

August 29, 2005

Gurbux Kahlon
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Electric Industry and Finance Branch
Energy Division
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Re: Request for Information concerning SMUD's Application for Annexation of Davis, West Sacramento, Woodland, and Unincorporated Areas of Yolo County

Dear Ms. Kahlon:

This letter responds to your letter dated August 18, 2005, regarding the Sacramento Municipal Utility District's (SMUD) July 29, 2005 application to the Sacramento Local Area Agency Formation Commission (LAFCO) to annex the cities of Davis, West Sacramento, and Woodland, and certain unincorporated areas of Yolo County. The Energy Division requested that PG&E respond to six questions. Each of the questions posed in your August 18th letter is repeated below, along with PG&E's response. We are continuing to study and evaluate SMUD's proposal, including recent changes made by SMUD in the area it proposes to annex, and accordingly, PG&E reserves the right and intends to supplement these responses.

Your letter correctly observes that Government Code Section 56131 states that the CPUC shall give its opinion whether "the proposed service by the district within the territory will substantially impair the ability of the public utility to provide adequate service at reasonable rates within the remainder of the service area of the public utility." In Resolution E-3472 (November 26, 1996), the CPUC used the following criteria for evaluating the proposed service and making a determination: 1) whether the customers of the proposed irrigation district will be able to bypass payment of generation-related transition costs, which would require the remaining PG&E customers to cover these costs, 2) whether the proposed irrigation district will install duplicate distribution infrastructure, potentially idling PG&E distribution facilities and requiring remaining PG&E customers to cover the costs of these idled facilities, and 3) whether the amount of

generation-related costs or idle distribution facilities shifted to remaining PG&E customers, if any, would have a significant rate impact on remaining PG&E customers.

In summary, PG&E believes that the proposed annexation will substantially impair PG&E's ability to provide adequate service at reasonable rates within the remainder of its service area.

This is the case for the following reasons:

- SMUD's annexation will result in a duplication of PG&E's facilities. Included in its proposal are the proposed construction of an 18 mile transmission line and a new substation. Neither of these facilities would be required if PG&E continues to serve this area.
- Although SMUD is expected to pay most of the generation-related transition costs, it will be able to take advantage of some exemptions from the Department of Water Resources (DWR) Power Charge and the Energy Recovery Bond Charge, described in response to question 1. The result will be to impose the recovery of these costs on other ratepayers.
- The impact of SMUD's annexation on other ratepayers that we have been able to quantify is estimated at approximately \$554 million (NPV), or approximately \$54.8 million/yr. on an annualized basis. This translates into a rate impact of about \$0.001/kwh. The specific details are provided in response to questions 1, 2 and 3, which provide an estimate of the generation, stranded cost and transmission/distribution related rate impacts, respectively. PG&E believes that this result is significant in and of itself, even ignoring the additional considerations described below.
- SMUD's efforts in its LAFCO Application to downplay any adverse impacts to PG&E's ratepayers should be rejected. Specifically, SMUD states that the Yolo Area represents a relatively small percentage of PG&E's electric service area – less than one year's growth -- and thus it should be inconsequential. However, this argument represents a distorted perspective of the policy considerations which the Commission should apply to a takeover such as this. Common sense dictates that PG&E's costs of serving urban, suburban, and industrial customers, is less than that of serving rural customers. If the trend to allow PG&E's urban, suburban, and industrial customers to be cherry picked as proposed by SMUD is continued, the cumulative effect will be that the CPUC and the California Independent System Operator (CAISO) will not be able to protect a large number of California customers or be able to operate an integrated electric transmission system that meets the needs of all Californians.
- Furthermore, there are other cumulative effects, which are more difficult to quantify, that will impact other customers. Specifically, other governmental entities (e.g., South San Joaquin Irrigation District and the City and County of San Francisco) are carefully following SMUD's actions, and may take similar steps if they are

- encouraged by SMUD's progress. The rate impacts of these efforts need to be taken into consideration in the context of this review, to be consistent with the CPUC's direction to consider the "cumulative impact" in question 6. The additional impact is estimated by PG&E to be approximately \$1.780 billion (NPV), or approximately \$175.9 million on an annualized basis. When combined with the direct impact of the SMUD annexation into Yolo, the rate impact climbs to over \$0.004/kwh.
- Moreover, although not specifically addressed by the data request, PG&E believes that there will be additional burdens placed upon its ratepayers due to the continued "balkanization" of the CAISO grid and state energy policies that SMUD's proposal fosters. Specifically, SMUD has established its own control area, which has essentially removed load from the area served by the CAISO. The annexation of Yolo will further this attrition, and result in additional cost-shifts to remaining PG&E customers. As CPUC President Peevey stated to Spencer Abraham (then Secretary of the U.S. Department of Energy) on July 29, 2004 regarding the decision by the Western Area Power Administration (WAPA) to withdraw from the CAISO and join SMUD's control area: "... this decision poses potential risks to the reliable operation of the transmission system in the Western Interconnection.... Western's decision will in any event result in the partial fragmentation of a significant portion of the primary control area in California, namely that of the CAISO. Such fragmentation directly contravenes long-standing federal policy encouraging consolidation of grid operations and reduction of 'seams' between control areas. It also undermines the on-going efforts of the transmission reliability entities across the country to prevent a recurrence of events such as the East Coast blackout on August 14, 2003." A copy of President Peevey's letter is attached.
 - Furthermore, SMUD, like most local publicly owned utilities, has no obligation to follow most of the energy policies that the Commission, in concert with the California Energy Commission and California Legislature, has worked long and hard to develop for application to investor owned utilities such as PG&E. Included are the preferred loading order, resource adequacy requirements, and various incentives to promote solar energy. Furthermore, residential usage by PG&E's customers at or below 130% of baseline is currently protected from rate increases pursuant to ABX1; customers served (or to be served) by SMUD have no such protection.

Table 1 below summarizes the approximate estimated quantitative impacts on PG&E’s remaining customers if the SMUD proposal to annex Yolo County is approved:

Table 1

Item	Q#	Total Cost (\$ NPV)	Annualized Cost (\$/yr)	Rate Impact (\$/kwh)
Generation-related Transition Costs	1	\$74 million	\$7.3 million	
Stranded Costs	2	\$21 million	\$2.1 million	
Transmission and distribution costs	3	\$439 million	\$43.4 million	
High voltage transmission costs	3	\$20 million	\$2.0 million	
Sub-Total		\$554 million	\$54.8 million	\$0.001/kwh
Other POUs	6	\$1,780 million	\$175.9 million	
Total		\$2,334 million	\$230.7 million	\$0.004/kwh

Energy Division Question 1: With a clarification that “generation-related transition costs” also includes all components included in the current cost responsibility surcharge (CRS) applied to departing municipal utility load, please address the first factor identified above, including an explanation as to whether any customers within the proposed annexation area would be responsible for paying any of the costs or whether they would be exempt from such payments. Please cite all relevant code sections and/or CPUC decisions. If any customers would be exempt, please quantify the costs that must be paid by remaining PG&E customers.

PG&E Response To Question 1.

PG&E believes that most of the customers within the Yolo area would be responsible for paying most or all of the generation-related transition costs. However, as described below, recent Commission decisions regarding exemptions to some of these charges leaves open the possibility that SMUD’s takeover in the Yolo area will result in a much a larger reduction in recovery of costs from these customers. These costs would thus become the responsibility of PG&E’s remaining customers.

Responsibility of Customers Taking Service From A Municipal Utility To Pay DWR and Other Non-Bypassable Charges. In Rulemaking 02-01-011 the Commission has been

determining the obligation of two types of municipal departing load (MDL) customers to pay the Cost Responsibility Surcharge:

- Transferred MDL – former PG&E customers that depart to take service from a publicly-owned utility (POU) such as SMUD; and
- New MDL – new “greenfield” consumers who locate in PG&E’s service area but take service from a POU.

In a series of decisions issued since 2003, Decision (D.) 03-07-028, D.03-08-076, D.04-11-014, D.04-12-059, D.05-07-038, and D.05-08-035, the Commission has now ruled on the obligations of transferred and new MDL customers to pay the four components of the CRS: the DWR bond charge (DWRBC), the DWR power charge (DWRPC), the competition transition charge (CTC), and the energy cost recovery amount (ECRA) charge.

- The DWRBC recovers the costs associated with the bonds DWR issued in 2002 to recover the costs it incurred to procure power during the energy crisis. The charge is expected to continue through 2022. It is currently \$0.005/kwh.
- The DWRPC covers the above-market costs associated with the contracts entered into by DWR. This charge is expected to continue through 2012.
- The CTC covers the above-market portion of the contracts that PG&E executed with qualifying facilities, as authorized via AB 1890. The charge for MDL is currently \$0.007/kwh.
- The ECRA charge, sometimes referred to as the Energy Recovery Bond charge or the Dedicated Rate Component, collects the costs associated with the energy recovery bonds issued to finance PG&E’s bankruptcy-related costs. It is expected to continue through 2012, and is currently \$0.005/kwh.

These costs are currently being recovered from all PG&E customers as part of their rates, and the various Commission decisions provide a framework for their recovery from MDL customers as described below. The amounts for MDL are currently capped at \$0.027/kwh. In addition, transferred and new MDL are obligated to pay other, non-CRS related non-bypassable charges (NBCs) like the nuclear decommissioning charge (NDC) put in place in 1996 by Assembly Bill 1890.¹

Transferred MDL: The net result of the aforementioned Commission decisions is that transferred MDL sales in the annexation area would continue to be responsible for the DWRBC, the CTC, the ECRA, and the NDC. However, a portion of the transferred MDL sales would be

¹ Assembly Bill 1890 also obligated residential and small commercial MDL to pay the Fixed Transition Amount charge. However, that charge expires at the end of 2007, prior to the time at which SMUD proposes to begin serving customers in the annexation area. In addition, per D.97-08-056, all transferred MDL sales are exempt from the Public Purpose Program (PPP) charge.

exempt from the DWRPC per D.04-11-014 and D.04-12-059, which prescribed exemptions for any transferred MDL sales served by a POU that appeared in PG&E's August 2000 Bypass Report. That Bypass Report assumed that there was a 10 percent probability that the City of Davis would be served by a POU, and consequently 10 percent of Davis' sales, or 38.8 GWh per year, was included in the Bypass Report and is thus eligible for a DWRPC exemption.²

Furthermore, D.04-11-014 specified that "unused" or "leftover" DWRPC exemption amounts associated with the bypass forecast that it adopted would be available for use by entities that were providing service to at least 100 customers as of July 10, 2003. Thus it is possible that SMUD could receive "left-over" DWRPC exemptions to serve additional transferred MDL above and beyond the 38 GWh per year associated with the City of Davis. This depends on the extent to which the entities identified in the decision use their allocations, and/or other POU's apply for, and receive, the "left-over" exemptions ahead of SMUD. To the extent SMUD is successful in obtaining these additional exemptions, even greater amounts of cost-shifting to PG&E's remaining ratepayers would occur. Since the total GWh of exemptions adopted by D.04-11-014 is well in excess of the incremental amounts served by the POU's in the bypass report, it is possible that SMUD could qualify for 583 additional GWh per year of DWRPC exemptions. However, for this analysis PG&E has assumed SMUD would not receive these additional exemptions.³

New MDL: New MDL would be exempt from the DWRPC so long as the total amount of such exemptions does not exceed 80 MW in PG&E's and Southern California's service area. PG&E has assumed all new MDL in the annexation area would receive the DWRPC exemption. Moreover, Public Utilities Code Section 848.1(c) (added by Senate Bill 772 in 2004) and D.05-08-035 require that all new MDL sales that are eligible for the DWRPC exemption also receive an exemption from the ECRA charge.⁴

Combined Effect for Both Transferred and New MDL: To estimate the net effect on remaining PG&E customers of the lost NBC revenues, PG&E has developed a 20-year economic model,⁵ first estimating the net effects on an annual basis and then calculating the net present

² This expected value calculation was developed under the assumption that the proposal being considered at the time, the creation of a Davis Municipal Utility District, had a 10 percent probability of success.

³ If SMUD were to receive these exemptions, this would result in an additional \$21.6 million (NPV) of shifted costs to remaining PG&E customers.

⁴ SMUD has assumed, and PG&E agrees, that new MDL would be obligated to pay the CTC. However, there is the possibility that SMUD may in the future argue that new MDL it serves is entitled to a CTC "stand-alone" exemption per Public Utilities Code Section 369. If that occurs, and the Commission agrees, then additional costs would be shifted to PG&E's remaining ratepayers.

⁵ 20 years has been chosen to develop ballpark estimates. In point of fact, the losses would be significantly larger since SMUD would serve these customers for many more than 20 years.

value (NPV) of the 20-year stream of effects. The result shows the NPV adverse impact on remaining customers of \$74 million over the 20-year analysis period.

For both the leftover DWRPC exemptions for transferred load, and the up-to-80 MW DWRPC exemption for new load, PG&E expects that SMUD or other parties may counter that the Commission made these exemptions available with the understanding that they would be used, and therefore they do not represent a cost-shift. However, PG&E believes the exemptions are not an entitlement, and if they are not employed by SMUD, there is the likelihood that they will not be used, and all other customers will benefit. The fact of the matter is that, to the extent SMUD uses exemptions that would not otherwise be used, the overall cost obligation that those departing load customers would otherwise have paid must be spread among PG&E's remaining ratepayers (who will pay higher rates as a result).

Energy Division Question 2: SMUD states that there will be no duplication of PG&E's distribution or transmission infrastructure but states that there are minimal facilities that may be stranded by the proposed plan. Please address SMUD's assessment and quantify any costs that would be passed on to remaining PG&E customers.

PG&E Response To Question 2.

As a threshold matter, PG&E disagrees with SMUD's assessment that the annexation will not create any duplication of PG&E's transmission and distribution facilities. First, SMUD is planning to build 18 miles of completely new transmission facilities, plus a new substation, to serve load that is already adequately served by PG&E with its existing T&D infrastructure. This represents duplication of facilities, and has environmental impacts that have not yet been evaluated.

Second, SMUD's annexation – and the associated severance activities required to separate SMUD's acquired system from PG&E's remaining system -- will necessarily strand some of PG&E's assets. The primary assets stranded are 7.2 miles of parallel circuit on the Rio-Oso-West Sacramento and West Sacramento-Brighton lines, and 29.5 miles of single circuit Rio Oso-West Sacramento 115 Kv lines. The estimated value for the former is approximately \$4.5 million, and the latter is approximately \$16.3 million (RCNLD).

SMUD has identified the Rio-Oso Woodland #1 and #2, and a small portion of the Brighton-Davis as the only two stranded facilities. However, SMUD does not appear to plan to pay compensation to PG&E or its ratepayers for any stranded costs. If SMUD's efforts proceed to the condemnation phase, PG&E will argue in court that SMUD should be required to compensate PG&E for the cost associated with those stranded assets to ensure no loss for its remaining customers. However, to the extent the court does not require SMUD to fully compensate PG&E, its remaining ratepayers will bear the shortfall.

Additionally, if the annexation proceeds, SMUD has proposed that UC Davis and Barker Slough, located outside of the annexation area, would no longer be connected to the PG&E grid. Instead, SMUD has proposed for its own convenience that PG&E would interconnect with the SMUD grid to serve these customers. PG&E has not completed its evaluation of this proposal, but anticipates that it may need to find alternate arrangements to serve these customers, thus resulting in additional costs for which SMUD should be liable.

Energy Division Question 3: If there are costs to remaining PG&E customers identified in PG&E's responses to (1) and (2) above, or any other costs to PG&E's remaining ratepayers associated with SMUD's application, indicate the rate impact to these customers.

PG&E Response To Question 3.

In addition to the burden shouldered by PG&E's remaining customers as a result of prior Commission decisions permitting transferred and new MDL sales to escape the NBCs described in response to question 1, remaining customers are also adversely affected by the lost transmission and distribution (T&D) revenue that PG&E otherwise would have collected from the customers in this area. PG&E would avoid some T&D-related costs should the annexation occur; however, the lost revenue is expected to exceed the avoided costs,⁶ so that contribution to margin would decrease -- and with it, the welfare of PG&E's remaining ratepayers whose rates would increase as a result. This impact is consistent with the "Revenue Adjustment Mechanism" ratemaking that is applicable to the recovery of transmission and distribution costs incurred by PG&E on behalf of its customers. If SMUD's proposed annexation proceeds, PG&E will lose substantial T&D contribution to margin from October 2008 and beyond that would otherwise have gone towards the recovery of fixed costs.

These losses in T&D contribution to margin would be partly offset by the compensation ultimately provided by SMUD for the T&D assets, up to their book value (i.e., historical cost less depreciation) -- since this value would be removed from PG&E's rate base. SMUD's LAFCO application relies on the assumption that SMUD will only have to pay PG&E book value for the T&D facilities it acquires, which it estimates at \$84 million. PG&E believes it is entitled to current fair market value for its facilities, which is more accurately represented by a replacement cost new less depreciation (RCNLD) valuation. This is consistent with the Commission's finding in D.03-04-032.⁷ For purposes of responding to this question we have assumed that SMUD's \$84 million estimate is at or below the actual book value of assets in place (much less

⁶ The annexation will produce lost economies of scale: PG&E now provides both gas and electric service in this area, and would continue to provide gas service even if some of its Yolo electric facilities are condemned. Thus, the avoided costs will be less than PG&E's average cost to serve this area, since many functions (such as meter reading and service centers) will need to remain.

⁷ Finding of Fact 24 states: "The price for the assets sold by PG&E to TID based on RCNLD is reasonable."

those that PG&E expects to install between now and October 2008, which PG&E estimates at greater than \$40 million but to which SMUD has assigned zero value), and thus ratepayers would receive this entire amount. After netting out the \$84 million book value figure, the losses in T&D contribution to margin are estimated to be \$439 million (NPV).

The annexation will also result in a reduction of revenues that PG&E receives for leased space on its transmission facilities. This includes various types of telecommunications and fiber assets owned by others, for which PG&E receives a revenue contribution that is shared with its ratepayers. While PG&E will demand compensation as part of the condemnation trial, it is possible that the court may not recognize, as the CPUC would, the full impact of these lost revenues. PG&E has not yet quantified these impacts.

In addition to the lost CTM associated with the condemnation of PG&E's transmission and distribution facilities in the proposed Yolo Annexation area, PG&E estimates that it will incur costs necessary to reinforce various high voltage (230 KV and 500 KV) transmission assets that it owns that are used, in part, to wheel power to SMUD. If the approximately 350 MW of Yolo load, plus additional 50 to 80 MW of UC Davis load (since SMUD has proposed that UC Davis be served through SMUD's facilities) is added to the SMUD area, the power to serve this load will flow over a different path than is presently the case. PG&E believes that, as a result, facilities south of Rio Oso Substation would become overloaded and need to be upgraded. The costs to upgrade these facilities is estimated at roughly \$20 million, although more analysis will be required to produce an estimate with greater precision, and to determine the extent to which these investments might be required absent SMUD's annexation, albeit at a later date.

Overall Rate Impacts: To estimate the net effect on remaining PG&E customers of the lost NBC revenues, stranded costs and T&D CTM, PG&E has developed a 20-year economic model, first estimating the net effects on an annual basis and then calculating the net present value (NPV) of the 20-year stream of effects. The result shows the approximate estimated NPV adverse impact on remaining customers of \$554 million over the 20-year analysis period.

PG&E has also estimated the rate impact to remaining customers of these cost shift by first converting the NPV impacts to an annualized basis (so that the shifted costs are in units of dollars per year) and then dividing by expected 2008 annual sales of PG&E's remaining customers. The annualized figure is approximately \$54.8 million/year.

To develop the denominator in the calculation (i.e., the sales to remaining PG&E customers that will bear the cost-shift burden), PG&E first netted out the 2008 forecasted annexation area sales from the total forecasted PG&E system sales in 2008. Second, PG&E then netted out the 2008 forecasted portion of these sales that are legislatively protected from any rate increase under SB 1X. The table below shows the details of the calculation:

	Current PG&E System	Within Yolo Annexation Area	Outside Annexation Area
All Sales (GWh/yr)	85,500	1,361	84,139
Sales Protected by SB1X (GWh/yr)	24,100	384	23,716
Sales Not Protected by SB1X (GWh/yr)	61,400	977	60,423

Absent the annexation, PG&E forecasts it would be serving 85,500 GWh per year in 2008, of which 24,100 GWh per year would be protected from rate increases. A total of 1,361 GWh per year of sales is forecasted in the annexation area in 2008, of which 384 GWh per year would be protected. Subtracting the sales within the annexation area from total system sales for each row shows a forecasted total of 84,139 GWh per year for PG&E's remaining customers outside the annexation area. But since 23,716 GWh per year would be protected from rate increases, the cost-shift burden resulting from SMUD's proposed annexation would be borne by the remaining 60,423 GWh per year of unprotected sales.

Dividing the \$54.8 million annualized cost-shift by 60,423 GWh yields a rate increase to remaining customers of \$0.001/kWh.

Energy Division Question 4: Provide workpapers showing how any costs and rate impacts provided in response to [the] above questions were quantified.

PG&E Response To Question 4.

The work papers describing how these figures were calculated will be submitted on or before Thursday, September 1, 2005.

Energy Division Question 5: Please explain whether, in PG&E's opinion, the proposed service by SMUD would substantially impair PG&E's ability to provide adequate service at reasonable rates within the remainder of its service territory. Explain the basis for PG&E's response.

PG&E Response To Question 5.

Yes, it is PG&E's opinion that the proposed service by SMUD would substantially impair PG&E's ability to provide adequate service at reasonable rates within the remainder of its service territory.

As described in your letter, in Resolution E-3472 adopted November 26, 1996, the Commission adopted three criteria for evaluating a Government Code Section 56131 request:

Whether the customers of the proposed irrigation district will be able to bypass payment of generation-related transition costs, whether the proposed irrigation district will install duplicative distribution infrastructure, and the rate impact of these actions on remaining PG&E customers are reasonable criteria for evaluating Government Code Section 56131.

San Joaquin County Local Agency Formation Commission. Request for a Commission Opinion on the Effect of the Proposed Formation of the Crossroads Irrigation District Within Pacific Gas and Electric Company's Service Territory, Resolution E-3472, Finding No. 3, p. 5.

In Resolution E-3472, the Commission was faced with the proposed formation of an irrigation district by commercial developers seeking to provide electric distribution service. In that situation, PG&E collected bundled annual revenues of \$932,472 within the proposed district boundaries. Resolution E-3472, page 4. The Commission ultimately concluded that "the formation of Crossroads Irrigation District would substantially impair PG&E's ability to provide adequate service at reasonable rates in the remainder of PG&E's service area." Resolution E-3472, Finding 9, p. 5; emphasis added.

The conclusion in Resolution E-3472, reached despite another finding that the loss of existing revenues (if spread over PG&E's entire customer population) would not amount to substantial impairment, focused on the installation of duplicative distribution infrastructure, and the resulting cost-shift that unfairly, and therefore unreasonably, increased rates for other customers. That cost-shift substantially affected the reasonableness of the resulting rates, even though the overall dollar impact on individual customers might be small.⁸ See, e.g., PacifiCorp v. Surprise Valley Electrification Corp., D. 95-10-040, mimeo at pp. 7-8, 62 CPUC2d 135, 139 ["From the inception of the Commission, a feature of its regulation has been the Commission's early determination that direct competition in the same geographic area where it would involve duplicating service facilities would be contrary to the public interest. It results in an unnecessary burden on the ratepayers of both utilities."].

⁸ PG&E acknowledges that the Commission has not been consistent in how it has applied this test from Resolution E-3472, finding a substantial impairment in E-3472 but finding no substantial impairment in Resolution E-3528 (April 23, 1998) regarding the reorganization of the Patterson Water District into the Patterson Irrigation District and Resolution E-3549 (September 3, 1998) regarding the formation of the McAllister Ranch Irrigation District. PG&E respectfully disagrees with the application of the E-3472 test in those other matters, and believes that the Commission, in those two situations, did not fully consider the reasonableness aspect of rates and the unfair burden on ratepayers. Moreover, the CPUC itself backed away from statements embracing distribution competition found in the Patterson and McAllister Ranch resolutions. See D.00-03-062, addressing PG&E's Application for Rehearing of the Patterson resolution, in which the Commission said some of its language in Resolution E-3528 was dicta. Finally, in Resolution E-3876, the CPUC ruled on SMUD's proposed annexation of a 12 acre parcel in West Sacramento to serve a proposed pumping plant.

In the current instance of SMUD's proposed annexation of portions of Yolo County, PG&E believes that the impact is large on its own terms. Furthermore, there will be duplication of facilities which calls into focus the Commission's conclusion in E-3472. Finally, as discussed in response to question 6, the cumulative impact of this proposed annexation, along with others that are watching SMUD's (and the Commission's) actions, will further impair PG&E's ability to provide adequate service at reasonable rates within the remainder of its service area.

SMUD will likely argue that the proposed Yolo County annexation does not constitute cherry picking, and would not duplicate PG&E's facilities since it would be acquiring all such facilities and serving all customers within the impacted area. However, as discussed in response to question 2, there will be a duplication of facilities (most notably the 18 mile transmission line, and new substation, neither of which are needed were PG&E to continue serving this area). Furthermore, SMUD's efforts are clearly designed to "cherry pick" areas in Yolo in a manner that will maximize its own future revenue. In fact, it has focused on the most dense portions of Yolo County, and SMUD's criterion to only consider areas that are growing demonstrates an intent to selectively serve areas with higher revenue potential. Furthermore, SMUD changed its map between its April 2005 report and July 2005 LAFCO Application to replace a wetlands area that likely won't be developed with another area that will, leaving to PG&E the customers with a higher per-unit cost -- without regard for how that might increase severance costs/stranding.

Furthermore, SMUD has argued in its LAFCO Application, and will likely continue to argue in its comments to the CPUC, that the level of costs that might be shifted to PG&E's remaining customers is small when considered relative to PG&E's total electric revenue requirement. PG&E disagrees, and believes that the estimates it is providing in this response constitute a large cost-shift. However, even were this not the case, the fact that PG&E's annual revenues are in the billions does not mean that potential bypass needs to involve billions of dollars in revenue to have an effect. Any evaluation of service at reasonable rates must address cost-shifting issues, for this Commission and the Legislature have on numerous occasions sought to minimize or eliminate unnecessary cost shifting due to fairness in ratemaking issues. This approach focuses on the fairness element in reasonableness. The logic is that distribution bypass can create a cost-shift that unfairly, and therefore unreasonably, increases rates for other customers. Here, a cost-shift of the magnitude discussed will substantially affect the reasonableness of the resulting rates, even though the overall dollar impact on individual remaining customers might be small in percentage terms.

When SMUD or other municipal utilities pick off the largest customers, leaving smaller customers to be served by the CPUC-regulated utilities, it has the potential for an adverse impact on rates in the aggregate, even if each individual situation taken in isolation does not appear substantial. The annexation of this area will have a significant adverse effect on other customers, and is not in the public interest.

Energy Division Question 6: In Resolution E-3876 dated August 19, 2004, the CPUC found that an individual annexation proposal did not have a significant impact on the regulated utility's ability to serve its remaining customers but that the cumulative impact of additional such proposals in the future may pose a substantial impairment to the utility's ability to provide adequate service at reasonable rates. Please address the cumulative impact of annexation proposals on PG&E's ability to provide adequate service at reasonable rates. Include all workpapers and supporting documents used to quantify any such impacts.

PG&E Response To Question 6.

Many publicly owned utilities in California are actively pursuing or studying takeover of the electric service now provided by electric utilities supervised by the CPUC. In addition to the SMUD application that is the subject of this data request, two other LAFCO requests are now pending. On July 20, 2005, the South Joaquin Irrigation District (SSJID) filed with the Stanislaus County LAFCO an application to provide electric service to PG&E customers in the area around and including Manteca, which is between Stockton and Modesto. SSJID has indicated that it plans to condemn PG&E's lines in the area. Similarly, the Lathrop Irrigation District has voted to annex territory near the City of Lathrop. The Lathrop ID area is expected to eventually include over 11,000 residential customers and 4.5 million square feet of commercial space. The City of Santa Maria recently voted to form a municipal electric utility serving many loads in this City of approximately 50,000 customers. In addition, San Francisco continues to study takeover of retail service to electric customers in the City, and its LAFCO is seeking funding for a full takeover study. Other cities, irrigation districts, and other POUs are also studying the issue, and consultants like RW Beck and others frequently offer studies encouraging the takeover of CPUC-regulated utilities.

These parties are following the SMUD Yolo County takeover effort with great interest. Similarly, various San Francisco public power advocates have argued that "SMUD is taking the lead and SF should follow."

PG&E has estimated the cumulative impacts on remaining customers should SSJID and San Francisco follow SMUD's lead and condemn PG&E's facilities in their respective areas. Using a similar 20-year economic model, PG&E estimated an additional \$1,780 million (NPV) in lost NBC revenue and T&D contribution to margin should this occur. This represents an annualized cost of \$175.9 million/year which, when added to the \$54.8 million/year figure for the proposed Yolo annexation, yields a cumulative impact of \$230.7 million/year. Moreover, these additional cost-shift amounts would be borne by even fewer sales, as shown by the table below.

	Current PG&E System	Within Yolo Annexation Area Plus SF and SSJID	Outside Annexation Area
All Sales (GWh/yr)	85,500	6,843	78,657
Sales Protected by SB1X (GWh/yr)	24,100	1,929	22,171
Sales Not Protected by SB1X (GWh/yr)	61,400	4,914	56,486

Dividing the \$230.7 million/year cost shift by 56,486 GWh/year yields a rate increase to remaining customers of slightly more than \$0.004/kWh.

The SMUD proposal will also place additional burdens on IOU ratepayers due to the continued “balkanization” of the State’s electric transmission grid. Specifically, SMUD has established its own control area, which has essentially removed load from the area served by the CAISO. SMUD considered whether to use ISO services to serve Yolo County, since the lines already exist, and are under ISO control, but SMUD staff concluded that even though separation of these lines from ISO control would cost millions of dollars for new lines, SMUD should take the Yolo County area out of the ISO grid. Other POU’s are following suit. Recently, two other POU’s also chose to leave the ISO. The Modesto Irrigation District voted to join the SMUD control area and the Turlock Irrigation District voted to form its own control area. Moreover, as discussed above, WAPA decided to join the SMUD control area. The California IOU’s spent literally billions of dollars setting up the ISO, but many California POU’s want nothing to do with it. The annexation of Yolo County will further this attrition, and result in additional cost-shifts to remaining PG&E customers.

In addition, some of the areas that are considering municipalization (like the SMUD annexation) are some of the fastest growing areas of the state, potentially putting increasing amounts of the state’s load in the hands of utilities not supervised by the CPUC, and not following policies already established by the CPUC and under development. A recent example is the Yolo County/City (“Yolo County Parties”) request that PG&E not deploy advanced metering within this area since SMUD is pursuing condemnation. According to filings submitted by the Parties, SMUD is not pursuing AMI at this time.

Moreover, annexation should also be considered in the context of the State’s Energy Action Plan, where the jurisdictional entities are required to follow a preferred loading order of resources, including energy efficiency, distributed generation, demand response, before installing new natural gas fired units. Non-jurisdictional entities are not required to follow the EAP’s preferred loading order, and therefore an annexation will remove load that would otherwise be subject to the public policy underpinnings of the EAP. There may be impacts on overall grid reliability that will directly impact PG&E’s customers because SMUD is not required to adhere to the same statewide resource adequacy requirements as do the IOU’s.

Conclusion

In summary, PG&E believes that the proposed annexation will substantially impair PG&E's ability to provide adequate service at reasonable rates within the remainder of its service area. Because of the nature and extent of these impacts, PG&E requests that the CPUC consider holding immediate evidentiary hearings at which interested parties can provide testimony and cross-examine SMUD witnesses regarding the impacts of its proposal on State energy policies, safety, reliability, and electricity customers. PG&E appreciates this opportunity for comment.

As you requested, we have served this response on the attached service list, as updated on August 18, 2005, by e-mail. For convenience, we are also serving a copy by regular mail.

Sincerely,

RANDALL J. LITTENEKER

Attachments: Service List as Updated on August 18, 2005
Letter from Michael Peevey to the Secretary of Energy, dated July 29, 2004.

cc: All parties on service list
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Dian M. Grueneich, Commissioner
Susan P. Kennedy, Commissioner
John Bohn, Commissioner
Randolph Wu, General Counsel
Steve Larson, Executive Director
Paul Clanon, Deputy Executive Director
Laura Doll, Deputy Executive Director
Laura Martin, Energy Division

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August 18, 2005

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