



SMUD

SACRAMENTO MUNICIPAL UTILITY DISTRICT
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D.

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April 12, 2006
LEG 06-0231

VIA HAND DELIVERY

- Christopher Tooker, Chair
- Charles Rose, Vice Chair
- Commissioner Sophia Scherman
- Commissioner Kevin McCarty
- Commissioner Elliot Mulberg
- Commissioner Susan Peters
- Commissioner Illa Collin
- Alternate Commissioner John W. Jachens
- Alternate Commissioner Steve Miklos
- Alternate Commissioner Gay Jones
- Alternate Commissioner Roberta MacGlashan
- Peter Brundage, Executive Officer

**Re: Response to PG&E Comments on Valuation Report by
GES Engineers & Appraisers**

Dear Commissioners and Executive Officer Brundage:

The Sacramento Municipal Utility District (SMUD) appreciates this opportunity to respond to Pacific Gas and Electric Company's (PG&E's) April 5, 2006 comments (PG&E Comments) on the Analysis of the Economic and Level of Service Impacts Resulting from the Annexation by SMUD of PG&E's Service Territories in the Cities of West Sacramento, Davis, Woodland, and Unincorporated Areas of Yolo County prepared by GES Engineers & Appraisers (dated March 29, 2006) (GES Report). Notably, *PG&E provides no new information* in the PG&E Comments. PG&E's strategic advisor confirmed at the April 5, 2006, Sacramento Local Agency Formation Commission (LAFCo) meeting that PG&E *would not* provide a court in a condemnation action with information different from that which it has provided LAFCo.¹

¹ LAFCo, Transcript of Meeting, pp. 182-83 (April 5, 2006).

LAFCo independent consultant GES interviewed PG&E and SMUD and their consultants and reviewed all materials relevant to the scope of GES' review. Similarly, LAFCo independent legal consultant Davis Wright Tremaine LLP (DWT) reviewed all valuation legal analyses submitted by SMUD and PG&E and performed its own analysis. The GES Report and DWT Opinion accurately address the issues raised in the PG&E Comments and SMUD encourages LAFCo to rely on the GES Report and DWT Opinion. Accordingly, SMUD's response focuses only on the following points: (1) California's electric industry restructuring experience is irrelevant to the proposed Yolo area annexation; (2) SMUD's rates have been, are and likely will continue to be substantially lower than PG&E's; and (3) PG&E's blatant misrepresentation of the DWT opinion should be ignored.

1. *California's Experience with Electric Industry Deregulation has No Bearing on the Proposed Annexation.*

PG&E's current recipe for opposing the proposed SMUD annexation adds a dose of hysteria to weak facts. PG&E's claim that the annexation parallels California's electric restructuring experiment is preposterous, and totally irrelevant to SMUD's pending application to annex and supply electricity to the Cities of Davis, West Sacramento and Woodland and nearby unincorporated areas in Yolo County.

It is interesting to see PG&E criticize restructuring when PG&E, including PG&E strategic advisor Dan Richard, was heavily involved in developing the AB 1890 deregulation framework. It is true deregulation did not work out as planned; when electric prices skyrocketed, much of the State suffered rolling blackouts and PG&E went into bankruptcy. It is important to remember PG&E emerged from bankruptcy with one of the richest bailout packages in history. Also, contrary to statements in the PG&E Comments, not all thought the AB 1890 approach was the "right thing".² Publicly owned utilities like SMUD worked hard to ensure they were not required to participate in the failed experiment. Unlike PG&E, SMUD choose not to sell nearly all of its gas-fired generation for short-term financial gain and choose not to join the California Independent System Operator. Using prudent utility practices and sound management, SMUD and other public power entities, avoided catastrophe.

As Glenn Walker of GES pointed out during LAFCo's April 5, 2006, meeting, one thing is unmistakable – PG&E's customers in the annexation territory are not pleased with PG&E service. For nearly a century, legislation has made clear that California electric customers have the ability to choose public power. If PG&E truly desires to achieve its vision of becoming the, "leading utility in the United States," it should focus its efforts on improving service and reducing costs, not fighting those who

² PG&E Comments, p. 1.

seek to exercise a lawful choice.³ SMUD asks that LAFCo disregard PG&E's disingenuous attempt at a deregulation analogy.

2. SMUD's Rates Have Been, Are and Likely Will Continue to Be Substantially Lower than PG&E's.

Because the record before LAFCo supports the analysis and conclusions in the GES Report and addresses all PG&E's comments, SMUD does not respond to each argument made in the PG&E Comments, including PG&E's rate claims. However, with respect to rate issues, SMUD believes the Folsom annexation is instructive. Historically, SMUD's rates have been substantially lower than PG&E's. For example, over the past 15 years, SMUD's rates have been approximately 20% below PG&E's. SMUD's rates presently are approximately 30% lower than PG&E's. SMUD has adopted minor rate increases in recent years; PG&E has adopted increases which exceed SMUD's. In general, this is the case because both SMUD and PG&E are subject to energy supply market volatility to some degree, *i.e.*, "the boat rises with the tide." Based on SMUD's past performance vis-à-vis PG&E and the fact that both SMUD and PG&E are exposed to market volatility, there is no reason to expect that over the twenty-year study period, SMUD will not be able to provide service in the annexation territory at rates substantially lower than PG&E's.

The Folsom example bears out this point. In that case, as here, PG&E claimed that Folsom area ratepayers would pay higher rates than PG&E's as a result of annexation. That did not turn out to be the case. When SMUD annexed the Folsom area, SMUD's rates were significantly lower than PG&E's. SMUD used a surcharge (similar to the surcharge it proposes to impose in the annexation territory) to recover the costs of annexation from the Folsom area customers *only*. Including the surcharge, the Folsom area customers' rates were lower than PG&E's then-effective rates. SMUD's records show that the Folsom customers paid the full costs of acquiring PG&E's transmission and distribution facilities *and* saved SMUD's other customers at least \$125 million.

Before the Folsom annexation, PG&E claimed that the value of its electrical system in the Folsom area was likely "four times" greater than SMUD's estimated \$10 million, or \$40 million. Later, PG&E and its expert witness claimed in the eminent domain litigation that its Folsom system was worth \$36 million. Less than eight months later, SMUD paid \$13 million for PG&E's transmission and distribution system in

³ PG&E's 2007 General Rate Case, Exhibit PG&E-1, p. 1-1, line 19 (December 2, 1005).

the Folsom area in 1989. In other words, SMUD paid \$23 million less than the value claimed by PG&E.⁴

Between the time SMUD began providing service in the Folsom area in 1984 and the time PG&E settled the facilities acquisition cost in 1989, SMUD had collected \$18.4 million in surcharges and earned \$2.9 million in interest on that revenue. Thus, total revenues from the Folsom annexation exceeded costs by \$1.5 million; those revenues have benefited all SMUD's customers. Additionally, since SMUD began serving the Folsom area, Folsom area customers have saved \$238 million, measured in 2004 dollars, compared with what they otherwise would have paid PG&E for electric service.

In sum, SMUD's Folsom annexation provides LAFCo with a concrete, real world example demonstrating that the difference in rates between SMUD and PG&E does contribute to substantial benefits for *all* SMUD customers.

3. *PG&E Improperly Applies the DWT Opinion.*

PG&E misconstrues a quote from the legal memorandum prepared by DWT. PG&E alleges that GES improperly did not consider inflation in calculating the lower range of fair market value.⁵ In support of this claim PG&E relies on the statement that DWT "anticipates" PG&E and SMUD would present evidence regarding inflation, among other things, to conclude that, "LAFCo should direct GES to include escalation of OCLD for inflation as *required* by LAFCo's legal counsel."⁶ Clearly, a general statement that DWT anticipates that parties may present evidence regarding inflation is not a requirement as PG&E suggests. PG&E also ignores the other methodologies GES evaluated to determine the lower range of fair market value. In addition to OCLD, GES also considered the income capitalization and sales comparison approaches, both of which take inflation into consideration.⁷ GES reports that both those methods support the range of fair market value.⁸ LAFCo should disregard PG&E's erroneous application of the DWT Opinion.

⁴ SMUD also paid PG&E \$3.4 million in accrued interest and spent an additional \$3.4 million in system upgrades. SMUD notes that SMUD and PG&E ultimately settled the Folsom eminent domain litigation.

⁵ PG&E Comments, p. 10.

⁶ *Id.* at 11 (emphasis added).

⁷ GES Report, p. 27.

⁸ *Id.*

Conclusion

The PG&E Comments clarify one key point: PG&E now disputes only three issues – SMUD's costs of obtaining power for the annexation territory, the nature of proposed PG&E infrastructure investments, and the fair market value of PG&E's facilities in the annexation territory.⁹ As noted above, the PG&E Comments *provide no new information*.

PG&E has been aware of the proposed annexation for a long time and has had ample opportunity to make its case. To support its claims, PG&E has provided GES with volumes of data. GES has carefully reviewed SMUD's and PG&E's filings and interviewed both parties and their consultants. PG&E has not questioned GES' expertise to perform the analysis LAFCo has requested. Likewise, DWT reviewed SMUD's and PG&E's valuation legal analyses and conducted its own analysis. PG&E does not dispute DWT's qualification to perform the legal analysis LAFCo requested. It is proper for LAFCo to rely on the GES Report and DWT Opinion, and SMUD urges it to do so.

LAFCo has developed a thorough record in connection with its review of SMUD's annexation application. That record shows that annexation will benefit both the Yolo area customers and SMUD's existing customers. SMUD requests that the Commission approve SMUD's application at its April 20, 2006 meeting.

Please contact me if you have any questions or require additional information.

Sincerely,



Arlen Orchard
General Counsel

/dm

cc: Nancy E. McFadden, PG&E
Nancy Miller, LAFCo General Counsel
Ann L. Trowbridge, Downey Brand LLP

⁹ PG&E states the PG&E Comments raise, "a number of significant issues" but focus on three in particular; in fact, all issues noted by PG&E fall into the three listed categories. (PG&E Comments, p. 2.)