STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

December 4, 2003

Alternate to Agenda ID #2983
Ratesetting

TO: PARTIES OF RECORD IN INVESTIGATION 02-04-026

Enclosed is the alternate proposed decision of Commissioner Lynch.

The Commission may act at the regular meeting, or it may postpone action until later. If action is postponed, the Commission will announce whether and when there will be a further prohibition on communications.

When the Commission acts on the proposed decisions, it may adopt all or part of them as written, amend or modify them, or set them aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decisions as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's Website at http://www.cpuc.ca.gov. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the Assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:epg

Decision **PROPOSED ALTERNATE DECISION #1 OF COMMISSIONER LYNCH (Mailed 12/4/2003)**

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 SETTLEMENT AGREEMENT AS MODIFIED

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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. We reject this settlement because it:

1) purports to bind the Commission for nine years in contravention of our statutory and constitutional requirements,
2) unnecessarily and illegally cedes Commission jurisdiction to the Bankruptcy Court,
3) guarantees PG&E an investment grade credit rating for nine years in contravention of our statutory mandates and legal precedent against binding future Commissions,
4) guarantees PG&E's dividends for nine years,
5) would alter the definition of headroom from the Commission's regulatory definition to one based on "Generally Accepted Accounting Principles" (GAAP), the PSA's definition would allow PG&E to recover costs not authorized by the Commission and artificially reduce headroom, in effect, giving PG&E shareholders higher dividends,
6) defines "headroom" in vague terms that endanger the bond indenture for the bonds sold on November 2, 2001 by the California Department of Water Resources (DWR),
7) creates a disincentive for PG&E to seek refunds from energy sellers engaged in price gouging during the power crisis,

8) prohibits the Commission from restricting PG&E's ability to pay dividends for any reason,

9) grants credit rating agencies with veto power over the settlement,

10) endangers the ongoing litigation the California Attorney General is pursuing against PG&E Corporation for return of approximately $4 billion in payments made from PG&E to PG&E's holding company (PG&E Corporation) prior to entering Chapter 11,

11) precludes the ability of PG&E to raise financing by issuing new stock as part of the settlement plan,

12) requires ratepayers to pay PG&E more than 100% of PG&E's litigation claims,

13) requires the use of illegal retroactive ratemaking by changing PG&E's authorized rate of return on equity for 2001 transition costs from roughly 7% to11.22%, and

14) imposes a monetary settlement of $7.2 billion with a regulatory asset of $2.21 billion that is unjust and unreasonable.

Unfortunately, the list of legal and financial infirmities above may not constitute all the legal and financial problems arising from the proposed settlement. Many procedural factors have combined to present this Commission with severely inadequate time and resources to consider sufficiently the historic costs, regulatory and legal consequences of this settlement. As a threshold issue, four of the five commissioners and the vast majority of the PUC staff was and still are precluded pursuant to an unprecedented gag order issued by the bankruptcy settlement judge from participating in or learning the basis of the proposed settlement and its components. This lack of information, understanding and ability to analyze the proposed settlement's components or legal meaning has impaired and continues to impair the ability of commissioners to perform their statutory and constitutional duties to determine if this proposal is in the public interest, much less whether it is in the best interest of the ratepayers.

The process entered into at the Commission to consider the proposed settlement unfortunately has also been rife with procedural infirmities. First, the scoping memo of the assigned commissioner unnecessarily crimped the evidentiary record developed and thereby limits the ability of the Commission to properly consider otherwise worthwhile programs and components, such as the Urban Youth Experience shoehorned into one of the alternate decisions without the benefit of development on the record. Comprehensive proposals that could have strengthened ratepayer benefits while ensuring financial creditworthiness of the utility have been precluded from consideration. Second, the limited time for hearings has jammed parties who raise concerns to this complex proposed settlement and crammed testimony and cross examination into a scope of time comparable that we take for small rate cases rather than the most monumental proceeding faced by this Commission in recent years. Third, the expedited timeframe for consideration of the proposed decision and multiple alternates by the end of the year affords no time for thorough comment, consideration and revisions as necessary. The proposed settlement agreement is an extraordinarily complex legal document with layers and layers of regulatory, financial and legal consequences that are still to be discovered. In fact, this alternate is a work in progress given the extremely short time frame within which to evaluate the proposed decision and two alternates that were first public on November 18th. The limitations adhering to this rushed process are exacerbated by the use of

Commission staff as proponents of the proposed settlement. The unique posture of the staff with the most knowledge, expertise and history of this settlement and indeed this legal proceeding has imposed barriers to communication with the staff who are best positioned to advise the Commission and individual Commissioners in the performance of their statutory and Constitutional duties. Finally, the imposition of an artificial drop dead date of December 31, 2003 for this Commission to act on the most important and far reaching matter to come before this Commission in years aggravates the lack of adequate consideration and analysis. No legal or financial reason exists to rush to judgment on this settlement this year. No rates will be reduced on January 1st, even if the proposed settlement is approved as is. Rather, PG&E's emergence from bankruptcy still faces many months of actions by this Commission and the bankruptcy court under any circumstance. Given that the resolution of the PG&E bankruptcy has enormous and far reaching consequences for years to come, this Commission should choose to get it right, rather than to get it quick.

Nonetheless, in an abundant of caution that this Commission will continue to barrel ahead, this alternate decision is offered on the timeframe that has been imposed.

This decision approves a Modified Settlement Agreement which deletes the rejected conditions and approves an alternate plan to allow PG&E to recover its energy crisis undercollection by applying all excess revenues (headroom) collected through the surcharges imposed by ratepayers by this commission on January 4, 2001, and March 27, 2001, and maintaining those surcharges until

PG&E's net undercollection[1] is reduced to zero. Additionally, PG&E would contribute its earnings towards paying down the undercollection while the surcharges remain in effect. The mechanism of the Modified Settlement Agreement, given current projections, would allow PG&E to eliminate its net undercollection, reinstate its lapsed debts, and emerge from bankruptcy by first quarter of 2005.

The Modified Proposed Settlement provides the simplest, least expensive mechanism to ensure PG&E's investment-grade creditworthiness without undue and excessive profits locked in for PG&E shareholders. It pays creditors in full and completely refinances the debt in the same manner as the PSA and the PUC plan. It provides a clear, simple and tested path to financial feasibility. It eliminates all the legal infirmities of the PSA and maintains this Commission's adherence to its statutory and Constitutional mandates. It protects the energy bonds sold by DWR and prevents the creation of new legal liabilities relating to inconsistencies with the Rate Agreement that are contained in the PSA.

Of critical importance, the MSA adopted here doubles the rate decrease provided by the PSA within one year of the PSA's projected but not promised rate decrease projections. It eliminates the debt overhang created by the PSA and eliminates and potentials conflicts of interest arising from the issuance of that projected debt. And it provides enhanced environmental stewardship of all

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[1] Estimated to be $2.95 billion, not counting anticipated headroom for 2003. Calculation of undercollection based on PG&E/ORA joint filed comparison exhibit, Exhibit No. 184. The determination of the $2.95 billion undercollection shall be discussed in later sections.

environmentally sensitive lands within PG&E's purview while maintaining the tax bases of the counties in which those lands are located.

I. Background

A. Background – PG&E Chose to Seek Chapter 11 Bankruptcy Protection

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.

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.

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 claimed 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) in September 2001. This Commission filed an alternate plan of reorganization for PG&E by express permission of the bankruptcy court on April 15, 2001, which the Commission modified during the summer and 2002.

Among other things, the Original CPUC Plan would have raised funds to pay PG&E's creditors through "headroom" revenues[2] 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).

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.

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.)

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

[2] "Headroom" is defined below.

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.. As a result of that process, in which President Peevey participated as the sole commissioner privy to the settlement, 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 and subsequent amendments by unanimous votes, the Commission did not participate in the settlement discussions that culminated in the PSA. The settlement discussions were conducted by a small number of the Commission staff and President Peevey, who were <u>not</u> authorized to bind the Commission. The PSA is before this Commission 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.

1. AB 1890 and California Energy Deregulation

Assembly Bill No. 1890 (Brulte, 1996) (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,[3] the 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 the 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."

The 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.

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

Footnote continued on next page

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

2. The California Energy Crisis and Resulting Electric Rate Increases

In November 2000, as the wholesale price and supply problems continued, PG&E and Edison brought federal actions against PUC. In essence, those utilities claimed that the rate freeze imposed by Assembly Bill 1890 was now depriving the utilities of their right, under federal law, to recover the costs of purchasing electricity for its customers. More particularly, Edison and PG&E 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.

The PUC granted Edison and PG&E emergency rate relief on January 4, 2001. Deeming the crisis one “that involves not only utility solvency but the very liquidity of the system,” the PUC in 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, on March 27, 2001, 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,” the 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.) The PUC refers to these increases collectively as the “four cent surcharge.” (The surcharge amounted to an average increase of 40 percent in retail rates.) In fact,

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specified.

the PUC authorized a four and a half cent surcharge in the March 27, 2001, because it authorized an extra half-cent to be charged in recognition that, due to the necessary lag in billing and collections, the four cent surcharge would not fully flow until later in 2001. However, despite repeated requests to discontinue the half-cent "catch up" surcharge, this Commission never removed or reduced the additional half-cent. PG&E has continued to collect four-and-a-half cents as a surcharge since the second quarter of 2001. 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 non-nuclear 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, passed and signed as an urgency measure with immediate effect in January 2001, § 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.)

B. Background – SCE Chose to Work with California

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

Under the terms of the Edison settlement, the Commission committed to keeping in effect the elevated rates first approved in March 2001 until Edison's energy crisis-related debts have been paid. Edison committed to applying all cash above cost of service (operating expenses and after tax return on rate base) to payment of its debts, which were collected in the Procurement Related Obligations Account (PROACT). The settlement placed significant limits on Edison's approved capital spending and suspended common and preferred dividends until the PROACT was paid. The settlement made no other changes to Edison's corporate or capital structure. Edison paid off the PROACT in July 2003 (after 21 months) and has received investment grade credit ratings from Fitch, Moody's, and Standard & Poors. The Edison settlement was entered into as a settlement of federal court litigation between Edison and the Commission. A stipulated judgment was entered by the federal district court and no continuing district court oversight of the Commission's regulatory authority was ever agreed to. Contempt proceedings existed as the sole enforcement mechanism. The authority of the Commission to enter into the settlement under state law was confirmed by the California Supreme Court on August 26, 2003, following approval of the settlement under federal law by the U.S. Ninth Circuit Court of Appeals in November 2003.

The Edison settlement applied a rigorous cost of service methodology to Edison's operations and utilized all of the revenue generated by rates in excess of cost of service to pay Edison's energy crisis-related debts and restore its credit. Through a mutual regime of economic and financial discipline on the part of Edison, a commitment to maintain rates at the level needed to pay off Edison's debt, the Commission and Edison cooperatively restored Edison's creditworthiness and financial metrics in less than two years. This included financing Edison's capital program through revenues from current rates without resort to the capital markets and provided sufficient earnings to enable Edison to significantly exceed the targeted equity ratio for cost of service ratemaking. At the end of July 2003, Edison reduced its rates by an average 13% across its entire system and will reduce them further as it recovers refunds from merchant generators and other malefactors and as DWR and other utility costs and energy crisis financial overhangs decline.

PG&E has had the benefit of the same high rates as Edison. By voluntarily resorting to bankruptcy, PG&E has erected additional obstacles to restoration of its credit over and above those faced by Edison. Nevertheless, PG&E has managed to finance its entire capital program and to retire more than a billion dollars in mortgage debt while amassing a significant cash reserve, as it defrayed a half billion dollars in litigation cost and operated its business on an ongoing basis as a debtor in possession with significant interruption or stress. The high rates approved by the Commission in March 2001 have done their job for both Edison and PG&E. The question now is how to bring PG&E along the final steps to emerge from bankruptcy, restore its credit and reduce its rates, while the Commission does its job for Northern California ratepayers and ensures just and reasonable rates in the future.

C. Procedural History of this Commission Proceeding[4]

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).[5] PG&E, PG&E Corporation, and the

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[4] 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.

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

OCC as co-proponents filed the Settlement Plan and disclosure statement for the plan with the Bankruptcy Court. The PSA constitutes an integral part of the Settlement Plan and is incorporated in the plan by reference. The Bankruptcy Court has stayed all proceedings related to the Commission's Joint Amended Plan and the PG&E Plan, until a confirmation hearing on the Settlement Plan.

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 Commissioner Peevey 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.[6] 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.

Despite the limitations on the development of the evidentiary record in this proceeding, numerous parties did submit suggestions and proposed amendments. We must, however, evaluate the parties' positions within the

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[6] *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.

confines set by the Assigned Commissioner's Scoping order which precluded parties from submitting for the Commission's evaluation alternate plans or frameworks to pay PG&E's undercollections. This limited record was made all the more limited by the refusal of PG&E and Commission staff to set for the or explain the basis for the numbers and language underlying or contained in the settlement documents.

Eight days of hearings on the limited scope of evidence 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.

II. Description of the PSA Terms and Conditions

A. Structure of the Proposed 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[7] as modified and limited by the terms of the Proposed Settlement Agreement.

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[7] 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.

B. Financial Elements of the PSA

1. Establishment of a 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 asset will not have any tax basis, both the amortization of the regulatory asset and the return on it will be grossed up for taxes (PSA, ¶ 2c).[8] 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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[8] 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. Profits Accruing to PG&E[9]

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.

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[9] 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)." This definition is at odds with the Commission's traditional definition based on approved regulatory accounts and could result in additional profits/headroom allocated to PG&E over and above what PG&E would be entitled to recover under the traditional regulatory definition.

3. Ratemaking Matters

The proposed settlement provides for PG&E's retail electric rates to remain at current levels through 2003, with a reduction effective as of January 1, 2004 (PSA, ¶ 3a)[10]. As of January 1, 2004, the TCBA and other Assembly Bill 1890 ratemaking accounts will be replaced by the regulatory asset and the ratemaking resulting from the proposed settlement (PSA, ¶ 2e).

PG&E's capital structure and authorized ROE will continue to be set in annual cost of capital proceedings, but until PG&E achieves a company credit rating of either A- from Standard & Poor (S&P) or A3 from Moody's, the authorized ROE will be locked in at 11.22 percent (after tax, with shareholders paying the tax on this profit) 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

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[10] Because of the necessary timeline and delays of the bankruptcy court process, ratepayers would not experience an actual rate decrease next month. It would be many months, and potentially even longer, for ratepayers to obtain any rate reductions pursuant to the PSA.

does not expect to pay a common stock dividend before the second half of 2005, but the PSA does not require or mention such a deferral. 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[11] 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 PSA also requires the Commission to act outside the record of another currently pending regulatory proceeding by requiring the Commission to 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

Under the PSA, PG&E commits to protect 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

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

commitment are worth approximately $300 million.[12] The determination of how best to protect these lands will be made by the board of a new California non-profit corporation (PSA, ¶ 17b). Under the Land Conservation Commitment Stipulation (Ex. 181), this non-profit corporation will be named the Pacific Forest and Watershed Lands Stewardship Council (the Stewardship Council). The Stewardship Council's governing board will consist of representatives from the Commission, the California Resources Agency, ORA, the State Water Resources Control Board, the California Farm Bureau Federation, the California Department of Fish and Game, the California Forestry Association, the California Hydropower Reform Coalition, the Regional Council of Rural Counties, the Central Valley Regional Water Quality Board, Association of California Water Agencies, The Trust for Public Land, and PG&E, and three public members named by the Commission. The U.S. Department of Agriculture-Forest Service and U.S. Department of Interior-Bureau of Land Management will together designate a federal liaison who will participate in an advisory and non-voting capacity. (Ex. 181, paragraph 10a.) Ratepayers will pay $70 million over ten years to fund the operation of this Stewardship Council (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.

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[12] 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.) These estimates have not been tested on the record through a formal financial evaluation process.

The second environmental commitment involves PG&E establishing and funding 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. All such commission appraisals of rates, tariffs, and other unspecified agreements could take considerable time, during which time any rate reductions would presumably be on hold.

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

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. As provided in the PSA, UBS Warburg and Lehman Brothers will be entitled to all commissions and fees for conducting such hedging without reasonableness review by this Commission (PSA, ¶ 13 d, f). Ratepayers will pay for all such fees and commissions for this hedging, without any parameters or limits.

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). Essentially, the settlement creates a complete refinancing of the company, rather than reinstatement of existing debt. 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.*), except for those costs shifted to the ratepayers by the operation of the GAAP accounting provisions of the PSA (PSA , ¶ 1y). Fees, commissions and other payments to Lehman Brothers and to UBS Warburg are locked in and expressly allowed under the PSA. (¶¶ 12, 13.

4. Releases

As part of the Settlement Plan, PG&E will release claims against the Commission, the OCC, and PG&E Corporation (PSA, ¶ 24). The Commission agrees to release PG&E and PG&E Corp. from all claims, actions, or regulatory proceedings (¶ 10).

5. Bankruptcy Court Supervision

The PSA requires that the settlement will be enforceable by the Bankruptcy Court for its full nine-year term (PSA, ¶¶ 20-23, 30, and 32) rather than entering into a judgment and releasing the continuing jurisdiction of the bankruptcy court. Instead, 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." (PSA , ¶ 22)

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. (PSA, ¶ 20)

III. Standard of Review

A. Just and Reasonable and in the Public Interest

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 our rules. 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).) Here, we are not in the usual settlement situation in which parties bring to us a settlement and the Commission evaluates the settlement in its quasi-judicial capacity. Rather here it is the Commission itself that is the settling party, making our rules for parties before us inapplicable. Thus, this Commission is guided by our statutory and

California Constitutional mandates to act in the public interest and ensure just and reasonable rates.

Our 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) 18 Cal. 573, 581. As the United States Supreme Court stated in Arkansas Electric Coop. v. Arkansas Pub. Serv. Comm'n (1983) 461 U.S. 375, 377, "the regulation of utilities is one of the most important of the functions traditionally associated with the police power of the states."

The source of the Commission's authority to exercise the police power of the State in this regard is Article XII of the California Constitution, which requires that the Commission actively supervise and regulate public utility services and rates in order to protect the people of the State of California from the consequences of monopolies in the public service industries. See Sale v. Railroad Commission (1940) 15 Cal.2d 612, 617. In addition, there is statutory authority for the Commission to exercise the police power of the State pursuant to Public Utilities Code §§ 451, 454, 701, 728, 761, 762, which require the Commission to ensure that the public utilities' rates are just and reasonable and that their facilities and services are adequate. See Camp Meeker Water System, Inc. v. Public Utilities Com. (1990) 51 Cal.3d 845, 861-862. We cannot shirk these duties by invoking Commission-made rules intended for a different kind of settlement in a different context.

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.

PG&E asserts the Commission's Rule 51 settlement criteria should apply to the PSA. As PG&E admonishes this Commission, 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.[13]

Under Public Utilities Code §§ 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,

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[13] 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.)

in and of itself, the optimal outcome. Instead, we stand back from the minutiae of the parties' positions and determine whether the settlement, ***as a whole***, is in the public interest.

Even though the schedule imposed has made it impossible to delve deeply into the particulars of this settlement and the gag orders issued by the bankruptcy settlement judge have made it impossible for other Commissioners and staff to evaluate fully the PSA and its underpinnings, we reject the PSA, because it is unjust and unreasonable. Many of the PSA's defects are patent and 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 find that maintaining rates and requiring the payment of deferred dividends and earnings to reduce the back debt until PG&E has recovered its actual undercollection will achieve that result and constitutes a reasonable compromise of the differences between PG&E and the Commission staff.

B. Adequacy of Representation In the Settlement Process

The PSA was negotiated by President Peevey and selected Commission staff under the judicial supervision, restrictions, and mediation of a United States Bankruptcy Court judge.

We are unsure as to the adequacy of representation by the Commission staff involved in the settlement negotiations. We have no mechanism to evaluate the adequacy of representation given the continuing limitations of the gag orders issued by the bankruptcy settlement judge. We do not doubt the technical, financial, and ratemaking expertise of the Commission staff, yet we are troubled that the proposed settlement agreement put before us, even under conservative analysis, would attempt to resolve outstanding legal issues between PG&E and the Commission at 150% of claims. Many commissioners have been significantly hindered in their evaluation of the settlement because of the continuing gag orders which erect significant barriers to obtaining adequate advice of counsel and necessary financial consultant advice, and because of the truncated nature of the evidence and testimony before the Commission imposed the limits of the proceeding's scooping orders. Finally, the extremely expedited nature of the Commission's decision-making process in conjunction with the Thanksgiving holidays has resulted in cursory analysis without the benefit of thoughtful testing of that analysis commensurate with the enormity of this decision and its historic consequences. Nonetheless, we plunge forward into these uncharted and murky waters.

IV. Legal Context for Review 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 solvent debtor.[14] PG&E's disclosure statement (Ex. 101b, p. 2) seconds this:

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[14] As a solvent debtor, while litigating in bankruptcy court, PG&E has paid off approximately $1.56 billion of its debts (Direct testimony of P. Clanon, at 12), and has

Footnote continued on next page

"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 under the PSA.

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.) The U.S. Court of Appeals November 18, 2003 decision in this instant case is consistent with this reading of the federal bankruptcy statutes.

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

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continued its utility operations, including maintaining and constructing facilities and equipment necessary to provide electric service.

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

At the time this Commission first raised rates on an emergency basis on January 4, 2001, 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 (enacted as an immediately effective emergency measure, in January 2001) 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. However, the other statutory ratemaking principles and rules are still in effect, especially the mandate that this Commission ensure just and reasonable rates.

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.) 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.)

C. 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 that ultimately will determine whether any given proposed plan is feasible. The Commission should not authorize any settlement unless the Commission believes that the settlement is likely to result in a feasible plan consistent with the Commission's Constitutional and statutory duties to follow the law of the State of California and to ensure just and reasonable rates. For the reasons detailed below, the PSA, modified as we propose, satisfies this requirement.

D. 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 $11.0 billion[15]) 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

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[15] Ex. 120B, p. 12-4, ORA / McManus. Table 12-A outlines TCBA costs, including procurement undercollections ($9.7 billion) and Interest Costs ($1.3 billion), but does not include headroom.

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. PG&E's reorganization plan appears even less feasible in light of the recent U.S. Ninth Circuit Court of Appeals decision on November 19 that[16]" confirms significant legal hurdles for the PG&E disaggregation plan. Moreover, the PG&E plan faces enormous financial and practical financing issues. PG&E's plan cannot obtain assurances of creditworthiness or any 2003 assurances that the financing required and anticipated by the PG&E plan can in fact be obtained in this changed energy industry marketplace.

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 $11.0 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. The Commission continues firm in its belief that these risks are highly unlikely as both valid legal arguments exist to preclude such claims as well as extensive factual bases to offset any such claims. Moreover, any such risk is much less likely now that the U.S. Court of Appeals for the Ninth Circuit has decided the express preemption issues in the Commission's favor on November 19, 2003.[17]

Regardless of the Commission's strong position in the courts, the Commission's costs and delays of further litigating against PG&E are likely to be considerable (although totaling only a small fraction of PG&E and its affiliated companies' costs), given the possibility of appeals through several layers of the federal court system. The Commission already has expended approximately $25 million in PG&E's bankruptcy, and has not completed the trial and post-trial briefing on its own plan.

On the other hand, PG&E faces much more extensive risks, expenses, and delays. Even if it were to prevail in persuading the Bankruptcy Court to impliedly or expressly 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 claimed $11.0 billion in unrecovered costs of utility service and financial distress which it asserts are recoverable from retail

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[17] Pacific Gas and Electric Company v. People of the State of California, Nos. 02-16990 and 02-80113, issued November 19, 2003.

electric ratepayers. (Ex. 120b, 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.)[18] The components of these ratepayer

[18]

	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

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.

To determine if this settlement amount is just and reasonable, we must compare the ratepayer contributions to PG&E's legitimate claims. Witness McManus asserts that PG&E's total unrecovered costs are 11.9 billion. (Ex. 120b, p. 12-4, PG&E / McManus).

PG&E and ORA's late-filed comparison exhibit on unrecovered costs provides a great amount of detail about the actual amount of PG&E's valid claims. (Ex. 184, p.1, PG&E and ORA) PG&E estimates its total unrecovered costs to be $3.7 billion[19], whereas ORA's estimate is $800 million. The differences are in the amount of profit or headroom, return on URG, and bankruptcy-related costs.

The headroom numbers between ORA and PG&E are inconsistent because, unlike other proceedings before this Commission, PG&E has chosen to use Generally Accepted Accounting Principles ("GAAP") as a basis for calculating headroom. The difficulties created by using a GAAP methodology, rather than

[19] It is worth noting that PG&E's $3.7 billion value is pre-tax and is equivalent to a $2.21 after-tax regulatory asset. In other words, PG&E's values indicate that a $2.21 billion regulatory asset will fully compensate PG&E for all of its bankruptcy costs, filed rate doctrine claims, plus provide PG&E with a bonus on its 2001 Return on Equity.

standard regulatory accounting shall be discussed later in this decision (see section V(B)2)

In the late-filed comparison exhibit, PG&E asserts that it possesses a valid claim for $387 million in Return and Taxes on Retained Generation Plant. PG&E asserts that it is entitled to the recovery of these dollars (even though this issue was addressed in D.02-04-016) because "PG&E has filed or would be likely to file claims for recovery … in the end-of-freeze rehearing proceeding." (Ex. 120b, p. 12-8/McManus) In establishing the end-of-freeze proceeding, D.02-01-001 noted that "we must also determine the extent and disposition of stranded costs left unrecovered" [20]– in other words, the end-of-freeze proceeding is to focus on the TCBA. However, PG&E's claim herein is not related to the collection of unrecovered stranded costs; it is a proposal to retroactively increase the rate of return on transition costs from the 7% in place in 2001, up to PG&E's full 2003 return on equity (ROE) of 11.22%. This claim clearly is not reasonable, and is effectively retroactive ratemaking. Therefore, we shall not include this asserted cost in our cost-benefit analysis for the purposes of evaluating the PSA.

We are troubled by PG&E's inclusion of its bankruptcy-related costs in its asserted claims. In justifying these bankruptcy-related costs totaling $672 million (pre-tax), PG&E's witness (Exh. 120b, p. 12-8/McManus) stated that "[n]othing in CPUC policy or past decisions would suggest that PG&E should not recover these costs it incurred for continuing to provide safe reliable service to customers." This testimony directly contradicts testimony PG&E has provided in a separate proceeding pending before this Commission; its General Rate Case

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[20] D.02-01-001, at p. 25

(GRC). PG&E has not included any bankruptcy costs in its GRC application.[21] The CEO of PG&E, Gordon Smith, noted in his testimony that PG&E was not seeking recovery of bankruptcy related costs in its GRC, because "PG&E's GRC request covers the … ordinary course of business costs of continuing to provide distribution services to PG&E's customers."[22] (A.02-11-017. Exh. 1, Ch 2, pp 2-10/Smith). In its GRC application, PG&E made clear that it has not included its costs for legal costs associated with the bankruptcy.[23] The bankruptcy related costs are not valid claims in our view: they are not clearly part of the TCBA, and PG&E has not included these costs in any application before the commission.

Based on the discussion above, we shall not rely on the inflated assertions of claims provided by PG&E in its direct testimony, and rather, shall use the numbers included in the PG&E/ORA comparison exhibit (summary table from Exh. 184).

Comparison of PG&E and ORA Assertions (in $millions)

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[21] A.02-11-017

[22] This material can be found in the record for PG&E's Test Year 2003 GRC currently pending before the Commission (A.02-11-017), documents, and pleadings of which the Commission may take official notice. The record in PG&E's GRC is available on PG&E's website (at https://www.pge.com/regulation/GRC2003-Ph-I/Testimony/PGE/2002-11-Fwd/GRC2003-Ph-I_Test_PGE_20021108-002-Exh001-Ch02.doc), as well as on the CPUC website, at http://www.cpuc.ca.gov/proceedings/A0211017.htm

[23] "PG&E has hired outside counsel to help PG&E prepare its PoR to find an equitable and expeditious way out of Chapter 11. Such costs are not included in PG&E's GRC request…." PG&E GRC Direct Testimony (Exh. 1, Ch. 4, at pages 4-10, 4-11).

Line #	PG&E's Asserted Unrecovered Costs	PG&E's Position		ORA's Position	
1	Balancing Account Unrecovered Costs		6,952		6,952
2	Adjustments for URG net Plant		(1,610)		(1,610)
3	Return and Taxes on Retained Gen Plant		387		0
4	Incremental Interest Expense		1,287		0
5	Forgone Tax Benefits		133		0
6	Bankruptcy Costs		444		0
7	Gas Hedge Contract Termination		(16)		0
8	Gas Hedge Contracts Termination		112		0
9	2001 Headroom*		(780)		(547)
10	2002 Headroom*		(2,368)		(3,131)
11	Settlement Headroom	(775)	(875)	(775)	(875)
12					
13	**Total Unrecovered Costs (at 12/31/03)**	**3,766**	**3,666**	**889**	**789**

* Differences in Headroom result from PG&E's use of GAAP accounting, vs Regulatory Accounting

We agree with ORA's analysis that the asserted claims on line 3 should be removed, as well as those bankruptcy-related claims on lines 5 through 8.

We find that the $1.3 billion in Incremental Interest Expenses (line 4) are reasonable claims because a majority of those interest costs would have been incurred because PG&E was not creditworthy. It would be impossible to differentiate which portion of the interest was solely due to PG&E filing for Chapter 11, versus simply being uncreditworty.[24]

For the headroom for 2001 and 2002 (lines 9 and 10), we shall use ORA's numbers, because they are based on regulatory accounting, rather than the GAAP accounting used by PG&E.[25]

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

[24] In the Edison settlement, the Commission allowed Edison to recoup its interest costs.

[25] For a discussion of GAAP accounting versus Regulatory Accounting and its consequences to Northern California Ratepayers, see below at section V(B)2.

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.) PG&E responded 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 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. As a regulatory agency, we cannot rely on GAAP accounting, because it allows PG&E to manipulate its expenditures in such a way to minimize GAAP-defined headroom which results in undercounting of PG&E's funds available to pay down PG&E's undercollection, requiring more ratepayer dollars be paid to PG&E. Moreover, locking down a definitional switch in headroom from the standard regulatory definition to GAAP can result in double payments of PG&E's costs between the bankruptcy settlement and the GRC authorized costs.

These adjustments are shown in the table below:

Reasonable Net Undercollection (in $millions)

Line #	Categories of Claims and Offsets	Commission's Decision	
1	Balancing Account Unrecovered Costs		6,952
2	Adjustments for URG net Plant		(1,610)
3	Return and Taxes on Retained Gen Plant		0
4	Incremental Interest Expense		1,287
5	Forgone Tax Benefits		0
6	Bankruptcy Costs		0
7	Gas Hedge Contract Termination		0
8	Gas Hedge Contract Termination		0
9	2001 Headroom		(547)
10	2002 Headroom		(3,131)
11	Settlement Headroom	(775)	(875)
12			
13	**Total Unrecovered Costs (at 12/31/03)**	**2,176**	**2,076**

Using the Commission staff's estimate of ratepayer contributions (less headroom contributions), and comparing it to PG&E's valid pre-settlement claims (reduced by headroom offsets), the proposed settlement would force ratepayers to settle PG&E's $2.1 billion (line 13 of table above) in claims for a ratepayer contribution (in net present value) of $3.2 billion[26], or at 150% of the claims value.

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

[26] Ex. 122, p. 9, CPUC Staff/Clanon.

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 benefits that ratepayers will receive directly from the settlement itself. The settlement does not fare well under this calculus. The threat of PG&E's Plan of Reorganization being confirmed is highly unlikely due to its substantial legal barriers and financial infirmities, and with the evaporation of that threat, so goes the threat that PG&E's ratepayers and Californian's at large will be harmed by PG&E's attempts to disaggregate and avoid state regulation. In addition, the proposed settlement plan would maintain rates at a high level, requiring between $520 million and $620 million per year over the nine-year span of the regulatory asset – at an average cost to ratepayers of 0.8 cents per kilowatt-hour for the next nine years.

The record demonstrates that PG&E's total claims (netted against 2001 and 2002 headroom) are approximately $2.1 billion, and that the ratepayer costs of the Settlement Agreement, using the Commission staff's calculations, are about 150% of those claims. This comparison shows that the ratepayer dollar settlement is unfair and unreasonable 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. PG&E's current system average rate is 13.6 cents/Kwh. Using the asserted revenue requirements for PG&E's various cost components, current rates would provide $1.158 billion in headroom (approximately 1.62 cents/Kwh).[27] PG&E's estimate of the proposed settlement's regulatory asset revenue requirement would only cut the 1.6 cents/Kwh paid to headroom in half, and maintain those high rates for nine years. The PSA provides no guarantee of any overall rate reduction. Instead, the Commission relies on probable outcomes based on likely estimates.

PG&E's estimated revenue requirement ranges from $520 million in 2004 to $670 million in 2012. (PSA, Part E of Appendix A) This revenue requirement translates into approximately 0.8 cents[28] per kilowatt-hour for PG&E's customers. These high revenues over the next nine years, would allow PG&E to pay historic dividends.[29] In its own financial projections, PG&E anticipates that it can provide cash to shareholders that range from $922 million in 2006, to over 1.3 billion in 2011.[30] PG&E forecasts the total amount of cash to shareholders over the life of the regulatory asset to be $6.6 billion.

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[27] Based on P. 3 of PG&E's reply brief, filed October 20, 2003; derived from Ex. 117b, p.10-7, Table 10-1, PG&E/Montana, and Ex. 9, Corrected Attachment A, "Rate Comparisons," line 20, CPUC Staff/Clanon.

[28] Calculated as $520 million divided by 71.3 billion Kwh, derived from Ex 9, Corrected Attachment A, "Rate Comparisons," line 20, CPUC Staff/Clanon.

[29] TURN Op. Br. At 28 – 31.

[30] PG&E Chapter 5.

PG&E's reply briefs claim that their pre-crisis earnings are "in line with those in the settlement." (PG&E Reply Br. at 9. 28) This claim by PG&E is a red herring, obfuscating how large a profit PG&E makes from the regulatory asset. In the first place, PG&E does not disagree that its dividends to shareholders, what the utility pays in cash to its shareholders, will be roughly double the level of dividends PG&E paid historically. Historic dividends were in the range of $500 to $600 million annually. PG&E forecasts that with the regulatory asset, it will be able to pay annual dividends of $922 million to $1.3 billion in the future.

Rather than admitting this embarrassment of riches, PG&E doesn't address the increase in dividends but refers to future earnings instead. The earnings PG&E cites in the future are roughly the same as the historic level of earnings, roughly $1 billion per year. However, this does not tell the whole story regarding PG&E's profits from the regulatory asset.

Closer scrutiny of the workpapers underlying PG&E's assertions on their level of earnings demonstrates that this claim is misleading. In an interesting accounting trick in PG&E's workpapers[31], PG&E is obscuring the revenues, or earnings, it receives when it amortizes the regulatory asset by entering it as depreciation, rather than earnings. The fact that PG&E must pay taxes on the amortization demonstrates that all the money paid towards the regulatory asset is actually revenue for PG&E, and is not repayment of a debt. It is precisely because of the very high revenues and earnings PG&E receives from its regulatory asset that it is able to enrich shareholders so handsomely in the later

[31] Footnote 2, p. 15 of the workpapers to PG&E's Chapter 5

years of the regulatory asset. Combining the income PG&E receives from what it classifies as depreciation of the regulatory asset with its other earnings, shows that PG&E's actual net income available to pay dividends to its shareholders increases significantly in the future compared to the historic $1 billion level. That is why PG&E is able to increase the size of the actual dividend payout to nearly double historic levels.

In evaluating the amount of funds PG&E will need to collect from ratepayers and in determining the necessary size of the regulatory asset, PG&E and the Commission Staff have failed to consider all the revenues PG&E expects to have available in 2004. For example, they do not include any amounts related to pending refunds from generation companies subject to our litigation at FERC. They also fail to include expected revenues associated with the AEAP incentive mechanism, which in a decision just last month the Commission reiterated it would continue to be paid to utilities. The joint analyses also fail to include any additional headroom that will be available during the first quarter of 2004 prior to the implementation of any rate decrease (none of the currently forecasted rate decreases from the PSA or the general rate case are scheduled to be implemented on January 1, 2004, but will instead be implemented at some later date).

Whereas the PSA contains a mechanism for reducing the size of the regulatory asset on an after tax dollar for dollar basis for any funds that become available from pending FERC refunds, there is nothing in the PSA addressing how other funds excluded from their analyses should be used. To correct this oversight, we will require that any additional funds that become available which PG&E and the Commission Staff failed to consider or reflect in their analyses should be treated similarly to the treatment of FERC refunds.

V. Necessary Modifications to PSA Provisions

We now undertake to analyze the legal, regulatory, and financial underpinnings of the PSA. These components are integral to the settlement proposal before us.

A. illegal and unconstitutional restrictions on the Commission in the PSA.

1. Prohibition on Ceding Police Powers or Binding 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 clause of the PSA requiring future Commissions to be bound is found at 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.

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).)[32]

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 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:

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[32] 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…."

"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.)

* * *

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.)

* * *

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.[33] 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.”

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 Public Utilities Code §§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

[33] 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.)

not have authority to limit or prevent future Commissions from determining whether or not PG&E's rates are just and reasonable.

2. Jurisdiction of the Bankruptcy Court

The PSA mandates the continuing jurisdiction of the Bankruptcy Court over all aspects of PUC decision making that could affect this plan, as set forth in paragraph 22.

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

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. PU Code § 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 contrary to the provisions of PU Code § 1759. We recognize that the Bankruptcy Court has the power to enforce its orders and nothing hold in this decision should be construed to deny that power. To consent to continuing jurisdiction of this Commission's every move for nine years goes far beyond the harmony envisioned between federal and state courts in the federal constitution and federal court statutory framework.

3. Conflict of Laws

The PSA's exposition of controlling law is explicit in its attempt to preempt applicable state law. 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.

The California Constitution expressly prohibits this Commission from agreeing to such preemption of state laws. As discussed above, this current Commission 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). Further, this Commission cannot limit the decisions and orders of a future Commission such that the Commission could no longer protect PG&E's ratepayers from unjust and unreasonable rates. 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. Thus, we have eliminated paragraph 32.

4. Requiring Rate Reductions and All Regulatory Actions to be Contingent on Rating Agency Actions

PG&E says that it is essential that PG&E's credit be rated investment-grade upon emergence from bankruptcy.[34] 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"[35] 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."[36]

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. They also provide an important benchmark for the bankruptcy court in determining the feasibility of any plan of reorganization.

PSA ¶ 16 states:

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[34] An investment-grade rating for PG&E would provide value to PG&E and its ratepayers. At this time, we shall not require PG&E to tie executive compensation to PG&E's credit rating, but we encourage PG&E's management to consider all options, including options that don't hinge upon ratepayer contributions, for achieving creditworthiness.

[35] Exhibit 122 at 11.

[36] 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 fulfill 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 Edison was capable of providing safe, reliable electric service at reasonable rates without having an investment grade credit rating.

Thus we delete paragraph 16 and substitute a representation and warranty that the parties intend for this plan to meet the objective investment grade creditworthiness criteria as established by the dominant rating agencies.

5. 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.

In November, the Attorney General sent a letter to each of the five commissioners joining in CCSF's request. The Attorney General's letter pointed out "serious concerns regarding the apparent intention of PG&E, PG&E Corporation and its directors to improperly use the Proposed Settlement Agreement … as a basis to undermine the respective law enforcement actions file against them by me on behalf of the People of the State of California and by the City and County of San Francisco."

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 agree with CCSF's request.

6. Dividends

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

This paragraph is unacceptable and is stricken. We interpret the "shall not restrict" PG&E from paying dividends or repurchasing common stock language to mean that for nine years this Commission must set rates so that

PG&E shall be able to pay dividends. Not only is there no amount specified, there is no limit to the amount of dividends PG&E would be entitled to declare. Should we reduce PG&E's rates that could "restrict the ability," of PG&E to declare dividends of its choosing and should we fail to grant a PG&E requested rate increase, that too, would restrict its ability to pay out dividends of its choosing. Paragraph 6 would divest the Commission for nine years of any authority under Sections 451, et seq., 701, and 728 to find PG&E's dividend practices unreasonable, both impermissibly tying the hands of future Commissions and ceding its regulatory authority to the bankruptcy court and the regulated entity.

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 does not comport with PU Code §§ 453(a) and 728. It is not in the public interest.

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

7. 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 and the bankruptcy court to determine in the first instance. There is no need to narrow either's options.

8. PSA's Definition of Headroom Endangers Bond Indenture

Paragraph 7aof the PSA states

> The Commission acknowledges and agrees that the Headroom, surcharge, and base revenues accrued or collected by PG&E through and including December 31, 2003 are property of PG&E's Chapter 11 estate, have been or will be used for utility purposes, including to pay creditors in the Chapter 11 Case, have been included in PG&E's Retail Electric Rates consistent with state and federal law, and are not subject to refund.

As written, Paragraph 7a affects the commitments that this commission has with regard to the energy bonds sold by DWR in the Rate Agreement it signed with the California Department of Water and Power in February, 2002. This definition is inconsistent with the definitions in the Rate Agreement which specify that Power Charges and Bond Charges accrue to DWR in specified ways, in specified time frames. The Bond Indenture that DWR signed in reliance upon the Rate Agreement tracks the relevant language and definitions in the Rate Agreement with respect to these monies. PG&E has been a vociferous opponent of the Commission's decisions that segregated a portion of the rate stream for the benefit of and as the property of DWR. PG&E has mounted numerous challenges to this regulatory and legal firewall erected for the benefit of DWR.

Paragraph 7a appears to be another attempt by PG&E to change the deal made by this Commission pursuant to its AB1x statutory authority and mandates. That paragraph, as written, changes the legal definitions of that portion of funds collected by PG&E to be transmitted to DWR as its property, pursuant to AB1x and the commission's orders giving effect to AB1x and the DWR power purchase program, to become the property of PG&E. In so doing this paragraph may affect the flow of monies that underlies the bonds. If so, the indenture would be violated and this Commission, DWR and the State could be subject to the full range of penalties and litigation outlined in the indenture, as well as pursuant to all relevant laws. This potentially enormous legal liability would operate to impose considerable delay on the emergence of PG&E from Chapter 11 reorganization as well.

Pursuant to the expedited consideration of this settlement and the apparent lack of analysis by Commission or DWR bond counsel or financial advisors as to the effect of Paragraph 7a on the Rate Agreement or the Bond Indenture, the prudent and in fact necessary step this Commission must take is to strike this paragraph in its entirety.

B. Financial Terms of the PSA

1. The Size and Structure of the PSA's Regulatory Asset is Not in the Public Interest.

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 an unreasonable compromise of the economic differences of the proponents of the PSA.

Because the proposed settlement amount is unreasonable, we shall "delve deeply" within its components and modify the financial component of the settlement plan.

The size and structure of the $2.21 billion regulatory asset, as described in the proposed settlement is unreasonable. As described above, after taking PG&E's 2001 and 2002 headroom into account, the regulatory asset in the proposed settlement would require a ratepayer contribution of $3.2 billion (in net present value) to settle $2.1 billion in claims.

2. Headroom

The PSA's definition of headroom is found in Paragraph 1y:

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

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

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

> "In general, headroom revenues consist of the difference between recovered revenues at the frozen rate levels (including the reduced rate levels for residential and small commercial customers beginning in 1998) and the reasonable costs of providing utility services, which for convenience we refer to as the authorized revenue requirement." (70 CPUC 2d at 223.)

Clearly, the PSA definition is not the same as the 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.)

We agree with ORA's analysis, and are concerned by the complications that are likely to arise in determining the amount of headroom for PG&E, should we diverge from standard regulatory practice, and entertain PG&E's use of GAAP accounting. Therefore, for the modified PSA, we strike the definition of headroom in Paragraph 1(y) and replace it with the Commission's own definition of headroom from D.96-12-076. This change in headroom definition would also clarify that ratepayers shall not be saddled with PG&E's bankruptcy-related costs, and would requires modification of PSA Paragraph 15 ("Fees and Expenses").

We can foresee numerous complications that could arise from this shift from normal regulatory accounting to GAAP. PG&E would be able to pre-pay for work scheduled for the first quarter of 2004, thereby earning a double-benefit: 1) this would reduce the amount of headroom available to reduce PG&E's undercollections, and 2) the pre-paid amount would be a windfall in 2004, because PG&E would receive revenues from ratepayers to pay for the costs that had already been recouped. In addition, PG&E could pay for items that have not been authorized by this Commission, such as paying its legal fees associated with the bankruptcy, including reimbursements of PG&E Corporation for its bankruptcy-related costs, with ratepayer dollars. In sum, PG&E could use this definitional change to recover all manner of costs not approved by the Commission.

3. 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.

However, we do find that reasonable rates for Northern California, as well as a solid credit rating for PG&E are goals that PG&E's management, along with the Commission, should strive to maintain. For this reason we shall open a new proceeding to determine an appropriate mechanism to limit executive salaries, and make bonuses contingent upon low rates as well as PG&E's overall credit rating.

VI. The Modified Settlement Agreement (MSA) Will Allow PG&E to Recover its Undercollection and Emerge from Bankruptcy.

The Modified PSA adopts a simple and short-term methodology that utilizes current rates and contribution of PG&E earnings to recover PG&E's undercollection, allowing PG&E to regain financial health in the very near term. The Modified PSA, would maintain the current rates through the end of 2004, and drop rates by approximately 1.6 cents per kilowatt-hour in 2005, which would cost the ratepayer approximately $3.1 billion less than the regulatory asset scheme proposed in the settlement agreement. At its essence, the Modified Settlement Agreement (MSA) adopted today, is similar to the Edison model, and shall commit to maintaining rates at current levels until the undercollection is reduced to zero, or until the first quarter of 2005, whichever is sooner. In addition, it provides for a reduction of the undercollection by any refunds obtained from FERC during the repayment period. 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.) Finally, it contains PG&E's commitment not to unilaterally attempt to disaggregate.[37]

There are provisions in both the PSA and the Modified PSA that enhance PG&E's fiscal soundness. These elements are: the ratemaking treatment

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

associated with the use of headroom to recover PG&E's undercollection;[38] a Commission commitment not to allow procurement costs to impair collection of other costs; and a Commission commitment not to discriminate against PG&E as compared with other utilities.[39] With the undercollection resolved, and the benefit of our experience with the Edison PROACT repayment methodology, we are confidant PG&E will be able to emerge from bankruptcy and continue to provide safe, reliable service.

To find a more equitable resolution of PG&E's financial condition, and to ensure that PG&E recovers its actual undercollections, we shall approve a modified settlement that would adopt a similar mechanism as to the one we used to ensure Edison's investment-grade creditworthiness. In oral arguments on December 2, 2003, CLECA's representative, William Booth stated that the large industrial users CLECA represents would prefer sustaining today's high rates for one more year, rather than prolong the high rates that the Proposed Settlement Agreement would require for nine years.

ORA recommends a mechanism similar Edison-style method to make PG&E whole. (Ex. 139, Chapter 4, ORA/Danforth) ORA proposes that we maintain PG&E's current rates through the end of 2004. At the conclusion of 2004, ORA recommends that if the net undercollection is less than $1 billion, the current rates would remain in effect until the TCBA undercollection is reduced to

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[38] Exhibit 139, Chapter 4.

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

zero; and if the net undercollection[40] should be greater than $1 billion, the remaining amount would be recovered via financing paid for by securitized bonds to be paid for with a Dedicated Rate Component ("DRC").

We shall adopt a modified settlement that utilizes an "Edison-style" methodology, similar to the one proposed by ORA, however, we shall modify ORA's recommendation to simply maintain current rates and require the contributions of PG&E's dividends to pay down accumulated debt until PG&E's undercollection is reduced to zero (referred to hereafter as "the repayment period").

In the discussion above, not including headroom for 2003, we have found PG&E's net undercollections to be $2.95 billion. The proposed settlement agreement settled on 2003 headroom between $775 million and $875 million. It is reasonable to expect that the headroom will in fact total or approach the amounts for headroom expected for 2004, or about $1 billion.[41] Based on the information in PG&E's reply briefs[42], we expect that current rates would generate approximately $1.15 billion in headroom in 2004. (Ex. 139, p. 4-2, ORA/Danforth) In addition, we shall require PG&E to contribute its available dividends[43] over the repayment period. Subtracting the $2.15 billion in

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[40] ORA's recommended calculation of PG&E's undercollection is "the sum of the balances in the TCBA, as restated pursuant to D.01-03-082, and the Generation Asset Balancing Account ("GABA")." (Ex. 139, p. 4-2, ORA/Danforth)

[41] Estimate based on PG&E's quarterly TCBA reports, filed with the CPUC, which track the accumulation of headroom.

[42] PG&E reply briefs, p. 3, filed October 20, 2003.

[43] Available dividends are earnings less amounts needed to fund capital expenditures.

headroom from 2003 and 2004 from the $2.95 billion undercollection, and contributing PG&E's dividends for 2004[44] would allow PG&E to recover its entire undercollection by the first quarter of 2005. These estimates are highly conservative estimates, based largely on PG&E's un-audited information.

A summary table is included below.

Edison-Style Plan Pays PG&E Undercollection by 2005

(in $millions)

Line #	Categories of Claims and Offsets	Commission's Decision
1	Balancing Account Unrecovered Costs	6,952
2	Adjustments for URG net Plant	(1,610)
3	Return and Taxes on Retained Gen Plant	0
4	Incremental Interest Expense	1,287
5	Forgone Tax Benefits	0
6	Bankruptcy Costs	0
7	Gas Hedge Contract Termination	0
8	Gas Hedge Contract Termination	0
9	2001 Headroom	(547)
10	2002 Headroom	(3,131)
12	Estimated 2003 Headroom	(1,000)
13		
14	**Total Unrecovered Costs (at 12/31/03)**	**1,951**
15	2004 Headroom	(1,158)
16	2004 Contributed Dividends	(460)
17		
18	**Remaining Unrecoverd Costs (at 12/31/04)**	**333**

We approve a modified settlement that utilizes the above method for recovering PG&E's undercollection because it 1) treats PG&E and Edison similarly, without giving PG&E an economic, legal, and regulatory windfall

[44] Based on information contained in PG&E's Workpapers, Chapter 5, pp 5, 11 PG&E/Campbell.

because of its attempts to circumvent state regulation via the bankruptcy courts, 2) it fairly shares the burden of PG&E's bankruptcy on shareholders and ratepayers, and 3) it will allow rates to be reduced by at least 1.6 cents per kilowatt-hour in the first quarter of 2005, and 4) after our experience with Edison, we know such a method is capable of repaying the utility's debts and ensuring investment-grade creditworthiness.

Moreover, it is free of the considerable legal vulnerabilities discussed in Section V(A) above, which will not close this chapter but will instead spawn additional litigation and unjustifiably higher rates that what would otherwise be just and reasonable.

VII. The Environmental Provisions of the MSA are in the Public Interest

A. The Land Conservation Commitment (LCC)

The PSA gives environmental representatives 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 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 – instead a partnership of the environmental community, state and local governments, and environmental stewardship organizations will help 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 paid by ratepayers through their 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 Audubon 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,[45] 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

[45] 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.

three additional board members to further provide for public representation. This board ensures that all of the key constituencies are represented in the development and implementation of the land conservation plan.

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

Problems identified with the framework and reporting requirements of the Board include placing a PG&E representative on a supposedly independent board that will advise PG&E as to specific actions with regard to PG&E watershed and other environmentally sensitive lands. To ensure the appearance and the reality of independence, the MSA deletes the PG&E representative from the board membership as PG&E will have ample opportunity to engage in a dialogue and discussion of the proposals submitted by the Board.

A second and potentially more serious legal vulnerability arises with respect to the Commission's statutory and constitutional jurisdiction over utility assets, including the property at issue here. We must avoid the challenge that the Commission is ceding its mandated authority to protect the ratepayers' interests in these lands and to implement the full panoply of state laws safeguarding the environment, as discussed above in the context of the legal infirmities associated with ceding Commission regulation and jurisdiction either by contract or to a federal court.

Moreover the Stipulation recognizes the fact that any transfers or disposition of lands will first need to be submitted to the Commission for analysis and consideration pursuant to the P.U. Code sec. 851 process, the MSA modifies the reporting requirements of the Board. Instead of reporting to PG&E, the Board shall report to and work with the Commission as well as with PG&E to determine the best and most environmentally sound uses of the lands at issue. This modification expands the scope of environmental analysis from that which has been traditionally undertaken by the Commission. The Commission envisions the Board functions to include being available to the Commission to undertake analyses and recommendations for the preservation of all environmentally sensitive lands within PG&E territory. We envision that such assistance could provide invaluable benefits to the Commission as it undertakes its regulatory functions and mandates. For example, the Board could undertake analyses, not only of land management issues, but also of concomitant streamflow issues which would assist the Commission in its analysis of costs necessary to address hydroelectric power licensing issues of paramount concern to Californians. Expanding the scope of the mission of the Board and refining the reporting requirements results in the LCC providing invaluable analysis and recommendations for all environmentally sensitive lands, not just the identified 140,000 acres called out by PG&E in the PSA.

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 vague and, rather than clarifying the land conservation commitment, would only result in more confusion and debate. We agree with SWRCB that the Commission should ensure the commitment to California's environment by specifying that all uses of land to be protected be environmentally sensitive.

The Commission supports the intent of the LCC and believes that the structure contained in the parties' stipulation are reasonable. Notwithstanding any statements in the PSA and the stipulation that the Commissions will give up its ongoing authority and oversight of the amounts and uses of the money that are to be applied to the LCC, the Commission will retain its ability to modify this program as necessary as it deems necessary future. By retaining ongoing oversight and making clear the reporting requirements to the Commission are not solely to PG&E, we will avoid any potential problems regarding our ceding the Commission's authority, provide an opportunity for changes to the program scope and funding levels, and ensure that the LCC program meets its intended goals.

C. Environmental Opportunity For Urban Youth N Found in the Record

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 do not live in the Sierra foothills, where the vast majority of the 144,000 acres are located. The requested expansion might be in a manner of having PG&E's ratepayers provide a wilderness experience for urban youth, especially disadvantaged urban youth, and to acquire and maintain urban parks and recreation areas. While the purposes of such experiences may be laudable, this issue was not presented or analyzed within the Commission's public tested procedures, and is not in our record for consideration.

The Commission agrees with the goals of the urban youth experience program and decries the lack of funding that has been devoted to such parks and programs by other governmental entities through the years. However, the Commission must carefully consider the scope of its regulatory authority and ensure that it does not use ratepayer monies for purposes not authorized by statute. Of course, PG&E Corp. is free at any time to propose and institute such a program with shareholder monies and we would applaud such an effort. The Commission further believes that it could make an agreement that could support urban parks and community groups through an appropriate public process, where the legal authority, the advantages and costs of such a program would be full vetted in a public process and with a public record. However, this analysis, discussion and evaluation has not yet occurred in this proceeding. For instance, we have no basis to conclude that $15M is the appropriate or sufficient amount of funding to ensure the success of this program. We can also envision a host of worthy programs that might be brought to the commission for funding consideration. All such programs, however, must be consistent with our regulatory and statutory mandates and authority, as this commission wields enormous powers to impose costs on all ratepayers located in investor owned utility service territories in California. Before imposing such costs or creating such programs, we much follow our own procedures and statutes, which could be begun immediately during the pendancy of the bankruptcy reorganization plan adopted herein.

Thus imposing such a requirement must be deferred given the complete lack of record presented here, until such a time that the public analysis creates a record to support it.

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. Of course, this commission already supports considerable clean energy research through its low-emission vehicle proceedings and resulting decisions. To best optimize such research and development, we believe that all such funds and programs should be considered together, and prevent duplication and overlap, within the context of the Commission's already established LEV and clean energy proceedings.

VIII. 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.

We need not determine the applicability of a DRC under the modified settlement agreement adopted herein. We welcome comment on the applicability of such a DRC in this context.

IX. 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 granted. 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.

X. Comments on the Proposed Decision

The alternate proposed decision of Commissioner Lynch in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on ___________ and reply comments were filed on ____________.

XI. 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 $2.1 billion.

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 modified settlement will achieve that result by maintaining current rates until PG&E's undercollection is reduced to zero.

17. Once the undercollection is eliminated, we anticipate rates would be reduced by approximately 1.6 cents per kilowatt-hour.

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 proposed settlement would settle PG&E's claims at 150% of value.

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 ORA's proposal to maintain rates at their current levels until PG&E's undercollection is reduced to zero. In addition, the Modified Settlement Agreement offers the State significant environmental benefits.

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 Audubon 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 as modified herein 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.

29. PG&E representatives gave conflicting testimony regarding the nature of its bankruptcy-related costs in this proceeding and A.02-11-017.

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. Paragraph 10 unduly releases PG&E Corporation from claims. The Commission currently has no pending proceedings against PG&E Corporation, nor has PG&E any claims against the Commission.

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 Appendix A re PG&E Corrected Exhibit Proposed Settlement Agreement
Barnett Appendix B re PG&E Proposed Settlement Agreement
Barnett Appendix C in PG&E Proposed Settlement Agreement
Barnett Appendix D List of Appearances in PG&E Proposed Settlement Agreement