FINAL REPORT

Volume I

Pacific Gas and Electric Company

Audit of Affiliate Rules Compliance for 2004

As Required By the

CPUC's Uniform Affiliate Transaction Rules

Per CPUC Decisions D.97-12-088, D.98-08-035, and D.98-11-027

April 28, 2005

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Vantage Consulting, Inc.

Pacific Gas and Electric Company
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Table of Contents

I. EXECUTIVE SUMMARY

A. AUDIT OBJECTIVE AND METHODOLOGY

On December 16, 1997, the California Public Utilities Commission (CPUC or Commission) adopted the Affiliate Transaction Rules ("Rules") in D.97-12-088. These Rules apply to all business transactions between utilities in the State of California and their affiliates that meet certain criteria. According to *Rule VI.C.*, "No later than December 31, 1998, and every year thereafter, the Utility shall have audits performed by independent auditors who cover the calendar year which ends on December 31, 1998, that verify that the utility is in compliance with the Rules set forth herein. The utilities shall file the independent auditor's report with the Commission's Energy Division beginning no later than May 1, 1999, and serve it on all parties to this proceeding. The audits shall be at shareholder expense." This report addresses the calendar year 2004 and is to be filed by Pacific Gas and Electric Company (Company or PG&E) no later than May 1, 2005.

B. AUDIT APPROACH AND WORK PLAN

This audit differed somewhat from previous year audits. With the divestiture of National Energy and Gas Transmission (NEGT), there are no longer any active Rule II.B affiliates. Consequently, the avenues for violating affiliate rule compliance are decreased dramatically. In 2004, compliance was primarily with rule structure as opposed to relations with affiliates. Despite the lack of any Rule II.B affiliates after October 29, 2004, the Company maintained its compliance structure, rules, training and other compliance processes. Our audit was modified from previous years in some respects. Much of our work confirmed that there were no changes in compliance plans and procedures from previous years. Once we concluded that there were no Rule II.B affiliates, we could confidently state that there were not violations of specific interactions with Rule II.B affiliates.

Information gathering and analysis began in December 2004. Field interviews were initiated in January 2005. In total, 109 separate information requests were submitted and utilized in the audit of PG&E. In addition, 23 formal interviews were conducted, with approximately 25 people attending. All members of Affiliate Rules and Regulatory Compliance (ARRC) were interviewed several times. In addition, several phone calls and e-mails supplemented the interviews.

Sampling and testing of data and transactions were conducted in accordance with appropriate Generally Accepted Auditing Standards (GAAS). In all cases, where required, an adequate sample population was selected for audit testing and conclusions were based on the results of the tested sample. In cases where anomalies were discovered, these items were immediately brought to the attention of Company personnel for immediate correction. A discussion of our use of Generally Accepted Auditing Standards is provided in *Section A of Volume II.*

The final report was completed on April 28, 2005.

C. REPORT LAYOUT

The layout of this report has been designed to accommodate both the senior level reader who has interest in overall conclusions and recommendations, as well as the ARRC and CPUC staff who must deal with the specifics of each conclusion and recommendation. To achieve this, we have organized the report into two Volumes. *Volume I* provides an overall summary of our audit as well as details on all areas where problems, if any, were discovered, or where opportunities for improvement exist. *Volume I* is organized into four chapters.

- Chapter I - Executive Summary - provides a summary of our approach, overall conclusions, major findings, and recommendations.
- Chapter II - Background and Issues - provides some perspective on the many major events that occurred in 2004, or were on-going, that had a direct and profound impact on Pacific Gas and Electric Company. It also provides discussion on other major topics such as Federal Sentencing Guidelines and Pacific Gas and Electric Company's bankruptcy.
- Chapter III - Audit Summary - is a table that identifies each section of the Rules that Pacific Gas and Electric Company must comply with, and indicates whether the Company has met the standard. It also has a listing of the analysis our consultants performed.
- Chapter IV – Detailed Audit Analysis - provides details on all areas where problems may exist or where improvements need to be made. It also includes a table that lists last year's recommendations, and summarizes the progress made on implementation.

The details and background used in developing our conclusions have not been discarded. Vantage moved all details on audit process, analysis, and issues with no negative findings into *Volume II*. This Volume will contain a great deal of detail, some of which may be confidential. This detail will include:

- A summary of the GAAS (generally accepted audit standards) used for sampling and analysis.
- A copy of the Work Breakdown Structure (WBS) which provides the outline for work requirements, assignments, and related interviews and information requests.
- An Interview Request List which identifies all personnel interviewed as part of the assignment.
- An Information Request List which provides a description of all information requested from ARRC.
- Work papers which include individual analyses and working notes of each consultant.

- Key data and analysis which includes copies and/or summaries of key data we analyzed or developed.

D. OVERALL CONCLUSION

Before addressing overall conclusions, recommendations and areas that need improvement, let us put the compliance program in perspective.

Pacific Gas and Electric Company has a mature Compliance Plan in place that has evolved over seven years, and is generally successful in all areas. The table in *Chapter III* that describes our audit effort and Pacific Gas and Electric Company's compliance with the Rules has 27 individual categories of rules identified. Our analysis indicates that Pacific Gas and Electric Company is in compliance in all areas. This is not to say that there are no recommendations for improvement or that all areas are perfect. In fact, one global and two technical recommendations are made that should lead to continued improvements in both the Affiliate Rules and Regulatory Compliance program and PG&E's record-keeping in general.

During 2004, Pacific Gas and Electric Company and the ARRC Department have continued to improve the overall Compliance Plan, especially the implementation of past report recommendations and follow-up.

A total of three recommendations have been made in the report. They are summarized later in the report and the details and support related to them are at the end of this volume.

One major point that should not be overlooked is that there were no formal reports of potential violations in 2004.

E. RECOMMENDATION SUMMARY

The following are the recommendation statements from the report. Each recommendation is numbered and references the findings that support it. Details on each recommendation are in Section IV.

R1 The current compliance program for Affiliate Rules, including training, reporting, and record-keeping, should be continued even though the likelihood of affiliate transactions has diminished with the exit of NEGT. (This is a general recommendation and not specific to any findings.)

R2 Establish a formal procedure to notify all PG&E executives and affiliate executives of the formation of new affiliates including a description of the business activities of the new affiliate and an assertion of whether the new affiliate is covered by the Affiliate Rules Compliance Plan.

R3 Continue efforts to modify allocation methodology for shared space on poles so that the difference between actual and allocated costs is minimal. Further, determine the impact of inaccuracy on corporate earnings and/or customer rates.

II. BACKGROUND AND ISSUES

This Chapter provides some background on major issues or policies that have an effect on affiliate rules compliance. It is intended to give the reader a sense of how external activities often impact internal compliance requirements.

A. AFFILIATE RULES MODIFICATIONS

II -F1 Although both of the proceedings, OIR 01-01-001 and OII 01-04-002, remained open during 2004, there was no activity in either docket and therefore no impact on PG&E's Compliance Plan or this audit. With the April 7, 2005 closing of OIR 01-01-001 the potential for any future impact is mitigated.

During 2000, the CPUC established a forum to receive comments on its affiliate transaction rules from all interested parties. The intent was to re-visit the rules after they had been in effect for three years to determine if there was a need to modify the rules. Numerous comments were received. Generally, the comments suggested modifications that would simplify and further clarify the rules. In addition, there were suggestions for modifications to reduce the cost of compliance with the rules. Based on these comments and consistent with the intent of its original orders on these matters, the CPUC initiated rulemaking OIR 01-01-001 on January 4, 2001. This rulemaking intended to "re-look" at the affiliate transactions rules as well as interim reporting requirements. In this Order the CPUC reiterated its objectives. The primary objectives were to foster competition and protect consumer interests. The CPUC also stated that it wanted to prevent cross-subsidization and self-dealing, customer confusion in product promotion and advertising, and to protect the Utility's release of customer-specific information. The Order included a procedural schedule that anticipated a final Order by October 2001. On April 25, 2001, the CPUC issued an Order that stayed any further proceedings in OIR 01-01-001. On January 28, 2005, the assigned ALJ issued a ruling that provided parties with notice that after having been stayed for almost four years the Commission intended to close the Rulemaking and gave parties until February 28, 2005 to file any objections. Both PG&E and ORA filed comments. The comments did not oppose the closing of the docket. On April 7, 2005, the Commission issued an Order closing OIR 01-01-001.

On April 3, 2001, the CPUC issued an Order Instituting Investigation, OII 01-04-002. The Order indicated the CPUC's interest in investigating whether the utilities and their respective holding companies violated relevant statutes and CPUC rules and decisions. The CPUC also expressed its interest in determining whether changes should be made to rules, orders, and conditions pertaining to respective holding company systems.

Since there was no activity in either of the aforementioned proceedings, OIR 01-01-001 and OII 01-04-002, during 2004, there was no impact on PG&E's Compliance Plan or this audit. With the closing of OIR 01-01-001 the potential for any future impact is mitigated.

B. BANKRUPTCY AND PLAN OF REORGANIZATION

II -F2 On December 22, 2003, the bankruptcy court confirmed the new Plan of Reorganization (PoR). During 2004, PG&E successfully emerged from bankruptcy as a vertically integrated utility.

II -F3 On October 29, 2004, National Energy and Gas Transmission, Inc. ("NEGT") and its affiliates emerged from bankruptcy. NEGT was owned by PG&E Corporation and was an affiliate of PG&E. As a result of the resolution of the bankruptcy, NEGT and its affiliates are no longer owned by PG&E Corporation and are no longer affiliates of PG&E.

On April 6, 2001, PG&E filed bankruptcy pursuant to Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court for the Northern District of California. The key factor in leading PG&E into bankruptcy was the dramatic increase in wholesale energy prices during the summer of 2000. There was no regulatory mechanism for PG&E to recover the increased costs so PG&E applied to the CPUC for an emergency rate increase. When the emergency rate relief was not forthcoming, PG&E was forced to file for bankruptcy protection.

On September 20, 2001, PG&E filed a Proposed Plan of Reorganization ("PoR"). Under the PoR, four lines of business would be established. The lines of business would be a retail gas and electric distribution; electric transmission; interstate gas transmission; and electric generation. Further, the proposed PoR provides that a separate holding company would be created and that the electric transmission, interstate gas transmission, and electric generation lines of business would become wholly owned subsidiaries of PG&E Corporation. PG&E would retain the retail gas and electric distribution and become a stand-alone gas and electric distribution utility regulated by the CPUC.

In April 2002, the CPUC proposed an alternative plan for reorganization. The Official Committee of Unsecured Creditors joined in its support for the CPUC alternative plan. On December 19, 2003, the CPUC, PG&E Corporation and PG&E entered a settlement agreement that resulted in a new PoR. Under the new PoR, PG&E would remain a vertically integrated utility. On December 22, 2003, the bankruptcy court confirmed the new PoR. During 2004, PG&E successfully emerged from bankruptcy as a vertically integrated utility. Also, on October 29, 2004, National Energy and Gas Transmission, Inc. ("NEGT") and its affiliates emerged from bankruptcy. NEGT was owned by PG&E Corporation and was an affiliate of PG&E. As a result of the resolution of the bankruptcy, NEGT and its affiliates are no longer owned by PG&E Corporation and are no longer affiliates of PG&E. One consequence is that PG&E currently has no Rule II.B. affiliates covered by the CPUC's affiliate rules.

C. UTILITY ELECTRICITY PROCUREMENT

II -F4 Specific rules are in place as of 2004 that address procurement electricity.

Beginning January 1, 2003, PG&E resumed responsibility for procuring electricity for its residual net open position. In January 2004, the CPUC adopted short-term procurement plans for PG&E, SCE and SDG&E. In October 2004, the CPUC adopted an interim resource adequacy decision that accelerated the target date to June 1, 2006 for all load serving entities to achieve a reserve margin of 15-17% in excess of their peak requirements. In December 2004, the CPUC adopted long-term procurement plans for PG&E, SCE and SDG&E. This decision lifted the ban on long-term affiliate transactions entered through an open, transparent solicitation process. It maintained the ban on short-term affiliate transactions. CPUC Decision D.04-010-50, (pp. 78-79) discusses gas service transactions between PG&E operating divisions. These transactions will be subject to rules adopted by the CPUC and these transactions will be the subject of a management audit review. The CPUC has previously expressed concern about self dealing with respect to gas storage and intrastate backbone transmission services (Resolution E-3825). To the extent that competitive alternates exist, PG&E is expected to procure such services through a competitive solicitation or Request For Offer. In cases where there are no competitive alternatives, PG&E must demonstrate that the price paid for use of the Utility's services are reasonable. PG&E's compliance with these rules may be subject to independent audit. There was no impact on this audit of the 2004 Compliance Plan.

III. AUDIT SUMMARY

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section II. Applicability & Training	**Yes**	None	• Reviewed Attachment D listing of companies. • Isolated inconsistencies with the list and other sources, including Compliance Plan, Attachments A – K, reviewed Web Site, specifically looking at linked and related companies. • Reviewed changes from previous years and determined appropriateness.
Reference Section III. A. No Preferential Treatment	**Yes**	None	• Reviewed the DTR database. Interviews with Pipeline operations and ARRC personnel. • Reviewed former affiliate websites, TransCanada Website and also Piperanger. • Reviewed Attachment B. Updated December 12, 2004. • Verified that information provided to employees, including new hire orientation handout, has not changed. • Reviewed Attachment E.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section III.B. Offering of Discounts	**Yes**	None	• Reviewed all relevant sections of Attachment B Affiliate Rules memos and the Detailed Summary of Affiliate Rules Compliance Plan. • Reviewed DTRs and all supporting documentation. Reviewed all DTRs dealing with electric transactions. • Verified that no gas commodity deals were done with affiliates in 2004. • Confirmed that ET was not a shipper on CGT during 2004. • Reviewed the latest Piperanger and other public posting data for affiliate transactions.[1] • See also III.F.
Reference Section III.C. Tying of Services Prohibited	**Yes**	None	• Verified that all training presentations are the same for 2004. • Reviewed number of employees trained compared to previous years. • Reviewed internal and external information channels to verify no tying. • Confirmed that all links are now severed between PG&E and The Holding Company.

[1] / Vantage routinely downloads the public data from Piperanger and other affiliate posting sites (including NEGTNW) and saves these files. As such we had the latest posted data for 2004 even though the data is no longer visible online.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section III.E. Business Development and Customer Relations	**Yes**	None	• Verified that the Compliance Plan for current requirements has not changed. • Interviewed key ARRC and management personnel. • Analyzed complaints and/or transactions in this area.
Reference Section III.F. Affiliate Discount Reports	**Yes**	None	• Reviewed DTRs and all supporting documentation on a sample basis. • Confirmed that no gas commodity transactions occurred in 2004 between affiliates and PG&E, including pipeline and storage operations. (See also III.B.)
Reference Section IV.A. Customer Information	**Yes**	None	• Verified by selecting a statistical sample of the Customer Information Release Request (CIRR) database are obtained before releasing customer information. • Verified through interviews, information requests, and observation, that adequate policies are established and disseminated regarding release of customer information. • Verified through interviews, information requests, and observation, that customer information releases are posted on the Internet site. • Verified through information requests and observation, that the Departing Employee Checklist appropriately addresses Standards for Personal Conduct and Business Decisions.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section IV.B. Non-Customer Specific Non-Public Information	**Yes**	None	• Reviewed training information. (Intranet based.) • Reviewed the policies and procedures pertaining to IV.B. • Reviewed D.98-08-035, modifying D.97-04-011.
Reference Section IV. C. Service Provider Information	**Yes**	None	• Reviewed lists of information provided to CPUC for dissemination to ratepayers.
Reference Section IV.D. Supplier Information	**Yes**	None	• Discussed with Procurement personnel to determine that no non-public information and data was provided to any third parties.
Reference Section IV.E. Affiliate Related Advice or Assistance	**Yes**	None	• Verified by obtaining objective, verifiable evidence that the policies for communicating with customers regarding bundled service, virtual direct access, etc. are in place and have been communicated to new employees who may need to address this issue. • This continues to have limited potential for violation given the absence of ESP and limited customer choice via gas.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section IV.F. Record Keeping	**Yes**	Improvement compared to 2003	• Reviewed DTR database, additionally reviewed 20 randomly selected DTRs, reviewed DTR/SAP reconciliation work papers, interviewed ARRC department personnel. • Reviewed detailed purchasing practices of Gas Procurement Dept. relative to affiliates including: - DTR Summary; - Weekly Reminders; - Affiliate Reminders; - Affiliate Binder
Reference Section IV.G. Maintenance of Affiliate Contracts and Related Bids	**Yes**	None	• Verified by obtaining objective, verifiable evidence that contract and bid records are maintained for a minimum of three years. • Reviewed all contracts with Rule II.B. affiliates for 2003.
Reference Section IV. H. FERC Reporting Requirements	**Yes**	None	• No analysis performed in this area.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.A. Corporate Entities	**Yes**	None	• Verified no changes with the Holding Company Decision and Application, (D.96-11-07 and A.95-10-024.) • Reviewed financial information, noting separation, available on the internet. • Discussed with ARRC and Corporate Accounting personnel.
Reference Section V.B. Books and Records	**Yes**	None	• Reviewed Financial Statements. • Discussed with ARRC, Internal Auditing and Corporate Accounting.
Reference Section V.C. Sharing of plant, facilities, equipment, or costs	**Yes**	None	• Performed limited walk-through of the Company noting access is controlled. • Noted no instances in which affiliates share space with the Utility. • Noted SAP controlled access.
Reference Section V. D. Joint Purchases	**Yes**	None	• Interviewed Procurement personnel. Reviewed cost allocations of jointly purchased software licensing. No other items were jointly purchased.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.E. Corporate Support	**Yes**	None	• Verified no changes to services allowed as noted in the Compliance Plan and Attachment E. • Reviewed all Inter-Company bills noting services provided and received, and trending of dollars. • Reviewed Inter-Company bills for services not allowed. • Through all work, noted no instances in which support services were being used as a conduit to pass information. • Examined allocation methods used by PG&E Corporation. • Verified no changes to confidentiality agreements signed by Corporate Communications and Public Relations. • Reviewed memos distributed regarding Corporate Support and Affiliate Rules. • Discussed with other team members their review results. • Interviewed ARRC and Corporate Accounting Personnel.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.F. Corporate identification and advertising	**Yes**	None	• Reviewed website noting appropriate identification. • Reviewed training. • Reviewed Corporate Booklets and internal checklists. • Reviewed Inter-Company checklists. • Verified no R&D work and advanced technology research pertained to affiliate rules. • Interviewed ARRC, Legal Compliance and Business Ethics personnel.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section V.G. Employees	**Yes.**	System is in place in ARRC to track DECs. No employees transferred or rotated in 2004 so no DECs were collected.	• Reviewed officer and directors listing noting appropriateness. • Reviewed DEC collection system noting appropriateness. • Reviewed signed confidentiality agreements for sample of new employees.
Reference Section V.H. Transfer of goods and services	**Yes**	Issue continues pertaining to overpayment by PG&E to other users of poles due to potential inadequacy of allocation formula.	• Verified by obtaining objective, verifiable evidence that transfers of goods and services between the Utility and its Rule II.B affiliates are priced as required by the Rules. • Verified by obtaining objective, verifiable evidence that procedures are in place for transfer and billing of goods and services transferred between the Utility and its Rule II.B Affiliates. • Verified by obtaining objective, verifiable evidence that procedures are in place to assure that the Rules regarding accounting are being adequately enforced.

Work Step (Compliance Plan Section)	In Compliance	Issues	Independent Analysis or Testing Performed
Reference Section VI.A. Regulatory Oversights	**Yes**	None	• Reviewed Compliance Plan in conjunction with CPUC regulations.
Reference Section VI.B. New Affiliate Compliance Plans	**Yes**	None	• Reviewed all advice letters filed with CPUC in 2004. • Interviewed ARRC personnel.
Reference Section VI.C. Affiliate Audits	**Yes**	None	• Reviewed ARRC monitoring plan. • Discussed audit plan with ARRC personnel.
Reference Section VI.D. Witness Availability	**Yes**	None	• Interviewed ARRC personnel.
Reference Section Non-tariffed Products and Services VII. A-H	**Yes**	Question whether N.E.1. Facility joint use arrangements should be a non-tariffed product.	• Reviewed and analyzed Categories of Non-Tariffed Products and Services from 2004 draft annual report to CPUC. • Reviewed cost allocation methodologies. • Reviewed mechanisms developed for treatment of benefits and revenues. • Summarized and reviewed reports developed for non-tariffed products and services. • Summarized and reviewed property transfers. • Reviewed all advice letters addressing non-tariffed products and services.

IV. DETAILED AUDIT ANALYSIS

A. SUMMARY OF 2003 RECOMMENDATION DISPOSITION

The 2003 audit provided four recommendations for consideration by ARRC and PG&E. All four were addressed in a satisfactory manner. The following table illustrates the actions taken on each recommendation. This is followed by Vantage's own audit results of the areas related to the recommendations. In general, all recommendations were adequately resolved or addressed.

Recommendations	Action Plan	Resolution
R1 The current compliance program for Affiliate Rules, including training, reporting, and record-keeping, should be continued even though the likelihood of affiliate transactions has diminished with the pending exit of NEGT and other related companies. (This is a general recommendation and not specific to any findings.)	The affiliate rules program will remain in place.	Completed
R2 Re-evaluate the DTR/SAP Reconciliation to determine how the process could be improved and possibly streamlined.	ARRC to communicate with Affiliate Accounting	Completed. Due to revisions in the process, reconciliation problems have been resolved.

R3 Assign ownership of employee departure notification and the Departing Employee Checklist (DEC) to a specific department, such as Human Resources or Payroll to ensure that the checklists are complete and more importantly, that the tasks that need to be completed (notifying Payroll and Information Technology of employee departure) have occurred.	See Resolution column	The following steps will occur: HR will stress to their HR Advisors the importance of filling out DECs, who will then pass on this notice of importance to their client groups, specifically targeting "supervisors". Payroll will send an e-mail to EASY 2000 Preparers and Releasers reminding them to complete DECs for all departing or terminating employees. For the future SAP/PR system, there will be an automatic electronic prompt (possibly including the DEC) emailed to a departing employee's supervisor reminding them to fill out the checklist (already installed this as an action item for the new system). The new system is scheduled to go live summer 2006. This is currently not feasible because the current PR system cannot identify each employee's supervisor.
R4 Appoint a study committee to begin the design and implementation of a new work order entry system.	ARRC to communicate with Affiliate Accounting	Affiliate Accounting's IT Program Manager and an initial review indicate that at this time a replacement/rewrite of the Order Request System is not recommended. Any new Inter-Company services are now limited to services that the Utility provides to PG&E Corporation and new services are limited in number, making it more cost effective to use the work-around process compared with replacing the entire existing system. Additionally, the limited available department resources are already deployed on most urgent SAP optimization projects. We will also take another look at possible future steps as department resources become available next year.

RESOLUTION OF MAJOR ISSUES AND RECOMEMNDATIONS FROM 2003 AUDIT

Continuation of Affiliate Rules Compliance Program

IV -F5 The affiliate compliance program at PG&E remained in place and all elements were continued despite the reduction in the potential for violations.

Last year, Vantage recommended that the affiliate rules and all associated programs remain in place. This recommendation was made for two reasons. First, the regulatory rules do not have a provision for ending the program unilaterally. Second, there is always the chance that PG&E will acquire or develop new affiliates that will be affected and this would require re-establishing the program.

In 2004, the last Rule II.B affiliate, NEGT, was completely separated from PG&E, resulting in a year end status of no Rule II.B affiliates. Based on this situation, a company might consider relaxing its compliance process since violations cannot occur.

2004 DTR Finding

IV -F6 The 2004 DTR reconciliation data shows a reconciliation process that is operating smoothly and efficiently.

The DTR / SAP reconciliation process shows a great improvement over 2003. The reconciliation binders were well organized, with a completed summary form in the front of the binder and the supporting reconciliations filed under tabs alphabetically by Vice President / Director for the reconciled area. All reconciliation forms tested for inclusion in the binder were noted to be in the appropriate place, filed under the appropriate tab, so that the forms and detail could be located easily for any area. The lead sheets to the reconciliation binders showing reconciliations received and reviewed was complete and very legible. In 2003, many miscellaneous papers were noted to be stuffed into a front pocket of a binder. Some of these papers supported the reconciliation process and needed to be filed in the binder and some did not. In 2004, it was noted that binders without pockets were used for the reconciliation process, thereby completely eliminating the chance of miscellaneous papers accumulating.

2004 Overall DTR Process Finding and Prior Years DTR Process Overview

In 2003 there was some room for improvement in the DTR reconciliation process. 2004 showed a smoother operation with some changes to the process that helped the individuals reconciling the report do so more easily. It is important to understand how much the DTR process has improved over the past years. A review and update on the findings and recommendations from previous years will help the reader appreciate this improvement. Below is a brief description of the 2001 and 2002 findings. For detail of these findings, please refer to the Vantage Affiliate Rules Compliance reports from those years, which in part says:

> "Multiple findings and recommendations were made in 2001 regarding the DTR process. First and foremost was the fact that the DTR process appeared to be uncontrolled and the subsequent posting of activity with Rule II B affiliates to the internet. Also, the DTR / SAP reconciliation had not been performed during the year 2001. The first three quarters were being reconciled when Vantage began fieldwork in late 2001. And the Gas Procurement area had multiple internal DTR violations. "

As the above finding excerpt indicates, problems existed in the DTR process in 2001. Vast improvements were noted in 2002 and then some backsliding occurred in 2003. Last year, 2004, shows again, a steady improvement above and beyond the ARRC process in 2003 and even 2002.

Departing Employee Checklists (DEC)

There is no consistent procedure, company-wide, for the reporting of departing employees to Human Resources (HR), Payroll (PR) and Information Technology (IT). In the past, PG&E has relied on the various departmental supervisors to remember to file the DEC when an employee leaves. Receipt of this form is the notification needed by HR, PR, and IT to inform them that an employee has left PG&E. Once they are notified, they can update their systems to reflect that fact. For example, when IT receives this form, a departed employee's computer access is changed so that they can no longer access the computer systems at PG&E.

ARRC has used, and is currently using, a computer generated monthly data report that summarizes departed employees. If there is an employee that departed to a Rule II.B. affiliate, ARRC will ask the supervisor for the DEC if they had not received one. The Company as a whole is using the HR and PR departments to keep in communication with their clients to reiterate the importance of the DECs. In the future, the new SAP system will remind departmental supervisors of departing employees to complete the DEC. Currently, reminders are also included with e-mails and other communications regarding the importance of DECs. With the reminder notices, as well as HR's and PR's attention, an improvement should be noted in the receipt of DECs by PR, HR and IT.

A follow-up should be planned for next year to determine if the DECs, company-wide, were received more timely after the increased focus and attention of HR and PR. The DEC process is expected to be even more improved after the implementation of the new SAP system in mid 2006.

Commodities and Transportation

In the previous Vantage audits[2] a significant amount of focus and effort was directed toward transactions involving commodity purchases and sales to affiliates as well as

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[2] / Auditing years 2001, 2002 and 2003.

pipeline transactions between PG&E and affiliates. Two significant events in 2004 impacted this section of the audit.

In 2004 PG&E had no commodity transactions with Rule II.B. affiliates. The primary audit focus of PG&E affiliate gas transactions in previous audits was PG&E Energy Trading (ET). The primary affiliate audit focus was to ensure that price, terms and conditions afforded to the affiliate were comparable and fair to non-affiliates. ET effectively ceased to exist in 2003 with the bankruptcy of its parent NEGT. PG&E did continue some contracts in 2003 which were in the favor of PG&E[3], but even then was unwinding from any dealing with the affiliate. Even during 2003, the credit position of ET makes conducting transactions difficult if not impossible[4]. During 2004 there were no commodity transactions with ET or any other energy supply affiliate. After a brief review to confirm the absence of transactions, this section of the review was truncated in 2004.

In addition to commodity purchases between affiliates, gas transmission was also a focal point. This included transactions on California Gas Transmission (CGT) lines as well as affiliate Gas Transmission Northwest (GTN). On CGT, transactions were examined involving affiliates (primarily ET) to determine if comparable terms and conditions were extended to non-affiliates. Particular attention was paid to non-tariffed transactions and discounts provided to affiliates. In addition, operational flow orders and <u>all</u> manual override adjustments were examined in previous years. In 2004, ET was absent as a shipper so there were no transactions to review under the affiliate rules. Other shippers do use CGT pipelines, terminals and storage but the affiliate rules audit is limited to a review of non-discrimination with regards to affiliates. In addition, GTN (a subsidiary of NEGT) was sold to TransCanada during 2004.

Electric transactions have always been reviewed as well but after the suspension of Direct Access Service in 2001 concerns about information exchange, customer information releases and discrimination became irrelevant as to energy service providers. Until 2003, PG&E had no flexibility as to electric purchases and in 2004 had only minimal flexibility as to direct electric purchases. Audit focus has been on any contracts between PG&E and generating plants (essentially La Paloma). In 2004 this amounted to electric contracts for sales to La Paloma which were minimal in terms of total dollar transactions.

IV -F7 <u>The absence of Rule II.B. affiliates in 2004 have eliminated the opportunities for discrimination with regards to gas transactions.</u>

As noted, the primary focus of affiliate audits in the energy area has been transactions with Energy Trading. In the absence of Energy Trading as a viable entity, opportunity for discrimination between affiliates and non affiliates no longer exist.

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[3] / Essentially, PG&E continued a contract with ET in order to avoid having to replace the volume on the spot market at higher than contract prices. See the 2003 Vantage audit for details.

[4] / Vantage also reviews credit policies of PG&E. Credit policies towards affiliates are the same as for non affiliates.

IV -F8 PG&E has continued to improve in terms of self-reporting even in the absence of Rule II.B. affiliates.

Each year Vantage does a detailed review of the Detailed Transaction Review (DTR) database. This is both a subjective and objective review. Each year Vantage has audited PG&E, the content of the DTRs has improved with regard to commodity purchases. This positive trend continued during 2004 even in the absence of commodity transactions. Although the normal crosschecks did not exist (due to the lack of payments) the DTR database included attachments and detailed explanations of the reasons for posting.

IV -F9 Sarbanes Oxley requirements have increased the formal reviews in ISTS which indirectly strengthens the PG&E affiliate compliance reviews.

Sarbanes Oxley requirements are obviously much broader in scope than affiliate transaction rules. However, many of the key performance indicators developed and monitored for Sarbanes Oxley have direct and positive impact on affiliate rules compliance. Notable among these is control and termination of departing employee access to computer systems. Although affiliate rules audits are primarily concerned with employees departing to affiliates, the issue is, in fact, much broader and includes employees potentially departing to competitors. The Sarbanes Oxley performance indicators cover these employees as well.

B. ISSUES IDENTIFIED IN 2004 AUDIT

This section provides our analysis, findings, and recommendations for those areas of affiliate compliance in which improvements could be made. Please note that in cases where there were no issues or negative findings, our analysis is summarized in *Chapter 2* and details on our work are provided in *Volume II.* The reference numbers for finding are from the sequential numbering of all findings in *Volume II.*

GENERAL

IV -R1 The affiliate compliance program at PG&E should remain in place and all elements should be continued despite the reduction in the potential for violations.

Last year, Vantage recommended that the affiliate rules and all associated programs remain in place. This recommendation was made for two reasons. First, the regulatory rules do not have a provision for ending the program unilaterally. Second, there is always the chance that PG&E will acquire or create new affiliates that will be affected and this would require re-establishing the program.

In 2004, the last Rule II.B. affiliate, NEGT, was completely separated from PG&E, resulting in a year-end status of no Rule II.B. affiliates. Based on this situation, a company might consider relaxing its compliance process since violations cannot occur. Vantage recommends that this not happen. While there are no Rule II.B. affiliates in place today, there is always the possibility that now that PG&E is once again healthy, it will buy or establish new businesses. Should this occur, it would be costly and time consuming to re-establish an affiliate compliance program.

Furthermore, the Affiliate Rules and Regulatory Compliance Department (ARRC) should continue in its role of monitoring compliance. This is now a part-time responsibility of the Department and does not require incremental resources. The personnel are well trained and experienced in monitoring compliance and can efficiently assure that PG&E stays in compliance with minimal cost.

RULE VI.B. REGULATORY OVERSIGHT

Notice of New Affiliates

Rule VI.B. requires PG&E to immediately notify the Commission of the creation of any new affiliate and that no later than 60 days after the creation of the affiliate to file an advice letter with the Energy Division of the Commission as well as the parties to the proceeding establishing the affiliate rules. PG&E is in complete compliance with this section of the affiliate rules. However, PG&E does not have any formal procedures for providing notification to executives of PG&E and its affiliates.

IV -F10 PG&E has no formalized procedures in place for informing executives of the formation of affiliates.

During our audit we requested a description of how PG&E executives and PG&E affiliate executives are informed of the creation of new affiliates. The response indicated that there is no formal notification process but that executives "tend to be informed if the affiliate's activities would affect their area of responsibility, and the information is available to all through the Corporate Secretary's corporate data sheets and the Tax Department's organization charts". (Information Request No. 36)

IV-R2 Establish a formal procedure to notify all PG&E executives and affiliate executives of the formation of new affiliates including a description of the business activities of the new affiliate and an assertion of whether the new affiliate is covered by the Affiliate Rules Compliance Plan (Refer to Finding IV-F10.)

Although the CPUC's regulations only require notification to the CPUC of the formation of an affiliate, it is imperative for the effective implementation of the rules and PG&E's Compliance Plan that the executives at the Utility, Corporation and the Affiliate, when applicable, be fully informed, not only of the formation of a new affiliate but also the nature of the business of the new affiliate and whether it raises affiliate compliance issues. This is of particular concern as there is currently no significant affiliate activity at PG&E and as a result interest in these matters wanes.

The establishment of a formal notification procedure to all executives will mitigate the possibility that if a new affiliate is formed, that notice is not received and a violation of the affiliate rules occurs. The old adage "better safe than sorry" is certainly applicable.

NON-TARIFFED PRODUCTS AND SERVICES – RULE VII

Cost Allocation Methodologies – Non-tariffed Products and Services – (VII.B)

IV -F11 With the exception of N.E.1, Facility joint use arrangements, PG&E has appropriate cost allocation methodologies in place to prevent cross-subsidization of tariffed and non-tariffed products and services, and the methodologies and procedures have been communicated to the appropriate personnel.

IV -F12 The cost allocation methodology used for N.E.1, Facility joint use arrangements has consistently led to under-recovery of expenditures by PG&E.

The table at the end of this section summarizes all of the transactions included in the annual Non-tariffed Products and Services Report filed with the CPUC each March. Our key concern in this report was the very first, N.E.1, Facility joint use arrangement, which addresses space on poles; inspection and remedial chemical treatment of jointly used poles. Our concern here is that the allocated cost is over $22 million, the revenue collected is only $19.9 million. This shortfall of almost 10% is due to the allocation method used.

In interviews of ARRC and operating personnel[5], we learned that the methodology used to allocate the costs of space on poles is very complicated and is re-negotiated regularly with other users of pole space such as telephone and cable companies. While efforts have been made to correct the differences, allocation results have not yet matched actual expenses.

IV -R3 Continue efforts to modify allocation methodology for shared space on poles so that the difference between actual and allocated costs is minimal. Further, determine the impact of inaccuracy on corporate earnings and/or customer rates. (Refer to Finding IV-F12.)

The significant difference between revenue and cost for this service should be addressed. Further, an effort should be made to determine the effect these differences have on earnings and or rates.

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[5] / Interview with Ed Mah of ARRC and related telephone call to Steve Grimes of the operating department.

		Pacific Gas and Electric Company Non-tariffed Products and Services Report				
		January - December 2004				
Category & Description		Number of Transactions	Allocated Costs ($ 000)	Revenues ($000)	Types of Relevant Assets	Estimated Annual Proportion of Assets Used
N.E.1. Facility joint use arrangements.						
	Space on poles; inspection and remedial chemical treatment of jointly used poles.[1]	105,349	22,022	19,945	Employees, Vehicles, Poles, Equipment	19.51%
N.E.2. Infrared scanning for others.						
	Overhead Infrared Inspection	1	0.12	0.56	Employee, Vehicle, Equipment	<1%
N.E.3. Hot-washing of electrical equipment for others.						
	Hot-washing of substations and distribution lines.	14	29	31	Employees, vehicles, equipment	<1%
N.E.4. Sale of hourly metered QF data to QFs.						
	QF metered data and processing services.	78	25	63	Employee, Equipment	<1%
N.E.5. Troubleshooting interference and other electrical problems for Telecom, CATV.						
	No Transaction Completed In 2004					
N.E.6. Repair and maintenance on third party power plants.						
	No Transaction Completed In 2004					
N.E.7. Joint nuclear services.						
	STARS-Washington Representative	1	141	212	Employee	<1%
[1] Joint pole credits, included with revenues, are a return for services PG&E previously provided to others.						
N.E.8. Transmission construction and						

maintenance services.						
	Construction and maintenance services on customer or third party transmission system.	8	24	25	Employees, Vehicles, Tools, Materials	<1%
N.E.9. Transmission planning, engineering, and consulting.						
	No Transaction Completed In 2004					
N.E.10. Customer emergency transformer/generator loans.						
	Transformer and Associated Equipment Loans	2	38	100	Employees, Transformers, Equipment, Materials	< 1%
N.E.11. UEG pipeline capacity brokering.						
	No Transaction Completed In 2004					
N.E.12. Incidental non-utility water sales.						
	Annual water deliveries: Bureau of Reclamation Water and Cal Water Delivery Contracts.	2	117	525	Employees, Equipment, Materials	1.40%
N.G.1. Sale of extraction liquids.						
	Sale of gas well condensate	336	3	5	Employees	<1%
N.G.2. Pipeline maintenance, excavation, leak detection for others.						
	No Transactions Completed In 2004					
N.G.3. Specialty gas work for others.						
	No Transactions Completed In 2004					
N.G.4. Meter cabinet construction and extension of customer owned piping.						
	No Transactions Completed In 2004					
N.C.1. Testing, analysis, evaluation, measurement of customer or third party systems and equipment.						

	Non-destructive in-service inspection of equipment and facilities; calibration and repair of test equipment and revenue meters; products and materials testing and evaluation.	29	317	326	Employees, Equipment, Facilities	1.23%
N.C.2 Environmental analysis, assessment, monitoring for others.						
	Environmental Assessment and Compliance Monitoring: Quantification and analysis of the environmental impacts of operations.	19	157	184	Employees, Equipment, Facilities	<1%
N.C.3. Wireless attachment to PG&E facilities; installation/maintenance and related land rights services.						
	No Transactions Completed In 2004					
N.C.4. Short-term use of facilities/real property with associated services.						
	Day and overnight use of conference facilities; catering and food services; business support services (AV equipment, copying, planning).	558,943	1,325	1,698	Employees, Land, Equipment, Facilities	20.21%
N.C.5. Testing measurement analysis services supporting research for Industry Association.						
	Testing, measurement and analysis services.	4	21	25	Employees, Equipment	<1%
N.C.6. Sales of Meteorological analysis/modeling.						
	No Transactions Completed In 2004					
N.C.7. Sales of standards manuals and other publications to third-parties.						
	Sale Of Resource Books	10	0.06	0.45	Employees, Manuals	<1%
N.C.8. Laser Alignment service.						
	No Transactions Completed In 2004					

N.C.9. Business support services.						
	Mail Services, Reprographic Services	4	90	85	Employee, Vehicle, Equipment	<1%
N.C.10. Operation, maintenance, repair, inspection and construction and related land rights service for customer owned						
	or third party facilities.					
	Operation, maintenance, repair, and construction on third party facilities.	9	116	150	Employees, Vehicles, Equipment, Materials	<1%
N.C.11. Training for customers and third parties.						
	Training for third parties.	33	157	183	Employees, Facilities, Equipment	<1%
N.C.12. Gas pressure regulation and flow analysis. Electric protective relay settings, voltage regulation and capacity studies.						
	No Transactions Completed In 2004					