

**PACIFIC GAS AND ELECTRIC COMPANY**  
**General Rate Case 2007 Phase I**  
**Application 05-12-002**  
**Data Response**

PG&E Data Request No.:	TURN_0003-004		
PG&E File Name:	GRC2007-Ph-I_DR_TURN_0003-004		
Request Date:	January 4, 2006	Requester DR No.:	0003
Date Sent:	January 19, 2006	Requesting Party:	TURN
PG&E Witness:	Peter Corippo	Requester:	Matt Freedman

**Pensions and benefits**

**QUESTION 4**

Please identify the target returns on debt and equity and other investments (break all down further by type – e.g., domestic stocks vs. international stocks) for PG&E's trust funds for pensions, PBOPs, and long-term disability. Please provide documentation of the basis for the target returns and reconcile the figures to the target return for PG&E's entire portfolio of each of the trust funds.

**ANSWER 4**

**Pensions.** As prescribed by prior CPUC decisions<sup>1</sup>, ratemaking for pension costs is based on projected contributions to the trust. These contributions are governed by ERISA regulations using accepted actuarial methods and assumptions. For contribution determination, the expected return on plan assets is used as the plan's discount rate. In this proceeding, the expected return associated with PG&E's pension plan is 7.0 percent. This rate was selected in accordance with the American Academy of Actuaries guidelines for selection of economic assumptions. The application of these guidelines to PG&E's investment policy (60% equities and 40% bonds), along with projected investment returns for various asset classes, indicates that 7.0% is a reasonable rate.

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<sup>1</sup> D. 90-12-057, pp. 84, 415| D. 88-03-072

The table below validates this return estimate using Towers Perrin's U.S. Capital Market Assumptions for Asset/Liability Forecasting as of January 1, 2005:

	PG&E Retirement Plan Target Allocation	Projected Asset Class Return	Asset Allocation Weighted Return
US Equity	40%	8.3%	3.3%
Non-US Equity	20	8.3%	1.7
Fixed Income	40	4.5%	1.8
Total	100%		6.8%

Further, Towers Perrin's asset class assumptions are consistent with similar projections made by a variety of institutional investment consultants and other investment experts:

	US Equity	Non-US Equity	Fixed Income	PG&E Asset Alloc 40/20/40
Towers Perrin	8.30%	8.30%	4.50%	6.78%
Barclays Global Investors	7.75%	7.75%	4.75%	6.55%
BlackRock Financial Mgmt	8.00%	9.00%	4.00%	6.60%
Goldman Sachs Asset Mgmt	6.80%	6.50%	3.70%	5.50%
Greenwich Associates	8.10%	8.70%	4.90%	6.94%
JPMorgan Asset Mgmt	7.25%	7.75%	4.50%	6.25%
Morgan Stanley Inv Mgmt	6.20%	6.20%	3.90%	5.28%
Pacific Inv Mgmt Co	7.50%	10.50%	4.50%	6.90%
Rocaton Investment Adv	7.20%	7.40%	4.90%	6.32%
Russell Investment Group	8.00%	8.00%	5.40%	6.96%
Standish Mellon	7.50%	8.50%	4.20%	5.38%
Average	7.51%	8.05%	4.48%	6.41%

PG&E's asset allocation for the pension plan was justified most recently by an asset/liability study conducted in 2003 by Russell Investment Group. Over the forecast period, the chart below depicts the distributions of cumulative contributions for the 60% current equity allocations as well as for portfolios with greater and lesser equity allocations:

**Projected Cumulative Contributions**  
2003-2011  
\$ Billions

	40% Equity	50% Equity	Current 60% Equity	70% Equity	80% Equity
Worst**	\$4.8	\$4.9	\$5.0	\$5.3	\$5.6
75th Percentile	\$3.5	\$3.4	\$3.3	\$3.5	\$3.7
Median	\$2.8	\$2.4	\$2.1	\$2.2	\$2.2
25th Percentile	\$2.2	\$1.6	\$1.3	\$1.3	\$1.3
Best*	\$1.3	\$1.1	\$0.7	\$0.6	\$0.5

For the best and worst cases above, the results were consistent with expectations. That is, as equity allocations increase, long-term contributions were higher in the worst

case. Similarly, for the best cases, as equity allocations increased, long-term contributions declined. However, this relationship was interrupted in the 75<sup>th</sup> percentile and median cases. As equities grew from 50 to 60 percent, cumulative contributions declined but then went grew again for the 70 percent portfolio. The model suggested that the current 60 percent equity allocation was a "sweet spot" in terms of projected contributions.

The asset allocations for the other trusts are inferred from the pension plans asset/liability results, generally favoring a higher level of equities for the less well-funded and taxable plans.

**PBOPs and LTD:** As prescribed by prior CPUC decisions<sup>2</sup>, rate recovery for PBOPs is based on the expense calculated under SFAS 106 subject to the utility's ability to contribute this amount on a tax-deductible basis to a trust. As a result, several notions of expected return are required to formulate PBOP rate recovery.

Determination of the tax-deductible limit uses the same 7.0% discount rate as the Retirement Plan.

However, FAS 106 uses separate notions of expected return for discounting liabilities and for estimating trust returns. As required by the accounting standard, the FAS discount assumption assumes an all bond portfolio. PG&E's assumption was of 5.8% was based on current yields for high quality fixed income investments that resulted as of December 31, 2004. Because it is not used to discount liabilities, the return on trust assets assumption used for financial reporting is of lesser relevance and impact. As suggested by the SEC staff<sup>3</sup>, PG&E grounds this assumption in historical data. Actual investment returns for both equities and bonds have benefited from secular interest rate declines and price/earnings ratio expansion. This approach results in a higher return assumption than is expected by the sample of market experts above who are factoring in current historically interest rates and prognosticating that over the next ten years, rising rates will result in lower stock and bond market returns. Benchmarking for other companies shows a trend toward reducing the return on assets assumption used for financial reporting purposes. Some companies, including Edison and Sempra, are now using the same lower assumption for both funding and financial reporting purposes.

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<sup>2</sup> D.92-12-015

<sup>3</sup> 2002 AICPA SEC Conference

The table below depicts how PG&E developed its return on assets assumptions for the Bargained Medical, Life and Long-Term Disability Trusts as well as the after-tax return on the taxable Non-bargained Medical Trust.

	Bargained PBOP Medical and Life Target Allocation	Asset Class Return	Asset Allocation Weighted Return
US Equity	50%	9.5%	4.8%
Non-US Equity	20	9.5%	1.9
Fixed Income	<u>30</u>	6.0%	<u>1.8</u>
Total	100%		8.5%

	Non-bargained PBOP Medical <sup>4</sup> Target Allocation	Asset Class Return	After-tax Asset Class Return <sup>5</sup>	Asset Allocation Weighted Return
US Equity	57%	9.5%	8.9%	5.1%
Non-US Equity	20	9.5%	8.9%	1.8
Fixed Income	20	6.0%	3.6%	0.7
Cash	<u>3</u>	2.0%	1.2%	<u>0.0</u>
Total	100%			7.6%

	Bargained LTD Target Allocation	Asset Class Return	Asset Allocation Weighted Return
US Equity	47%	9.5%	4.4%
Non-US Equity	30	9.5%	1.9
Fixed Income	20	6.0%	1.8
Cash	<u>3</u>	2.0%	<u>0.1</u>
Total	100%		8.2%

<sup>4</sup> Annual contributions and withdrawals for the non-bargained Long-Term Disability Trust are approximately equal and so this trust is maintained in short-term investments assumed to earn a return of 2% annually.

<sup>5</sup> Assumptions: Equity turnover = 25%, equity dividend = 1.8%

Tax rate = 15% on equity dividends and capital appreciation; 40% on bond coupon interest

After-tax equity return =  $9.5\% - 15\%[1.8\% + .25(9.5\% - 1.8\%)] = 8.9\%$

After-tax fixed income return =  $6.0\%(1-40\%) = 3.6\%$