

Both Hercules and TURN doubt that any potential situation would arise that would involve “interim rates.” Hercules states, “This question presents a hypothetical situation that is not likely to occur and thus there is no need for the

⁷⁵ PG&E Response to Scoping Memo at 13.

⁷⁶ PG&E Application at 15.

⁷⁷ ORA Response to Scoping Memo at 6.

Commission to address this remote contingency.”⁷⁸ Similarly, TURN points out that it is not aware of any previous example where the Commission has established interim rates for a subset of PG&E or other utility customers based on geographic location.⁷⁹

4.6.3. Discussion

In this decision, once the Commission approves the acquisition and transfer of HMU assets to PG&E, and HMU customers become PG&E customers, it is appropriate that new PG&E customers should receive service according to the appropriate PG&E tariff and rate schedules in effect. PG&E estimates an initial “de minimis” rate increase of 0.03% associated with its proposal which includes new capital and other safety and reliability expenditures between 2014 and 2016, and PG&E’s benefits sharing proposal. This decision denies PG&E’s benefits sharing proposal and only allows PG&E to recover the \$7.4 million book value of HMU assets that it will acquire. In phase 2 we will consider whether PG&E should be allowed to recover new capital and safety expenditures. We estimate that the increase in revenue requirements authorized by this decision will be on the order of 0.01%.

4.7. Procedural Venue to Address Ratemaking and Cost Recovery

4.7.1. PG&E Position

In PG&E’s reply to protests and responses, PG&E opposed TURN’s request to bifurcate the proceeding into two phases.⁸⁰ PG&E agreed with TURN

⁷⁸ City of Hercules Response to Scoping Memo at 9.

⁷⁹ TURN Response to Scoping Memo at 14.

⁸⁰ PG&E Reply to Protest and Responses at 7.

that an initial determination on the 50/50 benefits proposal could be based on pleadings and needs no evidentiary hearings.⁸¹

Following the publication of the Scoping Memo, PG&E asserts that “The Commission should address the ratemaking issue associated with the acquisition of HMU in a second, expedited phase of this proceeding not in PG&E’s next GRC.”⁸² It argues that it cannot close the transaction until a Commission decision on cost recovery is accomplished. Waiting until the next GRC to close the transaction would perpetuate financial hardship for the citizens of Hercules.⁸³

4.7.2. Parties’ Position

The remaining parties concur that the issue of cost recovery should be addressed in this proceeding rather than the GRC. However, they have different views about appropriate timing for a close of the proceeding. In an initial response to PG&E’s Application, the City of Hercules urged the Commission to grant PG&E authority to purchase HMU and to grant the authority on an expedited schedule.⁸⁴ The City agreed with PG&E that hearings would not be necessary and that there should be no material issues of contested fact. The City claimed that hearings would delay any issuance of a final proposed decision and subject the City to financial risks and uncertainties associated with the delay in the closing of the sale of HMU.⁸⁵

⁸¹ PG&E Reply to Protest and Responses at 7.

⁸² PG&E Response to Scoping Memo at 13.

⁸³ PG&E Response to Scoping Memo at 13.

⁸⁴ City of Hercules Response to Application at 1.

⁸⁵ City of Hercules Response to Application at 6-7.

Further, according to the City of Hercules, “PG&E should be expected to construe a Commission decision imposing such a loss of revenue as an ‘unacceptable’ Commission decision.” If the transaction falls through and Hercules must go back to the market to seek financial relief, the City of Hercules believes that it is doubtful that another qualified purchaser would emerge. If the transaction is delayed until summer of 2014, the City of Hercules argues this risks a “financial Armageddon” for Hercules.⁸⁶

In TURN’s Protest to PG&E’s Application, TURN requested that the Application be bifurcated into two parts: (1) approval of the acquisition and transfer of assets, which TURN does not oppose and could be resolved on an expedited basis; and (2) PG&E’s effort to shift the benefits of the transaction to shareholders. TURN also said that any initial determination could be based on pleadings and not evidentiary hearings. According to TURN, in any initial determination, “[I]f PG&E is allowed to claim any benefits for shareholders, then discovery and evidentiary hearings would be needed on the net benefits calculation, which is based on factual assumptions that need to be tested and are subject to dispute.”⁸⁷

TURN agrees that the ratemaking issues associated with the acquisition of HMU should be addressed in this proceeding, rather than the next GRC. “This is a proceeding with principles, but small dollars at stake...[O]nce the Commission makes the decision on the principle of whether PG&E ‘net benefits’ sharing proposal should be considered, the remaining ratemaking issues are likely to

⁸⁶ City of Hercules Response to Scoping Memo at 11.

⁸⁷ TURN Protest to Application at 4.

resolve quickly.”⁸⁸ ORA observes that the Commission can issue one decision to address all of the issues in the application.⁸⁹ Prior to the next GRC, it does not object to the incremental revenue requirement being collected through the DRAM as PG&E suggested in its Application. ORA opposes PG&E’s recommendation that PG&E’s recover an additional \$2.7 million in 2014 identified as “transaction benefits.”⁹⁰

4.7.3. Discussion

In this decision, we adhere to the phasing of this proceeding into two phases as detailed in the September 16, 2013, Scoping Memo. Given this Phase 1 Decision on the acquisition and transfer, purchase price, “net benefit” sharing proposal, and appropriate rates for HMU customers who will become PG&E customers, the transaction can now close. Given the precarious financial conditions that the City of Hercules is experiencing, PG&E’s timely completion of the purchase of HMU is in the immediate public interest and there is no reason to delay PG&E’s purchase. Any remaining ratemaking issues pertaining to the proposed \$3.6 million for proposed long-term safety and reliability enhancements can be resolved quickly in a follow up second phase which the ALJ will schedule accordingly.

⁸⁸ TURN Response to Scoping Memo at 14.

⁸⁹ ORA Response to Scoping Memo at 17.

⁹⁰ PG&E’s A.13-07-001, Table Four, Lines 1 and 4, at 25. *See* discussion on “Net Benefits Proposal,” in Section 4.3 of this decision.

5. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure.

Opening Comments were filed and served on January 2, 2014 by PG&E, City of Hercules, TURN, CCSF, and Merced ID and Modesto ID. Reply Comments were filed and served on January 7, 2014 by PG&E, City of Hercules, TURN/ORR, CCSF, and Merced ID and Modesto ID.

In both Opening and Reply Comments on the Proposed Decision, parties support various provisions of the decision regarding approval of the acquisition and transfer of the Hercules Municipal Utility (HMU) assets; approval of the proposed purchase price of \$9.5 million; authorization of PG&E to record and recover the revenue requirement associated with the asset book value of \$7.4 million; acknowledgement that the proposed decision does not constitute a "project" for CEQA purposes; and authorization of rates for the HMU customers who will become PG&E customers.

Further, as TURN/ORR point out in their Joint Reply Comments, "The one point on which all parties agree is the City of Hercules is in a perilous [financial] position due to its commitments associated with the Hercules Municipal Utility (HMU)." ⁹¹ In its Reply Comments, the City of Hercules echoes this concern and warns that "the sooner the Commission enables PG&E to make the commitment to complete the pending purchase of the HMU, the sooner Hercules will be able to initiate the actions necessary to retire the HMU bond

⁹¹ TURN/ORR Joint Reply Comments on Proposed Decision at 1.

debt and relieve Hercules from the risk of a 'financial Armageddon'."⁹² At the beginning of the proceeding both PG&E and the City of Hercules asked for an expedited final decision so that the City could obtain needed financial relief as soon as possible.

However, there are several areas of disagreement between PG&E and the parties including: 1) whether the "net benefits" proposal should be accepted or rejected and whether it should be finally determined in Phase 1 or Phase 2 of the proceeding; 2) what conditions trigger a final and non-appealable Phase 1 decision and appropriate timing of the close of the APA transaction; and 3) to what extent the record supports "significant strategic benefits" for PG&E's existing and future customers.

"Net Benefits" Proposal and final consideration in Phase 1 or 2 of this proceeding

As discussed in Section 4.3 of this decision and Opening and Reply Comments on the Proposed Decision, TURN, ORA, CCSF, and Merced ID and Modesto ID support denial of the proposed "net benefits" proposal. PG&E does not accept this position and rehashes failed arguments which it raised in its initial application and subsequent pleadings. In addition, PG&E's comments stray beyond the limits set forth in Rule 14.3(c) to "focus on factual, legal, or technical errors" by introducing new arguments in support of its proposal. For example, PG&E strongly objects to the characterization that the "net benefits" proposal provides a "financial bonus" to PG&E because it believes this transaction is a certain loss to shareholders and it is not recovering the full

⁹² City of Hercules Reply Comments on Proposed Decision at 6.

market price paid for acquiring the existing HMU system.⁹³ The financial incentive mechanism, such as benefit sharing, represents only a “modest incentive” and provides a “win/win” for ratepayers and shareholders.⁹⁴ PG&E also improperly provides new examples of other “win/win” arrangements in an effort to compare them to its benefit sharing proposal. Specifically, PG&E cites customer energy efficiency shareholder incentives (D.07-09-043) and core procurement incentive mechanisms (D.97-08-055) in which the Commission supported the “alignment of shareholder and ratepayer interest” by departing from a cost-of service regulatory framework and generating “meaningful” earnings for shareholders. At the same time, PG&E acknowledges that “there are differences between an energy efficiency incentive mechanism and PG&E’s cost sharing proposal in terms of the level of complexity and the symmetry that balances the risk between ratepayers and shareholders.”⁹⁵

PG&E states that it may be unwilling to pursue the transaction if the “net benefits” proposal is not approved in this Phase 1 decision. It states that “unless the PD is revised, it is doubtful that the utilities would pursue such a transaction given that shareholders would not expect to recoup the fair market value for the acquisition of assets even if the transaction creates significant benefits for customers.”⁹⁶ Instead, it believes the Commission should approve “benefit

⁹³ PG&E Opening Comments on Proposed Decision at 6.

⁹⁴ PG&E Opening Comments on Proposed Decision at 5.

⁹⁵ PG&E Opening Comments on Proposed Decision at 6.

⁹⁶ PG&E Opening Comments on Proposed Decision at 6.

sharing” and leave the dollar amount, and assumptions to Phase 2 “as originally envisioned in the Scoping Memo.”⁹⁷

The City of Hercules states that it does not necessarily oppose PG&E’s proposed “net benefits” proposal. “However, the extreme financial exigencies confronting Hercules demand that the Commission issue a decision adopting or modifying the Proposed Decision on January 16, as now scheduled.”⁹⁸

In this decision, we agree with the City and County of San Francisco and TURN/ORCA, that despite PG&E’s attempt to raise new arguments in comments to the Proposed Decision, PG&E does not identify any factual or legal errors that justify reversing the Commission denial of the “net benefits” proposal. PG&E is subject to cost of service regulation where the GRC process typically rewards ratepayers for any economies for acquisition synergies absent a separate ruling that authorizes benefit sharing. Under the cost-of-service scheme, PG&E ratepayers should bear the risk and the rewards of the acquisition. Assuming ratepayers bear the risk of losses, PG&E doesn’t explain why ratepayers should be deprived of any benefits. This transaction entails minimal risk because the small number of customers who will transition to PG&E service already reside within PG&E’s certificated territory. Further, the size of the transaction is small compared to the size of PG&E’s overall system. Reward should follow risk and these elements are not properly aligned in the proposed “net benefits” proposal.

Further, as PG&E acknowledges, the application fails the “four-factor” test as summarized in Section 4.3 of this decision. PG&E cites numerous

⁹⁷ PG&E Opening Comments on Proposed Decision at 4.

⁹⁸ City of Hercules Opening Comments on Proposed Decision at 1.

performance-based ratemaking (PBR) cases to support its position and is not persuasive. For example, the Pacific Enterprises and Enova merger involves a PBR structure and five-year financial “industry standard” term versus PG&E proposed fifteen-year term. PG&E’s attempt to use an energy efficiency case to support the net benefits proposal is misplaced and doesn’t provide an analogous situation from which to determine sound policy. As stated above, even PG&E admits the shortcomings of this approach. Further, as TURN/ORR point out, energy efficiency programs are based on “real and verified” savings and “the vast majority of economic benefits flow to ratepayers, not the 50% allocation PG&E would have the Commission adopt here.”⁹⁹

In this decision, we agree with TURN/ORR and Merced ID and Modesto ID that this Commission should not and does not condone the “hard ball” and brazen tactics in which PG&E threatens to “walk away” from the transaction and hold the City of Hercules “hostage” unless the “benefits sharing” proposal is approved in this phase of this proceeding. This position is untenable given the dire financial conditions Hercules is currently experiencing and will continue to experience if any final decision is delayed. The “net benefits” cost recovery proposal and capital upgrade proposals are not part of the original APA. In other words, each is *independent* of PG&E’s rate recovery for the purchased assets and associated intellectual property that HMU currently owns and operates. If we address the policy elements of the “net benefits” proposal in the first phase of this proceeding, then the contentiousness regarding the approval of the APA is

⁹⁹ TURN/ORR Opening Comments to Decision at 4.

eliminated, and parties should be able to quickly resolve non-urgent capital upgrade matters in Phase 2 of this proceeding.

Further, contrary to what PG&E states in its Opening Comments, the original September 6, 2013 Scoping Memo for this proceeding did not intend to delay consideration of net benefits to Phase 2. Rather, Phase 2 would have dealt with details of a net benefits proposal only if approved in Phase 1.¹⁰⁰ The purpose of Phase 1 is to adopt a basic policy determination whether PG&E's proposed 50% of "net benefits" shall be credited to shareholders is just and reasonable. Only if the "net benefits" is approved on a conceptual level, would Phase 2 address methodology to calculate and various questionable quantitative assumptions. In such a case, lengthy evidentiary hearings could be required. Phase 1 of this proceeding demonstrates that PG&E's "net benefits" proposal is not just and reasonable. Therefore, there is no basis to discuss this proposal further in Phase 2 of this proceeding.

Conditions which trigger a final and non-appealable Phase 1 decision and appropriate timing of the close of the transaction

Both PG&E and the City of Hercules, who negotiated the subject APA, disagree over conditions which trigger a "final and non-appealable" Phase 1 Decision and appropriate timing of the close of the transaction.

PG&E maintains that even if the APA is approved by the Commission, it has a right to terminate it if terms are deemed unacceptable or "otherwise

¹⁰⁰ Scoping Memo at 6.

unsatisfactory to the Buyer.”¹⁰¹ In this case, it argues that a financial review of the “net benefits” proposal should continue into a Phase 2 of the proceeding.

On the other hand, the City of Hercules emphasizes that the single Commission-related precedent to PG&E’s obligation to purchase the HMU is that “CPUC approval shall have been obtained.”¹⁰² They cite the following:

‘CPUC approval’ means the final and non-appealable order of the CPUC which approves this Agreement in its entirety, including payments to be made by the Buyer and cost recovery of the Purchased Assets at the commencement of the Purchased Assets dedication to utility service...*(italics added)*¹⁰³

The City of Hercules maintains that CPUC approval requires only that the Commission approve the cost recovery for the “purchased assets” which translates to authorizing PG&E to include the \$7.4 million book value in rate base.¹⁰⁴ The City acknowledges that PG&E could retain some flexibility to not proceed with the transaction either if the “order issued by the CPUC (i) does not constitute a CPUC approval [i.e., the Commission declines to grant PG&E rate recovery for the Purchased Assets], or (ii) is otherwise unsatisfactory to PG&E [i.e., PG&E determines that the rejection of its “net benefits” request renders any

¹⁰¹ PG&E Opening Comments on Proposed Decision at 7 citing APA Section 6.06(c)(ii)(c).

¹⁰² City of Hercules Opening Comments on Proposed Decision at 3 citing APA Section 7.02(d) at 2.

¹⁰³ City of Hercules Opening Comments on Proposed Decision at 3 citing APA, Article 1-Definitions at 3.

¹⁰⁴ City of Hercules Opening Comments on Proposed Decision at 3.

Commission order “otherwise satisfactory].”¹⁰⁵ However, the City of Hercules forewarns that if PG&E exercises the second option then it could come at a minimum cost of \$500,000 as liquidated damages.¹⁰⁶

TURN/ORAs believe that the Commission’s adoption of the decision would meet all of the regulatory condition precedents that are contained in the APA and that the sale should go forward based on the Phase 1 decision.¹⁰⁷ TURN/ORAs claim that PG&E distorts what is meant by an “as-yet unmet condition” by citing the APA’s definition of “CPUC Approval Application.”¹⁰⁸ TURN/ORAs argue that indeed this term is tied to what it filed at the Commission, but the more important and operative term is “CPUC Approval” which is “the final and non-appealable order of the CPUC which approves this agreement in its entirety.” As stated previously, TURN/ORAs remind parties that there are no provisions in the APA that address the “net benefits” proposal or post-acquisition capital expenditures.

As mentioned above, in this decision, we deny the “net benefits” proposal. Therefore, it is not on the table for consideration in Phase 2 of this proceeding. This outcome is consistent with what is outlined in the original Scoping Memo in this proceeding. To ensure there is no ambiguity, this January 2014 decision is a “final decision” in Phase 1 of this proceeding. Consistent with this direction, Ordering Paragraph 2 is added to this decision:

¹⁰⁵ City of Hercules Opening Comments on Proposed Decision at 4 citing APA 6.06(c)(ii)(C)(2).

¹⁰⁶ City of Hercules Opening Comments on Proposed Decision at 8.

¹⁰⁷ TURN/ORAs Reply Comments on Proposed Decision at 4.

¹⁰⁸ TURN/ORAs Reply Comments on Proposed Decision at 5.

This Phase 1 Decision approving the Asset Purchase Agreement is effective immediately. Pacific Gas and Electric is directed to initiate the closing process for this transaction within 30 days of the issuance of this decision.

Assuming this directive is clear, and that PG&E will go forward with closing the transaction based on a final and non-appealable Phase 1 decision, it is desirable to resolve Phase 2 issues regarding the reasonableness of the forecasted \$3.6 million of capital expenditures as quickly as possible.

Strategic benefits to existing PG&E customers and future customers

In this decision, we reference PG&E's Application (pages 13-18) which explains in more detail benefits of the transaction to existing PG&E customers, current HMU customers, and the City of Hercules. Benefits to existing PG&E customers and future customers primarily deal with increased contribution to margin (revenue net of costs) that PG&E expects from new customers and economies of scale achieved through operating efficiencies. Throughout Phase 1 of this proceeding, parties disputed PG&E's proposed allocation of benefits rather than the nature of specific benefits. Therefore the focus of the discussion in this decision is the merits of the proposed "net benefits" proposal

6. Assignment of Proceeding

Carla J. Peterman is the assigned Commissioner and Colette Kersten and Seaneen M. Wilson are the ALJs and Presiding Officers.

Findings of Fact

1. On May 28, 2013, PG&E and the City of Hercules executed an APA at a purchase price of \$9.5 million.
2. On July 1, 2013, PG&E filed an Application for the recovery of costs associated with the acquisition and transfer of HMU.

3. The key driver of the sale of HMU assets to PG&E was the City of Hercules' declining financial stability with approximately \$13.2 million in outstanding bonds and insufficient HMU revenues to cover debt service.

4. The City of Hercules has been suffering ongoing operating losses from the operation of the HMU assets and will be exposed to more serious and adverse financial conditions if it receives no relief by early 2014.

5. The APA provides benefits for the City of Hercules, HMU customers, PG&E customers, PG&E shareholders, and future customers.

6. The APA (excluding proposed cost recovery conditions that were not part of the signed acquisition agreement) was supported by all parties.

7. The APA is supported by the local community of Hercules and was accomplished in a manner consistent with state and local laws.

8. The rate impact of PG&E's proposed revenue requirement is "de minimis" due to the small size of the transaction compared to PG&E's overall electric system.

9. Timely execution of the APA allows the City of Hercules to improve its financial situation by being relieved of bond payments funded through bond proceeds, cease losses attributable to HMU operations, and maintain current level of City services.

10. Currently, PG&E's non-industrial rates are currently 17.9% lower on average than HMU's rates, and include services beyond those provided by HMU.

11. Following the close of the transaction, PG&E customers in the City of Hercules area will enjoy the same level of service as before.

12. The APA pertains to a small volume of 800 residential and commercial customers with 825 meters.

13. PG&E already serves a large volume of 8,000 residential customers and 460 commercial customers located inside the City of Hercules but outside the HMU service area.

14. The increase in number of customers and acquisition of HMU facilities will enable shareholders to earn returns on ratebase.

15. The APA price of \$9.5 million is the result of a competitive bidding process.

16. PG&E made no showing of breakdown of what constitutes an “acquisition premium” of the \$2.1 million above the book value of \$7.4 million.

17. According to PG&E, the acquisition of HMU is forecasted to produce “net benefits” over the first 15 years with a net present value of approximately \$5.3 million.

18. The GTE/Contel and Pacific Enterprises/Enova Corporation mergers, which enjoyed 50/50 sharing of “net benefits” between shareholders and ratepayers, apply to PBR rather than cost-based traditional ratemaking frameworks.

19. PG&E’s “net benefits” proposal and related assumptions (e.g., 15-year versus five-year period to determine allocable savings, load growth assumptions) are contested by most parties.

20. PG&E’s “net benefits” proposal does not satisfy the PBR “four factor” test that supports allocating benefits to shareholders.

21. The acquisition and purchase of HMU assets does not provide significant economies of scale or cost reductions that would typically be enjoyed by mergers and acquisitions since this transaction is so small.

22. In the past, the Commission has not provided PG&E “above the line” incentives, such as “net benefits” sharing of benefits, to acquire municipal utilities.

23. The acquisition and transfer of HMU assets, including funding of those activities, does not constitute a project within the meaning of CEQA.

24. PG&E does not seek approval to construct or improve the HMU electric lines and appurtenances or to extend its territory.

25. As a result of the transaction, HMU customers who transition to PG&E service will enjoy comparable electrical service that other PG&E customers receive in the City.

26. As a result of the transaction, HMU customers who transition to PG&E service will enjoy lower rates and enhanced service.

27. The City of Hercules does not have the capacity or financial stability to add a substation or necessary infrastructure to support accelerated load growth in the future.

28. If the City of Hercules experiences load growth in the coming years, PG&E’s existing Franklin Substation will be able to accommodate this growth.

29. Following a Phase 1 Decision in this proceeding, a Phase 2 of this proceeding will review \$3.6 million in proposed safety and service enhancements over a period of 2014-2016.

30. In the short-term, existing HMU facilities are able to provide safe and reliable services to its customers.

31. In the long-term, there are advantages for first responders being able to coordinate emergency response with one utility rather than two utilities.

32. Once the transaction closes, PG&E plans to interconnect existing HMU facilities with PG&E's Franklin Substation and existing facilities without service disruption.

33. Waiting for the next GRC to close the transaction would perpetuate financial hardship for the City of Hercules.

Conclusions of Law

1. Since the proposed acquisition and transfer agreement itself did not involve any material disputed issues of fact, evidentiary hearings were not necessary during the first phase of this proceeding.

2. The acquisition and transfer of HMU assets to PG&E should be resolved quickly so that the City of Hercules can be relieved of some short- and long-term financial distress.

3. Under Section 451, the Commission has broad authority to ensure that rates are just and reasonable.

4. It is reasonable for the Commission to approve the APA dated May 13, 2013 because it is in the public interest of the City of Hercules, HMU customers, PG&E customers, PG&E shareholders, and future customers.

5. It is reasonable that PG&E be authorized to purchase HMU assets at a purchase price of \$9.5 million.

6. It is reasonable that PG&E be authorized to recover the book value of the HMU assets at \$7.4 million.

7. It is not reasonable to support the 50/50 sharing of benefits between shareholders and ratepayers or "net benefits" proposal, because it harms ratepayer interests.

8. In traditional cost of service ratemaking, if ratepayers incur the risk of a transaction, then they should also enjoy the reward of such a transaction on an equitable basis.

9. The proposed “net benefits” proposal is not reasonable because it fails the PBR “four factor” test that supports allocating benefits to shareholders.

10. PG&E shareholders are not likely to need any added incentives to acquire a municipal utility.

11. Once the transaction closes, it is reasonable that HMU customers who become new PG&E customers should receive service according to the appropriate PG&E tariffs and rate schedules in effect.

12. Consistent with the Scoping Memo for this proceeding, dated September 6, 2013, and following the approval of a Phase 1 Decision, it is reasonable to expedite the second phase of this proceeding to ensure that any remaining cost recovery issues are addressed in a timely fashion.

13. With a timely close of this transaction, the City should be able to pay off bond obligations and thus be relieved of future bond payments, eliminate ongoing losses to HMU operations, and maintain current acceptable levels of service.

14. The revenue requirement for this acquisition should be collected through DRAM and incorporated in rates as part of the AET advice filing, or as soon as practicable following a Commission decision in this proceeding.

15. The acquisition and transfer of assets from HMU to PG&E and related funding activities should have no adverse impact on the environment.

O R D E R

IT IS ORDERED that:

1. The Asset Purchase Agreement dated May, 13, 2013 between Pacific Gas and Electric Company (PG&E) and the City of Hercules is approved subject to the following cost recovery conditions:

- a) PG&E shall book the \$7.4 million book value of assets to its rate base;
- b) PG&E's proposed "net benefits" proposal is denied; and
- c) Once the transaction closes, Hercules Municipal Utility customers who become new PG&E customers shall receive service according to the appropriate PG&E tariffs and rate schedules in effect.

2. This Phase 1 Decision approving the Asset Purchase Agreement is effective immediately. Pacific Gas and Electric is directed to initiate the closing process for this transaction within 30 days of the issuance of this decision.

3. Pacific Gas and Electric Company shall collect the revenue requirement that reflects the book value of \$7.4 million for Hercules Municipal Utility assets beginning on the effective date of transaction close. The revenue requirement will be collected through the Distribution Revenue Adjustment Mechanism and incorporated in rates as part of the Annual Electric True-Up advice filing, or as soon as practicable following a California Public Utilities Commission decision in this proceeding.

4. Application 13-07-001 remains open to address Phase 2 issues as detailed in the Scoping Memo.

This order is effective today.

Dated _____, at San Francisco, California.