Dissenting Opinion of Commissioner Carl Wood
Pacific Gas & Electric Bankruptcy Proposed Settlement on Item 53b

Today we take an important step in putting the California Energy Crisis behind us – approval of a Settlement Agreement with PG&E that could end its bankruptcy and rehabilitate its credit.

I want to accomplish this goal very much. For my brothers and sisters who work at PG&E, it would dispel the cloud of uncertainty that bankruptcy throws over the collective bargaining relationship. For consumers it would enable us to give greater assurance that the energy supplies on which we all depend will be there at a just and reasonable, affordable price through a fully regulated utility.

I have stated repeatedly that we must do what is necessary to enable PG&E to pay its debts and emerge from bankruptcy, at the lowest reasonable cost to ratepayers and as quickly as possible. Unfortunately, I am concerned that the Majority Decision does neither – it is too expensive and too freighted with legal error to provide firm footing for those next steps.

I proposed an Alternate which I believe is the only way to accomplish the multiple objectives we have for ending the PG&E bankruptcy. The text of that Alternate is attached to this Dissent and incorporated here.

- It provides PG&E with enough cash to settle its debts and emerge from bankruptcy quickly through the sale of bonds.
- It meets all of the credit rating agency requirements for cash flows and other financial ratios to achieve investment grade credit ratings.
- It limits the intrusion of the federal courts on our regulatory ratemaking activity.
- It lowers rates substantially immediately, and does not postpone further rate reductions for nine (9) years.
- It complies in all respects with state laws, unlike the Proposed Settlement Agreement, so that it can survive appellate review and actually be implemented.

The Majority Decision is built around a regulatory asset to enable PG&E to rebuild its capital and repay its debts. The Regulatory Asset is a binding promise by this

Commission that we will make ratepayers pay extra money to PG&E to rebuild its capital, over and above what is needed to pay the costs of providing energy service.

It is an extremely expensive way to go, because its creation – the making of the promise – is a taxable event for PG&E. When we issue our order, PG&E will receive income on which it must pay taxes. Under the Peevey proposal, for PG&E to realize $2.21 billion in additional capital, PG&E must receive from ratepayers over $3.8 billion. Put another way, ratepayers must pay $1.70 for each dollar of additional capital. Of all the possible ways to get PG&E the extra money it needs, this is the most expensive way. On top of this, since PG&E would receive the $3.8 billion over time, it will earn a profit on the unamortized regulatory asset balance, on which it also have to pay taxes.

I do not object to the regulatory asset on principle, because I view it as a necessary evil to achieve the objective of rapid emergence from bankruptcy. The basic obligation of this Commission is to use this most expensive approach carefully and judiciously to avoid creating unjust and unreasonable rates that overly burden ratepayers. We should make the regulatory asset no larger than it needs to be to support emergence from bankruptcy. The Majority Decision fails in this regard. It is far too generous with ratepayer money in creating a regulatory asset that is larger than it needs to be. The regulatory asset should be no more than $1.2 billion because that is what is needed to make the investment grade credit metrics and enable PG&E to pay its debts and get out of bankruptcy.

The function of the regulatory asset is to assure that PG&E has sufficient assets to support the capital structure invested in the utility. In traditional cost of service ratemaking, the invested capital of the utility supports its rate base, its plant and equipment used and useful in providing service to the public. In the Settlement Plan, PG&E proposes to refinance its entire company at the time it pays off its allowed claims in bankruptcy. The "allowed claims" include all of its financial debt including first mortgage bonds and all of its remaining liabilities related to the energy crisis and all other activities taken by the utility.[1] Since PG&E has at all times been a solvent debtor, it must make these payments in cash, which it will raise using available cash on hand and the sale of new corporate debt of various maturities. The amount of cash available directly influences the amount of new debt that PG&E must take on in order to pay the allowed claims and therefore the size of the regulatory asset.

As of September 30, 2003, PG&E reported $4.23 billion in cash in the Form 10-Q it filed with the Securities and Exchange Commission. At that time it had remaining only $2.4 billion in remaining first mortgage bonds and approximately $9.3 billion in

1 The current plan proposes to reinstate preferred stock and certain pollution control bonds, in an amount of between $1.1 billion and $1.55 billion.

unsecured debts, characterized as "Liabilities subject to Compromise" in its Form 10-Q.[2] PG&E needs to raise around $7 billion in new debt in order to have the cash necessary to pay its allowed claims and emerge from bankruptcy, with the exact amount depending on how much of the $4.23 billion is left at the end of the year, assuming prudent management and oversight by the bankruptcy court. We should calibrate the regulatory asset at no higher than needed to support new debt, which we estimate to be approximately $1.2 billion. Cash flows would be based on straight line, rather than mortgage style, amortization in order to assure cash flows at levels appropriate to meet the investment credit ratios for the debt issuances during the life of the regulatory asset.

Calibrating the regulatory asset at this level is consistent with the Commission's prior plan of reorganization. The regulatory asset proposed in that document 18 months ago did not take into account additional headroom of at least $875 million that PG&E would receive over and above cost of service during 2003. Additional headroom over and above that amount would reduce the required size of the regulatory asset, not increase it.

A different way of estimating the appropriate size of the regulatory asset involves recalling the disciplined approach to cost of service that we applied to SCE in the Edison settlement. The regulatory asset is an amount that ratepayers contribute above and beyond the earnings which PG&E is entitled to receive through return on ratebase, giving full effect to PG&E's investments in distribution, transmission and retained utility generation (URG). The retained earnings that PG&E has booked reflect full recovery of costs on a cost-of- service basis for investment in plant in service. The regulatory asset is an additional amount over and above plant in service that supports PG&E's current financial statements.

This increment over and above cost of service can be justified as ratepayer contribution to full financial rehabilitation of PG&E needed to pay its energy crisis-related debts. Another way of saying this is that the regulatory asset represents an additional payment by ratepayers to fully fund PG&E's legitimate recovery in its Filed Rate Doctrine Litigation. ORA has estimated amounts that PG&E has yet to recover at no more than $1.4 billion and as little as $700 million. PG&E's estimate, when adjusted for the admissions of PG&E Witness McManus, is no more than $2.2 billion. A regulatory asset of $1.2 billion is thus in the appropriate range between the ORA and PG&E estimates. The Majority Decision provides a regulatory asset that pays PG&E more than 150 % of its claims, an amount which is not just or reasonable on its face.

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[2] PG&E owes the PX and ISO approximately $1.7 billion, and has offsetting claims for refunds against various generators totalling in excess of $3 billion. Any net after-tax recovery will be credited against the regulatory asset. The regulatory asset thus also partly finances the timing difference between emergence from bankruptcy and recovery of refunds, the timing of which is directly controlled by the FERC.

A regulatory asset of $1.2 billion is also consistent with the "compromise" that has ratepayers paying 60 % of PG&E's claims with a combination of headroom and regulatory asset. Headroom – or cash above cost of service including authorized earning and taxes – has been around $4.8 billion dollars since 2001. A $1.2 billion regulatory asset with tax gross up would bring the ratepayer contribution to nearly $7 billion dollars – double the amount we paid for Edison's energy crisis debts under that settlement.

A smaller regulatory asset can be amortized more quickly. Rapid amortization is a key element in defending the Modified Settlement Agreement from significant legal infirmities pointed out in the Proposed Decision of Judge Robert Barnett concerning the ability to bind the Commission in the future by a settlement agreement.

As I have demonstrated in Appendix A of my Alternate, this regulatory asset and associated tax gross up meet all of the cash flow and credit metric demanded by the rating agencies.

In this regard, I am concerned that the DRC cash flows will be inadequate to support investment grade ratings and that one of two things will occur –

1) The DRC will not happen; or

2) PG&E will not emerge from bankruptcy because it will have substandard credit metrics after the first year.

<u>I want to make it clear that I support the use of a DRC as a tool to help us reduce ratepayer costs. It is not a substitute for a smaller regulatory asset.</u>

I have prepared a chart comparing cash flows and credit metrics under my proposal and under the DRC as it has been described in the Joint Comments that are basis for the Majority Decision. This chart is attached to this Dissent as Appendix A. It suggests that cash flows after the first year will be significantly less than what rating agencies have wanted to see to support investment grade credit ratings.

If cash flows are reduced in the early years as this suggests, either PG&E does not really need the cash, or the credit metrics will not work. If the former, we are being had; if the latter we are losing the benefit of this "deal." The DRC will not be implemented.

The uncertainty on this score was a strong argument for not going forward today if we had really want to save ratepayers money, using the DRC. Now we have wagered against the house.

Rate Reductions

Like the Peevey Proposal, my Alternate provided a substantial rate reduction in 2004, on the order of $550 million (as compared with the Peevey Proposal reduction f $670 million.) But this is it -- the Majority Decision continues – and actually increases ratepayers costs for the next nine years . The combination of a smaller starting number and a shorter amortization mean that ratepayers would have provided PG&E with $2.3 billion over 4 years, not $5.3 billion over 9 years. The Majority Decision effectively gives away $3 billion dollars that come out of the pockets of Northern California residents and businesses.

PG&E's customers have been stuck with the most expensive possible bail-out.

<u>NON-ECONOMIC ISSUES – THE HOLDING COMPANY</u>

PG&E's parent is the source of much of its trouble. I am pleased that the Majority Decision maintains the AG's litigation against PG&E. However, we need to do more. My Alternate proposed that if PG&E's association with its parent had any negative affect on the rating agencies' view of the utility's credit, we may take steps including compelled divestiture to rectify this. The rating agencies have made it very clear in their recent rating actions on Edison and Sempra that they carefully scrutinize holding company behavior to determine if utility money or business is placed at greater risk. This needs to be actively addressed. The Majority Decision does not do this.

<u>NON-ECONOMIC ISSUES – LEGAL INFIRMITIES</u>

I am very eager to end the bankruptcy quickly and – as I have stated – I am willing to approve a larger regulatory asset to accomplish this. I am concerned that the provisions of the Settlement Agreement pass legal muster, and I am afraid that they do not. I want to focus on three areas:

- It is too one-sided – it imposes obligations on the Commission without imposing similar obligations on PG&E.
- It authorizes a federal court to coerce Commissioners in the performance of their Constitutional duties.
- It restricts the Commission's future regulatory and ratemaking activities for too long.

On rehearing, the Commission must accept the modifications to the Settlement Agreement text I am suggesting. If we fail here, I am concerned that the Settlement Agreement will be illegal and ineffective and will not go into effect.

I will discuss each of these infirmities in more detail:

Too One-Sided

Virtually every affirmative obligation in the Settlement Agreement is addressed to some restriction on Commission actions, with no corresponding limitation on PG&E action. Particularly with respect to achieving and maintaining investment grade credit, PG&E's management is the primary party responsible for the bankruptcy of NEG, and was the decision-maker in escalating the energy crisis by taking the utility into bankruptcy. We know this because of the very different behavior of Edison's management and the very different outcome.

PG&E's management must be fully committed to minimizing risks, prudently managing its business, fully disclosing its costs and practices to this commission as an element in restoring the confidence of the investment community. Much has been said about the role of this Commission and state government in dashing investor confidence, but it is clear that around the country the management of energy companies – from Enron to PG&E's unregulated businesses to the rest of them – are a grave source of concern. We are willing to step up and make commitments; so must PG&E.

Too Long -- 9 Years versus 4 Years

The Majority Decision could be in effect for 9 years, and could be enforceable by the federal court for nine years. The issue of whether the Commission can enter into an enforceable judicial settlement agreement has been hotly debated. After the Supreme Court's approval of the Edison settlement, I think it is clear that we can settle cases, but only under some fairly stringent statutory guidelines. I want to discuss this in detail, because it affects numerous provisions of the Peevey Proposal.

There cannot be any doubt that under certain circumstances, the Commission can legally settle litigation by agreement. In *Southern California Edison Co. v. Peevey* the California Supreme Court relied upon the Commission's broad authority under Article XII of the California Constitution, sections 701 and 728 of the Public Utilities Code, and prior precedent to conclude that the Commission is a "state agency of constitutional origin with far-reaching duties, functions and powers whose 'power to fix rates [and] establish rules' has been 'liberally construed.'" Because the Commission had not acted contrary to specific state laws and in light of the Commission's inherent authority, the California Supreme Court upheld the Commission's entering into a binding judicial settlement with SCE in its federal district court case against the Commission. This case stands for the general proposition that the CPUC may enter into judicial settlements, <u>but only to the extent consistent with state law</u>.

As Judge Barnet and numerous parties have pointed out, in *the Diablo Canyon Case* 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.

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

I agree with the Majority Decision that a court-approved settlement, consistent with state law, would bind the Commission to a limited extent. There is an important difference between the Commission's authority within the scope of its own proceedings, and the Commission's efforts to resolve litigation in courts.

<u>The Commission must abide by court orders and a subsequent Commission does not have the authority to ignore a court order approving a settlement to which the Commission is a party with impunity. The Commission has the authority to exercise its regulatory and police powers to resolve the Bankruptcy Court litigation through a settlement which it is legally bound to honor</u>.

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

This is an application of the more general principle that:

> "[P]owers conferred on public agencies and officers which involve the exercise of judgement or discretion are in the nature of public trusts and cannot be surrendered or delegated to subordinates in the absence of statutory authorization.

The issue is whether the specific terms of a judicial settlement agreement, including the one at issue here, are enforceable or not enforceable, based on the legislative authority under which the Commission operates. <u>The Commission's authority to enter into judicial settlement agreements is not unlimited</u>.

The Peevey Proposal relies on an expansive view of the Commission's "necessary and proper clause," Pub. Util. Code section 701 as statutory support for a binding settlement. The California Supreme Court recently expressed a very different view of section 701 in a suit brought by the State Legislature:

> … Section 701 provides that "[t]he commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction." Past decisions of this court have rejected a construction of section 701 that would confer upon the Commission powers contrary to other legislative directives, or to express restrictions placed upon the Commission's authority by the Public Utilities Code. … Whatever may be the scope of regulatory power under this section, it does not authorize disregard by the commission of express legislative directions to it, or restrictions upon its power found in other provisions of the act or elsewhere in general law.
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> Assembly of the State of California v, CPUC,(1995), 12 C. 4th 87, 103.

The federal courts also recognize this doctrine of limited surrender of state regulatory authority. In *Southern California Edison Co. v. Lynch* (9th Cir. 2002) 307 F.3d 794, 809, the Ninth Circuit held that if the Commission's judicial settlement agreement violated state law, "then the Commission lacked capacity to consent to the Stipulated Judgment, and [the Ninth Circuit] would be required to vacate it as void. State officials cannot enter into a federally-sanctioned consent decree beyond their authority under state law."

We therefore must determine that the Peevey Proposal is consistent with state law before we can enter into the settlement. First, Paragraphs 21 and 32 of the Negotiated Agreement provided that the settlement agreement, the settlement plan and any court orders was intended to be binding and enforceable under federal law, "notwithstanding any contrary state law." My alternate, like the Peevey Proposal, strikes that language.

However, there remains the problem of Pub. Util. Code section 1708, which authorizes the Commission to:

> …at any time, upon notice to the parties, and with opportunity to be heard as provided in the case of complaints, rescind, alter, or amend any order or decision made by it. Any order rescinding, altering, or amending a prior order or decision shall, when served upon the parties, have the same effect as an original order or decision.

Some parties try to sweep this statute away by characterizing the Settlement Agreement as a "contract," not an "order."

Like the economist who gets out of a hole by assuming a ladder, this argument ignores the reality that the "decision" approving the Settlement Agreement predetermines the decisional outcome of specific future commission proceedings and – if valid – is both itself unalterable and prevents the rescission, alteration or amendment of those future decisions for an extended period of time. There is a potentially a double violation of a specific statute that, after *Assembly*, section 701 cannot over-ride.

The specific decisions in question are Commission cost-of-capital proceedings that occur annually. These are the essence of Commission ratemaking activity, because they directly control utility profitability and indirectly control a host of cost elements including state and federal taxes of all varieties. The Peevey Proposal would radically affect these proceedings in two different ways for nine years.

In Section 2.b. of the Peevey Proposal, the return – or earnings -- on the Regulatory Asset is to be set by the Commission, but with a floor of 11.22 % on the equity component. There is no authority for creating a floor or a ceiling on authorized return that cannot be altered for a period of nine years. 1708 would permit the Commission to affirmatively alter it in any case.

In Peevey Proposal Section 3.b. the return on the equity component of PG&E's entire rate base is set at 11.22% until PG&E achieves a target credit rating from specified rating agencies, without any obligation on PG&E's part to undertake affirmative steps including ridding itself of holding company entanglements, to achieve the objective.[3] Attempting to abrogate section 1708 on these issues for nine years, or three complete ratecase cycles under the Commission's Rate Case Plan, is not lawful, because it attempts to prevent the Commission from altering decision in response to changing conditions.

In light of the constitutional requirement that the Commission actively supervise and regulate public utility rates and the statutory requirements under sections §§451, 454, 728 that the Commission ensure that the public utilities' rates are just and reasonable, the Commission must retain its authority to set just and reasonable rates during the term of the settlement and thereafter free from the threat of federal court coercion.

The regulation of utilities is one of the most important of the functions traditionally associated with the police power of the states. This Commission's authority to regulate public utilities in the State of California is pursuant to the State's police power. 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."

Whether or not the Commission could enter into a settlement agreement without violating state law turns on whether the settlement agreement would surrender or suspend the Commission's exercise of its police powers or whether the settlement agreement is consistent with the Commission exercising its regulatory powers. In every case cited by any party to this proceeding on the subject, there has been an express legislative authorization for the contractual limitation on the police power. For example, in the case of *Santa Margarita Area Residents Together v. San Luis Obispo County Bd. of Supervisors* ,on which the Peevey Proposal relies, the Court found that a development agreement at issue there was an appropriate exercise of a county's powers under the Development Agreement Statute, Gov. Code sections 65684 et seq. In rejecting the argument that the development agreement was an unconstitutional restraint on the county's police powers, the court focused on two factors: (1) the conclusion that the county had reasonably interpreted an express statutory authorization and (2) the limited duration of the contract – not more than five (5) years.

There is no express statutory authorization for the type of judicial settlement agreement that is proposed in the Peevey Proposal. Under cases like those discussed above, and those relied on by other parties, this would be fatal. However, in the *Edison* case, the Commission entered into a judicial settlement that expressly limited the duration of its obligation for four (4) years and in fact accomplished the objectives in 21 months. While the *Santa Margarita* concept of a limited waiver of police power authority may be applicable here, the absence of an express statutory authorization makes compliance with the other factor – limited duration – even more important. It is the only way arguably to get within the ambit of the *Edison* case. The 9 year duration must be reduced to four years.

COERCING COMMISSIONERS

Paragraph 23 of the Settlement Agreement says:

> It is understood and agreed by each of the parties hereto that money damages would not be a sufficient remedy for any material breach of any provision of this Agreement by any party, and each non-breaching party shall be entitled to specific performance and injunctive or other equitable relief as a remedy for any such breach, without the necessity of securing or posting a bond or other security in connection with such remedy, consistent with state law.

By putting in this provision in connection with the provisions of 2.b. and 3.b., PG&E is attempting to create a regime where it can use the federal court to control the outcome of cost of capital proceedings, and therefore its profits, for 9 years.

The idea that the Commission is "bound" for the term of the Agreement implies that there must be remedy for breach, and I accept that. However, the remedy for breach, if there is one, is normally damages for economic harm, if any. The Commission cannot be powerless to protect PG&E's ratepayers from unjust and unreasonable rates or practices during the 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."

The effect of section 23 is to create a gaping hole in the police power which may be created at any time by a federal court. We must strike Section 23, in order to obtain a lawful judicial settlement agreement.

I can understand why PG&E would want this provision, but it is over-reaching and illegal. It must be stricken.

DEDICATED RATE COMPONENT

As I have indicated, I have some concern about whether the DRC can be implemented in a way that meets the cash flow and financial metrics required by the rating agencies. However, I embrace the concept and if it really saves ratepayers money it is a tool we should use. I supported the TURN legislation when it was introduced last August and am happy that the rest of the Commission now sees fit to support it. The legislature should act and we should see what we can do.

We need to be very clear about what the Majority Decision does and does not do about a DRC. Although much has been made of the "TURN-PG&E Deal," about saving ratepayers money through implementation of a DRC, the Majority Decision does not contain a DRC. The Majority Decision does not – DOES NOT -- save anyone any money. It contains only vague promises about future actions that may or may not ever occur. It is all optics and no substance at this point.

Specifically, the Majority Decision promises that the CPUC will sponsor legislation to authorize the substitution of a DRC for part or all of the regulatory asset that will be created by this decision. But the mechanics entail the creation of the Regulatory Asset now, and the issuance of securities now. The enactment of DRC legislation does not by itself assure that the DRC mechanism

The Majority Decision approves the most expensive PG&E deal from a ratepayer's economic standpoint -- $5.3 billion over 9 years. The DRC would reduce this ratepayer cost somewhat because it would lower the required earnings and taxes, by as much as a billion dollars over the nine years. But this occurs only if the DRC is actually implemented. As proposed, the DRC will be implemented through a second bond issue – a bonanza for lawyers, consultants, banks and underwriters – some years down the road. It will not reduce the amount that ratepayers have pay.

There is a significant benefit from the use of a DRC that we should make use of, if it goes forward. The DRC concept depends on a "true sale" of the stream of revenue to a remote "special purpose entity." The result of the sale is that PG&E has cash to pay off its regulatory asset. Once this occurs, there is no reason to maintain bankruptcy court supervision of PG&E, and the bankruptcy case can be dismissed. This is a way to address the legal infirmity of a too lengthy restraint on the Commission.

Some may argue that there are non-economic, non-bankruptcy issues for PG&E, particularly the nine years of federal supervision of the CPUC's ratemaking process. We should never assent to this infringement of our regulatory authority. As shown above, it is illegal. Any DRC legislation that we support should require dismissal of the bankruptcy court case in full, once the DRC has been implemented and PG&E has its cash.

CONCLUSION

When TURN announced its "deal" with PG&E, Mike Florio was quoted in the Chronicle as saying that the deal was too expensive and not that good for ratepayers, but it was "the best they could get." That was not a resounding vote of confidence in this Commission. I think we can do better for the ratepayers, while meeting all of the realistic objectives of emerging from bankruptcy and rehabilitating PG&E's credit. PG&E will always want more. They will always bluster and blow. We could have shown TURN and the rest of California that we can get to the goal of rehabilitating PG&E and getting it out of bankruptcy on our feet, not on our knees. We failed.

/s/ CARL WOOD
Carl Wood
Commissioner

San Francisco, California
December 18, 2003