

Decision **PROPOSED ALTERNATE DECISION #1 OF COMMISSIONER PEEVEY**

(Mailed 11/18/03)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation into the ratemaking implications for Pacific Gas and Electric Company (PG&E) pursuant to the Commission's Alternative Plan of Reorganization under Chapter 11 of the Bankruptcy Code for PG&E, in the United States Bankruptcy Court, Northern District of California, San Francisco Division, In re Pacific Gas and Electric Company, Case No. 01-30923 DM.

(U 39 M)

Investigation 02-04-026
(Filed April 22, 2002)

(See Appendix B for Appearances.)

**OPINION APPROVING THE PROPOSED SETTLEMENT
AGREEMENT OF PACIFIC GAS & ELECTRIC COMPANY,
PG&E CORPORATION AND THE COMMISSION STAFF**

TABLE OF CONTENTS

Title	Page
I. Introduction and Background.....	2
II. Procedural History.....	8
III. Description of the PSA Terms and Conditions.....	9
A. Structure of the Settlement Plan of Reorganization.....	9
B. Financial Elements of the PSA	9
1. Regulatory Asset	9
2. Headroom.....	11
3. Ratemaking Matters.....	11
4. Dividends and Stock Repurchases	12
C. Dismissal of Energy Crisis-Related Disputes.....	12
D. Environmental Provisions	13
E. Conditions Precedent to Effectiveness of Settlement Plan.....	14
F. Other Provisions.....	14
1. Assignability of DWR contracts	14
2. Interest Rate Hedging.....	15
3. Financing	15
4. Fees and Expenses.....	16
5. Releases.....	16
6. Bankruptcy Court Supervision	16
IV. Standard of Review.....	16
V. Lawfulness of the PSA.....	20
A. The Purpose of the Commission v. The Purpose of the Bankruptcy Court	20
B. The Commission’s Ability to Bind Future Commissions.....	22
C. Jurisdiction of the Bankruptcy Court.....	35
D. Consistency with Assembly Bill 1890 and § 368(a)	37
VI. Whether the Proposed Settlement Agreement Is in the Public Interest.....	39
A. Adequacy of a Settlement Proposal in Achieving Feasible Plan of Reorganization	39
1. The PSA Will Allow PG&E to Emerge Promptly From Bankruptcy... 40	40
2. The Rating Agencies (S&P and Moody’s)	41
B. Fairness and Reasonableness	45
1. Relationship of Settlement to Parties’ Risks of Achieving Desired Results 45	45
2. The Risk, Expense, Complexity, and Likely Duration of Further Bankruptcy Litigation	46
3. Reasonableness of Settlement of Other Claims and Litigation	47
4. Reasonableness of Rates.....	50
5. Adequacy of Representation In the Settlement Process.....	51
6. Release of PG&E Corporation	52

- C. Public Interest 53
 - 1. The Regulatory Asset..... 53
 - 2. Headroom..... 54
 - 3. Dividends 55
 - 4. Credit Rating..... 56
 - 5. Assignability of DWR Contracts 58
 - 6. Environmental Matters..... 59
 - The Land Conservation Commitment (LLC) 59
 - (a) The Stewardship Council..... 60
 - (b) Environmental Opportunity For Urban Youth 63
 - (c) Clean Energy Technology Commitment..... 63
- VII. The TURN Dedicated Rate Component Proposal..... 64
- VIII. Rulings of the Administrative Law Judge (ALJ) 68
- IX. Comments on the Alternate Proposed Decision 68
- X. Assignment of Proceeding..... 69

Appendix A
Appendix B

Summary

This decision approves the Proposed Settlement Agreement (PSA) offered by Pacific Gas & Electric Company (PG&E), PG&E Corporation, and the Commission staff. We find that the settlement agreement, is fair, just and reasonable and in the public interest. Therefore, we can enter into the Proposed Settlement Agreement (PSA).

I. Introduction and Background

The Proposed Settlement Agreement (PSA) between PG&E, PG&E Corp. (hereafter generally referred to as PG&E) and our staff offers the promise of allowing PG&E to emerge quickly from bankruptcy protection in a proceeding now pending in the United States Bankruptcy Court for the Northern District of California as a financially strong utility subject to the directives in California laws and the continuing jurisdiction of this Commission. The timely resolution of PG&E's financial difficulties and the PSA come before this Commission pursuant to a background of unprecedented developments, and our careful consideration of their related consequences is of utmost importance to the ratepayers of PG&E and the citizens of California.

To delve yet again into the facts and forces that led to the dysfunctional electricity market in California during the period from mid-2000 to early 2001 serves no purpose here. A succinct and readable summary of the market behaviors, and responsive actions taken by the California Legislature, as well as State and federal regulators, is contained in the recent opinion of the California Supreme Court in *Southern California Edison Co. v. Peevey* (2003) 31 Cal. 4th 781. We provide a condensed version of this summary in the background section herein. As noted in that opinion, this Commission deemed the energy crisis one

that involved not only utility solvency but the very reliability of the State's electrical system.

PG&E responded to the financial difficulty it was facing by filing for Chapter 11 bankruptcy protection on April 6, 2001. Numerous creditors and other parties, including the Commission, appeared (in the Commission's case, subject to its sovereign immunity rights and defenses under the 11th Amendment of the U.S. Constitution and related principles). PG&E asserted that as a result of the energy crisis beginning in May 2000 and because its retail electric rates were frozen, it was unable to recover approximately \$9 billion of electricity procurement costs from its customers, resulting in billions of dollars of defaulted debt and the downgrading of its credit ratings by all of the major credit rating agencies. PG&E's decision to seek Bankruptcy Court protection came in the wake of its earlier decision to sue this Commission in federal district court to recover these costs under a "filed rate doctrine" theory *See* PG&E v. Lynch, No. C-01-3023-VRW, N.D. Cal. (the "Rate Recovery Litigation"). The Commission vigorously defended this action, and a similar lawsuit filed by Southern California Edison Co. (SCE), on behalf of the customers of the two utilities. The costs and complexities of this litigation were tremendous. The outcome was far from certain.

On September 20, 2001, PG&E and PG&E Corporation, as co-proponents, filed a plan of reorganization (PG&E Plan) in PG&E's bankruptcy case. The PG&E Plan provided for the disaggregation of PG&E's businesses into four companies, three of which would have been regulated by the Federal Energy Regulatory Commission (FERC). The Commission and others opposed the PG&E Plan. The PG&E Plan was amended and modified a number of times.

It was an exceedingly bold proposal that went far beyond the traditional and usual purpose of resolving creditor claims and returning the utility to financial viability. As noted in the Commission staff's opening brief, PG&E's proposed plan of reorganization was expansive in the extreme, and threatened its ratepayers in three ways. First, it would have disaggregated the utility and would have divested this Commission of authority over significant aspects of PG&E's operations. Secondly, it had potentially disastrous environmental consequences. Finally, it locked in, for twelve years, power purchase costs that would have resulted in high retail rates, and then would have left PG&E's power purchase costs to the markets that were largely responsible for PG&E's financial predicament in the first place.

The Commission's formal response to PG&E's proposal in the Bankruptcy Court was strong and swift. As Commissioner Lynch noted in her declaration supporting our opposition:

“In its proposed plan, PG&E demands sweeping declaratory and injunctive relief against the Commission. The Commission believes PG&E's purpose is to carry out a frontal assault upon the State of California as a government and regulator, as PG&E seeks to preempt no fewer than 15 core statutes and laws essential to the health and safety of California's citizens.” This strategy was referred to as “the regulatory jailbreak”.

Specifically, the utility proposal would have removed PG&E's hydroelectric generation facilities, natural gas transmission assets and nuclear facilities from state regulatory control. That proposal raised the potential that the Commission would be unable to ensure the provision of basic service in case of an energy supply or capacity crisis; the potential that the pricing of service for captive customers would undermine the availability of affordable service for California citizens and necessitate the widespread use of alternative fuels,

thereby creating adverse impacts on the environment; and adverse effects to the safety and welfare of California residents through the loss of local regulation.

In response, on April 15, 2002, the Commission authorized the filing of its original plan of reorganization for PG&E (Original CPUC Plan). It was crafted to permit PG&E to emerge from bankruptcy by repaying creditor claims in full while avoiding the negative consequences of the PG&E plan. Among other things, the Original CPUC Plan would have raised funds to pay PG&E's creditors through "headroom" revenues¹ and the issuance of new debt and equity securities, while at the same time maintaining PG&E as a vertically integrated utility subject to regulation by the Commission. Subsequently, the Commission and the Official Creditors Committee (OCC) filed an amended plan of reorganization for PG&E, dated August 30, 2002 (as amended, Joint Amended Plan) (supplemented by a "Reorganization Agreement" to be entered into by the Commission and PG&E). The Joint Amended Plan was not well received by PG&E, and thus the battle to restore PG&E to financial viability was launched on a second major front, with legions of lawyers and financial experts poised to do battle before the Bankruptcy Court to prove the relative merits and flaws of the two competing plans. Lengthy and contentious trials proceeded on the plans.

Bankruptcy Court confirmation hearings on the competing plans of reorganization started on November 18, 2002. On November 21, 2002, during the trial on the Joint Amended Plan, PG&E made a motion for judgment against the Joint Amended Plan, on the grounds, *inter alia*, that the Reorganization Agreement proposed by the Commission would violate California law because it would bind future Commissions in a manner allegedly contrary to the Public

¹ "Headroom" is defined below.

Utilities Code and decisions and regulations of the Commission. On November 25, 2002, the Bankruptcy Court denied PG&E's motion, finding that the Commission did have the authority to enter into the Reorganization Agreement and to be bound by it under California and federal law. (Ex. 122, CPUC Staff/Clanon, Exhibit C.)

It was against this backdrop that the Bankruptcy Court ordered the initiation of a judicially supervised settlement conference between PG&E and the Commission staff in March of this year. On March 11, 2003, the Bankruptcy Court entered an order staying further confirmation and related proceedings to facilitate a mandatory settlement process. Pursuant to orders by the bankruptcy judge, parties to the settlement discussions are prohibited from disclosing information regarding or relating to the settlement discussions.

That effort produced the Proposed Settlement Agreement that is now before us for evaluation. On June 19, 2003, as a result of the settlement process, PG&E and the Commission staff announced agreement on a Proposed Settlement Agreement which would form the basis of a new plan of reorganization to be filed by PG&E in the Bankruptcy Court that embodies the terms and conditions contained in the PSA (the Settlement Plan).² PG&E, PG&E Corporation, and the OCC as co-proponents filed the Settlement Plan and disclosure statement for the plan with the Bankruptcy Court. The PSA constitutes an integral part of the Settlement Plan and is incorporated in the plan by reference. The Bankruptcy Court has stayed all proceedings related to the Commission's Joint Amended Plan and the PG&E Plan, until a confirmation hearing on the Settlement Plan. The procedural history below details the interaction between the Bankruptcy

² The PSA and the Settlement Plan are two different documents. The PSA is provided in Appendix A.

Court and this Commission in considering the completeness and balancing of competing interests embraced by the PSA.

In reaching our decision, we are informed by a complete record developed by the efforts of a number of parties during eight days of hearing in this proceeding. These parties directed their showings to the overall issue to whether the PSA is fair, just and reasonable, and in the public interest. In assessing our presentations, we pay particular attention to the following goals that have been at the heart of our opposition to PG&E's plan of reorganization:

1. Does the PSA result in PG&E abandoning its effort to evade adherence to state laws and our jurisdiction?
2. Does the PSA resolve energy crisis-related litigation between PG&E and the CPUC?
3. Does the PSA result in lower rates for PG&E's ratepayers?
4. Does the PSA result in PG&E's creditors being paid in full?

We do not undertake our consideration of the PSA against a blank slate. In conducting their settlement negotiations, our staff and PG&E were clearly aware of the settlement we entered into with SCE to restore that utility's financial viability and end its litigation against the Commission, as well as our proposed plan of reorganization for PG&E.

II. Procedural History³

On July 1, 2003, PG&E filed and served the PSA, the Settlement Plan, and a disclosure statement in this proceeding. On July 9, 2003, a prehearing conference (PHC) was held to determine the scope of proceedings for the Commission to consider the PSA. After the PHC, the Assigned Commissioner issued his “Scoping Memo and Ruling of Assigned Commissioner” (Scoping Memo) establishing the scope and schedule for this proceeding. The Scoping Memo, as amended, provided that the proceeding was limited to determining whether the PSA should be approved by the Commission, including whether the settlement is fair, reasonable, and in the public interest, using the criteria encompassed in various Commission, state, and federal court decisions.⁴ Excluded from the proceeding were alternative plans, rate allocation and rate design, and direct access issues. Proposed modifications to the PSA were permitted to be offered, but were required to be limited. Hearings were held on September 10, 11, 12, 22, 23, 24, 25, and 26. On September 25, 2003, PG&E, the Office of Ratepayer Advocates (ORA), and certain other parties and non-parties submitted a stipulation resolving issues regarding the land conservation commitment in the PSA. Concurrent opening briefs were filed on October 10, 2003, and reply briefs on October 20, 2003, when the matter was submitted.

³ This material is taken from the record in this proceeding as well as the record in PG&E’s bankruptcy proceeding, documents, and pleadings of which the Commission may take official notice. The record in PG&E’s Chapter 11 proceeding is available on the website of the U.S. Bankruptcy Court, Northern District of California, <http://www.canb.uscourts.gov>. In addition, documents relating to the Commission’s various plans and filings in the bankruptcy proceeding can be found in the record of this proceeding as well as on the CPUC website at <http://www.cpuc.ca.gov/static/industry/electric/pge+bankruptcy>.

⁴ *San Diego Gas & Electric Co.*, Decision (D.) 92-12-019, 46 CPUC 2d 538 (1992); *Dunk v. Ford Motor Co.* (1996) 48 CA4th 1794, 56 Cal. Rptr. 483; *Officers for Justice v. Civil Service Commission*, (9th Cir. 1982) 688 F.2d 615; *Diablo Canyon*, D. 88-12-083, (1988) 30 CPUC 2d 189; *Amchem Products v. Windsor*, (1997) 521 U.S. 591.

III. Description of the PSA Terms and Conditions

A. Structure of the Settlement Plan of Reorganization

PG&E's original plan of reorganization in the Bankruptcy Court provided for the disaggregation of PG&E's historic businesses into four separate companies, three of which would be under the regulatory jurisdiction of FERC rather than this Commission. Under the Settlement Plan, PG&E will remain a vertically integrated utility subject to the plenary regulatory jurisdiction of this Commission.⁵

B. Financial Elements of the PSA

PG&E asserts that restoration, maintenance, and strengthening of PG&E as an investment grade company is vital for the company's future ability to serve its customers. The PSA expressly recognizes this:

The Commission recognizes that the establishment, maintenance and improvement of investment grade company credit ratings is vital for PG&E to be able to continue to provide safe and reliable service to its customers. The Commission further recognizes that the establishment, maintenance and improvement of PG&E's investment grade company credit ratings directly benefits PG&E's ratepayers by reducing PG&E's immediate and future borrowing costs, which, in turn, will allow PG&E to finance its operations and make capital expenditures on its distribution, transmission, and generation assets at lower cost to its ratepayers. In furtherance of these objectives, the Commission agrees to act to facilitate and maintain investment grade company credit ratings for PG&E. (PSA, ¶ 2g.)

1. Regulatory Asset

The PSA establishes a regulatory asset with a starting value of \$2.21 billion as a new, separate, and additional part of PG&E's rate base (PSA, ¶ 2). The

⁵ Rates, terms, and conditions of interstate electric transmission service will remain subject to FERC regulation pursuant to the Federal Power Act (FPA), as they have been since 1998.

regulatory asset will be reduced dollar for dollar by the net after-tax amounts of any reductions in bankruptcy claims or refunds PG&E actually receives from generators or other energy suppliers (PSA ¶ 2d). The regulatory asset will be amortized on a mortgage-style basis over nine years starting on January 1, 2004 (PSA, ¶ 2a). The mortgage-style amortization keeps the revenue requirements associated with the regulatory asset relatively constant over its life rather than being front-end loaded as they would under traditional rate base treatment. Because the regulatory asset will not have any tax basis, both the amortization of the regulatory asset and the return on it will be grossed up for taxes (PSA, ¶ 2c).⁶ The PSA provides a floor on the authorized return on equity (ROE) and the equity component of the capital structure associated with the regulatory asset (PSA, ¶ 2b). While the regulatory asset will earn the ROE on the equity component of PG&E's capital structure as set in PG&E's annual cost of capital proceedings, the ROE will be no less than 11.22 percent and, once the equity component of PG&E's capital structure reaches 52 percent (expected in 2005), the equity component will be set for ratemaking purposes at not less than 52 percent.

The PSA provides that the Utility Retained Generation (URG) rate base established by D.02-04-016 shall be deemed just and reasonable and not subject to modification, adjustment or reduction (other than through normal depreciation) (PSA, ¶ 2f). Similarly, the value of the regulatory asset and URG rate base are not to be impaired by the Commission taking them into account

⁶ In order to protect PG&E against the possibility that the State and/or federal taxing authorities successfully assert that the regulatory asset should be taxed in full in the year in which it is established rather than as it is amortized, the proposed settlement authorizes PG&E to create a Tax Tracking Account to record such a tax payment and to collect it from the ratepayers over time rather than all at once.

when setting PG&E's other revenue requirements and resulting rates or PG&E's authorized ROE or capital structure.

2. Headroom⁷

The proposed settlement acknowledges that the headroom, surcharge, and base revenues accrued or collected by PG&E through the end of 2003 have been or will be used for utility purposes, including paying creditors in PG&E's Chapter 11 case (PSA, ¶ 8a). Those past revenues will no longer be subject to refund. The PSA establishes both a floor and a ceiling on 2003 headroom revenues. PG&E will be authorized to collect at least \$775 million, but not more than \$875 million (both pretax), of headroom (PSA, ¶ 8b). The Commission will adjust 2004 rates to refund any overcollection or make up any undercollection.

3. Ratemaking Matters

The proposed settlement provides for PG&E's retail electric rates to remain at current levels through 2003, and then come down effective as of January 1, 2004 (PSA, ¶ 3a). As of January 1, 2004, the TCBA and other Assembly Bill 1890 ratemaking accounts will be replaced by the regulatory asset and the ratemaking resulting from the proposed settlement (PSA, ¶ 2e).

PG&E's capital structure and authorized ROE will continue to be set in annual cost of capital proceedings, but until PG&E achieves a company credit rating of either A- from Standard & Poor (S&P) or A3 from Moody's, the authorized ROE will be no less than 11.22 percent and the equity ratio will be no less than 52 percent (PSA, ¶ 3b). (PG&E claims that this capital structure, with its

⁷ The PSA defines headroom as follows: "PG&E's total net after-tax income reported under Generally Accepted Accounting Principles, less earnings from operations, plus after-tax amounts accrued for bankruptcy-related administration and bankruptcy-related interest costs, all multiplied by 1.67, provided that the calculation will reflect the outcome of PG&E's 2003 general rate case (A.02-09-005 and A.02-11-067)."

52 percent equity ratio, is necessary to support the investment grade credit metrics contemplated by the proposed settlement. (Ex. 112, pp. 7-6, 7-16, PG&E/Murphy.)

PG&E is given a two-year transition period to achieve the 52 percent equity ratio. Until that time, PG&E's equity ratio for ratemaking purposes will be its Forecast Average Equity Ratio (as defined in the PSA, but no less than 48.6 percent (PSA, ¶ 3b).

4. Dividends and Stock Repurchases

Under the PSA, PG&E agrees not to pay any dividend on common stock before July 1, 2004 (PSA, ¶ 3b). PG&E has told the financial community that it does not expect to pay a common stock dividend before the second half of 2005. Under the PSA, other than the capital structure and stand-alone dividend conditions contained in the PG&E holding company decisions (D.96-11-017 and D.99-04-068), the Commission agrees not to restrict the ability of the boards of directors of either PG&E or PG&E Corporation to declare and pay dividends or repurchase common stock (PSA, ¶ 6).

C. Dismissal of Energy Crisis-Related Disputes

As part of the PSA, PG&E will dismiss its pending Rate Recovery Litigation⁸ against the Commission (PSA, ¶ 9). In that litigation, PG&E had sought recovery from ratepayers of approximately \$9 billion in unrecovered costs of purchasing power during the energy crisis. (Exs. 120 and 120c, PG&E/McManus.) The Commission will resolve Phase 2 of PG&E's pending Annual Transition Cost Proceeding (ATCP) application without any disallowance (PSA, ¶ 9). In the ATCP, ORA contends that PG&E incurred

⁸ *PG&E v. Lynch, et al.*, U.S. District Court, Northern District of California, Case No. C-01-3023-VRW.

approximately \$434 million of unreasonable power procurement costs and recommends disallowance of that amount.

D. Environmental Provisions

The PSA contains environmental benefits. First, PG&E commits to protect its approximately 140,000 acres of watershed lands associated with its hydroelectric system, plus the 655 acre Carizzo Plains in San Luis Obispo County, through conservation easements or fee simple donations (PSA, ¶ 17a). PG&E estimates that lands subject to this commitment are worth approximately \$300 million.⁹ The determination of how best to protect these lands will be made by the board of a new California non-profit corporation (PSA, ¶ 17b). Under the Land Conservation Commitment Stipulation (Ex. 181), this non-profit corporation will be named the Pacific Forest and Watershed Lands Stewardship Council (the Stewardship Council). The Stewardship Council's governing board will consist of representatives from the Commission, the California Resources Agency, ORA, the State Water Resources Control Board, the California Farm Bureau Federation, the California Department of Fish and Game, the California Forestry Association, the California Hydropower Reform Coalition, the Regional Council of Rural Counties, the Central Valley Regional Water Quality Board, Association of California Water Agencies, The Trust for Public Land, and PG&E, and three public members named by the Commission. The U.S. Department of Agriculture-Forest Service and U.S. Department of Interior-Bureau of Land Management will together designate a federal liaison who will participate in an advisory and non-voting capacity. (Ex. 181, paragraph 10a.) The Stewardship

⁹ This estimate is not based on an appraisal or other formal valuation but on PG&E's understanding that Sierra lands are worth \$2,000 per acre or more on average. Also, a March 9, 2001, *Los Angeles Times* article estimated that the watershed lands alone are worth \$370 million. (Ex. 101 at 1-14/Smith.)

Council will be funded with \$70 million through rates over 10 years (PSA, ¶ 17c). This funding will cover both administrative expenses and environmental enhancements to the protected lands. The governing board of the Stewardship Council will develop a system-wide plan for donation of fee title or conservation easements.

The second environmental commitment is that PG&E will establish and fund a clean energy technology incubator. This new, California non-profit corporation will be dedicated to supporting research and investment in clean energy technologies primarily in PG&E's service territory (PSA, ¶ 18a). PG&E will provide shareholder funding of \$15 million over five years (PSA, ¶ 18b) and will work with the Commission to attract additional funding (PSA, ¶ 18c).

E. Conditions Precedent to Effectiveness of Settlement Plan

Commission approval of the PSA as well as final, nonappealable approval of all rates, tariffs, and agreements necessary to implement the Settlement Plan and PSA are conditions to the effectiveness of the PSA (PSA, ¶ 37) and the Settlement Plan (PSA, ¶ 16b), respectively.

The PSA expressly provides that receipt of investment grade company credit ratings from both S&P and Moody's is a condition to the Settlement Plan becoming effective (PSA, ¶ 16a). The plan provides that this condition cannot be waived. (Ex. 101, pp.1-15, PG&E/Smith.)

F. Other Provisions

1. Assignability of DWR contracts

The settlement agreement provides that "[I]f the Commission desires it, PG&E agrees to accept assignment of or to assume legal and financial responsibility for the DWR Contracts" subject to certain conditions, including that "(a) PG&E's Company Credit Rating, after giving effect to such assignment

or assumption, shall be no less than “A” from S&P and “A2” from Moody’s; (b) the Commission shall first have made a finding that, for purposes of assignment or assumption, the DWR Contracts to be assigned or assumed are just and reasonable; and (c) the Commission shall have acted to ensure that PG&E will receive full and timely recovery in its Retail Electric Rates of all costs of such DWR Contracts over their life without further review. (PSA ¶ 7) The PSA has no limitation on the discretion of the Commission to review the prudence of PG&E’s administration and dispatch of the DWR Contracts, consistent with applicable law.

2. Interest Rate Hedging

To allow PG&E to take advantage of the current low interest rate environment, the proposed settlement authorizes the actual reasonable cost of PG&E’s interest rate hedging activities to be recovered in rates without further review (PSA, ¶ 12). The Commission recently issued D.03-09-020 in its Bankruptcy Financing Order Instituting Investigation (Investigation 02-07-015) authorizing PG&E to initiate interest rate hedging for any approved and confirmed plan of reorganization.

3. Financing

With the exception of certain pollution control bond-related obligations and outstanding preferred stock, the Settlement Plan contemplates that all of PG&E’s existing trade and financial debt will be paid in cash (PSA, ¶¶ 13a and 14). The financing will not include any new preferred or common stock (PSA, ¶ 13b). The cash to pay creditors will come from a combination of cash on hand and new long- and short-term debt issuances.

4. Fees and Expenses

PG&E will reimburse the Commission for its professional fees and expenses in the Chapter 11 case. (PSA, ¶ 15). The Commission will authorize PG&E to recover these amounts in rates over a reasonable time, not to exceed four years (*id.*). Similarly, PG&E will reimburse PG&E Corporation for its professional fees and expenses in the Chapter 11 case, but that cost will be borne solely by shareholders through a reduction in retained earnings (*id.*).

5. Releases

As part of the Settlement Plan, PG&E will release claims against the Commission, the OCC, and PG&E Corporation (PSA, ¶ 24).

6. Bankruptcy Court Supervision

The PSA ensures that the settlement will be enforceable by the Bankruptcy Court for its full nine-year term (PSA, ¶¶ 20-23, 30, and 32).

In paragraph 20 of the PSA, the Commission waives “all existing and future rights of sovereign immunity, and all other similar immunities, as a defense” and consents to the jurisdiction of any court, including a federal court, for any action or proceeding to enforce the Settlement Agreement, the Settlement Plan, or the Bankruptcy Court’s confirmation order.

In paragraph 22 of the PSA, the Commission and PG&E agree that the Bankruptcy Court shall retain jurisdiction over them “for all purposes relating to the enforcement of this Agreement, the Settlement Plan and the Confirmation Order.”

IV. Standard of Review

In evaluating whether the PSA is reasonable and in the public interest, we are guided not only by our precedents on settlements, but also by the overall “just and reasonable” standard of the Public Utilities Code. Under Rule 51 of the

Commission's Rules of Practice and Procedure, we will not approve a settlement unless the settlement is "reasonable in light of the whole record, consistent with law, and in the public interest." (Commission Rule 51.1(e).) In our decision approving a settlement of SDG&E's 1992 test year general rate case, we held that in considering a proposed settlement, we do not "delve deeply into the details of settlements and attempt to second-guess and re-evaluate each aspect of the settlement, so long as the settlements as a whole are reasonable and in the public interest." (*SDG&E*, (1992) 46 CPUC 2d 538, 551.) We agreed that the hearing on the settlement need not be a "rehearsal for trial on the merits." (*Id.* at 551.) Similarly, in *Officers for Justice v. Civil Service Commission*, the Court, affirming a lower court decision approving a class action settlement, stated that "the settlement or fairness hearing is not to be turned into a trial or rehearsal for trial on the merits." (*Officers for Justice v. Civil Service Commission*, (9th Cir. 1982) 688 F.2d 615, 625.)

As the PSA must be approved by this Commission, we look to our own precedents. In *Re Pacific Gas and Electric Company* (1988) D.88-12-083, 30 CPUC 2d 189 ("*Diablo Canyon*"), we approved a settlement proposed by PG&E and Commission staff (ORA's predecessor, the Division of Ratepayer Advocates (DRA)) that was vigorously opposed by other parties. The settlement resolved claims by DRA that \$4.4 billion in previous costs incurred by PG&E to design and construct Diablo Canyon should be disallowed from recovery in PG&E's future electric rates. In settling the case, PG&E, DRA, and the California Attorney General proposed that PG&E's investment costs and return on rate base for Diablo Canyon be recovered in future rates exclusively under a non-traditional performance-based ratemaking mechanism that would be in place for 28 years.

In evaluating the Diablo Canyon settlement, the Commission cited the *Officers for Justice* decision approvingly, as well as the Commission rules on settlements:

[T]he settlement affects the interest of all PG&E customers. In such a case, the factors which the courts use in approving class action settlements provide the appropriate criteria for evaluating the fairness of this settlement... When a class action settlement is submitted for approval, the role of the court is to hold a hearing on the fairness of the proposed settlement... However, the fairness hearing is not to be turned into a trial or rehearsal for trial on the merits. [Citations omitted.] The court must stop short of the detailed and thorough investigation that it would undertake if it were actually trying the case. [Citations omitted.]

The standard used by the courts in their review of proposed settlements is whether the class action settlement is fundamentally fair, adequate, and reasonable. [Citations omitted.] The burden of proving that the settlement is fair is on the proponents of the settlement. [Citations omitted.] Proposed [Commission] Rule 51.1(e) provides that this Commission will not approve a settlement unless the “ . . . settlement is reasonable in light of the whole record, consistent with law, and in the public interest.”

In order to determine whether the settlement is fair, adequate, and reasonable, the court will balance various factors which may include some or all of the following: the strength of applicant’s case; the risk, expense, complexity, and likely duration of further litigation; the amount offered in settlement; the extent to which discovery has been completed so that the opposing parties can gauge the strength and weakness of all parties; the stage of the proceedings; the experience and views of counsel; the presence of a governmental participant; and the reaction of class members to the proposed settlement. [Citations omitted.] In addition, other factors to consider are whether the settlement negotiations were at arm’s length and without collusion; whether the major issues are addressed in the settlement; whether segments of the class are treated differently in the settlement; and the adequacy of representation. [Citations omitted.] (*Diablo Canyon*, 30 CPUC 2d, 189, 222.)

PG&E agrees that these settlement criteria should apply to the PSA, and maintains that this is not the proceeding to consider alternative plans that one or more parties may prefer. Instead, PG&E contends that we should consider the proposed settlement on its own merits, “up or down,” and approve or disapprove it without change, consistent with the expectations of the parties who are proposing it.¹⁰ We disagree with PG&E’s view that our choices are so limited. We have often exercised our plenary power to modify settlements, which would otherwise not be reasonable or in the public interest. *See e.g.* D.02-12-068 (2002); D.01-12-018 (2001); D.01-04-038 (2001); D.99-12-032 (1999).

Under Rule 51 and §§ 451, 454, and 728, we review and approve a settlement if its overall effect is “fair, reasonable and in the public interest.” California and U.S. Supreme Court decisions provide that we may consider the overall end-result of the proposed settlement and its rates under the “just and reasonable” standard, not whether the settlement or its individual constituent parts conform to any particular ratemaking formula. (*FPC v. Hope Natural Gas Co.* (1944) 320 U.S. 591, 602.)

In reviewing a settlement we must consider individual provisions but we do not base our conclusion on whether this or that provision of the settlement is, in and of itself, the optimal outcome. Instead, we stand back from the minutiae of the parties’ positions and determine whether the settlement, as a whole, is in the public interest.

We will approve the PSA as we find that the settlement is fair, just and reasonable and in the public interest. We will discuss these matters more

¹⁰ PG&E counsel: “Rather, in our view, the decision for the Commission is a binary one. That is, vote the settlement up, approve it, and adopt it, or vote it down. We are not here to renegotiate a settlement” (R.T. (PHC) pp. 3-4.)

extensively, but we should begin our analysis of the PSA with its most important provisions, the regulatory asset and the total dollar amount of the settlement. To emerge from bankruptcy PG&E must pay its creditors in full. We agree that all allowed claims should be paid in full; and we agree that the dollar amount of the settlement, \$7.2 billion, will achieve that result and is a reasonable compromise of the differences between PG&E and the Commission staff.

V. Lawfulness of the PSA

A. The Purpose of the Commission v. The Purpose of the Bankruptcy Court

Before reviewing the specific legal issues, it is important to recognize the fundamental differences between the Commission and the Bankruptcy Court. The Commission regulates the relationship between public utilities and their ratepayers whereas the Bankruptcy Court is mostly concerned with the relationship between the debtor and its creditors.

As the California Supreme Court recently explained in *Southern California Edison Co. v. Peevey, supra*, 31 Cal. 4th at 792, the Commission's "authority derives not only from statute but from the California Constitution, which creates the agency and expressly gives it the power to fix rates for public utilities." The Supreme Court, in a prior decision, had declared that: The Commission was created by the Constitution in 1911 in order to "protect the people of the state from the consequences of destructive competition and monopoly in the public service industries . . . [The Commission] is an active instrument of government charged with the duty of supervising and regulating public utility services and rates." (*Sale v. Railroad Commission* (1940) 15 Cal. 2d 612, 617.) The Commission has legislative and judicial powers. (*People v Western Air Lines* (1954) 42 Cal. 2d 621, 630.) The fixing of rates is quasi-legislative in character. (*Clam v. PUC* (1979) 25 Cal. 3d 891, 909; *Southern Pacific Co. v. Railroad Com.* (1924) 194 Cal. 734, 739.)

In addition, the California Legislature has provided that “all charges by a public utility for commodities or services rendered shall be just and reasonable (§ 451) and has given the commission the power and obligation to determine not only that any rate or increase in a rate is just and reasonable (§§ 454, 728), but also authority to ‘supervise and regulate every public utility in the State . . . ’” (*Camp Meeker Water System, Inc. v. Public Utilities Com.* (1990) 51 Cal. 3d 845, 861-862.)

In contrast, the Bankruptcy Court operates under the authority of the Bankruptcy Code, and a central purpose of the Bankruptcy Code is to “provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy ‘a new opportunity in life . . . ’” (*Grogan v. Garner* (1991) 498 U.S. 279, 286.) Put another way, the two overarching purposes of the Bankruptcy Code are: “(1) providing protection for the creditors of the insolvent debtor and (2) permitting the debtor to carry on and . . . make a ‘fresh start.’” (*In re Andrews* (4th Cir. 1996) 80 F.3d 906, 909.) (We note that PG&E is a solvent debtor.) PG&E’s disclosure statement (Ex. 101b, p. 2) seconds this: “Under chapter 11, a debtor is authorized to reorganize its business for the benefit of itself, its creditors, and its equity interest holders.”

The Bankruptcy Code, 11 U.S.C. § 1129(a)(6), explicitly recognizes that utility ratemaking is the province of governmental regulatory commissions, such as the Commission, rather than the Bankruptcy Court. As stated in *In re Cajun Elec. Power Co-op., Inc.* (5th Cir. 1999) 185 F.3d 446, 453, “[s]ection 1129(a)(6) of the Bankruptcy Code further provides that any rate change in a reorganization plan must be approved by governmental regulatory commissions with proper jurisdiction.” The Court found no support for a narrow reading of § 1129(a)(6), because “such an argument ‘ignores the reasons which mandate [public utility commission] regulation in the first instance. The [commission] is entrusted to

safeguard the compelling public interest in the availability of electric service at reasonable rates. That public interest is no less compelling during the pendency of a bankruptcy than at other times.’ “(*Id.*, at 453, n. 11, quoting with approval Flaschen & Reilly, *Bankruptcy Analysis of a Financially-Troubled Electric Utility*, (1985) 59 Am.Bankr.L.J. 135, 144.)

Indeed, in an earlier phase of PG&E’s bankruptcy proceeding, PG&E sought from the Bankruptcy Court a stay of the Commission’s D.01-03-082 (the Accounting Decision). In finding that the public interest will not be served by issuing an injunction, the Bankruptcy Court declared that issuing a stay "would create jurisdictional chaos. The public interest is better served by deference to the regulatory scheme and leaving the entire regulatory function to the regulator, rather than selectively enjoining the specific aspects of one regulatory decision that PG&E disputes. PG&E has all the usual avenues for relief from the Accounting Decision, including appellate review and reconsideration by CPUC. These alternatives may be particularly apropos in the constantly-changing factual and regulatory environment.” (*In re Pacific Gas and Electric Company* (2001) 263 B.R. 306, 323; 2001 Bankr. LEXIS 629 **38, *appeal pending sub nom., Pacific Gas and Electric Company v. California Public Utilities Commission, et al.*, United States District Court for the Northern District of California No. C-01-2490 VRW.)

B. The Commission’s Ability to Bind Future Commissions

The clause of the PSA requiring future Commissions to be bound is paragraph 21.

21. Validity and Binding Effect. The Parties agree not to contest the validity and enforceability of this Agreement, the Settlement Plan or any order entered by the Court contemplated by or

required to implement this Agreement and the Settlement Plan. This Agreement, the Settlement Plan and any such orders are intended to be enforceable under federal law, notwithstanding any contrary state law. This Agreement and the Settlement Plan, upon becoming effective, and the orders to be entered by the Court as contemplated hereby and under the Settlement Plan, shall be irrevocable and binding upon the Parties and their successors and assigns, notwithstanding any future decisions and orders of the Commission.

There cannot be any doubt that under certain circumstances, the Commission can legally enter into settlements or contracts which would bind future Commissions.¹¹ In *Southern California Edison Co. v. Peevey, supra*, 31 Cal. 4th at 792, the California Supreme Court relied upon the Commission's broad authority under Article XII of the California Constitution, sections 701 and 728 of the Public Utilities Code, and prior precedent to conclude that the Commission is a "state agency of constitutional origin with far-reaching duties, functions and powers whose 'power to fix rates [and] establish rules' has been liberally construed.'" Because the Commission had not acted contrary to state law and in light of the Commission's inherent authority, the California Supreme Court upheld the Commission entering into a binding settlement with SCE in its federal district court case against the Commission. *Id.* at 805.¹²

¹¹ Among other things, the Commission may enter into contracts to rent offices § 306(a); may procure books, stationery, furniture, etc., (§ 306(d)); may hire consultants and advisory services (§§ 631, 1094); may contract with state agencies (§ 274); may award grants (§ 276.5(c)); and may hire experts to prepare EIRs and Negative Declarations (Rule 17). Water Code § 80110 grants the Commission express authority to enter into an agreement with the Department of Water Resources with respect to charges under § 451. (D.02-03-053, at p. 8.)

¹² During the energy crisis, the skyrocketing wholesale power costs and AB 1890's rate freeze had caused both SCE and PG&E to face mounting debts and lose their creditworthiness. Both utilities sued the Commission in federal district courts. The California Supreme Court upheld the Commission's settlement with SCE, which provided for SCE's recovery of its costs, which were incurred but unrecovered during the AB 1890 rate freeze. *Id.* at 791.

It is true that in *Diablo Canyon*, D.88-12-083, 30 CPUC 2d 189, we held that we lack the power to approve settlements that bind future Commissions. We relied upon cases which hold that a legislative body cannot restrict its own power or that of subsequent legislative bodies, as well as §§ 728 and 1708, which provide that, after a hearing, the Commission may rescind, alter or amend previous decisions, or may declare rates are unjust and unreasonable and fix the just and reasonable rates to be thereafter observed and in force. (*Id.* at 223-225.)

The proponents of the PSA distinguish *Diablo Canyon*, because that case involved a settlement pending before the Commission, whereas the PSA would be entered into by the Commission itself to settle litigation in federal courts. The proponents claim that a decision of the Commission by itself may not bind future Commissions, but the Commission may execute a settlement agreement or a contract to bind future Commissions.

We agree with the proponents that a court-approved settlement would bind the Commission. There is a fundamental difference between the Commission's authority within the scope of its own proceedings, and the Commission's efforts to resolve litigation in courts. The Commission must abide by court orders and a subsequent Commission does not have the authority to ignore a court order approving a settlement to which the Commission is a party. Particularly here, where the public interest would be greatly served by getting PG&E out of bankruptcy, the Commission must have the ability to exercise its regulatory and police powers to resolve through a settlement the Bankruptcy Court litigation. Upon approval by the Bankruptcy Court of such a settlement agreement, there is no question that subsequent Commissions cannot disregard the court order approving the settlement agreement.

When entering into settlement agreements or contracts, however, the Commission may not act inconsistently with state law. As the Court declared in *Southern California Edison Co. v. Peevey, supra*, 31 Cal. 4th at 792: “If PUC lacked substantive authority to propose and enter into the rate settlement agreement at issue here, it was not for lack of inherent authority, but because this rate agreement was barred by some specific statutory limit on PUC's power to set rates.”

Similarly, in *Southern California Edison Co. v. Lynch* (9th Cir. 2002) 307 F.3d 794, 809, the Ninth Circuit held that if the Commission’s settlement agreement violated state law, “then the Commission lacked capacity to consent to the Stipulated Judgment, and [the Ninth Circuit] would be required to vacate it as void. State officials cannot enter into a federally-sanctioned consent decree beyond their authority under state law.” We therefore must determine that a settlement is consistent with state law before we can enter into the settlement. Paragraphs 21 and 32 of the PSA provide that the Parties agree that the settlement agreement, the settlement plan and any court orders are intended to be binding and enforceable under federal law, “notwithstanding any contrary state law.” This is general language that does not specify the purportedly contrary state laws.

We do not agree with the objections asserted to the phrase “notwithstanding any contrary state law” in Paragraphs 21 and 32. First, and most important, we have carefully considered all objections that provisions of the PSA are illegal under substantive California law, and we have found those objections to be lacking in merit. As the PSA is consistent with substantive California law, the challenged phrases do not constitute a departure from the

principle, which we accept, that we may not enter into a settlement agreement that is illegal under valid California law.

Second, we do not believe that the argument set forth immediately above renders the phrase “notwithstanding any contrary state law” superfluous. Both phrases specifically refer to *enforcement* of the PSA (along with the Settlement Plan and certain orders of the Bankruptcy Court) under federal law. As a general matter, under Paragraph 32 the PSA is governed by California law.

The PSA is incorporated by reference in the Settlement Plan and is an exhibit thereto. It is contemplated that the Confirmation Order in PG&E’s bankruptcy case will refer to the PSA. More broadly, a major purpose of the PSA is to provide a structure for PG&E’s emergence from bankruptcy. In these circumstances, it is reasonable for the PSA to provide that it is intended to be enforceable under federal law, which we take to refer primarily to the Bankruptcy Code and to other bankruptcy-related sections of the United States Code. That is certainly the law under which the Confirmation Order and other orders of the Bankruptcy Court will be enforced; and the PSA is closely related to the Confirmation Order and to the Settlement Plan that the Confirmation Order will implement.

Paragraph 23 of the PSA provides that the Commission is to be subject to the jurisdiction of the Bankruptcy Court for all purposes relating to enforcement of the PSA. Federal law is the body of law that in the first instance confers powers on the Bankruptcy Court. As the Bankruptcy Court is given the power to enforce the PSA in Paragraph 23, Paragraphs 21 and 32 reasonably indicate that the PSA is intended to be enforceable under the body of law that gives that court its powers.

In light of the constitutional requirement that the Commission actively supervise and regulate public utility rates (*Sale v. Railroad Commission* (1940) 15 Cal. 2d 607 at 617) and the statutory requirements under the §§451, 454, 728 that the Commission ensure that the public utilities' rates are just and reasonable (*Camp Meeker Water System, Inc. v. Public Utilities Com.* (1990) 51 Cal. 3d 850 at 861-862), the Commission must retain its authority to set just and reasonable rates during the nine-year term of the settlement and thereafter.

“The regulation of utilities is one of the most important of the functions traditionally associated with the police power of the states.” (*Arkansas Electric Coop. v. Arkansas Pub. Serv. Comm’n* (1983) 461 U.S. 375, 377.) This Commission’s authority to regulate public utilities in the State of California is pursuant to the State’s police power. (*See, Motor Transit Company v. Railroad Commission of the State of California* (1922) 189 Cal. 573, 581.) The California Supreme Court has held that “it is settled that the government may not contract away its right to exercise the police power in the future.” (*Avco Community Developers, Inc. v. South Coast Regional Com.* (1976) 17 Cal. 3d 785, 800.)

The Commission cannot be powerless to protect PG&E's ratepayers from unjust and unreasonable rates or practices during the nine-year term of the proposed settlement. “The police power being in its nature a *continuous* one, must ever be reposed somewhere, and cannot be barred or *suspended* by contract or irrevocable law. It cannot be bartered away even by express contract.” (*Mott v. Cline* (1927) 200 Cal. 434, 446 (emphasis added).)

Whether or not the Commission could enter into a settlement agreement without violating state law turns on whether the settlement agreement would surrender or suspend the Commission’s exercise of its police powers for nine years or whether the settlement agreement is consistent with the Commission

exercising its regulatory powers. In *Santa Margarita Area Residents Together v. San Louis Obispo County Bd. of Supervisors* (2000) 84 Cal. App.4th 221, 233, the Court found that notwithstanding a zoning freeze, the County's agreement had not surrendered its police powers, because under the agreement, the project had to be developed in accordance with the County's general plan, the agreement did not permit construction until the County had approved detailed building plans, and the agreement retained the County's discretionary authority in the future. In light of the above, we must review the PSA to ascertain whether the Commission would be exercising or surrendering its police powers by entering into the settlement.

PG&E contends that on a going-forward basis, the PSA affects only approximately 5.4% of the electric bill, which is the impact from the Regulatory Asset. As explained below, we find that the proposed amount for and the regulatory rate treatment of the Regulatory Asset is just and reasonable. Moreover, the PSA did not address the ratemaking treatment or amounts going forward for the other 95% of PG&E's electric revenue requirements or what PG&E's overall retail electric rates should be during the next nine years. Therefore, we find that entering into the PSA, is fully consistent with the Commission's exercise of its ratemaking authority, because we find that the Regulatory Asset provision is just and reasonable and a necessary part of the settlement, and we will still decide the overall retail electric rates for PG&E's customers in pending and future proceedings.

Various parties have objected to PSA ¶ 6 (“Dividend Payments and Stock Repurchases”), principally on the ground that it leaves the Commission with insufficient discretion to deal with unexpected future circumstances. We do not agree. PSA ¶ 6 contains a precatory acknowledgement that PG&E and its Parent

must be able to pay dividends and repurchase common stock “when appropriate.” That sentence does not contain any acknowledgement that PG&E and its Parent must be able to pay dividends in all conceivable circumstances or in any particular amounts. The following sentence states that, subject to specified conditions, the Commission shall not restrict the ability of the boards of directors of either PG&E or PG&E Corporation to declare and pay dividends or repurchase stock. This sentence does not say, and we do not interpret it to mean, that the Commission has guaranteed to either PG&E or PG&E Corporation that the corporation will have sufficient available funds to pay dividends or repurchase stock at all, or to pay dividends or repurchase stock at particular levels. We interpret the sentence to mean only that, subject to the specified conditions, the Commission cannot order either corporation not to pay dividends or not to repurchase stock; and that, again subject to the specified conditions, the Commission cannot order either corporation not to declare or pay dividends exceeding a stated amount or not to expend more than a stated amount on stock repurchases.

When the paragraph is interpreted in this way, many of the objections to it disappear. It is said, for example, that the Commission must retain the flexibility to require that PG&E perform all of its public service obligations, even if performance of those obligations left PG&E temporarily unable to fund the payment of dividends or stock repurchases at all, or at the levels otherwise desired. Or, to provide a more concrete example, one might ask whether the Commission would retain the ability to order PG&E to expend funds on needed infrastructure repairs, even if the order would have the financial consequences just described.

The answer is that the Commission would retain the authority to take such a step. An order directing PG&E to perform specified public service obligations or to invest capital in needed infrastructure repairs would not be an order restricting the board of directors from declaring and paying dividends or from authorizing the stock repurchases. That is true even if the board of directors of PG&E found, after the required expenditure is made, that PG&E could not afford to fund dividend payments or stock repurchases at all, or at the levels the board might otherwise have desired.

Similarly, the Commission's disallowance of imprudently incurred costs would not be an order restricting the board of directors of PG&E from declaring and paying dividends or repurchasing stock. That, too, is true whether or not the cost disallowance might inhibit PG&E's dividend payments or stock purchases. After all, any order requiring PG&E to spend money for any purpose could, in principle, affect the ultimate amount of funds remaining for dividends and stock repurchases. PSA ¶ 6 could not reasonably be read to bar the Commission from issuing any order that requires PG&E to spend money for a designated purpose, and consequently we find the reading of the text adopted here to be reasonable and appropriate.

Other provisions of the PSA confirm this reading of PSA ¶ 6. As the PSA's "Statement of Intent" makes clear, under the PSA, "[t]he Commission intends to provide PG&E with the *opportunity* to recover all of its *prudently incurred* costs as well as a return of and return on its investment in utility plant." (PSA, ¶ 7) (emphasis added). As noted above, almost any cost disallowance could conceivably result in a potential reduction of the funds available for dividend payments or stock repurchases. The Statement of Intent, however, contemplates that the Commission will retain its traditional authority to disallow recovery of

imprudently incurred costs. It follows that PSA ¶ 6 cannot possibly be interpreted to prohibit the Commission from taking any action that might reduce or even eliminate the availability of funds for dividend payments or stock repurchases. In addition, Paragraph 2.j. of the PSA provides that “[t]he Commission agrees that, in the absence of compelling evidence to the contrary, PG&E’s expected regulatory outcomes and financial performance should be similar to those of other investor-owned energy utilities in California under similar circumstances.” *Id.*, ¶ 2.j. Paragraph 2.j. is obviously incompatible with a reading of PSA ¶ 6 that would guarantee the availability of funds at any level determined by the boards of directors of PG&E and PG&E Corporation (subject to the two specified conditions) for dividend payments or stock repurchases.

Furthermore, PSA ¶ 6 does not affect the applicability of California law apart from Commission decisions, including California statutes and common law governing and restricting dividend declarations and payments and stock repurchases. Under PSA ¶ 6, PG&E will remain subject to, *inter alia*, the requirement in Decision No. 96-11-017, section 7.10, that its dividend policy “be established by PG&E’s Board of Directors as though PG&E were a stand-alone utility company.” These principles would prevent many of the hypothetical abuses raised by objectors, such as the payment of dividends in furtherance of a fraud or crime, or the payment of inappropriately large dividends by P&E as the result of control exercised by PG&E’s parent.

In the exercise of our regulatory authority, adopting the reading set forth above of PSA ¶ 6, we do not mean to imply that PG&E or PG&E Corporation are likely, during the term of the PSA, to be financially unable to pay dividends or to repurchase stock. To the contrary, a fundamental principle of the PSA is a return to traditional cost-of-service ratemaking principles. Under those principles,

PG&E has historically paid dividends; and PG&E's ability to pay dividends is, of course, a key component of its ability to attract and retain equity investment, which in turn benefits ratepayers.

Historically, under traditional cost-of-service ratemaking, regulated utilities are provided the opportunity to earn a return on their investment, and have traditionally issued dividends or repurchased common stock under authorized capital structures approved by their regulators. Assuming that a utility is responsibly meeting its obligation to serve, the Commission does not micromanage the utility in its carrying out of its obligations and responsibilities and financial management practices. Indeed, PG&E witness and CFO Kent Harvey testified that prior to the energy crisis, PG&E was one of the healthiest energy utilities in the country, and enjoyed strong investment grade credit ratings and consistently paid dividends to its shareholders. (Ex. 103: 2-1, PG&E/Harvey). PG&E Witness and CEO Gordon Smith testified that until recently, (i.e., since the energy crisis) PG&E did not miss a single quarterly dividend since it began paying quarterly dividends in 1916. PG&E was able to do so while maintaining its authorized capital structure. (RT: p. 696). We would therefore anticipate PG&E will return to this historical practice under the PSA.

Many parties have expressed their opposition to Paragraph 2.g. of the PSA, which would require the Commission "to act to facilitate and maintain Investment Grade Company Credit Ratings for PG&E." The statutory requirements under sections 454 and 728 of the Public Utilities Code are that the rates must be just and reasonable (*see Camp Meeker Water System, Inc. v. Public Utilities Com.*, 51 Cal. 3d at 862), and the opponents have argued that the investment grade requirement would supplant the just and reasonable standard. As discussed in more detail below, however, we believe that we can clarify this

commitment in a way that is consistent with our statutory responsibility to ensure that PG&E's rates are just and reasonable.

Our commitment will remain, as provided in Paragraph 2.g., to act to facilitate and maintain the investment grade credit ratings. However, we do not interpret Paragraph 2.g. to require the Commission to guarantee such a credit rating when there are other causes, besides the Commission's actions (e.g., PG&E's imprudent conduct resulting in a disallowance), which are responsible for any threats to PG&E's investment grade credit rating. Therefore, under the PSA, PG&E's ratepayers will still be protected from unjust and unreasonable rates.

In setting just and reasonable rates, in addition to protecting the consumers, we also must consider the financial health of the public utility. Indeed, we view this commitment to act to facilitate and maintain investment grade credit ratings as essentially doing what we have always done under cost-of-service regulation: provide just and reasonable rates and authorize a reasonable capital structure that maintains the fiscal integrity of the utility. As already discussed, our traditional regulation resulted in high investment grade ratings of our energy utilities.

In the balancing of interests of the utility and its ratepayers that we undertake in setting rates, a major factor is the utility's financial integrity. There should be enough revenue for all of the utility's prudently incurred costs or operating expenses, investments and costs of debt. *See Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299, 310; *FPC v. Hope Natural Gas Co.*, *supra*, 320 U.S. at 603. We are therefore exercising our regulatory authority in agreeing with this commitment in Paragraph 2g., as clarified above, because we find as part of our

regulatory responsibilities, that it is in the public interest to get PG&E out of bankruptcy and restore its investment grade credit ratings.

In *Southern California Edison Company v. Peevey*, *supra*, 31 Cal.4th at 791, the California Supreme Court explicitly recognized that the Commission's settlement with SCE was intended to "restore SCE's creditworthiness and avoid further instability and uncertainty for the company and consumers." The Court not only upheld the Commission's authority to enter into the settlement, it also confirmed the Commission's "duty and authority to guarantee that the electric utilities would have the capacity and financial viability to provide power to California consumers." *Id.* at 793.

Just as the Court found in *Santa Margarita Area Residents Together v. San Louis Obispo County Bd. of Supervisors*, *supra*, 84 Cal. App.4th at 233, that the County had not surrendered its police powers, because in entering the agreement, the County had exercised its regulatory powers and retained the County's discretionary authority in the future, the Commission would not be surrendering or suspending its police powers, because the PSA, as clarified by this decision, is a reasonable exercise of those police powers based upon the record in this proceeding. The Commission has retained its discretionary authority over PG&E's overall retail electric rates, and, after considering all of the evidence and positions of the parties in this proceeding, we find that the provisions concerning the regulatory asset, which will comprise approximately 5.4% of PG&E's retail electric rates, are just and reasonable.

As *Southern California Edison Co. v. Peevey*, *supra*, 31 Cal.4th at 792 makes clear, we have the inherent authority to enter into binding settlements where we are not limited by state law. The Commission's settlement with SCE was approved by a federal district court's stipulated judgment, and the California

Supreme Court upheld our right to enter into and be bound by the settlement even without hearings, a written decision with findings, and a vote in a public meeting. *Id.* at 805.¹³

In the present case, the PSA is consistent with state law. We have held a hearing, issued a written decision with findings, voted in a public meeting and clarified provisions in the PSA in reaching our finding that the PSA is fair, just and reasonable and in the public interest. Accordingly, we find that we can enter into the PSA and bind future Commissions.

C. Jurisdiction of the Bankruptcy Court

The clause of the PSA regarding the jurisdiction of the Bankruptcy Court is paragraph 22.

22. Enforcement. The Parties agree that the Court shall retain jurisdiction over the Parties for all purposes relating to enforcement of this Agreement, the Settlement Plan and the Confirmation Order.

The present case is not the usual case where the Commission issues its decisions involving public utilities' rates. We are in an extraordinary situation involving PG&E's bankruptcy. Under sections of the United States Code and Bankruptcy Code, 28 U.S.C. §§ 157(b), 1334, and 11 U.S.C. § 1129, the Bankruptcy Court has jurisdiction over the plan of reorganization, which must be confirmed in order to get PG&E out of bankruptcy. By agreeing to this PSA, it

¹³ In *Southern California Edison Co.*, 31 Cal.4th at 802-805, the Supreme Court found that a hearing, decision with findings and vote in a public meeting were not statutorily required, because the Commission had "maintained" and not "changed" SCE's rates. That case had a very unique factual situation. The Commission frequently has proceedings, issues written decisions with findings, and votes in public meetings, because the far more typical situation addressing a public utility's recovery of costs, such as the present case, involves changes to the public utility's rates.

is our intent to present the Bankruptcy Court with a plan that is lawful under state law and that the Court will be able to confirm.

We also recognize that the Bankruptcy Court must have jurisdiction over the parties to enforce the agreement, the settlement plan and the Court's own confirmation order. Under sections of the United States and Bankruptcy Code, 28 U.S.C. §§ 157(b), 1334, and 11 U.S.C. § 1142, the Bankruptcy Court has jurisdiction over the implementation of the bankruptcy plan. As discussed above, we find that the PSA is consistent with state law and is just and reasonable. Having done so, we may bind the Commission to an agreement that is part of the settlement plan before the Bankruptcy Court. Just as the Commission was bound by the settlement with SCE and the federal district court can enforce the stipulated judgment (which adopted the settlement), the Bankruptcy Court can enforce the PSA to the extent that it becomes part of the settlement plan approved by the Bankruptcy Court's confirmation order.

Contrary to the views of opponents of the PSA, the Bankruptcy Court's potential enforcement of the PSA, the settlement plan incorporating the PSA and the Court's confirmation order, in no way means that the Bankruptcy Court will be deciding PG&E's rates or services for the next nine years or supplant the California appellate courts from their judicial review of Commission orders involving PG&E. As discussed above, the PSA will result in the Commission retaining authority over PG&E's rates and services subject to judicial review in the California appellate courts. Except for its enforcement of the specific provisions in the PSA, the Bankruptcy Court will not be supervising the Commission's determinations as to PG&E's rates and services.

For the most part, after the Bankruptcy Court confirms the plan of reorganization, the Bankruptcy Court no longer supervises or protects the

debtor. *See Southwest Marine Inc. v. Danzig* (9th Cir. 2000) 217 F.3d 1128, 1140. As the Bankruptcy Court stated with regard to the Commission's plan of reorganization, the Bankruptcy Court "is being asked to enforce the reorganization agreement. Nothing more... I see this Court's role as more limited than PG&E's counsel predicts". The Bankruptcy Court gave limited examples where it could find the Commission would be in breach of the reorganization agreement, but the Court recognized the Commission's "historic practice for [authorizing the] recovery of prudently incurred costs," and stated that only a departure from this practice for the "recoverable costs in the agreement" could be a breach. (Exhibit No. 122, Exhibit C, pp. 6-10-6-11.)

PG&E concedes that the PSA would not result in the Bankruptcy Court sitting as a super appellate court over the Commission decisions affecting PG&E. Under these circumstances, it is justifiable for the Commission to agree to the enforcement provisions in paragraph 22, and for the Bankruptcy Court to have jurisdiction to enforce the PSA, the settlement plan incorporating the PSA, and the Court's confirmation order.

D. Consistency with Assembly Bill 1890 and § 368(a)

At one time there was uncertainty as to whether AB 1890 had limited the Commission's authority to allow PG&E to recover all of the wholesale power costs it had booked into its Transition Revenue Account (TRA), or all of its uneconomic generation-related costs in its TCBA. The uncertainty was due to the AB 1890 provision (i.e. § 368(a)) putting the utilities at risk for those costs not recovered by the time that the AB 1890 rate freeze ended (i.e., no later than March 31, 2002).

All parties recognize that there no longer is any uncertainty about the Commission's authority to allow PG&E's recovery of its TCBA balance because

AB 6X restored the Commission's ratemaking authority over generation-related facilities owned by the public utilities under our jurisdiction. As the California Supreme Court held in *Southern California Edison Company v. Peevey, supra*, 31 Cal.4th at 793, "after the enactment of AB 6X in 2001,...PUC was authorized to approve rates allowing SCE to recover the costs...." Referring to AB 6X as a "major retrenchment from the competitive price-reduction approach of AB 1890," the Court found that AB 6X reemphasized "PUC's duty and authority to guarantee that the electric utilities would have the capacity and financial viability to provide power to California consumers."

The Commission has the authority to allow the utilities to recover their prudently incurred generation-related costs, because AB 6X eliminated AB 1890's market valuation requirement for the utilities' retained generation assets and AB 6X "allowed PUC to regulate the rates for power so generated pursuant to ordinary 'cost-of-service' ratemaking." (*Id.* at 795.) Due to the restoration of the Commission's ratemaking authority over these assets, AB 6X "largely eliminated the category of 'uneconomic' generating asset costs" and, therefore the limit in § 368(a) "no longer applies to the generation-related costs of the utilities." *Id.*

In view of the California Supreme Court's recent decision finding that AB 6X made § 368(a) inapplicable to the utilities' unrecovered costs, it is clear that the Commission's authority to allow PG&E to recover the balance in its TCBA is not limited by AB 1890.

TURN argues that under basic principles of utility ratesetting, ratepayers cannot be forced to contribute capital to a utility and utilities are not entitled to earn a return on their expenses. (TURN Op. Br. p. 11-13.) We do not agree that that principle applies to this settlement. In *Diablo Canyon*, (1988) 30 CPUC 2d 189, and subsequent decisions for the nuclear powerplants owned by PG&E,

SCE, and SDG&E, the Commission approved incremental cost incentive pricing that allowed the utility to recover its operating expenses on the basis of operating performance rather than actual cost, thus allowing the utility to recover more than its actual operating expenses if performance exceeded benchmarks. As we discussed above, in *Southern California Edison Co. v Peevey*, *supra*, 31 Cal. 4th at 793, the Court reemphasized the Commission’s duty and authority to guarantee that the electric utilities would have the capacity and “financial viability to provide power to California customers.” (Emphasis added.)

VI. Whether the Proposed Settlement Agreement Is in the Public Interest

A. Adequacy of a Settlement Proposal in Achieving Feasible Plan of Reorganization

The Bankruptcy Code requires any plan of reorganization to be feasible – to allow a debtor to successfully emerge from bankruptcy. To be feasible, a proposed plan must be such that if implemented it will leave the debtor in a situation where it is not likely that the reorganization will be followed by unanticipated liquidation or further reorganization:

Before the bankruptcy court may confirm a plan of reorganization, 11 U.S.C. § 1129(a)(11) requires that it find that the plan is not likely to be followed by unanticipated liquidation or further reorganization. In other words, the plan must be feasible. Under this feasibility test, the bankruptcy court must look to the plan’s projected income, expenses, assets and liabilities and determine whether the plan will leave the estate financially stable. *In re Pizza of Hawaii, Inc.*, 40 B.R. 1014, 1017 (D. Hawaii 1984).

A necessary corollary of this requirement is the requirement that the provisions of any proposed plan of reorganization can, in fact, be implemented:

[T]he feasibility test contemplates the probability of actual performance of the provisions of the plan. Sincerity, honesty, and

willingness are not sufficient to make the plan feasible, and neither are any visionary promises. The test is whether the things which are to be done after confirmation can be done as a practical matter under the facts. *In re Clarkson*, 767 F.2d 417, 420 (8th Cir. 1985).

It is the Bankruptcy Court which ultimately will determine whether any given proposed plan is feasible. And it is clear that the Commission should not authorize any settlement unless the Commission believes that the settlement is likely to result in a feasible plan. For the reasons detailed below, the PSA satisfies this requirement.

1. The PSA Will Allow PG&E to Emerge Promptly From Bankruptcy

The PSA is fair, just and reasonable and in the public interest. First, its provisions for the regulatory asset and the cash allowances will pay creditors in full, and improve PG&E's credit metrics. Second, the PSA calls for the amortization of the regulatory asset "mortgage style" over nine years.¹⁴ Third, it offers the state significant environmental benefits.¹⁵ Fourth, it provides for reduction of the regulatory asset on account of any refunds obtained from energy suppliers. Finally, it contains PG&E's commitment not to unilaterally attempt to disaggregate for the life of the plan.¹⁶

There are provisions in the PSA that enhance PG&E's fiscal soundness. These elements are: the ratemaking treatment associated with the regulatory asset;¹⁷ the assurances of recovery of headroom within a certain range¹⁸ in 2003;¹⁹

¹⁴ "Nine years is sufficiently short to provide the needed cash flows to improve PG&E's credit statistics, while moderating rate impacts." Exhibit 122 at 20.

¹⁵ Exhibit 101a, PG&E/Smith, ¶¶ 17-18.

¹⁶ *Id.* Statement of Intent ¶ 3; Agreement ¶ 11(b).

¹⁷ Exhibit 101, PG&E/Smith, ¶ 2.

acknowledgement by the Commission that the URG rate base established by D.02-04-016 shall be deemed just and reasonable and not subject to modification;²⁰ imputation of a capital structure to PG&E;²¹ and a Commission commitment not to discriminate against PG&E as compared with other utilities.²² Further elements of the PSA enhancing the attractiveness of the Settlement Plan to rating agencies are the assured recovery of the full amount that PG&E sought in the ATCP,²³ and the dismissal with prejudice of PG&E Corporation (PG&E's parent) from the Commission's Holding Company OII as to past practices.²⁴ With those financial and regulatory benefits in place we are confident PG&E will be able to emerge from bankruptcy and continue to provide safe, reliable service.

2. The Rating Agencies (S&P and Moody's)

PG&E says that it is essential that PG&E's credit be rated investment-grade upon emergence from bankruptcy. It believes that these entities' blessing of the plan, through the assignment of investment-grade credit ratings, is crucial to feasibility. PG&E's witnesses testified: "It is critical for PG&E to meet at least

¹⁸ \$775 million to \$875 million. Exhibit 101a, PG&E/Smith, ¶ 8(b).

¹⁹ Should 2003 headroom collections fall outside the prescribed range, "the Commission shall take such action in 2004 as is necessary" to return overcollections to ratepayers, or to allow PG&E to recoup any undercollections. *Id.*

²⁰ Exhibit 101, PG&E/Smith, ¶ 2f.

²¹ The PSA, paragraph 3(b), provides part that "the authorized equity ratio for ratemaking purposes shall be no less than 52 percent, except for a transition period as provided below [setting floor equity ratio of 48.6 percent in '04 and '05]."

²² Exhibit 101, 1-9:2-6, PG&E/Smith. *See generally* Exhibit 101a, PG&E/Smith, ¶ 2(f).

²³ Exhibit 101a, PG&E/Smith, ¶ 10 and App. C.

²⁴ *Id.*

minimum investment-grade ratings”²⁵ if emergence is to take place at all. “PG&E needs access to the liquidity and efficiency of the investment grade debt market in order to raise the approximately \$8 billion required to emerge from Chapter 11.”²⁶

Investment-grade credit ratings are important not only to achieving a feasible plan of reorganization, but also to ensuring on an ongoing basis that PG&E can reliably and efficiently raise capital to finance construction of new infrastructure, accommodate seasonal fluctuations in cash collections and disbursements, and meet its obligations to serve customers.²⁷ “Continuous access to the capital markets and access to low cost capital facilitates the funding of power procurement activities as well as the capital expenditures necessary to sustain the safety and reliability of a utility’s operations.”²⁸

Among the important longer-term benefits PG&E and ratepayers can expect from PG&E obtaining creditworthy status are a lower cost of debt.²⁹ Because there would be a greater amount of capital available and a lower risk associated with investment grade debt compared to junk-rated debt, the cost of investment grade debt is considerably less. As shown in the testimony of Paul J. Murphy (Chapter 7), PG&E’s ability to issue investment grade debt under the Settlement Plan saves ratepayers approximately \$2.1 billion in interest costs over

²⁵ Exhibit 122 at 11, Staff/Clanon.

²⁶ Exhibit 103, PG&E/Harvey.

²⁷ Exhibit 103, 2-9:3-16, PG&E/Harvey.

²⁸ Exhibit 112, 7-19:30-7-20:5, PG&E/Murphy.

²⁹ Exhibit 103, 2-10:3-25, PG&E/Harvey; Exhibit 122 at 14, Staff/Clanon.

10 years (compared to junk-rated debt).”³⁰ Thus the lower cost of a utility’s debt translates into lower rates, all else being equal.³¹

There would also be lower transaction costs associated with an investment grade rating.³² A company that is non-investment grade must generally post collateral to engage in purchase transactions. “Investment grade credit ratings are critical for activities such as power procurement; without investment grade ratings, PG&E would need to post additional collateral, further increasing its cost of operations.”³³ “To acquire firm pipeline capacity, PG&E recently had to post nearly \$20 million of collateral, representing three months of payments. Had PG&E been investment grade, it would not have had to post collateral.” Moreover, a utility with a “junk bond” rating would likely have to provide security or put up cash as collateral in various contracts (such as for energy supply) or to meet certain regulatory commitments (such as environmental remediation requirements). “Indeed, under such conditions, energy procurement through long-term contracts, even if accessible to a weak utility, creates a new set of problems. If they include mark-to-market provisions, periodic market swings could jeopardize the utility’s remaining but limited credit capacity. In addition, a financially-weak utility would inevitably face less favorable terms at higher cost and for a more limited duration.”³⁴

³⁰ Exhibit 103, 2-6:4-9, PG&E/Harvey.

³¹ Exhibit 112, 7-20:2-5, PG&E/Murphy.

³² Exhibit 103, 2-10:26-11:4, PG&E/Harvey.

³³ Exhibit 112, 7-20:24-27, PG&E/Murphy.

³⁴ Exhibit 110, 6-10:22-30, PG&E/Fetter.

Also investment grade credit ratings for PG&E should require lower working capital requirements,³⁵ should facilitate the construction of new power supplies for its customers,³⁶ and are crucial in order for PG&E to carry out its public purpose responsibilities in an appropriate manner in the future.”³⁷ And, as witness Murphy notes: “[t]he utility industry is capital-intensive. PG&E’s financial forecast highlights this fact with regard to PG&E: over \$8 billion of capital expenditures are expected during the next five years. Ease of access to the debt market on reasonable terms to fund such expenditures serves the interests of customers as well, since investment-grade debt is significantly more economical than non-investment-grade debt.”³⁸ Staff Witness Paul Clanon concurred, concluding that “[n]on-investment grade credit ratings are bad for ratepayers.”³⁹ Thus adopting a long-term goal of maintaining and improving PG&E’s credit ratings is good public policy and indeed it is the Commission’s “duty and authority to guarantee that the electric utilities would have the capacity and financial viability to provide power to California consumers.” *Southern California Edison Co. v. Peevey, supra*, 31 Cal. 4th at 793.

³⁵ Exhibit 103, 2-11:5-16, PG&E/Harvey.

³⁶ Exhibit 112, 7-20:19-20, PG&E/Murphy; *see also* Exhibit 122 at 13, Staff/Clanon.

³⁷ Exhibit 110, 6-3:6-8, PG&E/Fetter.

³⁸ Exhibit 110, 6-10:17-22, PG&E/Fetter.

³⁹ Exhibit 122 at 12, Staff/Clanon; *see also id.* at 13 (referencing Murphy testimony).

B. Fairness and Reasonableness**1. Relationship of Settlement to Parties' Risks of Achieving Desired Results**

For more than three years, the Commission and PG&E have been in continuous litigation against each other before the state appellate courts, the federal courts, and the Bankruptcy Court. A settlement between PG&E and the Commission would end this litigation and resolve claims totaling billions of dollars made by PG&E against the Commission and ratepayers.

Prior to the settlement, both the Commission and PG&E faced risks and consequences depending on the outcome of PG&E's litigation claims and proposal to disaggregate itself through the asserted preemptive authority of the Bankruptcy Court. On the one hand, PG&E filed a complaint in federal court seeking authority to recover billions of dollars of undercollected costs (which PG&E now estimates at \$11.8 billion) from retail ratepayers and to transfer its assets outside the regulatory reach of the State of California. On the other hand, the Commission and other agencies of the State, including the State Attorney General, continue to fight PG&E's proposals, vowing to carry their opposition beyond the federal trial court and Bankruptcy Court to the highest appellate levels. In addition, the Commission had proposed an alternative plan of reorganization in the Bankruptcy Court, and had obtained the support of the OCC for its alternative plan. PG&E just as vigorously opposed the Joint Amended Plan, and threatened to carry its opposition to the highest appellate levels. There was skepticism regarding the feasibility of either plan of reorganization. The litigation costs incurred by both sides were enormous, and threatened to mount to even higher levels, given the likelihood of additional appellate litigation. In short, both parties faced enormous risks that they would fail to achieve their desired results unless they reached a settlement.

2. The Risk, Expense, Complexity, and Likely Duration of Further Bankruptcy Litigation

From the perspective of the Commission and ratepayers, the risks of continued litigation in PG&E's bankruptcy proceeding and the federal court are that some combination of the Bankruptcy Court and federal district and/or appellate courts ultimately may approve PG&E's request for injunctive relief, as well as its proposal to disaggregate its traditional utility business into four separate entities, three of which would be permanently outside the jurisdiction of the Commission. The U.S. Court of Appeals for the Ninth Circuit or the U.S. Supreme Court, would ultimately decide the express preemption issues. However, even if there is no express preemption a Bankruptcy Court judge has affirmed the right of the Bankruptcy Court to impliedly preempt the Commission where necessary to implement a financially viable plan. (*Memorandum Decision Regarding Preemption and Sovereign Immunity*, February 7, 2002, *In Re. Pacific Gas and Electric Company*, Bankruptcy Case No. 01-30923DM, United States Bankruptcy Court, Northern District of California.)⁴⁰

Moreover, the Commission's costs and delays of further litigating against PG&E are likely to be massive, given the possibility of appeals through several layers of the federal court system, possibly all the way to the U.S. Supreme Court. . On the other hand, PG&E faces similar risks, expenses, and delays. Even if it were to prevail in persuading the Bankruptcy Court to impliedly or expressly preempt state law and in so doing limit the Commission's jurisdiction, the Commission has vowed to appeal and further challenge PG&E's plan

⁴⁰ A copy of the February 7, 2002, Bankruptcy Court decision, Docket No. 4710, is available on the Bankruptcy Court's website at <http://www.canb.uscourts.gov>.

through the courts. If PG&E were not to prevail, the Joint Amended Plan would reduce the amount of money sought by PG&E.

In short, further litigation between PG&E and the Commission in and beyond the Bankruptcy Court would be costly, complex and lengthy, potentially delaying any resolution as the case winds its way through the federal appellate court system, no matter who prevails at the trial court level.

3. Reasonableness of Settlement of Other Claims and Litigation

PG&E presented testimony that identified \$11.8 billion in unrecovered costs of utility service which it claims are to be recoverable from retail electric ratepayers. (Exs. 120 and 120c, PG&E/McManus.) PG&E asserts that it is likely to prevail on its claims before the Commission and/or the state and federal courts. (Exs. 120, 120c, 121, PG&E/McManus.) PG&E cites the ruling of Judge Walker in *PG&E v. Lynch*, which held that the “cost of wholesale energy, incurred pursuant to rate tariffs filed with FERC, whether these rates are market-based or cost-based, must be recognized as recoverable costs by state regulators and may not be trapped by excessively low retail rates or other limitations imposed at the state level.” (Ex. 120 and 120c, PG&E/McManus.) PG&E also presented testimony on its claims for cost recovery under state law. (Ex. 120 and 120c, PG&E/McManus.) This testimony asserts that even if its undercollected costs are not classified as wholesale costs protected by the Filed Rate Doctrine under federal law, the costs are still legitimate costs of utility service that PG&E is legally entitled to recover in full from retail ratepayers under California state law.

The Commission staff presented testimony arguing that PG&E was unlikely to prevail in *PG&E v. Lynch*. (Ex. 122, p. 17, CPUC Staff/Clanon.) The

staff relied on the testimony of an expert who argued that Judge Walker's ruling was incorrect. The Commission staff estimated that the net present value of the estimated ratepayer contribution to the settlement would be \$7.129 to \$7.229 billion. (Ex.122, p. 9, CPUC Staff/Clanon.)⁴¹ The components of these ratepayer contributions use the same time frames and components that PG&E used to estimate its claims, *i.e.* the period from the beginning of the energy crisis to the present. This period treats PG&E's 2001 and 2002 pre-tax headroom revenues under the Commission's surcharge revenue decisions as a ratepayer contribution under the settlement. The Commission staff then quantified the net present value of the regulatory asset, including the costs of taxes and return on the asset. Using the Commission staff's estimate of ratepayer contributions, the proposed settlement would allow ratepayers to settle PG&E's \$11.8 billion in pre-settlement claims at a cost of \$7.1 to 7.2 billion, or about 60 cents on the dollar, with PG&E giving up \$4.6 billion in claims.

In its testimony, ORA questioned the accuracy of PG&E's calculation of undercollected costs in light of headroom revenues reported in PG&E's regulatory balancing accounts. (Ex. 139, ORA/Reid, Danforth; Ex. 187, ORA/Bumgardner.) By ORA's calculation, PG&E had collected \$694 million more in headroom revenues during 2001- 2002 than PG&E estimated in its testimony. (Ex. 187, ORA/Bumgardner.) In response, PG&E said that the difference between ORA and PG&E was that ORA did not take into account

	In \$Millions
⁴¹ 2001 and 2002 Pre-Tax Headroom	\$3,200
2003 Pre-Tax Headroom	\$775 to \$875
NPV of the Regulatory Asset	\$2,210
NPV of the Tax Component of the Regulatory Asset	\$944
Estimated Ratepayer Contribution	\$7,129 to 7,229

anticipated additional costs or reductions in revenue that PG&E had accrued and reported in its SEC financial reports under generally accepted accounting principles (GAAP), but that had not yet flowed through PG&E's regulatory balancing accounts.

ORA estimated the ratepayer contribution under the settlement using the same time frame and components as Commission staff, to be in the range of \$9.0 to \$9.1 billion, \$1.9 billion higher than Commission staff. (Ex. 139, ORA/Reid, Bumgardner; Ex. 187, ORA/Bumgardner.) ORA estimated the amount of headroom received by PG&E in 2001 and 2002 to be \$694 million more than PG&E's estimate. Additionally, ORA computed the net present value of the regulatory asset to PG&E to be only \$1.5 billion.

The only other parties presenting any detailed testimony on the strength and quantification of PG&E's claims were The Utility Reform Network (TURN) and the City and County of San Francisco (CCSF). TURN's testimony relied primarily on the legal position taken by the Commission staff's outside expert as well as the position TURN itself took before the California Supreme Court in the *SCE* case. TURN also alleged that PG&E's estimate of undercollected costs was inflated. CCSF assumed that PG&E's undercollected procurement costs should be netted against \$2.5 billion in power generation revenues identified in the same exhibit. (Ex. 138, p. 6, CCSF/Barkovich.)

PG&E argues that although it is possible for the Commission to quantify the amount of PG&E's various claims that the utility would be giving up under the settlement, it is not so easy to compare those claims to the costs ratepayers would bear under the settlement. This is primarily because before any comparison can be done, the costs of the settlement to ratepayers must be netted against the quantifiable and unquantifiable benefits that ratepayers will receive

directly from the settlement itself. In this regard, one of the direct and quantifiable benefits to ratepayers under the settlement is that they receive over \$670 million a year in estimated rate relief effective January 1, 2004, and as much as \$2.1 billion in interest cost savings over the next ten years.

The record demonstrates that PG&E has asserted total claims of approximately \$11.8 billion, and that the ratepayer costs of the Settlement Agreement, using the Commission staff's calculations, are about 60% of those claims. This comparison does not include the direct, positive benefits ratepayers will obtain if this matter can be settled. Those benefits include immediate rate reductions; the ability of the Commission to regulate PG&E on an integrated, cost of service basis; and the environmental and public interest benefits offered by PG&E. PG&E's forgoing its unilateral attempt to transfer valuable utility assets to unregulated affiliates, and its land conservation commitments are not readily quantifiable, but they are nonetheless real and valuable. This comparison shows that the ratepayer dollar settlement is fair and reasonable when compared to the claims PG&E would waive and release.

4. Reasonableness of Rates

Analysis of the reasonableness of the settlement must begin with the rates themselves. The proposed rates under the PSA were originally forecasted to be:⁴²

	<u>Current</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Bundled Rate (cents/Kwh)	13.87	13.36	13.32	13.16	13.18	12.92

⁴² Exhibit 122, p. 7 (Clanon).

The initial revenue reduction in 2004 was updated by PG&E, which more recently forecast the revenue reduction in 2004 to be approximately \$670 million, resulting in a projected 12.91 cents per kWh rate for 2004. (Ex. 117b, p.10-3.)

In evaluating the rate impacts of a settlement it is important to bear in mind that the ratemaking process contains significant elements of art as well as science. All ratemaking proceedings are inherently complex undertakings that require many judgment calls. Projected system average rates under the settlement are expected to be lower than current rates. Rates under the settlement agreement lie between the rates ratepayers would see under PG&E's disaggregation plan and the Joint Amended Plan were either to be implemented. (Ex. 122, p. 10, Staff/Clanon) Accordingly, as to anticipated rates, the PSA satisfies our concern that the settlement fall within the "reasonable range of outcomes" that would result had the case proceeded to trial. (*See, Southern Calif. Edison Co.*, D.02-06-074.)

In any case, the PSA will not be a major driver of PG&E's rates in the near term. The costs associated with the PSA – principally the costs associated with the regulatory asset – are only a small share of PG&E's total costs, and are dwarfed even by such relatively small cost components as transmission costs. The proposed rate reduction is reasonable.

5. Adequacy of Representation In the Settlement Process

The PSA was negotiated by staff of the Commission, under the judicial supervision and mediation of a United States Bankruptcy Court judge. According to the judge, "...[Y]ou should know that the staff of the Public Utilities Commission, who participated in the settlement process, in my opinion, displayed diligence, competence and professionalism. I do not believe that they

overlooked opportunities to reduce costs to ratepayers, even as they agreed that the company should be restored to financial health.” (Ex. 146, p.2.)

The presence and involvement of Commission staff was adequate for three reasons. First, there is no question regarding the motives, independence, or professional competence of the governmental representatives in the negotiations. Second, the Commission staff has represented the Commission in the Bankruptcy Court on the Commission’s own plans of reorganization for PG&E. Finally, the Commission staff has played a prominent role in representing the Commission before the Legislature, the investment community, the rating agencies, and other constituent groups throughout the California energy crisis. We do not doubt the technical, financial, and ratemaking expertise of the Commission staff.

PG&E argues that the active participation of an independent, competent Commission staff in the settlement is a significant indication of the overall reasonableness and fairness of the PSA. In addition to the Commission staff, other governmental participants have endorsed the environmental provisions of the PSA, particularly the Land Conservation Commitment. (Ex. 181.)

Considering adequacy of representation in a different manner, whether or not representation was adequate in the bankruptcy settlement negotiations is now moot because the fairness of the PSA has been examined in this proceeding. In this investigation, where we approve the PSA, it is clear that ratepayers have been adequately represented by, among others, ORA, TURN, Aglet, and CCSF. We find that the Commission and ratepayers had adequate representation in the settlement process.

6. Release of PG&E Corporation

Paragraph 10 of the PSA states in part: “PG&E and PG&E Corporation, on the one hand, and the Commission on the other, will execute full mutual releases

and dismissals with prejudice of all claims, actions or regulatory proceedings arising out of or related in any way to the energy crisis or the implementation of AB 1890 listed on Appendix C hereto.” CCSF says the release language should be modified to exclude PG&E Corporation. It believes there is no need for any release of claims against PG&E Corporation in this proceeding, because such claims have nothing to do with helping PG&E resolve its bankruptcy. More importantly, it contends, the Commission currently has no pending proceedings against PG&E Corporation and certainly none that are listed in Appendix C. Nor has PG&E Corporation any claims against the Commission. CCSF argues that this release goes not to the Commission’s claims, but to the pending actions against PG&E Corporation brought by the California Attorney General and the City and County of San Francisco in the Superior Court. The Commission, CCSF maintains, should not provide PG&E Corporation with this very significant release as PG&E Corporation is not providing any consideration for the proposed release.

We will not accede to CCSF’s request. It is not a party to this settlement and it is not covered by the mutual releases; the Commission is not a party to the Superior Court action. Our objective in agreeing to mutual releases is to settle all matters between the settling parties (and no others) and return to a regulatory relationship not burdened with extraneous claims which, by paragraph 10, we now relegate to history.

C. Public Interest

1. The Regulatory Asset

The regulatory asset has been described above. It is \$2.21 billion amortized over nine years. It was sized to provide for the revenue, cash flow, and capital structure requirements that will enable PG&E to emerge from

bankruptcy as an investment grade company. This asset, when combined with the headroom, provides a \$7.2 billion ratepayer contribution (exclusive of direct and indirect ratepayer benefits under the PSA). (Ex. 122, p. 8.) As we have discussed above, this is a reasonable compromise of the economic differences of the proponents of the PSA. We also recognize that the settlement provides for net-of-tax generator refunds or offsets received by PG&E in 2003 or thereafter, which may offset dollar for dollar the amount of the regulatory asset. (PSA ¶ 2d) This is a further potential benefit for ratepayers. We understand that these generator refunds or offsets are not "headroom" under the settlement and will be applied solely to reduce the regulatory asset. This further feature of the design of the regulatory asset is also in the public interest.

2. Headroom

The PSA's definition of headroom is:

"PG&E's total net after-tax income reported under Generally Accepted Accounting Principles, less earnings from operations, plus after-tax amounts accrued for bankruptcy-related administration and bankruptcy – related interest costs, all multiplied by 1.67, provided that the calculation will reflect the outcome of PG&E's 2003 general rate case (A.02-09-005 and A.02-11-067)."

The Commission's definition of headroom is found in Re Proposed Policies, etc., (1996) D.96-12-076, 70 CPUC 2d 207:

"Freezing rates stabilizes collected revenues (subject to sales variation), and declining costs create "headroom," i.e., revenues beyond those required to provide service, that can be applied to offset transition costs. The utilities' reasonable costs of providing service are currently identified as their authorized revenue requirements. (70 CPUC 2d at 219.)

"In general, headroom revenues consist of the difference between recovered revenues at the frozen rate levels (including the reduced

rate levels for residential and small commercial customers beginning in 1998) and the reasonable costs of providing utility services, which for convenience we refer to as the authorized revenue requirement.” (70 CPUC 2d at 223.)

Clearly, the PSA definition is not the same as the Commission’s definition. Nevertheless, the Commission will adopt the definition in the PSA. When PG&E submits its filing to the Commission to implement the PSA, PG&E must demonstrate to the satisfaction of the Commission that PG&E has fairly and accurately accounted for the headroom. Any headroom revenues in excess of the \$875 million cap for 2003 are credited to PG&E’s ratepayers. Rather than attempt here to resolve potential disputes about headroom calculations, as ORA suggests, the Commission can address the disputes, if any, at the time of PG&E’s filing.

3. Dividends

6. Dividend Payments and Stock Repurchases. The Parties acknowledge that, for the Parent, as PG&E’s shareholder, to receive the benefit of this Agreement, both PG&E and its Parent must be able to pay dividends and repurchase common stock when appropriate. Accordingly, the Parties agree that, other than the capital structure and stand-alone dividend conditions contained in the PG&E holding company decisions (D.96-11-017 and D.99-04-068), the Commission shall not restrict the ability of the boards of directors of either PG&E or PG&E Corporation to declare and pay dividends or repurchase common stock.

As discussed above, this paragraph as we have interpreted it, is in the public interest.

As discussed above, under traditional cost-of-service ratemaking PG&E should be able to provide dividends or repurchase common stock. PG&E and SCE lost their creditworthiness and stopped paying dividends during the energy crisis due to skyrocketing wholesale procurement costs and the uncertainty caused by AB 1890’s deviation from cost-of-service ratemaking. However, as the

California Supreme Court explained in *Southern California Edison Co. v. Peevey*, *supra*, 31 Cal.4th at 795, the passage of AB 6X in January 2001 “allowed PUC to regulate the rates for power so generated pursuant to ordinary ‘cost-of-service’ ratemaking. PUC was thus authorized to permit SCE such recovery of past costs as necessary to render the utility financially viable and to ensure SCE would be able to continue serving its customers through electricity generated in its retained plants.” The Court contrasted the “competitive price-reduction approach” of AB 1890 with the cost-of-service rate regulation restored by AB 6X, which reemphasized the Commission’s “duty and authority to guarantee that the electric utilities would have the capacity and financial viability to provide power to California consumers.” *Id.* at 793.

Therefore, we have every reason to believe that in all likelihood, under our cost-of-service ratemaking authority, PG&E will be able to declare and pay dividends and maintain investment grade credit ratings. Since we do not interpret this provision in a way that inappropriately limits our regulatory authority in the future, we conclude that it is in the public interest.

4. Credit Rating

PSA paragraph 2g. states:

g. The Commission recognizes that the establishment, maintenance and improvement of Investment Grade Company Credit Ratings is vital for PG&E to be able to continue to provide safe and reliable service to its customers. The Commission further recognizes that the establishment, maintenance and improvement of PG&E’s Investment Grade Company Credit Ratings directly benefits PG&E’s ratepayers by reducing PG&E’s immediate and future borrowing costs, which, in turn, will allow PG&E to finance its operations and make capital expenditures on its distribution, transmission, and generation assets at a lower cost to its ratepayers. In furtherance of these objectives, the Commission agrees to act to

facilitate and maintain Investment Grade Company Credit Ratings for PG&E.

As discussed above, we do not find any reason to modify this provision, and we agree that it is in the public interest for PG&E to achieve and maintain an investment grade credit rating. Therefore, the Commission will act to facilitate and maintain such an investment grade credit rating for PG&E, which is part of the Commission's task in setting rates that are just and reasonable. Quoting *FPC v. Hope Natural Gas Co.*, *supra*, 320 U.S. at 603, the California Supreme Court in *20th Century Insurance Company v. Garamendi* (1994) 8 Cal.4th 216, 294 stated that the regulated entity has a legitimate concern that "there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock... [The return on equity] should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Consequently, the Commission is already obligated in setting just and reasonable rates to authorize a sufficient return on equity for the utility to maintain its creditworthiness. To commit to act to maintain PG&E's creditworthiness, as provided in this paragraph 2g, is consistent with the law. However, as discussed above, we feel compelled to clarify that the Commission's commitment does not require the Commission to guarantee such creditworthiness when there are factors threatening PG&E's investment grade credit rating besides the Commission's actions. We may authorize a sufficient return on equity, but imprudence or unreasonable conduct by PG&E may be the cause of PG&E not maintaining its creditworthiness. External forces in the marketplace may threaten PG&E's creditworthiness. Therefore, we must clarify

that this paragraph does not mean that the ratepayers will always have to pay higher rates to guarantee PG&E's investment grade credit rating.

Indeed, we interpret this paragraph in this way, because we must also balance the consumers' interests in setting just and reasonable rates. *20th Century Insurance Company v. Garamendi, supra*, 8 Cal.4th at 294. For example, we must take into account the imprudence or unreasonable costs of a utility when we set rates. *See City and County of San Francisco v. PUC* (1971) 6 Cal.3d 119, 129. If PG&E's own imprudence were to result in a disallowance that threatened PG&E's investment grade credit rating, it is PG&E's actions that would be responsible for this threat. Therefore, we do not interpret this paragraph to require the Commission to pass along imprudently incurred costs to the ratepayers.

As discussed above, however, we do not foresee this being a realistic problem in light of the decades in which PG&E and the other California utilities have had outstanding credit ratings, even when the Commission has on occasion disallowed imprudently incurred costs.

5. Assignability of DWR Contracts

Section 7 of the PSA provides for PG&E's agreement to the assignment and legal and financial responsibility for the DWR Contracts, subject to certain conditions precedent, as discussed earlier. Staff Witness Clanon testified that PG&E is currently dispatching most of these contracts and that it made sense from a policy perspective to put financial responsibility in with operational responsibility. Inasmuch as DWR's presence in the electricity power procurement business was an emergency measure, he further testified that such assignment was consistent with the Commission's policy of getting DWR out of the business as quickly as possible. (RT: 424: 2-19) We conclude that it is in the

public interest for DWR to get out of the business as quickly as possible, consistent with the conditions for assignment set forth in this provision.

6. Environmental Matters

The Land Conservation Commitment (LLC)

The PSA gives the people of California control over, and access to, 140,000 acres of land associated with PG&E's hydroelectric facilities (PSA ¶ 17), without compromising the ability of PG&E to generate electricity from those facilities. In 1999 PG&E proposed to sell these lands to the highest bidder. The PSA would remove forever that possibility, and replace the spectre of loss of public control with the promise of perpetual public access. The PSA's provisions for PG&E's either donating the land or granting conservation easements go much further than simply maintaining the status quo – the people of California can look to a partnership of the environmental community, state and local governments, and environmental stewardship organizations to preserve the lands and improve public access where desirable.

The proposed corporation and its governing board established in the PSA will ensure that PG&E complies with the requirement to donate the lands or grant conservation easements and will provide significant public (and Commission) oversight and participation into improvements made to the lands and the lands' ultimate disposition. Membership of the governing board would include representatives from PG&E, the Commission, the California Department of Fish and Game, the State Water Resources Control Board, the California Farm Bureau Federation, and three public members to be named by the Commission, plus others. This board should play an historic role in the protection of California's environment. The PSA expressly provides that enhancements to the lands not interfere with PG&E's hydroelectric operations, maintenance, or capital

improvements. Funding is provided by \$70 million to be paid over ten years, to be recovered in retail rates.

(a) The Stewardship Council

Fourteen parties served testimony regarding the land conservation commitment taking a diversity of positions and making numerous suggestions for improvement. Consequently, the presiding Administrative Law Judge (ALJ) encouraged the parties to resolve their differences through a stipulation. The ALJ waived the notice requirements of Rule 51 (Stipulations).

On September 25, 2003, Association of California Water Agencies, California Farm Bureau Federation, California Hydropower Reform Coalition, California Resources Agency, ORA, Regional Council of Rural Counties, State Water Resources Control Board, Tuolumne Utility District, U.S. Department of Agriculture-Forest Service, which are parties, and non-parties California Forestry Association, California Wilderness Coalition, Central Valley Regional Water Control Board, Mountain Meadows Conservancy, Natural Resources Defense Council, Northern California Council Federation of Fly Fishers, The Pacific Forest Trust, Inc., Planning and Conservation League, Sierra Club California, Sierra Foothills Audobon Society, Sierra Nevada Alliance, Trust for Public Land and U.S. Department of Interior-Bureau of Land Management presented to the Commission a “Stipulation Resolving Issues Regarding The Land Conservation Commitment” (the Land Conservation Commitment Stipulation (Ex. 181)), that implements Paragraph 17 and Appendix E of the Settlement Agreement and constitutes an enforceable contract among those parties.

Several parties had indicated that the governing board of the Stewardship Council,⁴³ as proposed in the PSA, would be more effective and representative if it was expanded to include the fuller array of interests and expertise of the public agencies, local government and trade associations, environmental organizations, and ratepayer organizations who have worked on the watershed land protection issue. The stipulation provides that, after its formation, the by-laws will be amended to provide that, in addition to the five members provided for in the PSA, the governing board will include one representative each from the California Resources Agency, the Central Valley Regional Water Quality Control Board, Association of California Water Agencies, Regional Council of Rural Counties, California Hydropower Reform Coalition, The Trust for Public Land, ORA, and California Forestry Association. (Ex. 181 ¶ 10(a).) In addition, the U.S. Department of Agriculture-Forest Service and U.S. Department of Interior-Bureau of Land Management will together designate a federal liaison who will participate in an advisory and non-voting capacity. The Commission will name three additional board members to further provide for public representation. This board ensures that all of the key constituencies are represented in the development and implementation of the land conservation plan.

The stipulation provides that decisions of the governing board will be made by consensus, that meetings will be public, and that there is a dispute resolution process. The stipulation delineates a planning and assessment process that will examine all of the subject lands in the context of their watershed and county. For each parcel, the plan will assess its current natural resource

⁴³ The stipulation provides that, once the PG&E Environmental Enhancement Corporation (EEC) is formed, its governing board will change its name to Pacific Forest and Watershed Lands Stewardship Council, referred to herein as the Stewardship Council.

condition and uses, state its conservation and/or enhancement objectives, whether the parcel should be donated in fee or be subject to a conservation easement, or both, that the intended donee has the capability to maintain the property interest so as to preserve or enhance the beneficial public values, that the donation will not adversely impact local tax revenue, assurance that known contamination be disclosed, appropriate consideration of whether to split the parcel, a strategy to undertake appropriate physical measures to enhance the beneficial public values, a plan to monitor the impacts of disposition and implementation of the plan, and an implementation schedule. Consistent with Appendix E to the PSA, the plan may also consider whether land “without significant public interest value” should be sold to private entities with few or no restrictions. The stipulation does not alter § 851 authority. Any proposed disposition will be presented to the Commission for public notice, hearing, and approval. The stipulation is expected to enhance the existing environmental and economic benefits of the Watershed Lands and Carizzo Plains on an overall basis.

We agree that the LCC as supplemented by the LCC stipulation will provide ratepayers with substantial benefits and is in the public interest. PG&E will undertake a study of all of these lands to determine current public values, and to recommend strategies and measures to preserve and enhance such values in perpetuity. PG&E will then implement such strategies and measures within six months after final receipt of all required government approvals no longer subject to appeal. The planning process, including surveys and inspections of 140,000 acres, will likely cost \$20 million or less (Ex. 127a, pp. 4-5, CHRC/Sutton), and thus the balance of the \$70 million will be available to implement physical measures, such as planting of trees to enhance fish and

wildlife habitat and water quality, construction or improvement of recreational access, and protection of Tribal or other historical sites. The LCC limits the discretion of PG&E to take inconsistent action in future proceedings.

The State Water Resources Control Board argues that the term “beneficial public values,” as used in Appendix C of the PSA, be modified to state that any agricultural, sustainable forestry and outdoor recreation uses on transferred lands “must be environmentally sensitive.” (SWRCB Op. Br. at 6.) PG&E opposes this modification, it argues that the term “environmentally sensitive” is hopelessly vague and, rather than clarifying the land conservation commitment, would only result in more confusion and debate. It asserts that the language in Appendix E has been crafted to give the Stewardship Council direction and the flexibility to determine how best to preserve and enhance the beneficial public values of the lands. The combination of state agency representation on the governing board with consensus voting, as well as the Commission’s § 851 approval process and CEQA review, will ensure that recreational uses that unduly harm the environment are not permitted. We agree with PG&E’s reasoning.

(b) Environmental Opportunity For Urban Youth

The Greenlining Institute has asked us to expand the LCC to address the needs of low-income urban PG&E ratepayers. A majority of PG&E’s ratepayers live in urban areas, not in the Sierra foothills, where the vast majority of the 140,000 acres are located. While recognizing that this idea may be meritorious, we nonetheless decline to modify the PSA in this regard.

(c) Clean Energy Technology Commitment

Under the PSA, PG&E will establish a shareholder-funded non-profit corporation dedicated to supporting research and investment in clean energy

technologies primarily in PG&E's service territory. (PSA ¶ 18.) The non-profit corporation's governing board will include Commission-selected appointees, PG&E-selected appointees, and appointees jointly selected by the Commission and PG&E. PG&E proposes an initial endowment of the non-profit corporation at \$15 million over five years (not to be recovered in rates). We view this commitment as part of the Commission's, and the State's, ongoing policies encouraging energy efficiency, demand response, renewable generation, and the entire range of more environmentally-friendly options for meeting load growth. We find that this provision is reasonable and in the public interest.

VII. The TURN Dedicated Rate Component Proposal

TURN recommends that the Commission approve the PSA modified to substitute the issuance of \$2.03 billion in energy recovery bonds (ERBs) secured by a dedicated rate component (DRC) in lieu of the regulatory asset.

TURN claims that this alternate financing structure will achieve all of the goals of the PSA, including restoring PG&E to creditworthy status, within the overall time frame contemplated by the PSA, at a cost to ratepayers of \$2.8 billion less than the cost of the PSA (TURN/Florio, Ex. 141). The TURN modification is a securitization of a future stream of revenues. California used such securitized financing for the rate reduction bonds (RRBs) which were issued by PG&E and the other California utilities in 1997 in conjunction with electric restructuring.

TURN explains its proposal as follows: In a securitization, steps are taken to legally separate the underlying assets (here the right to future cash flows to be collected from the utility's customers through a DRC) from the originating company. The assets are sold to a "special purpose entity" through a "true sale" to ensure that the assets would not become part of the estate of the originating company for bankruptcy purposes. Thus, PG&E would sell the right to receive

the DRC to a special purpose entity. That entity in turn would sell a note to a trust. The trust would then issue bonds secured by the proceeds of the note, which itself would be secured by the right to the DRC owned by the special purpose entity.

TURN proposes that the ERBs be structured in the same manner as the AAA-rated RRBs. The ERBs would be paid within nine years, but with a stated maturity of eleven years. The actual legal maturity is one to two years beyond the estimated bond redemption date to cover the risk that energy use deviates from projections at the time of issuance. A revenue requirement consisting of principal, interest, servicing fees, and a small overcollateralization component would be included as a separate component of utility rates. As was the case for the RRBs, a true-up mechanism would reduce the tariff if overcollections exceed 5% of projected revenue requirements, while the tariff would be increased if customer demand is less than projected.

PG&E would receive the proceeds from the sale of the bonds as cash up front. So long as the transaction is structured so that the proceeds are considered to be “debt” under IRS definitions, taxes are not due on the proceeds of the bonds. Instead, PG&E would owe taxes over time as service is actually provided and tariff revenue is received. To account for taxes, the \$1.2 billion which TURN proposes that ratepayers contribute to PG&E, is grossed-up by \$825 million. ERBs would be issued in the amount of \$2.03 billion.

In order for ERBs to be freely marketable, they will need a credit rating from at least one nationally recognized rating agency. The rating agencies assign a credit rating related to the likelihood that the issuer will be able to pay full principal and interest on the rated security in a timely manner in accordance with the terms of the security.

The tariff revenue requirement recovery mechanism must be irrevocable, prohibiting the Commission or any other governmental agency from rescinding, altering, or amending the tariff or transition property in any way that would reduce or impair its value. The bond recovery tariff must be nonbypassable by utility customers. The tariff is usually assessed as a distribution charge applicable to the monopoly utility service. Therefore, regardless of who generates the energy delivered to the customer, the tariff charge will be collected. The transaction must be structured so that bondholders are protected from interruption or impairment of cash flow in the event of a utility bankruptcy, usually accomplished by a “true sale” to a bankruptcy-remote special purpose entity, along with other steps to ensure that in a future utility bankruptcy, the special purpose entity would not be substantively consolidated with the transferor. Finally, the rating agencies will assess qualitative factors including the legal and regulatory framework, political environment, transaction structure, the utility as servicer of the debt, regional economic factors, and cash flow.

TURN asserts that the Commission has the legal authority to establish the right of utilities to future revenues, and to establish transferable rights to such future revenues. The California Supreme Court very recently noted the broad constitutional and statutory authority of the Commission and described it as “far-reaching.” (*Southern California Edison Co. v. Peevey, supra*, 31 Cal.4th 781.) The Court also noted that the Commission’s authority “has been liberally construed” in past judicial decisions.

PG&E counters with the argument that TURN’s proposal suffers from three fundamental flaws: (1) it will not work; (2) even if it could work, it would delay PG&E’s emergence from Chapter 11 to such an extent that the interest-rate risk alone would swallow the claimed savings; and (3) even if it could work, it

achieves most of its savings by shifting the payment of income taxes from customers to PG&E in violation of normal ratemaking principles.

A witness for PG&E testified that absent authorizing legislation, a rating agency could not see a short cut way to create a property right in future tariff collections that would be irrevocable and could not be changed by the legislature or other governmental body unless adequate compensation had been made to safeguard bondholder rights. Moreover, the structure would have to shield investors from the potential bankruptcy of the underlying utility by providing for an absolute transfer (or true sale) of the future tariff collections away from the utility to a special purpose vehicle or trust. Finally, the tariff surcharge would have to be nonbypassable to minimize the potential that future collections could decline.

In our opinion, the Commission cannot provide the essential elements of a securitization financing. An essential element of any rate securitization is the creation of a property right in future revenues. Future utility rate collections are normally an expectancy, not amounting to a present property right. For that expectancy to be turned into a property right, the utility must provide service to customers. Only when the service is provided does the utility have a right to payment. In the case of the RRBs, the Legislature bridged this gap by enacting a statute that created an enforceable property right in the future rate collection. (Pub. Util. Code § 843(c) (“Transition property shall constitute property for all purposes, including for contracts securing rate reduction bonds, whether or not the revenues and proceeds arising with respect thereto have accrued”).) Potential lenders in this securitization are expected to require legislation to provide assurance that the bonds will have the protections that TURN envisions this Commission can provide. Moreover, application of a DRC will increase the

risk of successfully completing a reorganization. There is no assurance that all parties whose approval of the transaction is required will be able to reach agreement. An adverse tax ruling, inadequate legislative mandate, weak structuring of a bankruptcy-remote financing entity, or assessment by the ratings agencies that the securitization bonds be treated as part of the PG&E credit structure are all factors that could negatively impact the transaction and could place at risk the achievement of PG&E's emergence from bankruptcy in a financially sound manner.

We need not analyze all PG&E's points as we are of the opinion that TURN's proposed securitization financing cannot be achieved without legislation. TURN's proposal is that the Commission should reject the regulatory asset in favor of a securitization financing of a type that has never been done before without legislation. TURN's own witnesses acknowledge that every utility securitization financing done to date has been pursuant to express enabling legislation. (Ex. 143, p. 23, TURN/McDonald.)

VIII. Rulings of the Administrative Law Judge (ALJ)

The request of CCSF for official notice of various documents filed with the Bankruptcy Court is granted to the extent set forth in this decision. (See footnotes 2 and 27.) The request of CCSF for official notice of San Francisco Superior Court Case No. CGC 02-404453, is denied. The petition of CCSF to set aside submission is denied. The rulings of the ALJ regarding admissibility of evidence, status as an intervenor, and status regarding intervenor compensation, are affirmed.

IX. Comments on the Alternate Proposed Decision

The alternate proposed decision of Commissioner Peevey in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(d)

and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on _____ and reply comments were filed on _____.

X. Assignment of Proceeding

Commissioner Michael R. Peevey is the Assigned Commissioner and Robert Barnett is the assigned ALJ in this proceeding.

Findings of Fact

1. The PSA is fair, is fair, just and reasonable and in the public interest.
2. On November 8, 2000, PG&E filed suit in the U.S. District Court for the Northern District of California against the five commissioners in their official capacity (the "Rate Recovery Litigation"). PG&E's complaint alleged that the Commission violated federal law by not allowing PG&E to collect in rates its costs of procuring wholesale energy. The Commission denied PG&E's allegations.
3. On April 6, 2001, PG&E filed for protection under Chapter 11 of the U.S. Bankruptcy Code, and has been operating under Bankruptcy Court supervision and protection since that date.
4. On September 20, 2001, PG&E and PG&E Corporation, as co-proponents, proposed a plan of reorganization for PG&E in its Chapter 11 proceeding. That plan provided for the disaggregation of PG&E's historic businesses into four companies, three of which would be regulated by the FERC rather than this Commission, as a means of raising the money necessary to pay all valid creditor claims in full and exit Chapter 11.
5. On August 30, 2002, the Commission and the Official Creditors Committee filed a Joint Amended plan of reorganization for PG&E.

6. PG&E and the Commission have vigorously opposed and litigated against the plans proposed by each other.

7. Bankruptcy confirmation hearings on the competing plans of reorganization started on November 18, 2002, and were ongoing on March 11, 2003, when the Bankruptcy Court entered an order staying further confirmation and related proceedings for sixty days to facilitate a mandatory settlement process under the supervision of Bankruptcy Court Judge Randall Newsome. The stay was later extended to June 20, 2003.

8. On July 25, 2002 in PG&E's federal district court case against the Commission, U.S. District Judge Vaughan Walker denied the Commission's motion to dismiss and denied PG&E's and the Commission's motions for summary judgment. In the course of his ruling denying the motions, Judge Walker held that the federal filed rate doctrine applies to purchases of energy at market based rates, but he found that there were numerous factual disputes and he set the matter for trial. The federal district court case has been stayed by the US Court of Appeals for the Ninth Circuit pending the appeal by the Commission of the District Court's denial of a motion to dismiss.

9. In the PG&E's federal district court case and other proceedings, PG&E claims to be entitled to recover from ratepayers \$11.8 billion of unrecovered costs of utility service. The Commission disputes this claim.

10. PG&E also claims to be entitled to retain \$2.5 billion in wholesale power generation revenues collected from retail ratepayers for September 2000 through January 2001. The Commission disputes these claims.

11. In the ATCP, ORA claims that \$434 million of costs of procuring power through the California Power Exchange should be disallowed as imprudently incurred. PG&E disputes ORA's claim.

12. On June 19, 2003, certain of the Commission's staff and PG&E announced that they had reached agreement on a proposed settlement that would resolve the competing plans of reorganization in the Bankruptcy Court, PG&E's case against the Commission in the U.S. District Court, and various pending Commission proceedings, all as set forth in the PSA.

13. There are substantial litigation risks to PG&E, the Commission, and ORA, and corresponding risks to ratepayers, in going to hearings on all issues and it is reasonable to approve a settlement that appropriately balances those risks.

14. PG&E has asserted claims, which total approximately \$11.8 billion, and the ratepayer costs of the settlement (\$7.2 billion), are about 60% of those claims. In addition there are direct, positive benefits ratepayers will obtain. Those benefits include immediate rate reductions; the ability of the Commission to regulate PG&E on an integrated, cost-of-service basis; and environmental betterments. The ratepayer dollar settlement is fair and reasonable when compared to the claims PG&E would waive and release.

15. It is in the public interest that PG&E emerge from bankruptcy promptly.

16. To emerge from bankruptcy PG&E should pay its creditors. All allowed claims should be paid in full. The dollar amount of the settlement, \$7.2 billion, will achieve that result and is a reasonable compromise of the differences between PG&E and the Commission staff. The headroom revenue is part of the total revenue package which we find reasonable and in the public interest.

17. If this PSA is implemented, the initial revenue reduction in 2004 is projected to be approximately \$670 million.

18. The presence and involvement of Commission staff in negotiating the PSA was adequate. The motives, independence, and professional competence of the governmental representatives in the negotiations are beyond dispute. The ratepayers had adequate representation in the settlement process.

19. The PSA will result in a feasible plan to permit PG&E to emerge from bankruptcy.

20. The PSA is fair, just and reasonable and in the public interest. First, it adopts the regulatory asset and the cash allowances of the PSA, and therefore will pay creditors in full, improving PG&E's credit metrics. Second, the PSA calls for the amortization of the regulatory asset "mortgage style" over nine years. Third, it offers the State significant environmental benefits. Fourth, it provides for reduction of the regulatory asset by any refunds obtained from energy suppliers. Finally, it contains PG&E's commitment not to unilaterally disaggregate for the life of the plan.

21. On September 9, 2003, the ALJ encouraged the parties to resolve their differences with respect to the Land Conservation Commitment in Paragraph 17 and Appendix E to the PSA.

22. On September 25, 2003, PG&E, California Resources Agency, ORA, Association of California Water Agencies, California Farm Bureau Federation, California Hydropower Reform Coalition, Regional Council of Rural Counties, State Water Resources Control Board, Tuolumne Utility District, U.S. Department of Agriculture-Forest Service and non-parties California Forestry Association, California Wilderness Coalition, Central Valley Regional Water

Control Board, Mountain Meadows Conservancy, Natural Resources Defense Council, Northern California Council Federation of Fly Fishers, The Pacific Forest Trust, Inc., Planning and Conservation League, Sierra Club California, Sierra Foothills Audobon Society, Sierra Nevada Alliance, Trust for Public Land and U.S. Department of Interior-Bureau of Land Management presented to the Commission a Stipulation Resolving Issues Regarding The Land Conservation Commitment (the “Land Commitment Stipulation”) that implements Paragraph 17 and Appendix E of the PSA and constitutes an enforceable contract among those parties.

23. The Land Conservation Commitment Stipulation is reasonable in light of the whole record, consistent with law, and in the public interest.

24. Under the LCC, no lands will be transferred or encumbered unless PG&E first applies for and obtains approval from the Commission pursuant to § 851.

25. TURN’s proposal to use a securitized financing supported by a dedicated rate component cannot feasibly be done without express enabling legislation. To wait for legislation would entail unreasonable delay in resolving PG&E’s Chapter 11 proceeding. Most of the savings claimed by TURN result from requiring PG&E to pay the taxes due on collections from ratepayers in violation of normal ratemaking principles.

Conclusions of Law

1. The PSA offered by PG&E and the Commission staff is fair, just and reasonable and in the public interest.

2. When entering into the settlement agreements or contracts, the Commission may not act inconsistently with state law.

3. The PSA is consistent with state law.

4. In light of the constitutional requirement that the Commission actively supervise and regulate public utility rates and the statutory requirements under the §§451, 454, 728 that the Commission ensure that the public utilities' rates are just and reasonable, the Commission must retain its authority to set just and reasonable rates during the nine-year term of the settlement .

5. The Commission cannot be powerless to protect PG&E's ratepayers from unjust and unreasonable rates or practices during the nine-year term of the proposed settlement.

6. The government may not contract away its right to exercise the police power in the future.

7. Entering into the PSA is fully consistent with the Commission's exercise of its ratemaking authority, because we find that the regulatory asset provision is reasonable and a necessary part of the settlement, and we will still decide the overall retail electric rates for PG&E's customers in pending and future proceedings.

8. Paragraph 2.g.'s commitment that the Commission will act to facilitate and maintain the investment grade credit ratings does not guarantee such a credit rating when there are other causes, besides the Commission's actions (e.g., PG&E's imprudent conduct resulting in a disallowance), which are responsible for any threats to PG&E's investment grade credit rating.

9. The Bankruptcy Court has jurisdiction over the plan of reorganization and over the parties to enforce the settlement agreement, settlement plan and the Court's own confirmation order, as well as jurisdiction over the implementation of the bankruptcy plan.

10. AB 6X made § 368(a) inapplicable to the utilities' unrecovered costs, and it is clear that the Commission's authority to allow PG&E to recover the balance in its TCBA is not limited by AB 1890.

11. The Commission and ratepayers had adequate representation in the settlement process. .

12. TURN's proposed securitization financing cannot be achieved without legislation.

13. The PSA (Appendix A of this order) is not contrary to state law and is fair, just and reasonable and in the public interest; therefore, it should be approved and adopted.

14. The rulings of the presiding Administrative Law Judge are affirmed.

15. The Commission has inherent authority under the California Constitution and Public Utilities Code §§ 451 and 701 to enter into and execute a settlement agreement.

16. The Commission has authority under Public Utilities Code § 701 and Rule 51 to approve the Land Conservation Commitment (LCC) Stipulation.

17. Under the LCC, the Commission retains its existing authority under § 851 to approve or disapprove of any proposed disposition or encumbrance of PG&E's property.

18. Should PG&E enter into the PSA and the Bankruptcy Court approve it as part of the settlement plan, the PSA will be binding upon future Commissions.

O R D E R

IT IS ORDERED that:

1. The Proposed Settlement Agreement (PSA in Appendix A) is approved and adopted by the Commission.
2. The rulings of the Presiding Administrative Law Judge are affirmed.
3. The Land Conservation Commitment Stipulation in Exhibit 181 is approved and adopted.
4. The Commission authorizes the Executive Director to sign the PSA (Appendix A) on behalf of the Commission.

This order is effective today.

Dated _____, at San Francisco, California.

**APPENDIX A
PACIFIC GAS AND ELECTRIC COMPANY
PROPOSED SETTLEMENT AGREEMENT (ORIGINAL)
CORRECTED EXHIBIT TO PREPARED TESTIMONY**

[See Appendix A attached to the Proposed Decision]

**APPENDIX B
LIST OF APPEARANCES**

[See Appendix D attached to the Proposed Decision]