FINAL REPORT

Volume I

Pacific Gas and Electric Company

Audit of Affiliate Rules Compliance for 2005

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, 2006

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Volume I

Vantage Consulting, Inc.

Pacific Gas and Electric Company
Audit of Affiliate Rules Compliance for 2005

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I. EXECUTIVE SUMMARY

A. AUDIT OBJECTIVE AND METHODOLOGY

Volumes I and II of this report provide the results of the audit of Pacific Gas & Electric Company's (PG&E or Company) affiliate relations. 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 2005 and is to be filed by Pacific Gas and Electric Company no later than May 1, 2006.

B. AUDIT APPROACH AND WORK PLAN

This audit differed significantly from previous year's audits since there were no affiliates owned by PG&E that fell under Rule II.B portion of the rules during 2005. With the divestiture of National Energy and Gas Transmission (NEGT) near the end of 2004, there were no longer any active Rule II.B affiliates to audit, therefore much of our effort was redirected. In 2005, 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 material changes in compliance plans and procedures from previous years. We also did a more in-depth search to ensure that there were no Rule II.B affiliates. Once this was verified, we could confidently state that there were no violations of specific interactions with Rule II.B affiliates.

A major thrust of the audit this year was to develop a prescriptive process for addressing any new Rule II.B affiliates that may be acquired or created. This process provides a framework or roadmap to follow in order to ensure that any new Rule II.B affiliate is introduced with a minimum chance of mistakes being made.

Information gathering and analysis began in December 2005. Field interviews were initiated in January 2006. In total, 115 separate information requests were submitted and utilized in the audit of PG&E. In addition, 20 formal interviews were conducted, with approximately 21 people attending. All members of the Compliance and Ethics Department (C&E) involved with Affiliate Rules 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, 2006.

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 C&E personnel 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 any major events that occurred in 2005, or were on-going, that had a direct impact on Pacific Gas and Electric Company. It also provides discussion on other major topics such as Federal Sentencing Guidelines which are interrelated with the Affiliate Rules in some ways.
- 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. This chapter also includes the "Prescriptive Plan" we have prepared that can serve as a guide for successfully introducing new Rule II.B affiliates.

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 C&E;
- 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 eight years, and is 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.

During 2005, Pacific Gas and Electric Company and the C&E Department have continued to improve the overall Compliance Plan, especially the implementation of past report recommendations and follow-up.

A total of two 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 2005.

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 In anticipation of the likelihood of the creation and acquisition of new affiliates, the C&E Department needs to be prepared to maintain continued compliance.

R2 Make an effort to convert the facility joint use arrangement to a tariffed service in order to improve collection of full cost.

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

F1 The current proceeding in CPUC Case No. R. 05-10-030 had no impact on PG&E's Compliance Plan or this audit, however, it could very likely have an effect on future plans and audits.

In October 2005, the CPUC issued its Order in Case No. R. 05-10-030, Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities And Their Holding Companies And Non-Regulated Affiliates. The Order states at page 1 that the CPUC intends to "review current investments of the parent holding companies that is part of the overall energy infrastructure that California consumers depend upon. The Commission also will review the capital budgets of the utilities and their parent holding companies to better understand the amount of capital that is expected to be allocated to either the utilities or an affiliate for investment in energy infrastructure that will meet any part of California's need for reliable supplies of energy." The Order further acknowledges the recent enactment of the Energy Policy Act of 2005 which repealed the Public Utility Holding Company Act of 1935 and the resulting need to more carefully scrutinize utility companies' plans to expand their unregulated activities. These activities include attempts to merge with, or acquire, other companies or be acquired by other companies. Accordingly, the CPUC finds it necessary to review its existing regulations and to consider whether additional new rules or regulations are needed.

Obviously this CPUC investigation had no impact on the current affiliate rules and therefore no impact on our audit this year. However, it raises the potential for future changes in the affiliate rules and therefore the outcome of this investigation must be carefully monitored for on-going compliance by PG&E and future audits.

B. OVERSIGHT DEPARTMENT RESTRUCTURING

F2 The Affiliate Rules and Regulatory Compliance (ARRC) Department has been reorganized as part of the Compliance and Ethics (C&E) Department.

During 2005, the Affiliate Rules and Regulatory Compliance (ARRC) department was merged with two other departments to form the Compliance and Ethics Department (C&E). The other two departments were Legal Compliance and Business Ethics (at the Corporation) and Compliance Management Initiative. In a meeting with the Senior Vice President and Chief Risk and Audit Officer of PG&E Corporation, he stated:

"The combined department was created to better leverage resources and create an integrated compliance program that will work in partnership with all the operating organizations."[1]

Further, an email sent to all employees stated in part: [2]

As we move forward in our efforts to regain the leadership position in our industry, we want PG&E to set the standard for effective and efficient compliance with all laws and regulations.

Toward that end, we have decided to bring together three existing compliance departments to better leverage our resources and create an integrated compliance program that will work in partnership with all the operating organizations. Those three departments -- Legal Compliance and Business Ethics at the Corporation, Affiliate Rules and Regulatory Compliance at the Utility, and the Compliance Management Initiative team also at the Utility -- will come together to create a new compliance organization at the Utility.

Compliance and Ethics are the responsibility of every employee at PG&E.

The new Compliance and Ethics organization will work with the operating units to ensure that employees have the information they need to make the right decisions, to develop and implement a comprehensive and cost effective approach to compliance, and to identify steps PG&E can take to be a recognized leader in compliance and ethics in the years ahead.

C. PREPARATION FOR FUTURE AFFILIATES

F3 Changes in the corporate management and strategy indicate that the creation of new affiliates in the near future is likely.

Recently, PG&E has announced the creation of a new affiliate. Given the recent changes in corporate management and its strategy to expand its financial base through acquisition or creation of new affiliates, the recent announcement of the creation of a new affiliate is no surprise. In anticipation of future announcements we have provided a prescriptive approach to better enable the C&E Department to be ready to maintain its continuing compliance with the CPUC's affiliate rules.

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[1] / Interview #20 With Kent Harvey, Senior VP and Chief Risk and Audit Officer of PG&E Corporation

[2] / Excerpts from E-mail sent to all employees at PG&E

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. (Corporate files only, no II.B related DTRs) • Reviewed web sites, TransCanada and PipeRanger. • Reviewed Attachment B. Updated December 12, 2005. • Verified that information provided to employees, including new hire orientation handout, has not changed and remains in place. • 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. • Verified that no gas commodity deals were done with affiliates in 2005. • Confirmed that Energy Trading (ET) (or any other affiliate) was not a shipper on California Gas Transmission (CGT) during 2005. • Reviewed the latest PipeRanger and other public posting data for affiliate transactions. (None posted for 2005)[3] • See also III.F.
Reference Section III.C. Tying of Services Prohibited	**Yes**	None	• Verified that all training presentations are the same for 2005. • Reviewed number of employees trained compared to previous years. • Reviewed internal and external information channels to verify no tying.

3/ Vantage routinely downloads the public data from PipeRanger and other affiliate posting sites (including National Energy Gas Transmission Northwest [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 C&E and management personnel.
Reference Section III.F. Affiliate Discount Reports	**Yes**	None	• Reviewed DTR database. • Confirmed that no gas commodity transactions occurred in 2005 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 which 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 if necessary. • 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**	None	• Interviewed personnel involved with the DTR database and determined that the process was still in place, even though there are currently no Rule II.B affiliates and no DTRs • Reviewed reconciliation summary binders.
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. • No contracts with Rule II.B. affiliates for 2005.
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 C&E and Affiliate Accounting personnel.
Reference Section V.B. Books and Records	**Yes**	None	• Reviewed Financial Statements. • Discussed with C&E, Internal Auditing, and Affiliate 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. No joint purchases occurred during 2005.

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. • Interviewed personnel involved in the Inter-Company process noting no changes from previous years • 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. • Discussed with other team members their review results. • Interviewed C&E and Affiliate 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 web site 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 C&E 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 C&E to track DECs. No employees transferred or rotated in 2005, therefore no DECs were collected.	• Reviewed officer and directors listing, noting appropriateness. • Reviewed DEC collection system, noting appropriateness. • Interviewed personnel regarding signed confidentiality agreements for new employees.
Reference Section V.H. Transfer of goods and services	**Yes**	As there were no affiliates during 2005, there were no transfer of goods and services.	• Verified by obtaining objective, verifiable evidence that transfers of goods and services between the Utility and its Rule II.B affiliates would be 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 ensure 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 Oversight	**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 2005. • Interviewed C&E personnel.
Reference Section VI.C. Affiliate Audits	**Yes**	None	• Reviewed C&E monitoring plan. • Discussed audit plan with C&E personnel.
Reference Section VI.D. Witness Availability	**Yes**	None	• Interviewed C&E 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. Issue continues pertaining to overpayment by PG&E to other users of poles due to potential inadequacy of allocation formula.	• Reviewed and analyzed Categories of Non-Tariffed Products and Services from 2005 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 2004 RECOMMENDATION DISPOSITION

The 2004 audit provided three recommendations for consideration by C&E and PG&E. All three 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	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 exit of NEGT. (This is a general recommendation and not specific to any findings.)	This recommendation was accepted. PG&E continued the program as required and met all training and reporting needs.
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.	This recommendation was accepted by PG&E. PG&E implemented a formal procedure in 2005 to inform executives of the creation of new affiliates. The Corporate Secretary's office has responsibility for notifying all executives of new affiliates.
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.	While there has been progress in getting payments for direct costs, the total amount owed is still not being received. See Recommendation R2 from this year's audit

B. ISSUES IDENTIFIED IN 2005 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 findings are from the sequential numbering of all findings in *Volume II.*

GENERAL

R1 In anticipation of the likelihood of the creation and acquisition of new affiliates, the C&E Department needs to be prepared to maintain continued compliance.

PRESCRIPTIVE APPROACH FOR FUTURE AUDITS

Vantage has now conducted five annual affiliate transaction audits at PG&E. At this time, the number of affiliates (Rule II.B. affiliates[4]) has declined from several to zero.[5] At the same time, the variety and quantity of goods and services provided by these affiliates continuously declined. The number of audits and the changes over time, have given Vantage a unique view which offers an opportunity to suggest a prescriptive approach to be considered in future audits at such time that PG&E, once again, has affiliates covered under the CPUC affiliate transaction rules.

The affiliate transaction audits, conducted by Vantage to date, have tended to be organized on a rule by rule basis which is in keeping with the CPUC rules and also the PG&E Compliance Plan which must address each rule. For this prescriptive section, we have taken a broader approach and draw not only on our experience, but on the wealth of information and suggestions put forth by PG&E employees as to how the process could be improved.

In all cases we are assuming that PG&E has acquired a new affiliate, or affiliates, and that the affiliates fall under the category of what is currently termed Rule II.B Affiliate.

C&E- INITIAL COMMUNICATION WITH NEW AFFILIATES

Initial Communication and Fact Finding is Invaluable in Affiliate Rules Compliance

Perhaps the most valuable task that could be performed by C&E would be extensive upfront communication, training and coordination with any new affiliate. For example, what sort of contacts and transactions require a Detailed Transaction Report (DTR); what information can be shared; or what purchases can be made jointly.

4/ In this report section, unless noted otherwise "Affiliate" means a Rule II.B. affiliate.

5/ Many of these affiliates were under the NEG umbrella and/or were inactive.

At a minimum we would suggest the following steps after notification of a new II.B. affiliate.

- Conduct initial meetings with the new affiliate's management to identify the affiliate products and services.
- Conduct a risk assessment to identify those areas with the greatest opportunity for affiliate transactions and communications.
- Identify the nature and frequency of the likely transactions.
- Assign a single primary point of contact in both the affiliate and within C&E, for communication and coordination.
- Utilize the risk assessment to design any specific training required and to assign affiliate employees to existing training modules.
- Conduct follow-on presentations with affiliate employees in high risk areas that includes an open question and answer period.
- Ensure that a clear and complete understanding exists as to what does and does not require a DTR and in what form. (See next section).
- If necessary, provide an affiliate rules guidebook for high risk employees.
- Identify any areas of the affiliate rules Compliance Plan that may require additions or modifications.

Certain of these specific steps are expanded upon in the following sections, but all are meant to expand the face-to-face communication between C&E and affiliates and to allow a more tailored approach to compliance procedures.

Daily Transaction Report (DTR) Process

The DTR Process is the internal mechanism designed and implemented by C&E to identify and document transactions between PG&E and Rule II.B affiliates. This process has served PG&E well. It also provides an excellent starting point for audits of affiliate transactions as well as a cross reference. We have no suggestions for major modifications to the DTR process, but do suggest some minor changes.

Expand the Use of Blanket DTRs Where Possible

PG&E could benefit from making further use of "Blanket" DTRs when a specific DTR is not practical. A Blanket DTR is a detailed transaction report that is set up to handle multiple instances of contact or communications between PG&E and affiliates. Examples might be meetings and phone calls between PG&E personnel and an affiliate to discuss contract language. In this example, one Blanket DTR can be established to cover all these calls and meetings rather than a multitude of individual DTRs.

- Blanket DTRs should not be used in any situation where dollars are exchanged or services involving utility infrastructure, (such as parking, lending gas).
- The rules for when a Blanket DTR may be used should be clearly spelled out, even by affiliate if necessary.

- The risk assessment should be utilized to determine any exceptions to the Blanket DTRs

At first glance it would appear that the use of Blanket DTRs would diminish the information available to C&E and auditors. However, they actually increase the visibility of transactions with significant risk by diminishing the "noise" associated with numerous DTRs with very little potential risk. Put simply, it focuses attention where risk is the greatest.

Conduct an Affiliate Transaction Risk Assessment With Each New Affiliate

PG&E should undertake an Affiliate Rules violation risk assessment with any new affiliate. This risk assessment would take both an overall look and also, if necessary, examine the details of potential transactions. For example, C&E should first work with the affiliate to determine the extent of potential for any dealings or contact with affiliates or the opportunity for influencing non-affiliates in the California marketplace. C&E should then work to determine the specific types of interaction or impact that could take place. Both the overall and detail should directly determine the need for specialized training, process roll-out and due diligence. Examples of the items that would be looked for and the risk potential include:

- Commodity transactions (Gas or Electric sales or purchases) –High;
- Commodity movement (Gas or Electric transmission over PG&E facilities)- High;
- Indirect Commodity arrangements (Parking, Lending and Storage) –High;
- Communication of non-public information (discussions regarding upcoming operational constraints on pipelines or transmission) –High;
- Disclaimers on letterhead, business cards, and other appropriate items- Medium;
- News releases without appropriate affiliate disclaimer- Medium;
- Meetings conducted with Affiliate and Utility personnel without any disclosure or reporting- Medium;
- Employees transferring without signed confidentiality agreements- Medium.

Obviously the risk factors themselves will vary with the affiliate, but the overall concept remains the same, identify specific affiliate transaction risks.

Coordination with Internal Auditing

Throughout our audits at PG&E we have found Internal Auditing to be a tremendous knowledge resource. Although Internal Auditing has a separate charter from affiliate transaction audits, its knowledge of, and visibility into, company operations is an invaluable resource.

Arrange Periodic Meetings with Internal Auditing to Discuss Issues and Concerns

C&E should arrange periodic meetings with Internal Auditing to discuss general issues and concerns regarding affiliates. These meetings should provide an opportunity to exchange information on audit approaches, coverage, and general information. It also affords an excellent opportunity for a "what are we missing" comparison of C&E audits.

Gas and Electric Commodity Purchase, Sales and Services

Gas and electric commodity sales were an obvious choice for detailed scrutiny in the Vantage affiliate transaction audits. It is also a challenging audit area in that although the reasoning behind the review is straightforward and visible, (for example - an affiliate selling above market to PG&E), the manner in which the markets operate make detecting any violations very challenging. We believe the earlier discussion of an upfront approach to understanding new affiliates and the risk potential is critical in the commodity area. While this review will drive the specifics of C&E procedures, we offer the following as discussion starting points as to risk.

- Will the affiliate conduct any commodity transactions in California?
- Will these be commonplace or occasional?
- Will the affiliate transport at any time, to any customer over PG&E facilities?
- Will the affiliate utilize any PG&E services such as parks and lends?
- Does the affiliate have any arrangement with third parties to transport in their name over PG&E facilities?
- What communication will the affiliate have with PG&E operations and procurement personnel;
  - Regarding operations and commodity issues?
  - Peripheral such as CAISO, pipeline discussions, (occasions where personnel would be in the same meeting or same phone call regarding a commodity or operations issue but not dealing with each other)?
  - Inadvertent contacts – conferences, seminars, outings etc.
- Will the affiliate market or transport under any other names? For identification within PipeRanger and other systems, these names may be necessary.

While recognizing that systems, terminology and infrastructure names will change, the following offers some analytical starting points in the commodity area for future audits.

- Identify any Manual Override Adjustments made in the operations area.
- Examine transactions immediately before and after Operational Flow Orders.
- Examine all Park and Lends involving affiliates. Cross check against commodity prices at both ends of the transactions. (Regardless of sales to PG&E).
- Compare affiliate prices and terms for Parks, Lends and Storage with non-affiliates for comparable volumes and times.
- Compare commodity DTRs against SAP transactions for commodities (by affiliates) and the Summary of Negotiated Contracts.
- Examine nominations made around the time of any affiliate shipments on CGT.
- Examine all deal tickets and compare to DTRs and SAP detail.

Unintended Consequences

The affiliate transaction rules and the processes necessary to comply had the unintended consequence of discouraging or preventing dealings between affiliates, possibly to the detriment of PG&E and its ratepayers. Before developing this further, it should be pointed out that no evidence whatsoever suggests that PG&E deliberately chose a course of action that harmed the Company or ratepayers. However, our conversations with PG&E employees over the years leave little doubt that given any alternative, PG&E would elect to not conduct dealings with affiliates because of the risks and the onerous nature of reporting. It is our interpretation of the affiliate rules that this was never an intended consequence. On a going-forward basis, this problem is again best resolved, or at least mitigated, by up-front and continuous communications between C&E and the affiliates. With diligence, it should be possible to develop internal rules and procedures that satisfy affiliate reporting requirements and yet allow transactions between PG&E and affiliates when it is in the interest of both parties.

PG&E is Continuing the Departing Employee Checklist, even though some lapses have been noted

This Departing Employee Checklist process is in place for Rule II B affiliates and other companies within PG&E Corporation. When an employee leaves, this checklist is reviewed with the departing employee reminding them of their responsibility to keep confidential information confidential, and to turn in keys, building passes and company assets, such as cell phones. This is a necessary step for PG&E as a business, but it is absolutely critical to remind personnel of sensitive areas and not to share confidential information. For example, when a marketing director leaves PG&E and begins employment with a Rule II B affiliate, he/she should be reminded that all marketing data on PG&E customers must not be shared with the Rule II B affiliates, unless this information is available to all in the marketplace.

C&E is committed to maintaining the DTR / SAP reconciliation process

This reconciliation occurs between the SAP (General Ledger system) and DTRs (reports that document events that occurred between PG&E, PG&E Corporation and all of its subsidiaries, including Rule II B affiliates). If a PG&E employee charges time to a Rule II B affiliate through the general ledger system (SAP) and does not file a DTR, and vice versa, this discrepancy will show up when the two systems are reconciled. C&E has decided to keep this process in place even though there are currently no Rule II B affiliates. The reconciliation form shows just the SAP transactions that are occurring by cost center. However, with the process continuing, there will be no start-up costs or learning curves to achieve when a Rule II B affiliate is again functioning within the PG&E family of companies. It will be no additional work to institute this process, since it will already be in place and personnel will be familiar with it.

NON-TARIFFED PRODUCTS AND SERVICES – RULE VII

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

F15 With the exception of N.E.1, Facility joint use ("Joint Pole") 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.

F16 The cost allocation methodology used for N.E.1, Facility joint-use ("Joint Pole") arrangements has consistently led to under-recovery of expenditures by PG&E.

Our key concern in this report is category, 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 while the allocated cost was $22.022 million, the revenue collected was only $19.945 million. This shortfall of almost 10% is due to the allocation method used.

In interviews of C&E and operating personnel[6], 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.

R2 Make an effort to convert the Facility joint use ("Joint Pole") arrangement to a tariffed service in order to improve collection of full cost.

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. Based on this analysis, consideration should be given to requesting that this expenditure be included as a tariffed product.

[6]/ Interview with Ed Mah of C&E.