Decision **PROPOSED DECISION OF ALJ BARNETT (Mailed 11/18/2003)**

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 D for Appearances.)

OPINION REJECTING THE PROPOSED SETTLEMENT AGREEMENT OF PACIFIC GAS & ELECTRIC COMPANY AND THE COMMISSION STAFF, AND APPROVING A MODIFIED SETTLEMENT AGREEMENT

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OPINION REJECTING THE PROPOSED SETTLEMENT AGREEMENT OF PACIFIC GAS & ELECTRIC COMPANY AND THE COMMISSION STAFF, AND APPROVING MODIFIED SETTLEMENT AGREEMENT

Summary

This decision rejects the Proposed Settlement Agreement (PSA) offered by Pacific Gas & Electric Company (PG&E), PG&E Corporation, and the Commission staff. The reasons for rejection include: 1) it purports to bind the Commission for nine years, 2) it unnecessarily cedes Commission jurisdiction to the Bankruptcy Court, 3) it guarantees PG&E an investment grade credit rating for nine years, and 4) it guarantees PG&E's dividends for nine years. This decision approves a Modified Settlement Agreement which deletes the rejected conditions and approves all the other financing arrangements of the PSA, including a monetary settlement of $7.2 billion which includes a regulatory asset of $2.21 billion.

I. Introduction and Background

On April 6, 2001, PG&E filed a voluntary case under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Northern District of California. PG&E asserts that it was compelled to seek relief in the Bankruptcy Court because, 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 $8.9 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 and its parent, PG&E Corporation, filed a plan of reorganization for PG&E (as amended and modified, the PG&E Plan). This Commission filed a plan of reorganization for PG&E. Subsequently, the Commission and the Official

Committee of Unsecured Creditors (the OCC) filed their Third Amended Plan of Reorganization for Pacific Gas and Electric Company (the Commission Plan). On November 18, 2002, the Bankruptcy Court commenced a hearing on confirmation of the competing plans. During the confirmation hearing, the Bankruptcy Court, on March 4, 2003, ordered a judicial settlement conference and, on March 11, 2003, stayed all proceedings with respect to confirmation of the competing plans to facilitate the settlement process. As a result of that process, a Proposed Settlement Agreement (PSA, the subject of this proceeding) was reached, the terms of which are incorporated by reference into a plan of reorganization dated July 31, 2003. The stay has been continued indefinitely pending further order of the Bankruptcy Court.

It is important to understand that although this Commission filed a plan of reorganization for PG&E, the Commission did not participate in the settlement discussions which culminated in the PSA. The settlement discussions were conducted by a small number of the Commission staff, who were <u>not</u> authorized to bind the Commission. The PSA is before us for approval. (Appendix A.)

The background of the energy crisis in California has been recounted many times in the decisions of this Commission and the courts. An excellent exposition of the events leading up to the energy crisis and PG&E's bankruptcy is found in the recent California Supreme Court decision *Southern California Edison Company v. Peevey* ((2003) 31 Cal. 4th 781). That exposition of events is equally applicable to PG&E. We repeat the Court's exposition here, with minor modifications to denote effects on PG&E.

The essential background of this case lies in California's attempt, beginning in 1996, to move the system for provision of electrical power from a regulated to a competitive market, the crisis caused in mid-2000 to early 2001 by soaring prices for electricity on the wholesale market, and the urgency legislation enacted in January 2001 in response to that crisis.

Assembly Bill No. 1890 (1995-1996 Reg. Sess.) (hereafter Assembly Bill 1890), which became law in 1996 (Stats. 1996, ch. 854), was intended to provide the legislative foundation for "California's transition to a more competitive electricity market structure." (Assembly Bill 1890, § 1, subd. (a).) The new market structure included the creation of the California Power Exchange (CalPX), which was to run an "efficient, competitive auction" among electricity producers, and the Independent System Operator, which would control the statewide transmission grid. (*Id.*, § 1, subd. (c).) The state's main investor-owned electric utility companies (Southern California Edison Company (SCE), PG&E, and San Diego Gas & Electric Company (SDG&E) (hereafter the utilities) were expected to divest themselves of substantial parts of their generating assets, while retaining others at least during the period of transition. (*Id.*, § 10, adding Pub. Util. Code, former § 377.) Under the Assembly Bill 1890 scheme as implemented, all generators, including the utilities, sold their power through the CalPX; the utilities also bought, through that exchange, the electricity they needed to supply their retail customers. (*Cal. Exchange Corp.* v. *FERC* (*In re Cal. Power Exchange Corp.*) (9th Cir. 2001) 245 F.3d 1110, 1114-1115.)

Because this competition among producers was expected to bring down wholesale prices, the utilities believed that some of their generating assets, which they had built or improved with California Public Utilities Commission (PUC) approval, would become "uneconomic," in that the costs of generation (and of certain long-term contracts between the utilities and other generators) would be higher than prevailing wholesale rates would support. The costs associated with these potentially uneconomic assets are also known as "stranded costs" or "transition costs." The Legislature, in Assembly Bill 1890, intended to allow for "[a]ccelerated, equitable, nonbypassable recovery of transition costs" (Stats. 1996, ch. 854, § 1, subd. (b)(1)) and thereby to "provide the investors in these electrical corporations with a fair opportunity to fully recover the costs associated with commission approved generation-related assets and obligations" (Pub. Util. Code, § 330, subd. (t)). The legislative scheme for doing so without subjecting consumers to increased rates was complex, but consisted in its essentials of the following:

Under Pub. Util. Code § 367,[1] PUC was to identify and quantify potentially uneconomic costs (i.e., the PUC-approved costs that "may become uneconomic as a result of a competitive generating market"). The identified costs were to be recoverable through rates that would not exceed "the levels in effect on June 10, 1996," and the recovery was not to "extend beyond December 31, 2001." (§ 367, subd. (a).) The component of rates dedicated to recovery of transition costs was nonbypassable, i.e., it had to be paid to the utility whether the consumer bought power from the utility, from a generator in a single direct transaction, or from a generator in an aggregated direct transaction with other consumers. (§§ 365, subd. (b), 366, 370.)

Section 368 required each utility to propose, and PUC to approve, a "cost recovery plan" for the costs identified in § 367 that would set rates at June 10, 1996, levels, with a 10 percent reduction for residential and small commercial customers. Section 368, subdivision (a) continues: "These rate levels . . . shall remain in effect until the earlier of March 31, 2002, or the date on which the commission-authorized costs for utility generation-related assets and obligations have been fully recovered. The electrical corporation shall be at risk for those costs not recovered during that time period."

PUC implemented this cost-recovery scheme in part by creating, for each electric utility, a transition cost balancing account (sometimes herein referred to as a TCBA), in which the PUC-identified stranded costs were tracked. Transition costs were not to be forecast, but rather entered in the transition cost balancing account as the PUC determined them. Costs associated with utility-retained generating assets were to be determined by comparing the book value of the assets with their market valuations, a process to be completed by the end of 2001. These uneconomic generating costs were to be netted against the benefits of any *economic* generating assets (those having higher market than book value). The difference between rate revenue and the utility's other (nongeneration-related) costs was designated the utility's "headroom" and was to be credited against the stranded costs in the transition cost balancing account. The portion of each rate serving as headroom was designated the competition transition charge. (*In re Pacific Gas & Electric Co.* (1997) 76 Cal. P.U.C.2d 627, 646-653, 740-744.)

In the first few years of the transition period, the utilities recovered much of their stranded costs. SDG&E was found to have recovered all its transition costs, ending the rate freeze for that utility under § 368. SCE and PG&E, however, were still subject to the rate freeze when, in the summer of 2000, power procurement prices, and particularly prices on the CalPX spot market, rose drastically. They incurred huge debts buying electricity through the CalPX.

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[1] All further statutory references are to the Public Utilities Code unless otherwise

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(*Cal. Exchange Corp.* v. *FERC* (*In re Cal. Power Exchange Corp.*), *supra,* 245 F.3d at p. 1115.)

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specified.

In November 2000, as the wholesale price and supply problems continued, SCE brought its federal action against PUC. In essence, SCE claimed the rate freeze imposed by Assembly Bill 1890 was now depriving SCE of its right, under federal law, to recover the costs of purchasing electricity for its customers. More particularly, SCE claimed the freeze rates had become unconstitutionally confiscatory and violated the federal "filed rate" rule, which assertedly allows a utility to recover in state-regulated retail rates the costs of purchases made under federally approved tariffs.

PUC granted SCE and [PG&E] emergency rate relief in early 2001. Deeming the crisis one "that involves not only utility solvency but the very liquidity of the system," PUC in January 2001 authorized a temporary surcharge of one cent per kilowatt-hour. (*Application of Southern California Edison Co.* (2001) Cal. P.U.C. Dec. No. 01-01-018, pp. 1-4.) Two months later, still finding that "SCE's and PG&E's continued financial viability and ability to serve their customers has been seriously compromised by the dramatic escalation in wholesale prices," PUC made the January increase permanent and authorized an additional three cents per kilowatt-hour increase. (*Application of Southern California Edison Co.* (2001) Cal. P.U.C. Dec. No. 01-03-082, pp. 2-4.) PUC refers to these increases collectively as the "four cent surcharge," a usage we adopt. (The surcharge amounted to an average increase of 40 percent in retail rates.) PUC's March 2001 decision, while authorizing an increase to pay for ongoing power purchases, did "not address recovery of past power purchase costs and other costs claimed by the utilities." (*Id.*, at p. 2.)

The Legislature also took action in January 2001, in an extraordinary session called to address the power crisis. In that session's Assembly Bill No. 1 (Stats. 2001, 1st Ex. Sess., ch. 4; hereafter Assembly Bill 1X), the Legislature authorized the state Department of Water Resources to begin buying power for customers of SCE and PG&E. (*Id.*, § 4, adding Wat. Code, §§ 80100-80122.) In Assembly Bill No. 6 of that Session (Stats. 2001, 1st Ex. Sess., ch. 2; hereafter Assembly Bill 6X), the Legislature amended several provisions of Assembly Bill 1890, halting at least temporarily the transition to a competitive electricity market. In particular, Pub. Util. Code § 377, as first enacted by Assembly Bill 1890, had provided that PUC would continue regulating the utilities' retained nonnuclear generating assets "until those assets have been subject to market valuation," after which they would be sold off unless the utility convinced the PUC their retention was in the public interest. (Stats. 1996, ch. 854, § 10.) As amended by Assembly Bill 6X, § 377 provides that *all* the remaining generating assets are subject to PUC regulation and may *not* be sold until January 1, 2006, at the earliest. (Assembly Bill 6X, § 3.) Similarly, as enacted by Assembly Bill 1890, Pub. Util. Code § 330, subdivision (*l*)(2) had provided that the generating assets "should be transitioned from regulated status to unregulated status through means of commission-approved market valuation mechanisms." (Stats. 1996, ch. 854, § 10.) Assembly Bill 6X deleted this language, leaving only the general statement that "[g]eneration of electricity should be open to competition." (*Id.*, § 2.) PUC subsequently issued decisions, based on Assembly Bill 6X, reestablishing cost-based rate regulation of SCE's (and PG&E's) retained generating assets and modifying restrictions on the use of the four-cent surcharge. (E.g., *Application of Southern California Edison Co.* (2002) Cal. P.U.C. Dec. No. 02-04-016, p. 2; *Application of Southern California Edison Co.* (2002) Cal. P.U.C. Dec. No. 02-11-026, pp. 11-16.) (End of Court's exposition, 31 Cal 4th 781, 787 to 791.)

II. Procedural History[2]

On April 6, 2001, PG&E filed for protection under Chapter 11 of the Bankruptcy Code. Numerous creditors and other parties, including the Commission, intervened. On September 20, 2001, PG&E and PG&E Corporation, as co-proponents, filed a plan of reorganization (PG&E Plan). The PG&E Plan provided for the disaggregation of PG&E's businesses into four companies, three of which would be regulated by the Federal Energy Regulatory Commission (FERC). The Commission opposed the PG&E Plan. The PG&E Plan was amended and modified a number of times.

On April 15, 2002, the Commission authorized the filing of its original plan of reorganization for PG&E (Original CPUC Plan). Among other things, the Original CPUC Plan would have raised funds to pay PG&E's creditors through "headroom" revenues[3] and issuance of new debt and equity securities, while at the same time maintaining PG&E as an integrated utility subject to regulation by the Commission. Subsequently, the Commission and the OCC filed an amended plan of reorganization for PG&E, dated August 30, 2002 (Joint Amended Plan) (later supplemented by a "Reorganization Agreement" entered into by the Commission and PG&E).

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[2] 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.

[3] "Headroom" is defined below.

Bankruptcy Court confirmation hearings on the competing plans of reorganization started on November 18, 2002. On November 21, 2002, during the trial on the Commission's 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 contrary to the Public 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.)

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 discussions.

On June 19, 2003, as a result of the settlement process, PG&E and the CPUC staff announced agreement on a Proposed Settlement Agreement under which PG&E and the Commission agree to jointly support a new plan of reorganization in the Bankruptcy Court that embodies the terms and conditions contained in the PSA (the Settlement Plan).[4] 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

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[4] The PSA and the Settlement Plan are two different documents.

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.

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.[5] 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.

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[5] *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.[6]

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.)

[6] 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.

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 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. 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 aset 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).[7] 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.

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[7] 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.

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

2. Headroom[8]

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

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[8] 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)."

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 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, 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 Litigation[9] against the Commission based on the federal filed rate doctrine (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 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.[10] 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

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

[10] 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 (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 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. 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.

2. 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.

3. Fees and Expenses

PG&E will reimburse the Commission for its professional fees and expenses in the Chapter 11 case without the need for an application (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.*).

4. Releases

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

5. 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 our *Diablo Canyon* decision ((1988) 30 CPUC 2d 189), 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.]
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> 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."
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> 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. This is not the proceeding to consider alternative plans that one or more parties may prefer. Instead, as PG&E admonishes us, 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.[11]

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, ***<u>as a whole</u>***, is in the public interest.

We reject the PSA, not because we have "delved deeply" into its details, but because its defects are patent, obvious on first reading. We will discuss the obvious defects more 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. We agree that all allowed claims should be paid in full; and we agree

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[11] 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.)

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 concerned with the relationship between the debtor and its creditors.

As the California Supreme Court recently explained in *Southern California Edison Company v. Peevey* (2003) 31 Cal. 4th 781, 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. 3rd 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 <u>solvent</u> 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." Significantly, no mention is made of the ratepayers who are expected to shoulder 100 percent of PG&E's burden.

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, it 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 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 argument that the Commission would not be surrendering the State's police powers because the proposed settlement would only bind the Commission for nine years has no merit. 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 irrepealable law. It cannot be bartered away even by express contract." (*Mott v. Cline* (1927) 200 Cal. 434, 446 (emphasis added).)[12]

In Re Pacific Gas and Electric Company (1988) D.88-12-083, 30 CPUC 2d 189 ("Diablo Canyon"), 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

[12] It is interesting to note that the PSA confirms the fact that in adopting the settlement we are exercising our police powers. Recital G., p.2., states: "In the exercise of its police and regulatory powers, the Commission is entering into this agreement…."

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.)

An excerpt from Diablo Canyon sets forth the rationale and a solution.

> "A major concern in this case is whether a future Commission will adhere to the terms of a settlement agreement which fixes the price to be paid for Diablo Canyon electricity for the next 28 years. The parties agree that we cannot bind future Commissions. PG&E: "Since ratemaking is quasi-legislative in nature, it is a general principle that a commission cannot bind the actions of a future commission" (Brief. p. 71); AG: "As a legal matter, the Commission cannot bind its successors as to policy matters" (Brief, p. 5); the DRA: "No order of the Commission is binding on future Commissions" (Brief, p. 7); TURN: "It is well-established that a decision made by the current Commission cannot bind a future Commission" (Brief, p. 15). And we have specifically held that we cannot bind the actions of a future Commission. (*Re PG&E (*1981) 6 CPUC 2d 739 (abstract), D.93497 in A.59537.)
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> * * *
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> The CPUC is both a court and an administrative tribunal. It exercises both judicial and legislative powers. (*Re L. A. Metro. Transit Auth*. (1962) 60 CPUC 125, 127.) The fixing of rates of public utilities is an example of its legislative powers. (*People v. Western Air lines, Inc.* (1954) 42 Cal. 2d 621, 630.)
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> * * *
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> The Public Utilities Code strengthens the proposition that we cannot bind future Commissions. Section 1708 provides: "The commission may at any time . . . rescind, alter, or amend any order or decision made by it." Section 457 permits utilities to enter into an agreement for a fixed period for the automatic adjustment of charges for electricity with the caveat "Nothing in this section shall prevent the commission from revoking its approval at any time and fixing other rates and charges . . . ." Finally, Section 451 provides that "All

> charges demanded or received by any public utility . . . shall be just and reasonable" and Section 728 provides that if the Commission finds rates are unreasonable, "the commission shall . . . fix . . . the just, reasonable . . . rates . . . to be thereafter observed and in force." We have reviewed these statutes, which are familiar to all practitioners of public utility law in California, to impress upon the proponents of the settlement the limitations under which we act today. (Cf. *FPC v. Sierra Pac. Power Co*. (1956) 350 US 348, 100 L. Ed. 388.) And we deliberately refrain from commenting on the consequences of a future Commission's changing of the terms of the settlement. We believe the settlement is a fair compromise of a difficult, costly controversy and we intend that the terms and conditions of the Settlement Agreement and the Implementing Agreement shall be effective on the dates specified in the agreements. The proponents have prepared the following language to propitiate future Commissions, which we adopt.
>
> To the extent permitted by law, the Commission intends that this decision be binding upon future Commissions. In approving this settlement, based on our determination that taken as a whole its terms produce a just and reasonable result, this Commission intends that all future Commissions should recognize and give all possible consideration and weight to the fact that this settlement has been approved based upon the expectations and reasonable reliance of the parties and this Commission that all of its terms and conditions will remain in effect for the full term of the agreement and be implemented by future Commissions."

Conclusion of Law 4 in Diablo Canyon held: "This Commission cannot bind future Commission in fixing just and reasonable rates for PG&E." We reaffirm that holding and will adopt the mitigating language set forth above, expecting future Commissions to abide by our approval of a settlement extending for a period of years.

The proponents of the PSA attempt to 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 may not bind future Commissions, but the Commission may execute a settlement agreement or a contract to bind future Commissions. This distinction is absurd.

We do not doubt that under certain circumstances, the Commission can legally enter into settlements or contracts which would bind future Commissions.[13] However, when entering into the settlement agreements or contracts, the Commission may not act inconsistently with state law. In *Southern California Edison Co. v. Peevey*, (2003) 31 Cal. 4th at 792, the Court declared: "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."

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[13] Among other things, the Commission may 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.)

The PSA purports to bind the Commission for nine years. 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), we hold that the Commission has the authority to enter into settlements but does not have authority to limit or prevent future Commissions from determining whether or not PG&E's rates are just and reasonable.

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

> **21. <u>Validity and Binding Effect.</u>** 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.

Because we cannot bind future Commissions we strike the third sentence of the paragraph. And because of the view we take regarding consenting to Bankruptcy Court jurisdiction and choice of laws (discussed below) we have rewritten paragraph 21 to read as follows:

> The Parties agree not to contest the validity and enforceability of this Agreement or the Settlement Plan.

1. Jurisdiction of the Bankruptcy Court

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

> **22. <u>Enforcement.</u>** 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.

This paragraph is deleted in its entirety.

Under the PSA the Bankruptcy Court will be asked to determine such matters as a) whether the Commission discriminated against PG&E, *see* ¶ 2j; b) whether the Commission failed to act to maintain PG&E's investment grade company credit ratings, *see* ¶ 2g; or c) whether the Commission restricted the ability of PG&E to declare dividends or repurchase common stock, *see* ¶ 6; the PSA includes other provisions of a more general nature under which PG&E could request intervention by the Bankruptcy Court. Among many scenarios which might reasonably arise, we note three:

1. PG&E files an application for a 3% attrition increase. The Commission grants only 1% and places the entire increase on the large industrial customers. PG&E claims a violation of the PSA and seeks relief in Bankruptcy Court. Meanwhile, the industrial customers seek relief by appealing the Commission decision to the California appellate courts. The result would be a conflict of jurisdictions leading to conflicting decisions, delay, and increased expense.
2. On the facts above, the Bankruptcy Court orders PG&E to increase its rates by 2%, which it does without CPUC authorization; or the Bankruptcy Court orders the CPUC to raise PG&E's rates by 2% under threat of a contempt action.
3. The CPUC opens an investigation of PG&E seeking to reduce rates by a specific (or unspecific) amount. PG&E immediately moves the Bankruptcy Court for an injunction preventing the CPUC from proceeding with the investigation.

Appellate procedure to challenge the decisions of the Commission is clear. § 1759 states:

> 1759. (a) No court of this state, except the Supreme Court and the court of appeal, to the extent specified in this article, shall have jurisdiction to review, reverse, correct, or annul any order or decision of the commission or to suspend or delay the execution or operation thereof, or to enjoin, restrain, or interfere with the commission in the performance of its official duties, as provided by law and the rules of court.
>
> (b) The writ of mandamus shall lie from the Supreme Court and from the court of appeal to the commission in all proper cases as prescribed in Section 1085 of the Code of Civil Procedure.

For this Commission to consent to a dilution of the power of the Supreme Court of California and the appellate courts to review our orders and decisions is a step we are not prepared to take. We recognize that the Bankruptcy Court has the power to enforce its orders and nothing we say here should be construed to deny that power.

2. Conflict of Laws

The PSA exposition of controlling law is confusing. Paragraph 21 (set forth above) states, in part: "This Agreement, the Settlement Plan and any such orders [entered by the Bankruptcy Court] are intended to be enforceable under federal law, notwithstanding any contrary state law."

Paragraph 32 states:

> **32. <u>California Law.</u>** This Agreement shall be governed by, and shall be construed and enforced in accordance with, the laws of the State of California, without giving effect to the conflict of law principles thereof, except that this Agreement, the Settlement Plan and any orders of the Court (including the Confirmation Order) are intended to be enforceable under federal law, notwithstanding any contrary state law.

As discussed above, we cannot lawfully enter into a settlement that may be contrary to state law (S*ee, Southern California Edison co. v. Peevey (2003)* 31 Cal. 4th at 792; *Southern California Edison Co. v. Lynch* (9th Cir. 2002) 307 F.3d 794, 809), and we cannot limit the future decisions and orders of the Commission such that the Commission could no longer protect PG&E's ratepayers from unjust and unreasonable rates. Perhaps we are being unduly cautious, but under the PSA we foresee the intricacies of *Erie v. Tompkins* (1938) 304 US 64, 114 ALR 1487, lurking in the details of determining just what California laws are to be enforced under which federal law, and more to the point, a reiteration of *SCE v Lynch* (9th Cir. 2002) 307 F.3d 794, 812 with the federal court of appeals certifying questions of California law to the California Supreme Court. We have rewritten paragraph 32 to read as follows:

> **California Law.** This Agreement shall be governed by, and shall be construed and enforced in accordance with, the laws of the State of California.

3. 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*, 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 had eliminated AB 1890's market valuation requirement for the utilities' retained generation assets and Assembly Bill 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 had "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 had 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 that 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 v Peevey* 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 "<u>financial viability to provide power to California customers</u>." (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, modified as we propose, satisfies this requirement.

1. The Modified PSA[14] Will Allow PG&E to Emerge Promptly From Bankruptcy

The Modified PSA 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 Modified PSA calls for the amortization of the regulatory asset "mortgage style" over nine years.[15] Third, it offers the state significant environmental benefits.[16] Fourth, it provides for reduction of the regulatory asset by any refunds obtained from FERC. Finally, it contains PG&E's commitment not to unilaterally attempt to disaggregate for the life of the plan.[17]

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[14] The changes this decision makes in the PSA are shown in the redlined copy of the PSA in Appendix B. The version of the settlement which we approve is in Appendix C, where it is referred to as the Settlement Agreement.

[15] "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.

[16] Exhibit 101a, ¶¶ 17-18.

[17] *Id.* Statement of Intent ¶ 3; Agreement ¶ 11(b).

There are provisions in both the PSA and the Modified PSA that enhance PG&E's fiscal soundness. These elements are: the ratemaking treatment associated with the regulatory asset;[18] 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;[19] a Commission commitment not to allow procurement costs to impair collection of other costs (including those associated with the regulatory asset); imputation of a capital structure to PG&E;[20] and a Commission commitment not to discriminate against PG&E as compared with other utilities.[21] Further elements of both the PSA and the Modified PSA enhancing the attractiveness of the Settlement Plan to rating agencies are the assurances of recovery of headroom within a certain range[22] in 2003,[23] assured recovery of the full amount that PG&E sought in the ATCP,[24] and the dismissal with prejudice of PG&E Corporation (PG&E's parent) from the Commission's

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[18] Exhibit 101, ¶ 2.

[19] Exhibit 101, ¶ 2f.

[20] 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]."

[21] Exhibit 101, 1-9:2-6. *See generally* Exhibit 101a, ¶ 2(f).

[22] $775 million to $875 million. Exhibit 101a, ¶ 8(b).

[23] 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.*

[24] Exhibit 101a, ¶ 10 and App. C.

Holding Company OII as to past practices.[25] 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 it is these entities' blessing of the plan, through the assignment of investment-grade credit ratings, that is crucial to feasibility. Its witnesses testified: "It is critical for PG&E to meet at least minimum investment-grade ratings"[26] 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."[27]

To be "investment-grade" is to be assigned credit ratings at or above a certain level. Credit ratings matter because they determine the breadth and depth of markets that are accessible to a borrower, and because they determine the cost of debt that a borrower will pay. Certain markets are completely unavailable, or only of limited availability, to non-investment-grade companies, and non-investment-grade companies pay higher borrowing costs in whatever markets are available.

PSA ¶ 16 states:

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[25] *Id.*

[26] Exhibit 122 at 11.

[27] Exhibit 103.

> **16. <u>Conditions Precedent to Effective Date.</u>** Among other conditions to be contained in the Settlement Plan, the following shall be conditions precedent to the Effective Date:
>
> a. S&P and Moody's shall have issued investment grade company credit ratings for PG&E.
>
> b. The Commission shall have given final, nonappealable approval for all rates, tariffs and agreements necessary to implement the Settlement Plan. The PG&E Proponents shall have the right to waive this provision with respect to any appeal from the Commission's approvals.

This paragraph gives S&P and Moody's veto power over any settlement adopted by the parties and a veto over when PG&E emerges from bankruptcy. No witness from either rating agency testified. There is no assurance that approval of the PSA as written would satisfy them. In fact, there is evidence that the PSA does not fulfil all of S&P's requirements.

The witness for CCSF testified:

> Additionally, the PG&E Plan may be infeasible due to the difficulty of obtaining investment grade ratings for the debt securities to be issued under that Plan. By letter dated February 19, 2003, Standard & Poor's (S&P) listed many conditions that would have to be met for PG&E to achieve an investment-grade rating. Several of the conditions laid out by S&P cannot be assured. These include a provision that the Commission will continue to act consistent with AB 57, even after the law expires; that the Commission will allow, "in a timely manner that does not compromise cash flow" many gas and electric procurement-related costs; that the utility's distribution operation will earn its "contemplated rate of return without any material deviation from projected results"; that PG&E will be able to recover costs to replace QF power that "will be consistent with those forecast in the [company's] Model; and that "the CPUC will permit as a ministerial matter the recovery of the distribution company's costs of securing risk management tools and also permit the recovery of costs associated with that portion of the power and fuel

portfolio that is not hedged." (Exhibit 138 at 10 (discussing S&P February 19, 2003 letter to PG&E re the ratings for the amended Plan, which letter is Exhibit 149).)

Why this Commission, or the Bankruptcy Court, should put approval by a rating agency as the sine qua non of PG&E's emergence from bankruptcy escapes us. Should the rating agencies not approve we would expect PG&E to request from us additional economic enhancements. There is no evidence in this record to show that an investment grade credit rating is necessary for PG&E to emerge from bankruptcy, while there is overwhelming evidence that utilities have emerged from bankruptcy without investment grade credit ratings. Nor can we overlook the fact the SCE is now providing safe, reliable electric service at reasonable rates without having an investment grade credit rating.

We modify paragraph 16 as follows:

Conditions Precedent to Effective Date. Among other conditions to be contained in the Settlement Plan, the following shall be conditions precedent to the effective date:

a. S&P and Moody's shall have issued investment grade company credit ratings for PG&E.

b. The Commission shall have given final, nonappealable approval for all rates, tariffs and agreements necessary to implement the Settlement Plan.

c. The PG&E Proponents shall have the right to waive either or both of these provisions

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 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 Commission's alternative 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 principal risks of continued litigation in PG&E's bankruptcy proceeding is that some combination of the Bankruptcy Court and federal appellate courts ultimately will approve PG&E's requested $11.8 billion in unrecovered costs and its proposal to disaggregate its traditional utility business into four separate entities, three of which would be permanently outside the jurisdiction of the Commission. This risk is real, because the federal district court has affirmed PG&E's view of the broad authority of the Bankruptcy Court to expressly preempt the Commission's regulatory authority as part of a plan of reorganization under the Bankruptcy Code. (*In re Pacific Gas and Electric Company*, 283 B.R. 41 (N.D. Cal. 2002.) That decision is on appeal to the Ninth Circuit, U.S. Court of Appeals. Further, 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.)[28]

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. The Commission already has expended approximately $25 million in PG&E's bankruptcy, and has not even completed the trial and post-trial briefing on its own plan.

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

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[28] 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.

preempt the Commission's jurisdiction, the Commission has vowed to appeal and further challenge PG&E's plan through the courts. If PG&E were not to prevail, the Commission staff's plan would severely 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 and financial distress 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 and120c, 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.)[29] 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 anticipated additional costs or reductions in revenue that PG&E had accrued and

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[29]

	In $Millions
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

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's total claims are 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 foregoing 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:[30]

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

The initial revenue reduction in 2004 is expected to be approximately $670 million. (Ex. 117b, p.10-3.)

[30] Exhibit 122, p. 7 (Clanon).

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 Commission plan were either to be implemented. Accordingly, as to anticipated rates, the Modified 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 Modified PSA will not be a major driver of PG&E's rates in the near term. The costs associated with the Modified 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 we have rejected the PSA on other grounds. In this investigation, where we approve a modified PSA, it is clear that ratepayers are adequately represented by, among others, ORA, TURN, Aglet, and CCSF. We find that the Commission and ratepayers had adequate representation in the settlement process. Merely because we do not agree 100% with the result of the settlement process does not negate that adequacy.

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 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 requirement 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. (Ex. 122, p. 8.) As we have discussed above, this is a reasonable compromise of the economic differences of the proponents of the PSA.

Because the compromise amount appears reasonable we do not "delve deeply" within its components. But we caution the proponents that if further negotiations are needed to reach a settlement we will indeed "delve deeply."

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 <u>Re Proposed Policies, etc.,</u> (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 CPUC definition. As ORA cogently observes:

> "PG&E's definition of headroom raises more basic questions than it answers. PG&E has not clearly or unambiguously defined or explained "earnings from operations," or "after-tax amounts accrued for bankruptcy-related administration and bankruptcy-

> related interest costs." Nor has PG&E defined how "the calculation will reflect the outcome of PG&E's 2003 general rate case." Because these key terms remain undefined and unexplained, they will be subject to varying interpretations that can benefit PG&E shareholders, especially before the bankruptcy court. It will be very difficult and contentious for the Commission to audit 2003 headroom to make sure that it falls within the $775 million - $875 million range specified by the PSA.
>
> "The PSA's reference to modifying headroom according to generally accepted accounting principles (GAAP) presents a large substantive problem. To ORA's knowledge, no Commission's decision authorizes PG&E to modify its regulatory accounts by "generally accepted accounting principles" that are not explicitly stated in its tariffs." (ORA, Opening Brief, p.5.)

However, as the headroom revenue is part of the total revenue package which we find reasonable, for the purpose of this settlement we will not "delve deeply," but will find it to be in the public interest.

3. Dividends

> **6.** **<u>Dividend Payments and Stock Repurchases.</u>** 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.

This paragraph is unacceptable and is stricken. It says the Commission "shall not restrict" PG&E from paying dividends or repurchasing common stock. We interpret this to mean that for nine years we must set rates so that PG&E shall be able to pay dividends. Not only is there no amount specified, but also there is no limit to the amount of dividends PG&E might declare. Should we reduce PG&E's rates that would "restrict the ability," and should we fail to grant a PG&E requested rate increase, that too, would restrict its ability. Paragraph 6 would divest the Commission for nine years of any authority under Sections 451, <u>et seq.,</u> 701, and 728 to find PG&E's dividend practices unreasonable.

For example, even if imprudent conduct, reckless conduct, or criminal conduct would otherwise limit PG&E's ability to collect revenues necessary for dividends, the Commission would be powerless to restrict PG&E's dividend practices. If PG&E no longer has sufficient funds to perform its public service obligations due to an unreasonable dividend practice or common stock repurchase practice, we would be powerless to restrict the practice. Under cost-of-service ratemaking PG&E should be able to provide dividends or repurchase common stock, but we cannot guarantee that it will always be reasonable for PG&E to do so. There is no legal basis for us to strip the Commission of its statutory and constitutional authority to supervise PG&E's rates and practices in this regard.

Most importantly, to impose this limitation on our power to fix just and reasonable rates for PG&E, would require us to impose this limitation for all utilities under our jurisdiction. Should we deny the benefits of paragraph 6 to SCE or SDG&E, or any utility, arguably we would be discriminating against them in favor of PG&E. This Commission cannot grant a preference to any utility (§ 453(a), § 728). Paragraph 6 is not in the public interest.

In conformity with striking paragraph 6, we also strike the last sentence of paragraph 3b.

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.

We strike paragraph 2g. in its entirety. It is not in the public interest to "facilitate and maintain" an investment grade company credit rating for PG&E. The reasons stated above regarding restricting the ability of PG&E's to declare dividends are equally applicable to the requirement to "maintain" PG&E's credit ratings.

If we were to commit to PG&E that we would take action to guarantee to maintain its investment grade credit ratings for nine years, we predict that other public utilities under our jurisdiction would soon be requesting similar guarantees. The Commission does not operate in a vacuum. Our decision in one case is often cited as precedent in other cases. We stated, in a different context, "we believe the ramifications on the rate design of all water utilities by setting this new trend must be addressed. The requested separate rate district would set a precedent for future litigants to follow. "(*Re Apple Valley Ranchos Water Company* (1990) D.90-02-045, 35 CPUC2d 535, 545.) In the present case, we find that it is not in the public interest to tilt the ratemaking balance so heavily in PG&E's favor and against the ratepayers' interest or to set a precedent by guaranteeing PG&E that regardless of circumstances, we would effectively insulate PG&E from financial risks for the next nine years. Nor do we desire to open the floodgates for other utilities to demand such guarantees as they refer to this decision in future applications.

Because we find that the requirement to maintain an investment grade credit is not in the public interest, we modify the Statement of Intent paragraph (5) and (7) to conform to this finding.

5. Financing

We have stricken the sentence in paragraph 13 b.

> "The financing of the Settlement Plan shall not include any new preferred or common stock."

Issuing stock is a matter for PG&E to determine in the first instance. There is no need to narrow its options.

6. Environmental Matters

(a) 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.

(b) 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,[31] 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.

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[31] 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.

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 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.

(c) 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

144,000 acres are located. In order to ensure that environmental benefits of a substantial nature are realized by PG&E's urban ratepayers, our Modified Settlement Agreement will augment the $70 million devoted to environment activities by $30 million. These additional funds shall be expended to provide a wilderness experience for urban youth, especially disadvantaged urban youth, and to acquire and maintain urban parks and recreation areas. We direct that the acquisition of such parks and recreation areas be focused on creating an environment that will particularly serve the needs of urban low-income youth.

Of the $30 million, to be expended in equal installments over 10 years, we will expect approximately 1/3 would be used to provide seed money that would establish a permanent program for young people who are least likely to enjoy the wonder of California's natural beauty. This program would allow disadvantaged, inner city youth to experience the environment in nature's own setting. The program would select young citizens in an urban setting, and provide the means to visit these watershed lands for a week or two. While there, they would be exposed to living in the outdoors and see how the actions of man interact with animal and plant life, both favorably and unfavorably. The 2/3 balance of the $30 million would be used to acquire urban parks and recreation areas for inner city youth. We will use our three appointments to the Stewardship Council to champion this $30 million allocation, among their other duties.

(d) 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'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 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. However, $15 million is inadequate. We believe an additional $15 million (not to be recovered in rates) will assure adequate planning and funding.

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 v. Peevey*, 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 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 Proposed Decision

The proposed decision of ALJ Barnett 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 and reply comments have been filed. All comments merely repeat arguments previously made in the briefs of the parties and require no modification of the decision.

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 not in the public interest; it is rejected.

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 Filed Rate Case). The Filed Rate Case 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 all allegations in the Filed Rate Case.

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 filed an 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 the Filed Rate Case, U.S. District Judge Vaughan Walker denied the Commission's motion to dismiss and denied PG&E's motion 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 and that, notwithstanding the Commission's TURN accounting decision (D.01-03-082), he would hold a trial to determine what costs PG&E incurred in purchasing wholesale energy and what funds were available to it to pay for those purchases.

9. In the Filed Rate 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 staff dispute 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, the filed rate doctrine litigation 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's total claims are 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. The initial revenue reduction in 2004 is expected to be approximately $670 million.

18. Paragraph 6 of the PSA is unacceptable and not in the public interest as it impairs our ability to protect ratepayers. It requires the Commission to not

restrict PG&E from paying dividends or repurchasing common stock. We interpret this to mean that for nine years we must set rates so that PG&E shall be able to pay dividends. Not only there is no amount specified, but also there is no limit to the amount of dividends PG&E might declare.

19. Paragraph 2g. is unacceptable and not in the public interest. A commitment to PG&E that we would take action to maintain its investment grate credit ratings for nine years, would cause other public utilities under our jurisdiction to request similar guarantees. The Commission does not operate in a vacuum.

20. It is not in the public interest to tilt the ratemaking balance so heavily in PG&E's favor and against the ratepayers' interest or to set a precedent by guaranteeing PG&E that regardless of circumstances we would effectively insulate PG&E from financial risks for the next nine years.

21. 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.

22. The Modified Settlement Agreement will result in a feasible plan to permit PG&E to emerge from bankruptcy.

23. The Modified Settlement Agreement 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 Modified Settlement Agreement 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 FERC. Finally, it

contains PG&E's commitment not to unilaterally disaggregate for the life of the plan.

24. 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.

25. 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.

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

27. 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.

28. 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 rejected.

2. The Settlement Agreement in Appendix C of this order should be approved and adopted.

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

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

5. The Commission has authority under Public Utilities Code § 701 and Rule 51 to approve the Land Commitment Stipulation.

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

7. This Commission cannot bind future Commission in fixing just and reasonable rates for PG&E.

8. This Commission has the authority to enter into settlements but does not have authority to limit or prevent future Commissions from determining whether or not PG&E's rates are just and reasonable.

9. To the extent permitted by law, should PG&E and PG&E Corporation agree to the Modified Settlement Agreement, this Commission intends that this decision be binding upon future Commissions. In approving this settlement, based on our determination that taken as a whole its terms produce a just and reasonable result, this Commission intends that all future Commissions should recognize and give all possible consideration and weight to the fact that this settlement has been approved based upon the expectations and reasonable reliance of the parties and this Commission that all of its terms and conditions will remain in effect for the full term of the agreement and be implemented by future Commissions.

O R D E R

IT IS ORDERED that:

1. The Proposed Settlement Agreement offered by PG&E, PG&E Corporation, and the Commission staff is rejected.

2. The Settlement Agreement in Appendix C is approved and adopted by the Commission.

3. The rulings of the Presiding Administrative Law Judge are affirmed.

4. The Land Conservation Commitment Stipulation in Exhibit 181 is approved and adopted.

This order is effective today.

Dated ____________________________, at San Francisco, California.

APPENDIX A
PG&E PROPOSED SETTLEMENT AGREEMENT

APPENDIX B

PACIFIC GAS AND ELECTRIC COMPANY
APPROVED SETTLEMENT AGREEMENT (REDLINED

APPENDIX C
SETTLEMENT AGREEMENT

APPENDIX D

LIST OF APPEARANCES

Barnett Agenda Dec Appendix A