George E. Sansoucy, PE, LLC

GES Engineers & Appraisers

April 12, 2006

Sacramento Local Agency Formation Commission
Attn: Peter Brundage
1112 I Street, Suite 100
Sacramento, CA 95814

RE: Response to Pacific Gas and Electric Company Letter dated April 5, 2006

Dear Peter:

GES Engineers & Appraisers (GES) is pleased to provide the following comments in response to the April 5, 2006 letter submitted to the Local Agency Formation Commission (LAFCo) by Pacific Gas and Electric Company (PG&E) relating to our report of March 29, 2006 (Report) regarding SMUD's annexation in Yolo County. In its letter, PG&E raised three primary issues with respect to our Report which are summarized below.

First, PG&E criticizes the Report for not objectively analyzing or representing the risk associated with power supply costs in the Annexation Area and "requests[s] that LAFCo direct GES to perform its own independent, in-depth analysis of SMUD's specific power supply costs." In developing the Report, the SMUD and PG&E estimates of future power supply costs were analyzed and compared with independent forecasts of wholesale electric prices in northern California. Based upon this review and comparison, SMUD's estimates of power supply costs are considered reasonable and supported by independent analyses for the reasons discussed below.

Second, PG&E criticizes the Report for underestimating investments in Yolo between 2004 and 2008, while at the same time adjusting PG&E's forecast of future retail rates for high levels of investment statewide and "requests[s] that LAFCo direct GES to correct these two errors in the Report, and not summarily reject PG&E's forecast of future retail rates and additional investments in Yolo." PG&E is correct that adjustments were made to its forecast of retail rates and that certain findings relative to the amount of investment in the Annexation Area were made in the Report, both of which were appropriate and supported by research and analysis that are discussed below.

Third, PG&E criticizes the Report because it does not adopt a "split the difference" approach with respect to $320 million in disputed valuation issues and "requests[s] that LAFCo direct GES to revise its conclusions on each of the remaining disputed items relating to the $320 million difference between PG&E and SMUD on valuation, and adopt either a range of outcomes or 'split the difference' approach on each of these items for purposes of evaluating the range of possible overall outcomes on SMUD's cost of acquiring PG&E's facilities." PG&E states that the Report found "SMUD's estimate better on each and every one of these disputed items" that comprise the $320 million and that "the GES Report does not fairly or thoroughly address the full range of risk for both Yolo customers and SMUD's existing customers."

The criticism by PG&E that the Report should use a "split the difference" approach with respect to the disputed valuation issues is unfounded and not consistent with how a court or finder of fact will determine fair market value. Instead, the court will consider the evidence as presented, and based on this evidence, will determine fair market value, like the Report.

LAFCo retained GES to present its opinion of the most probable estimate of fair market value and economic impacts associated with the annexation. In performing this assignment, GES reviewed documents submitted by SMUD and PG&E and, based on these documents and its experience in estimating the value of electric utility property, independently concluded that a value estimate of $110 million was appropriate. PG&E argues that the "public interest is better served by presenting a range of outcomes that reflect the risk that courts will decide these issues, giving some points to SMUD, some to PG&E, and some in-between." In fact, the public interest was served by the analysis and conclusions in the Report that reviewed and reconciled each of the disputed valuation issues and found SMUD's estimate to reflect GES' opinion of how the courts will decide on each of the issues.

PG&E's April 5, 2006 letter did not set forth any new information for LAFCo to consider that would result in a conclusion other than that reached in our Report relative to the economic impacts of SMUD's annexation. PG&E simply made several requests that LAFCO direct GES to either reconsider or use a "split the difference" approach with respect to certain forecasts and conclusions of fair market value in the Report in order to establish a broader range of economic impacts. After a review of PG&E's letter and requests that certain information be reconsidered or a "split the difference" approach be applied, we find no reason to modify our original Report or range of potential economic impacts.

The responses to each of the issues raised by PG&E in its letter of April 5, 2006 are summarized below.

I. GES Accepts in Full SMUD's Estimate of Power Costs to Serve Yolo County, and Does Not Objectively Analyze or Represent the Risks Associated With SMUD's Estimate

In its April 5, 2006 letter and February 28, 2006 filing with LAFCo, PG&E identified that SMUD's estimated power supply cost was approximately 5% lower than its own estimate, the net present value of which is $105 million over the 20-year forecast period. In both instances, PG&E advocates that its forecast of future power supply costs is more reliable than SMUD's and "requests[s] that LAFCo direct GES to perform its own independent, in depth analysis of SMUD's specific power supply costs and plans for acquiring resources to 'keep the lights on in Yolo'". PG&E's criticism of the Report and its selection of the SMUD forecast are not supported by any new information, and provide no persuasive argument for use of another power supply forecast. As stated in the Report:

> "The difference in power supply cost estimates over the 20-year period is approximately 5% and is considered a reasonable difference for independent power supply cost forecasts. The difference in these forecasts is primarily due to the method of estimating the capital costs associated with new generating resources and the cost of the resources in the marketplace.
>
> In procuring its power supply, it is reasonable to assume that SMUD will be able to use a variety of methods to meet its resource needs that include building units, contracting for resources, and/or using demand-side management to defer the need for resources. PG&E's forecast of SMUD's power supply costs do not appear to account for SMUD's ability to use all of these methods and assumes that SMUD will only be able to build new units. This assumption leads to a higher estimate for the cost of generation supply than would be expected in the marketplace. Therefore, SMUD's estimate of power supply costs has been used to estimate the economic impacts of the annexation."[1]

In its letter of April 5, 2006, PG&E argues that its consultant, Global Energy, "performed state of the art 'Least Cost Resource Planning' analyses. Neither SMUD nor GES performed such an analysis." This statement is both misleading and irrelevant to the selection of SMUD's forecast. Like any prudent forecaster, SMUD did utilize "Least Cost Resource Planning" in its forecast of future power supply.[2] In preparing our Report, an independent forecast was not developed as it was beyond the scope of the Report. However, a review of supply and demand conditions and wholesale electric prices for the geographic region that includes the Annexation Area was made using information and forecasts prepared by Platts *Power Outlook Research*

[1] GES March 29, 2006 Report, pgs. 30-31.
[2] Least cost planning refers to a process used to identify, rank, select and price resources for a utility in such a way that all resources are evaluated on a comparable basis such that the resources selected represent the least cost.

Service[3] in February 2006 for the northern region of California. The forecasts of All-Hour and On-Peak wholesale electric prices for 2008 through 2025 are summarized in Attachment I along with the forecast presented by SMUD and PG&E (for 2008 through 2027). The Platts forecasts of All-Hour and On-Peak wholesale electric prices are below the estimates used by SMUD and PG&E. Therefore, SMUD's forecasts of power supply for the Annexation Area are considered reasonable, if not conservative.

In addition, PG&E claims that "[n]o other supply option (including power purchase contracts or demand side management) is as low cost as this 100% tax exempt debt option[4] assumed by Global Energy." This statement is unsupported and inconsistent with the current wholesale market conditions in California which are currently experiencing a surplus of capacity. This surplus of capacity is expected to exist through approximately 2012 and result in the market value of capacity being below the cost of new resources, even assuming tax-exempt financing.

Therefore, based upon the current market conditions and the forecasts developed by Platts, the SMUD estimates of power supply costs are considered reasonable and supported by independent analyses.

II. GES Inconsistently and Erroneously Assesses PG&E's Future Electric Rates and Future Infrastructure Investments in Yolo

In its April 5, 2006 letter, PG&E states that "GES performed two seemingly separate and independent tasks in evaluating the costs and benefits of SMUD's proposal to provide electric service to Yolo." PG&E then criticizes the Report for "inconsistently and erroneously" assessing PG&E's future electric rates and future infrastructure investment in Yolo and "requests[s] that LAFCo direct GES to correct these two errors in the Report, and not summarily reject PG&E's forecast of future retail electric rates and additional investments in Yolo."

PG&E argues that, "[w]ithout any analysis of PG&E's different priorities for investing in electric distribution and transmission facilities, GES summarily rejected PG&E's forecast electric distribution rates as *too low* (by $79 million net present value), and changed them upwards to reflect the same escalation rates PG&E applied to electric transmission rates." PG&E also criticizes that the retail rate adjustment is contrary to the Report's finding that the PG&E investments in the Annexation Area will be equal to its future depreciation.

[3] Platts is a division of The McGraw-Hill Companies, Inc. and is the world's largest provider of energy information and research. The *Power Outlook Research Service* is a continuously updated, independent, fully qualified forecast of forward power prices across North America.

[4] In developing its price forecast, Global Energy utilized tax-exempt debt, but amortized the cost of new units over periods shorter than would be expected under normal financing. These short amortization periods result in higher annual prices and account for some of the differences in the two forecasts.

First, the adjustment to PG&E's retail rates was not made summarily and "without any analysis." Instead, each component of the rate was analyzed and compared to statements made by PG&E to the investing community. The analysis included both the expected level of investment by PG&E in its transmission and distribution system statewide and its own estimate of the expected annual increase in its retail rates.

The expected level of investment in transmission and distribution property for the years 2006 through 2010 is summarized in Attachment II. This attachment demonstrates that PG&E's investment in transmission is expected to decline by approximately 37% between 2006 and 2010. However, PG&E's distribution investment is expected to decline by only 15%. Therefore, the adjustment of PG&E's retail rates was based on the expected level of future investment in transmission and distribution plant, as well as the cost of operating this additional plant within the PG&E system statewide.

In addition to this expected investment in transmission and distribution property, the Report considered PG&E's statement that its retail electric rates should, on average, increase at the rate of inflation after 2006.[5] The compound annual percentage change in the PG&E retail rate forecasts provided by SMUD and PG&E, and the adjusted PG&E rates for the period 2008 through 2027 are summarized in Attachment III. A comparison of the compound annual change in each forecast indicate that SMUD's rate forecast and the adjusted PG&E forecast escalate at an average compound rate of 2.35% and 2.1%, respectively, over the forecast period, which is close the 2.3% rate of inflation used in the economic analysis. PG&E's forecast of its rates escalates at an average rate of approximately 1.61%, which is below the rate of inflation used in the economic analysis and most other forecasts of inflation. Therefore, the SMUD and adjusted PG&E forecasts more closely reflect the statements made by PG&E to the investing community.

Second, PG&E then argues that adjustment of its retail rates in the Report is an admission that there will be higher investment in the Annexation Area. These are two separate and distinct components. PG&E ignores the actual conclusion reached in the Report dealing with additions that states "SMUD's assumption that additions will equal depreciation and retirement is considered reasonable and no adjustments to the RCNLD figure is made for abnormally high expenditures. If the relationship between capital additions and depreciation changes, SMUD has indicated that it will compensate PG&E for this property if it can demonstrate that its construction was prudent."[6] Therefore, PG&E has not provided additional information that demonstrates its expenditures in the Annexation Area will exceed depreciation. If, however, it does invest at levels that exceed depreciation, SMUD has agreed to compensate PG&E for this investment.

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[5] PG&E Corporation: Customer Focused, Value Driven Investor Conference, March 1, 2006, New York, NY.
[6] GES March 29, 2006 Report, Appendix C, pg. C-22.

III. GES Fails to Assess the Risk that the Court Will Agree with PG&E or "Split the Difference" on $320 Million In Valuation Items Disputed by PG&E at Table C-13 of the GES Report

In its letter of April 5, 2006, PG&E identified approximately $320 million in valuation items that are in dispute and not resolved by an agreement (with respect to the cost) between SMUD and PG&E or by "splitting the difference" in the Report. The $320 million of items in dispute relates to disagreements over the value of underground distribution facilities, the "going-concern" value of PG&E's facilities, the depreciation method to apply to PG&E's facilities, the value of PG&E's distribution rights-of-way, and the cost of new facilities to be added to the PG&E system. PG&E states that "[i]n each of these categories, SMUD and PG&E are far apart, both in their calculation of economic value, and in their ascertation of the appropriate legal and economic methodology to derive the economic value." PG&E requests "that LAFCo direct GES to revise its conclusions on each of the remaining disputed items relating to the $320 million difference between PG&E and SMUD on valuation, and adopt either a range of outcomes or 'split the difference' approach on each of these items for purposes of evaluating the range of possible overall outcomes on SMUD's costs of acquiring PG&E's facilities."

PG&E states that "on each and every one of those $320 million in disputed valuation items listed in Table C-13, GES concluded without independent analysis that SMUD's estimate or methodology would be the probable outcome." PG&E's claim that there was no "independent analysis" cannot be farther from the truth. The Report set forth a review of the information submitted by SMUD and PG&E as well as our recommendation of the differences between the parties with respect to each of these items.

PG&E's argument for requesting a "split difference" approach is the Davis, Wright, Tremain, LLP memorandum to LAFCo dated March 29, 2006 which states "[t]hus, as with most strongly held litigation positions, outside observers who do not perform any independent analysis would be expected to assume a wide range of risk of different outcomes in the litigation." However, in this instance, an independent analysis was performed and presented in the Report that narrowed the range of possible outcomes and provides our opinion of fair market value on each of the disputed items that will be the subject of litigation. Therefore, a broader range is not warranted or useful in determining the economic impacts of the annexation.

The following sections address each of the points raised by PG&E relating to the disputed valuation issues in PG&E's April 5, 2006 letter.

A. The GES Report Underestimates Underground Facility Acquisition Costs

PG&E identifies a dispute of $113 million over the cost new of underground facilities and "requests[s] LAFCo direct GES to adopt the 'brownfield' estimate used by PG&E or otherwise support its adoption of any different estimate with specific facts and analysis." PG&E argues that "brownfield" construction is the appropriate method of valuing these facilities and that its cost of $100 per foot is below its actual costs.

The Report sets forth our reasons for adopting SMUD's cost of underground facilities. These include SMUD's reasonable and supported cost of "brownfield" construction,[7] and that the value of PG&E's property is limited by the amount on with PG&E can earn in its retail rates based on its original investment. Calculating the cost of these facilities using PG&E's higher estimates of "brownfield" construction does not result in an additional value, but instead results in higher levels of depreciation or obsolescence in the final value estimate that equal this higher cost. Therefore, even if the cost of these facilities were based upon PG&E's cost estimate or a "split the difference" approach, the final value estimate would not change as a result of this higher cost as it would be offset by additional depreciation or obsolescence.

B. The GES Report Omits Any Estimate of Going Concern Value

PG&E claims that there is $124 million in disputed going-concern value that has been omitted from GES's value estimate and "requests[s] that LAFCo direct GES to include a reasonable estimate of going concern value in its finding regarding SMUD's acquisition costs, based on market analysis." In addition, PG&E claims that "GES rejects in total PG&E's proposed allowance for going concern value." This is not true. The Report only rejects the going-concern value arbitrarily determined at 25% by PG&E in its cost approach. As stated in the Report, "[t]ypically when valuing the component of going-concern, either the income capitalization or sales comparison approach is used to establish the value of the enterprise which must be greater than the RCNLD for going-concern value to be present."[8]

In fact, the Report does include going-concern value based on "market analysis" as requested by PG&E. The Report sets forth value estimates for PG&E's property using both the sales comparison and income capitalization approaches which implicitly recognize the value of going-concern. Therefore, not only did the Report include going-concern value, but it did so based on market analysis as requested by PG&E.

C. The GES Report Applies The Wrong Methodology for Depreciation and Salvage

PG&E claims that the Report applies the wrong methodology for depreciation and net salvage that results in a difference of approximately $22 million and "requests[s] that LAFCo direct GES to correct SMUD's depreciation rate to reflect the proper treatment of net salvage and use the present worth depreciation method."

[7] SMUD March 17, 2006 filing to LAFCo.
[8] GES March 29, 2006 Report, Appendix C, pg. C-21.

PG&E argues that present worth depreciation is the appropriate method for applying depreciation in California and that use of SMUD's depreciation rates understates the value of the property in the Annexation Area. The Report sets forth the reasons for selecting the estimate of depreciation used by SMUD. These include PG&E's system-wide depreciation rate and SMUD's use of the straight line method. The present worth method advocated by PG&E was considered and rejected, as its own appraiser could recognize only one case outside of California in which present worth depreciation was applied to electric utility property.

PG&E has set forth no new information in its April 5, 2006 letter that would support utilization of depreciation other than that selected by GES. Therefore, the use of SMUD's estimate of depreciation is reasonable and correct.

D. GES Fails to Value PG&E's Rights of Way at Current Market Value

PG&E claims that the Report underestimates distribution rights-of-way by $13 million and "requests[s] that LAFCo direct GES to use current fair market value in assessing SMUD's cost of acquiring PG&E's rights-of-way." PG&E criticizes the Report for ignoring the cost of acquiring these facilities as of the valuation date, and instead relying upon the price PG&E paid for these facilities "decades ago."

The Report does not assume the historic acquisition costs of PG&E's distribution rights-of-way, but instead recognizes that there has been little change in the value of these rights-of-way between the date of acquisition and the valuation date. Therefore, GES does not utilize the price PG&E paid "decades ago" to value the rights-of-way, but instead concludes that SMUD's estimate is appropriate as of the valuation date.

E. GES Fails to Include What SMUD Will Owe PG&E For Other Assets

PG&E claims that GES did not properly account for short-term assets that represent approximately $10 million in the purchase price and "requests[s] that LAFCo direct GES to incorporate the correct calculations of SMUD's costs of acquiring these other assets into the overall valuation." The Report addresses these short-term assets and indicates "[i]n the event SMUD has to pay PG&E for these assets, it will recover this amount from the customers in the Annexation Area based on services previously provided by PG&E."[9]

PG&E apparently agrees and states "these short-term assets will be recovered from customers in the Annexation Area." In the event that SMUD must pay for these assets, a corresponding revenue stream would be created in the economic analysis that off-sets

[9] GES March 29, 2006 Report, Appendix C, pg. C-23.

these amounts and results in no impact to the economic analysis. Therefore, an adjustment to the value for this component would have no measurable impact on the economic analysis as there would be a corresponding revenue source to offset the additional purchase price.

F. GES Misapplies the Use of Original Cost vs. Replacement Cost as a Measure of Valuation

PG&E's claim that the Report misapplies the use of original cost less depreciation (OCLD) versus replacement cost as a measure of valuation and "requests[s] that LAFCo direct GES to include escalation of OCLD for inflation as required by LAFCo's outside legal counsel." First, the OCLD figures used in the Report were one of several methods used to arrive at the concluded value estimate of $110 million. Trending these figures, while inappropriate, would not change the final value estimate due to the use of other approaches to value. As stated in the Report, "OCLD, as calculated in the manner presented by SMUD and PG&E, is used as a proxy for the actual net book value. In this context, it is another method of estimating value and in the absence of the actual net book, serves as a reasonable proxy of the property's net book and earnings potential in the marketplace."[10] In this context, the OCLD was one of several indicators used to establish a range of values for the property.

Second, a review of the memorandum by "outside legal counsel" does not reveal any requirement to escalate OCLD for inflation as used in this or any other context. However, the Report does indicate that another way to calculate the cost new using the original cost of the property is to adjust these amounts to the date of value (inflate) using industry accepted trending tables which neither SMUD or PG&E did in this instance. Therefore, the inflation of OCLD is neither appropriate nor required in this instance, and if OCLD were trended would result in an inappropriate value estimate for the property.

If you have any questions, please do not hesitate to call.

Sincerely,

Glenn C. Walker

GCW/dl

Attachments

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[10] GES March 29, 2006 Report, Appendix C, pg. C-25.

COMPARISON OF SMUD, PG&E & PLATTS FORECASTS OF POWER SUPPLY COSTS IN THE ANNEXATION AREA ($/MWh)

Year	SMUD Market Electricity (incl. renewables)	PG&E Market Electricity	Platts All-Hours Energy and Capacity	Platts Peak Energy and Capacity
2008	$60.51	$67.07	$70.31	$73.54
2009	$75.30	$78.49	$65.54	$68.34
2010	$63.65	$68.68	$60.41	$63.78
2011	$77.51	$81.16	$56.41	$61.62
2012	$74.37	$76.30	$52.84	$58.83
2013	$83.97	$84.63	$52.11	$58.62
2014	$80.76	$82.03	$51.38	$58.16
2015	$90.95	$98.23	$51.59	$58.53
2016	$91.60	$100.64	$51.20	$58.52
2017	$92.18	$97.34	$52.76	$60.64
2018	$96.87	$108.92	$58.12	$69.79
2019	$101.75	$111.90	$60.15	$72.17
2020	$104.31	$115.48	$58.99	$71.03
2021	$106.96	$117.57	$59.07	$71.33
2022	$111.14	$121.05	$62.37	$75.13
2023	$115.49	$127.84	$66.83	$80.46
2024	$118.99	$124.90	$70.52	$85.14
2025	$122.62	$127.68	$75.28	$91.28
2026	$122.82	$117.08	N/A	N/A
2027	$123.03	$122.12	N/A	N/A

Note: SMUD and PG&E Electricity Prices in $/MWh are calculated using the sum of the Power Supply and Renewable Power Supply costs per year divided by the Energy Requirement (which includes losses). Platts prices represent around-the-clock and peak prices.

Sources: SMUD February 15, 2006 filing, Attachment 1; PG&E March 15, 2006 filing, Attachment 3; Platts Power Outlook, February 2006, (2006-2025), WECC-CA-NP15+.

CAPITAL EXPENDITURE OUTLOOK
($ in millions)

Year	Distribution Investment	Transmission Investment
2006	$1,120	$510
2007	$1,130	$360
2008	$1,055	$320
2009	$960	$310
2010	$950	$320

Source: PG&E Corporation: Customer Focused, Value Driven Investor Conference, March 1, 2006, New York, NY.

Attachment III

COMPARISON OF SMUD AND PG&E RETAIL RATES FOR ANNEXATION AREA

($/kWh)

Year	SMUD Estimate of PG&E Rates	% Change	PG&E Estimate of its Rates	% Change	Adjusted PG&E Rates	% Change
2008	$0.1302	N/A	$0.1304	N/A	$0.1304	N/A
2009	$0.1425	9.45%	$0.1385	-3.66%	$0.1385	6.21%
2010	$0.1354	-4.98%	$0.1382	-0.41%	$0.1382	-0.22%
2011	$0.1473	8.79%	$0.1446	2.16%	$0.1446	4.63%
2012	$0.1468	-0.34%	$0.1366	1.54%	$0.1366	-5.53%
2013	$0.1508	2.72%	$0.1397	2.80%	$0.1397	2.27%
2014	$0.1506	-0.13%	$0.1401	-2.33%	$0.1401	0.29%
2015	$0.1613	7.10%	$0.1475	1.99%	$0.1489	6.28%
2016	$0.1640	1.67%	$0.1473	2.34%	$0.1498	0.60%
2017	$0.1667	1.65%	$0.1491	1.98%	$0.1528	2.00%
2018	$0.1723	3.36%	$0.1511	2.47%	$0.1560	2.09%
2019	$0.1777	3.13%	$0.1532	-1.68%	$0.1593	2.12%
2020	$0.1815	2.14%	$0.1555	5.12%	$0.1629	2.26%
2021	$0.1855	2.20%	$0.1570	2.47%	$0.1657	1.72%
2022	$0.1907	2.80%	$0.1581	2.41%	$0.1681	1.45%
2023	$0.1916	0.47%	$0.1587	-0.54%	$0.1700	1.13%
2024	$0.1963	2.45%	$0.1609	1.83%	$0.1737	2.18%
2025	$0.1958	-0.25%	$0.1688	-4.19%	$0.1829	5.30%
2026	$0.1991	1.69%	$0.1745	1.60%	$0.1902	3.99%
2027	$0.2025	1.71%	$0.1765	3.48%	$0.1937	1.84%
Average Compound Rate of Change (2008-2027)		**2.35%**		**1.61%**		**2.10%**

Sources: SMUD February 15, 2006 filing, Attachment 1; PG&E March 15, 2006 filing, Attachment 3.