Pacific Gas and Electric Company Securitization

A. 20-04-023

TURN HEARING EXHIBIT

TURN-6

Excerpt from PG&E Cost of Capital Testimony in A.19-04-015

Application: 19-04-
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Date: April 22, 2019
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PACIFIC GAS AND ELECTRIC COMPANY

COST OF CAPITAL 2020

PREPARED TESTIMONY

PACIFIC GAS AND ELECTRIC COMPANY
COST OF CAPITAL 2020
PREPARED TESTIMONY

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PACIFIC GAS AND ELECTRIC COMPANY
CHAPTER 5
COSTS OF LONG-TERM DEBT AND PREFERRED STOCK

A. Introduction

The purpose of this testimony is to present Pacific Gas and Electric Company's (PG&E or the Company) proposed 2020 costs of long-term debt and preferred stock and explain how those costs are developed. PG&E's Chapter 11 case, commenced on January 29, 2019, impacts the proposed rates, and those impacts are described in this testimony.[1]

Table 5-1 below compares the 2019 authorized costs of long-term debt and preferred stock to those proposed for 2020. The higher cost of debt in 2020 is primarily due to the higher cost of debt from PG&E's $5.5 billion, court-approved Debtor-In-Possession (DIP) facilities (the "DIP Facilities").

The decrease in the embedded cost of preferred stock results from reduced amortization of redemption costs of previously redeemed preferred stock.

TABLE 5-1
AUTHORIZED AND PROPOSED

Line No.		2019 Authorized	2020 Proposed
1	Long-Term Debt	4.89%	5.16%
2	Preferred Stock	5.60%	5.52%

B. Background

1. Financing Requirements

During the course of PG&E's Chapter 11 case, PG&E expects to continue full operations, including investing capital in its gas and electric infrastructure. However, other than with respect to the DIP Facilities, PG&E is unlikely to issue new debt or equity during the Chapter 11 case, and will rely on its cash from operations (internal financing) and proceeds of its DIP Facilities (external financing) in place of the long-term debt that it otherwise

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1 The conditions that precipitated the bankruptcy and consequent increase in debt costs are related to wildfire events in PG&E service territory in 2017 and 2018, and are discussed in Chapters 1 of this filing.

would have raised in the conventional capital markets. PG&E estimates a need for approximately $4.1 billion of external financing during 2019 and 2020. The total 2019 through 2020 financing amount is consistent with PG&E's November 2018 long-term debt application with the California Public Utilities Commission (CPUC or Commission).[2]

2. Bankruptcy Implications

As a result of the commencement of its Chapter 11 case, the accounting and ratemaking treatment of two components of the cost of debt have been impacted: (1) upfront debt issuance costs or fees; and (2) interest expense on pre-petition debt.[3]

Upfront fees are standard long-term debt financing costs including underwriting fees, legal costs, and rating agency fees. The benefits associated with these upfront costs are realized over the life of the debt and, as a result, companies capitalize and amortize upfront fees. However, GAAP ("Generally Accepted Accounting Principles") for companies operating in Chapter 11 require accelerated amortization of upfront fees. As a result, PG&E recorded expense for upfront costs associated with the DIP financing, and has created a regulatory asset for its unamortized upfront costs associated with PG&E's long-term pre-petition debt. However, for ratemaking purposes, the pre-petition debt and the DIP Facilities are still invested in, or will be invested in, PG&E's electric and gas utility systems. Thus, the upfront fees related to pre-petition debt and the DIP Facilities should be recoverable in rates, based on the established regulatory practice of amortizing the fees over the lives of the facilities. For purposes of cost recovery, PG&E amortizes the DIP Facilities' upfront fees through the DIP maturity date (23 months) and continues to amortize upfront costs on the pre-petition long-term debt, as it did prior to commencement of its Chapter 11 case.

Interest expense on pre-petition debt is the second component of cost of debt impacted by PG&E's Chapter 11 case. At the time of this application,

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[2] Application 18-11-001. The company subsequently withdrew this application as a result of its Chapter 11 filing.

[3] Pre-petition debt is PG&E's debt that was outstanding prior to January 29, 2019 when PG&E filed its petition for relief under Chapter 11 of the Bankruptcy Code.

PG&E is not paying interest on its pre-petition debt. The automatic stay imposed upon the commencement of PG&E's Chapter 11 case requires PG&E to cease interest payments on its pre-petition debt, and the amount of interest, if any, to be paid at the time PG&E exits Chapter 11 will be determined pursuant to a confirmed Chapter 11 plan of reorganization (POR) and in accordance with the Bankruptcy Code and otherwise applicable law. Until more information is available, PG&E is continuing to request recovery of the contractual interest costs owed to pre-petition debtholders.

3. Debtor-In-Possession Financing Facility

On January 21, 2019, PG&E entered into a commitment letter for DIP financing with a syndicate of banks, pursuant to which the commitment parties committed to provide $5.5 billion in senior secured super-priority DIP credit facilities in the form of a revolving credit facility in an aggregate amount of $3.5 billion, a term loan facility in an aggregate principal amount of $1.5 billion, and a delayed draw term loan facility in an aggregate principal amount of $500 million. The DIP Facilities were approved on a final basis by the bankruptcy court on March 27, 2019. The DIP Facilities, together with PG&E's expected operating cash flows, are expected to provide sufficient liquidity to fund ongoing operations during the Chapter 11 proceeding.[4]

The DIP Facilities will provide the $4.1 billion of cash for 2019 and 2020, including $1.5 billion already borrowed in April 2019, replacing long-term debt that would otherwise have been raised in conventional capital markets. PG&E intends to use the balance of the total $5.5 billion DIP Facilities, approximately $1.4 billion, to support procurement activities and other short-term cash needs.

The DIP Facilities carried upfront fees of approximately $107 million. These upfront fees were paid on or about February 1, 2019 when the DIP facilities were executed with the lenders.

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4 Item 1.01 of PG&E's Current Report on Form 8-K dated January 21, 2019, filed with the Securities and Exchange Commission.

The coupon rate for the DIP Facilities, both the term loan and revolver, is a variable rate set at the London Interbank Offered Rate (Libor) plus 225 basis points. The term loan portion of the DIP Facilities ($2 billion of the total $5.5 billion) is priced with an original issue discount (OID) equal to 0.5 percent of face value.[5] The revolver portion of the DIP ($3.5 billion of the total $5.5 billion) includes an annualized fee of 37.5 basis point on the unused portion of the facility. The tenor of the DIP Facilities has an option for a 12-month extension for a fee of 25 basis points on amounts then-outstanding (recovery of the extension fee is not requested in this application).

The DIP financing arrangements and pricing are further described in the bankruptcy declaration testimony of Mr. David Kurtz, Vice Chairman of Lazard and PG&E bankruptcy advisor, included as Attachment 1.[6] As described in Mr. Kurtz's declaration, the Company actively sought and achieved the most competitively priced capital under the circumstances to sustain its operations through the Chapter 11 proceeding. PG&E negotiated and selected the DIP Facilities with the most reasonable terms that balanced price and available liquidity.

C. Cost of Debt

1. Cost of Debt Methodology

To estimate its forecast cost of long-term debt for 2020, PG&E starts with its recorded cost of debt as of February 28, 2019. As described in Section 2, this recorded cost reflects the contractual interest rates that PG&E may have to pay debt investors on the pre-petition debt portfolio as part of its POR. Using this as a starting basis, PG&E incorporates projected changes in the amounts of debt outstanding, and changes to the costs of debt outstanding through the remainder of 2019 and 2020.

The forecasted levels of outstanding debt, variable rates, maturities, and amortization reflect projected financing activities. The forecast rate for the

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5 The original issue discount (OID) means the proceeds of the bond issuance are equal to the face value times 1 minus 0.5 percent.

6 United States Bankruptcy Court, Northern District of California, Case 19-30088, Doc#24, Declaration of David Kurtz.

test year (i.e., 2020) is equal to the average of the end-of-year 2019 forecast interest rate and the end-of-year 2020 forecast interest rate.

2. Recorded Cost of Debt as of February 28, 2019

The recorded cost of debt for the month of February 2019 is shown on line 1 of Table 5-3. The amounts shown on line 1 include the costs of PG&E's pre-petition debt and DIP Facilities, as described below.

a. Pre-Petition Debt Costs

As of February 28, 2019, PG&E's recorded cost of debt included long-term pre-petition debt of $18.4 billion, consisting of the following:

- $17.5 billion in senior unsecured fixed rate notes; and
- $0.9 billion in Pollution Control (PC) bonds.

1) Senior Unsecured Fixed Rate Notes

PG&E's recorded cost of debt as of February 28, 2019 includes the full amount of contractual interest on pre-petition senior unsecured fixed rate notes. As set forth above, any interest that may be paid on pre-petition debt will be determined pursuant to a confirmed Chapter 11 plan and in accordance with the Bankruptcy Code and otherwise applicable law. No determination has been made at this time. As of February 28, 2019, the weighted average coupon rate on the fixed rate unsecured senior notes was 4.52 percent.

2) Pollution Control Bonds

Pollution control (PC) bonds are another form of pre-petition long-term debt. Prior to filing its Chapter 11 case, the interest rates on PG&E's variable rate PC bonds were reset on a daily or weekly basis, and past cost recovery requests reflected these rates. These bonds included credit protection in the form of letters of credit issued by banks. Under an event of default, the holders of the letters of credit can demand payment of their principal from those banks. Following PG&E's Chapter 11 filing, the PC bondholders drew the letters of credit associated with the PC bonds.

Consistent with its request with respect to pre-petition senior unsecured fixed rate notes, PG&E is requesting recovery of the contractual interest on the PC bonds in this application. PG&E's contractual interest on this debt is calculated monthly by the following equation:

Coupon Rate = base rate + commitment fee + default penalty

The base rate for a given month is the higher of the Fed Funds rate plus 50 basis points or Libor. The commitment fee is fixed at 1.24 percent. The default penalty is 0 percent for the first 90 days following an event of default (January 29, 2019 in this case), 1 percent for the 91st through 180th day following an event of default, and 2 percent thereafter. For the month of February 2019, the weighted average coupon rate of the six variable rate PC bonds was 4.24 percent.

b. Debtor-In-Possession Financing Costs

As of February 28, 2019, PG&E had not drawn the DIP term loan, pending final bankruptcy court approval. However, the DIP Facilities were executed on February 1, 2019, and PG&E paid and, for purposes of cost recovery, began amortizing upfront fees at that time. Upfront fees are amortized over 23 months beginning in February 2019, and included in the Annual Charges in line 1, Column (f) of Table 5-3. As noted previously, this cost recovery request is deviating from GAAP, which requires accelerated amortization of the DIP Facilities fees for firms in a Chapter 11 proceeding.

Since only $4.1 billion (75 percent) of the $5.5 billion DIP Facilities is forecasted to fund capital expenditures for energy infrastructure, a pro-rata portion of the DIP upfront fees has been included in the cost of debt. Accordingly, $80 million of the $107 million upfront DIP Facilities fees are included in this application, of which twelve-twenty-thirds (12/23) will be amortized in 2020.

3. Forecasted Changes in the Remainder of 2019

For the remainder of 2019, changes to the February 28 recorded cost of debt are due to borrowings from the DIP Facilities and changes to the variable rate PC bonds. There are no changes to the cost of the pre-petition senior unsecured fixed rate notes.

a. Debtor-In-Possession Financing Costs

PG&E borrowed the $1.5 billion term loan from its DIP Facilities on April 3, 2019, and plans to borrow the $500 million delayed-draw term loan later this year. These term loans have a maturity date of December 31, 2020 and can be extended, as described above. PG&E expects that borrowings from the DIP Facilities that fund rate base will be replaced with permanent debt when PG&E exits bankruptcy. The interest rate on DIP Facilities borrowing varies monthly and is set at Libor plus 225 basis points. At the time of this filing, this equated to an annual forecast coupon rate of 4.90 percent for the months of April 2019 through December 2019, as shown in Column (a), lines 3 and 4 of Table 5-3. PG&E uses a forecast from Global Insights to estimate monthly Libor rates for the purposes of calculating an annual average rate on its DIP term loan as illustrated in Table 5-2 below.

TABLE 5-2
DIP FINANCING INTEREST RATE CALCULATION

Line No.	Contract Cost Element	Value	Description
1	1-month Libor	2.65%	Average of forecast monthly Libor rates, April through December 2019
2	DIP Spread	2.25%	225 basis point spread to 1-month Libor rate
3	Monthly Rate Forecast	4.90%	Sum of lines 1 and 2

To calculate 1-month Libor rates, PG&E used Global Insights' quarterly 3-month Libor forecast as a basis and adjusts to a monthly rate. PG&E estimated the average DIP interest rate over the remaining 9 months of 2019, based on an average forecast Libor rate of 2.65 percent over the same period.

Amortization of the OID, shown in Column (c) of Table 5-3, on the DIP term loans is included in the DIP term loan annual charges (Column (e) of Table 5-3). The OID for PG&E's DIP term loans is equal to 0.5 percent of the face value of the term loans. Consistent with its treatment of other DIP upfront fees, PG&E amortizes the term loan discounts over the respective tenor of each term loan.

DIP financing costs for 2019 also include the "unused" fee on the unused portion of the revolver that is financing long-term investments.[7] The unused fee is 37.5 basis points. Assuming a $2.1 billion unused balance of the DIP revolver in 2019, the unused fee for the period is calculated by multiplying the 37.5 basis points by $2.1 billion for the period the DIP revolver is outstanding. The unused fee is shown on line 6 of Table 5-3.

The projected 2019 average coupon rate for PG&E's DIP term loans is approximately 4.90 percent (Table 5-2, line 3 and Table 5-3, lines 3 and 4). The total annual charges for the DIP term loans, shown in Column (e), lines 3 and 4 of Table 5-3, include the interest rate and amortization of OID.

b. Pollution Control Bonds

PG&E uses a forecast of the Fed Funds rate and Libor from Global Insights to forecast the base rates in each month for the remainder of 2019. The projected 2019 average coupon rate for PG&E's variable rate PC bonds is 5.24 percent as shown on line 5 of Table 5-3. Coupon rates for PC bonds are calculated consistent with the description in Section C.2.a.2.

c. Average Cost of Debt for 2019

The changes described above result in an increase in PG&E's projected cost of debt from 5.05 percent at February 28, 2019 to 5.14 percent at December 31, 2019 as shown on lines 1 and 9, respectively, in Table 5-3.

4. 2020 Forecast

The estimated 2020 forecast cost of debt incorporates the projected changes in the amount of debt outstanding, as well as the changes in the costs of that debt. There are no changes to the interest costs of the

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7 The "unused" fee is charged on the average undrawn balance of the revolver portion of the DIP Facilities, because the banks must hold reserves to support the DIP revolver facility whether it is drawn or not.

pre-petition senior unsecured fixed rate notes other than an $800 million maturity in October 2020.

a. Debtor-In-Possession Financing Costs

To fund capital expenditures in 2020, PG&E expects to borrow approximately $2.1 billion in 2020 from the DIP Facilities at an average coupon rate of 5.10 percent as shown on line 11 of Table 5-3. The projected 2020 coupon rates are estimated in the same way as in the calculation of the 2019 DIP financing costs in Section C.3.a. The interest rate is included in the DIP revolver annual charges in Column (e), line 11 of Table 5-3.

DIP financing costs for 2020 also include the unused fee on the portion of the facility that is assumed to finance long-term investments. Based on the forecast, there is a zero balance on the DIP revolver in January 2020 and a maximum draw of $2.1 billion of revolver funds at the conclusion of 2020. The unused fee for the period is calculated as the average balance in 2020 ($2.1 billion ÷ 2 = $1.05 billion) multiplied by the unused fee of 37.5 basis points per year. The unused fee is shown on line 13 of Table 5-3.

b. Pollution Control Bonds

The projected 2020 average coupon rate for PG&E's variable-rate PC bonds is 6.06 percent (see line 12 of Table 5-3), estimated in the same way as in the calculation of the 2019 projected PC bond coupon rates.

c. Average Cost of Debt for 2020

The changes described above result in an increase in PG&E's projected cost of debt from 5.14 percent in December 2019 to 5.19 percent in December 2020 as shown on lines 9 and 16, respectively, in Table 5-3. The increase in the cost of debt is due to the additional DIP financing at rates above the pre-petition portfolio cost, and the maturity of $800 million in 3.50 percent senior notes in October 2020.

5. Test Year 2020 Cost of Debt Request

PG&E is proposing a 2020 cost of long-term debt of 5.16 percent. The request is based on the analysis provided above, and is the average of the forecasted cost of long-term debt at the conclusion of 2019 and 2020 as shown on line 17 of Table 5-3.

TABLE 5-3
2019 AND 2020 AVERAGE EMBEDDED COST OF DEBT
(THOUSANDS OF DOLLARS)

Line No.	Description	Coupon Rate[1]	Outstanding	Net Premium (Discount), or (Expense)	Net Proceeds	Annual Charges	Annualized Embedded Cost (end of year)
		(a)	(b)	(c)	(d)	(e)	(f) = (e) ÷ (d)
1	February 28, 2019 (Actual)	–	$18,387,100	$(242,375)	$18,144,725	$916,779	5.05%
2	2019 Forecast (March Through December)						
3	DIP Term Loan Draw 1	4.90%	1,500,000	(7,500)	1,492,500	77,382	
4	DIP Term Loan Draw 2	4.90%	500,000	(2,500)	497,500	25,794	
5	PC Bond Variable Rate[2]	5.14%	–	–	–	6,862	
6	Unused fee (on undrawn funds)	–	–	–	–	7,875	
7	Maturing Bonds	–	–	–	–	–	
8	Amortization and Adjustments[3]	–	–	27,969	27,969	1,822	
9	December 31, 2019		$20,387,100	$(224,406)	$20,162,694	$1,036,514	5.14%
10	2020 Forecast						
11	DIP Revolver	5.10%	2,100,00	–	2,100,000	107,155	
12	PC Bond Variable Rate[2]	6.06%	–	–	–	7,045	
13	Unused fee (on undrawn funds)	–	–	–	–	(3,938)	
14	Maturing Bonds	3.50%	(800,000)	1,181	(798,819)	(29,576)	
15	Amortization and Adjustments[3]	–	–	30,027	30,027	(1,404)	
16	December 31, 2020		$21,687,100	$(193,197)	$21,493,903	$1,115,797	5.19%
17	2020 Average (Lines (9 + 16)/2)						5.16%

Note:

(1) Coupon rates for DIP financing are the average of the monthly rates for a given period (i.e., 9-month average in 2019, 12-month average in 2020).

(2) PC Bond Variable Rate on lines 5 and 12 show the incremental interest payment required relative to end of period coupon rate amounts included in total Annual Charges on lines 1 and 9.

(3) Amortization and adjustments include collection of discount/expense on debt issuances, adjustments to variable rate debt (DIP term loan and revolver), step-up charges due to bond registration default, and adjustments to annual charges based on collection of discount/expense on debt issuances.

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CHAPTER 6

ANNUAL COST OF CAPITAL ADJUSTMENT MECHANISM

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ANNUAL COST OF CAPITAL ADJUSTMENT MECHANISM

A. Introduction

The Annual Cost of Capital Adjustment Mechanism (ACCAM)[1] is a symmetric Cost of Capital (COC) adjustment tool adopted by the California Public Utilities Commission (CPUC or Commission) in Decision (D.) 08-05-035. This chapter presents Pacific Gas and Electric Company's (PG&E or the Company) evaluation of the ACCAM since the decision in the utilities' last full COC application, D.13-03-015, that continued the mechanism first adopted by the CPUC in D.08-05-035. PG&E observes that the mechanism has generally achieved the Commission's objective to maintain a fair and reasonable COC, while reducing the time and costs to the CPUC and all parties associated with annual COC proceedings.

PG&E proposes that the ACCAM be continued for three years until the next full COC application for Test Year (TY) 2023 due April 20, 2022.[2] As discussed in Chapter 1, PG&E's risk profile is much higher today than in past years, and much higher than an average United States utility. PG&E recognizes that its risk may be dramatically reduced, as a result of changes in state policies. In that event, as PG&E has described in Chapter 1, PG&E would file an amended cost of capital in this proceeding, or a new cost of capital application otherwise. PG&E contemplates that the ACCAM will operate as planned, but may be superseded in its normal operation by a new cost of capital application.

PG&E also proposes that the applicable benchmark interest rate be reset to the October 2018 through September 2019 monthly average, consistent with the current mechanism.

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1 D.08-05-035 used the term "CCM" to describe the COC mechanism, but PG&E uses the term "ACCAM" herein, as PG&E did in the 2008 and 2013 COC proceedings.

2 PG&E anticipates that resolution of its Chapter 11 proceeding may alter PG&E's COC and supersede a decision in this proceeding. That notwithstanding, PG&E proposes that the ACCAM otherwise continue after PG&E's exit from bankruptcy as further described below.

B. Performance of the ACCAM From 2013-2018

1. Description of the Current Mechanism

The current mechanism, adopted in D.08-05-035, consists of: (1) a deadband of 100 basis points; (2) an interest rate index determined by each utility's specific credit ratings; (3) an interest rate benchmark using a 12-month average of utility bond interest rates; and (4) an adjustment percentage of 50 percent of the change in the benchmark. The index for each utility is the monthly average yield for Moody's Aa utility bonds for utilities rated Aa or higher, and Moody's Baa utility bond for utilities rated Baa or lower.[3] In its decision adopting the ACCAM, the Commission did not prescribe which interest rate index was appropriate for utilities with split ratings, i.e., utilities with ratings in different ratings categories. Nor would the applicable index be evident if a utility's credit ratings were to change during the period the ACCAM is in effect. In D.13-03-015, the CPUC clarified that PG&E shall use Moody's long-term Baa rated utility bond index in determining whether its ACCAM 100 basis point deadband has triggered, with a benchmark index value of 5.00 percent.[4]

2. Performance of the ACCAM

Changes in the Aa, the A and the Baa interest rate index did not exceed the 100 basis point deadband during the 6-year period the ACCAM was in effect following D.13-03-015 in 2013 (2013-2018). As a result, the ACCAM did not prompt a change to PG&E's authorized COC during this period.

Figure 6-1 below shows monthly interest rates during the period 2013-2018, as well as the rolling average index value through each 12-month measurement period. The graph shows that interest rates remained steady from October 2013 through October 2018, with all 60 recorded monthly values for the Baa interest rate index falling between 4 and 6 percent.

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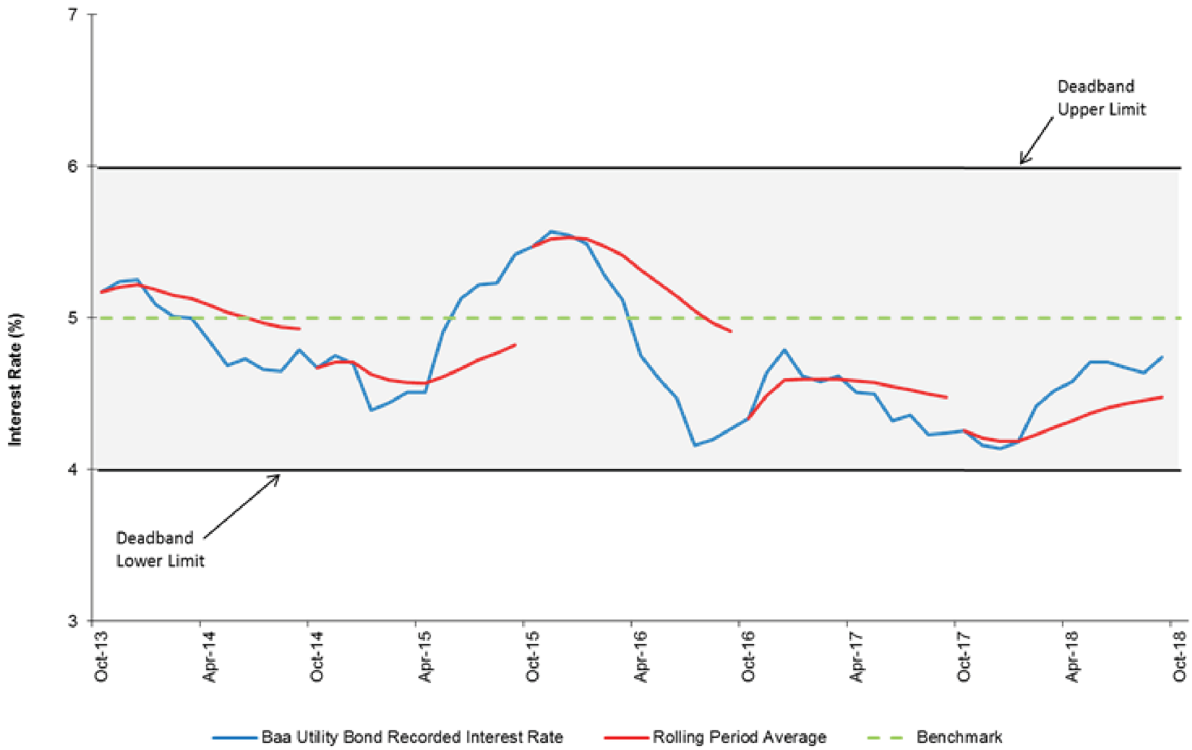
3 The decision did not specify the appropriate index for utilities rated A, but the presumption is that such utilities would utilize the Moody's A utility bond index.

4 CPUC D.13-03-015, p. 10.

FIGURE 6-1
PG&E COST OF CAPITAL MECHANISM (ACCAM) MOODY'S BAA UTILITY INDEX



In considering a COC mechanism that could replace annual COC proceedings, the CPUC in 2008 sought to determine whether a mechanism could be adopted to maintain fair and reasonable capital structures and Return on Equity for the major energy utilities, while reducing COC proceedings and simplifying workload requirements and regulatory costs.[5] To this end, it is reasonable to characterize the ACCAM as successful Commission policy: in a period of interest rate stability, two full COC proceedings and associated costs have been obviated. Customers have benefitted from stability in the financial markets and the resulting efficient regulation of utilities' COC.

C. PG&E Proposal for the ACCAM

PG&E proposes that the ACCAM be extended through 2022. For the years 2021 and 2022, the ACCAM would replace the annual COC proceeding, again streamlining the regulatory process with a less burdensome approach. The

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5 CPUC D.08-03-554, p. 3.

ACCAM proposal would make PG&E's next regular COC application due in 2022 for TY 2023.

Although the Company's post-bankruptcy credit rating is unknown, PG&E believes that overall changes in interest rates are generally captured by any of the ACCAM indices (e.g., Moody's Baa utility bond index) currently in use by the California utilities). The market conditions that would result in an ACCAM trigger would be observed regardless of which index is being monitored. Hence, no change in PG&E's bond index is needed.