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Decision No. 84600

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY, a corporation, for authority to sell its office building located at 101 Ash Street, San Diego, California.

Application No. 55596
(Filed March 31, 1975)

Guenter S. Cohn, Attorney at Law, for applicant.
John Witt, City Attorney, Ronald L. Johnson, and William J. Shaffran, Deputy City Attorneys, and M. W. Edwards, for City of San Diego; and James Robinson, for himself; interested parties.
Elinore C. Morgan, Attorney at Law, Jack Gibbons, and Louis G. Andrego, for Commission staff.

O P I N I O N

By this application San Diego Gas & Electric Company (SDG&E) requests authority to sell its office building located at 101 Ash Street, San Diego, California. Public hearings were held on June 2, 3, and 10, 1975 before Examiner Mattson at Chula Vista, California. This matter was submitted after oral argument on June 10, 1975.

Applicant's Evidence

Applicant's proposal is to sell its office building for $20 million. SDG&E will enter into a sale and lease-back arrangement with New England Mutual Life Insurance Company. The lease will be for a 30 year term at an annual rental of $1,945,000 with options to renew for four successive five year terms at fair rental value.

Applicant views the sale and lease-back as a financing device. SDG&E has a need to raise substantial additional capital in 1975. However, applicant is unable to issue new long term debt at this time because of its debenture indenture requirement that recorded earnings for a recent 12 months period must be twice annual interest requirements on all funded debt after the issuance of the new debt.

Viewed as a financing device, the sale results in net proceeds to the company of $19,800,000. Applicant assumes it will have no income taxes on the gain, and calculates its cost of capital at 9.19 percent for a thirty year term. At hearing the applicant assumed miscellaneous costs of sale of $50,000 and a net state tax on the gain from the sale of $403,388 (Exhibit 5). The "net state tax" assumed a state tax of $775,746 and reduced this tax by an assumed federal income tax savings attributed to the fact that the state tax would be a deduction in the federal tax calculation in 1976. The effect in applicant's cost of capital calculation of the assumed net state tax is to increase the annual cost of capital from 9.19 percent to 9.43 percent.

Applicant presented Exhibit 4 in an effort to compare cost of leasing the building versus the cost of ownership. There is no evidence that the exhibit compares costs on a comparable basis. The opposite appears to be the case. Federal taxes are assumed to be non-existent on the lease cost computation for 1975; for 1976 federal tax reductions are assumed to offset the state tax. Income taxes are a major factor in the costs computed for the ownership option. The ownership option costs computed in Exhibit 4 are based on an underlying study of the cost of various projects by SDG&E. In the absence of some detailed explanation relating the SDG&E underlying study to the assumptions in the cost-of-lease option we cannot rely upon the cost comparisions set forth in Exhibit 4.

The applicant would compare the cost of capital obtained from the sale of the building with current cost of debt. The applicant's cost of first mortgage bonds sold May 6, 1975 was 10.93 percent on a principal amount of $40 million. The term of the issue was seven years and the coupon rate was 10.7 percent. The company cannot issue mortgage bonds on the office building involved herein because of insufficient interest coverage under the debenture. If sufficient interest coverage existed, the building could be used to support mortgage bonds in the amount of 60 percent of the book value of the building. A witness on behalf of applicant testified that approximately $9 million in first mortgage bonds could be supported by the book value of the building.

An additional question arises regarding the commission of $200,000 to be paid John Burnham & Company on the sale. Mr. Malin Burnham, President and Chief Executive Officer of this company, is a member of the Board of Directors of SDG&E. The commission is one percent of the selling price.

Applicant presented the testimony of J. Frank Mahoney, III, a senior vice-president of Coldwell Banker regarding the one percent bokerage commission to be paid on the sale and lease-back transaction. Coldwell Banker is the largest real estate service business in the country in size and volume. Witness Mahoney had been a resident manager of Coldwell Banker's San Diego office for approximately 10 years. His present positions include the presidency of the commercial brokerage company of Coldwell Banker. He testified that he would be aware of most sale and lease-back transactions in excess of $10 million handled by his company's San Diego office. We can conclude that witness Mahoney is an expert on real estate commissions. He expressed the opinion that the one percent commission involved in SDG&E's proposed sale and lease-back is unreasonably low.

The applicant presented testimony that Mr. Malin Burnham has not been involved in any of the negotiations relating to the proposed sale and lease-back. The executive committee of the board authorized the transaction, and Mr. Malin Burnham is not a member of the executive committee.

The evidence is clear that Mr. Malin Burnham has a financial interest in John Burnham & Company. In addition to his position as chief executive officer of the company, he owns 80 percent of the outstanding stock of the company.

The applicant's evidence establishes that Malin Burnham, as a director of SDG&E. did not participate in the sale and lease-back transaction. The action of the executive committee of the board of directors did not involve Mr. Burnham. A corporate officer directly involved in the negotiations on behalf of SDG&E testified that Mr. Malin Burnham was not involved in the negotiations.

We do not find that Mr. Malin Burnham's position as a director has influenced the conduct of SDG&E in this matter. However, we would expect that SDG&E would follow the procedure described in Section 820(a) of the California Corporations Code in the future. When a director has a substantial financial interest in any transaction, the minutes should reflect that interest and such director should not vote on the matter. Moreover, copies of such minutes should be attached to any application involving such transaction.

We make no finding upon the reasonableness of the amount of the commission, but do find that because of the applicant's cash flow problems payment of the commission should be made over a reasonable period of time and at reasonable interest rates during that period.

Staff Evidence

The Commission staff presented the testimony of two witnesses. The staff witnesses disagreed with several contentions of SDG&E.

A staff witness from the Finance and Accounts Division did not accept the capital cost of 9.19 percent presented by the applicant. (Application, Exhibit D). The staff witness accepted the cost-of-capital approach as reasonable in analyzing the capital cost involved, but the staff witness deducted all expenses, including federal income tax, from the $20 million selling price. Using an estimated income tax of $3,095,403 and net proceeds after taxes and expenses of $15,654,597 the computed cost of capital becomes approximately 11.3 percent. The witness was of the opinion that the sale and lease-back would be justified only if the company has no alternative type of financing, cannot issue equity or bonds, and cannot rely on short-term credits.

The second staff witness presented Exhibit 8, an economic analysis of the cost of leasing versus the cost of owning the property. The exhibit set forth the present worth of the lease cost as $18.1 million and the present worth of the cost of ownership as $15.3 million. Exhibit 8 reflects the staff's view of the costs of the leasing or owning alternatives. The exhibit reflects a different approach than that used by SDG&E (Exhibit 4). However, as with Exhibit 4, substantial problems arise on analysis of the elements of the exhibit.

The present worth cost of leasing is computed at the annual net lease rate (the annual rental less annual amortization of the capital gain from the sale). A different result is obtained if the gain on the sale (the $7 million anticipated at the present time) is applied as a reduction of the present worth of the annual rental. The cost-of-ownership calculation includes an income tax cost item, but the cost-of-leasing calculation does not appear to incorporate a similar tax. Applicant presented a rebuttal witness who re-calculated the cost of ownership in the staff exhibit, in an effort to demonstrate that the present worth cost would be $17.8 million.

Staff counsel indicated that both applicant's Exhibits 4 and 5 and the staff computations are open to argument. We agree, as to Exhibits 4, 5, and 8. An economic study of the ratepayer's costs associated with ownership would appear to necessarily include, among other elements, the return associated with declining net book value of the building and equipment, depreciation expense, tax burdens and salvage values. These elements do not appear to be clearly defined in the exhibits in question.

Discussion

We agree with the staff position that the sale and lease-back of utility property is a limited method of raising capital. However, the evidence is uncontroverted that applicant cannot, at this time, issue long term debt. Moreover, SDG&E must raise substantial additional capital in 1975. Viewed as a source of long term capital, the $20 million (less expenses) available from the proposed sale and lease-back involves less capital cost than issuance of additional equity. To require SDG&E to exhaust all its available short term credit before authorizing this proposed sale would be unrealistic. Under such conditions, SDG&E would be in no position to bargain.

The cost of capital involved is certainly greater than the 9.19 percent applicant initially calculated. The staff's maximum estimate is approximately 11.3 percent if the gain on the transaction is subject to the full federal income tax. At this time, applicant may escape substantially all of the federal tax by means of available tax credits. Of course, such credits then become unavailable for tax reductions in future years. Balanced against the estimated capital cost is the known cost of 10.9 percent on the last long term debt issued by SDG&E.

We conclude that applicant's request for authority to sell and lease-back its office building should be granted. Under existing conditions, the proposed transaction does not appear to be adverse to the public interest.

Findings

1. Applicant San Diego Gas & Electric Company (SDG&E) has a need for additional capital in 1975.

2. SDG&E can obtain substantial capital ($19,750,000) before taxes by sale of its office building at 101 Ash Street, San Diego, California to New England Mutual Life Insurance Company.

3. SDG&E, as part of the proposed transaction, will lease-back its office building for an initial term of 30 years at $1,945,000 per year. SDG&E will have four successive five year renewal options at fair rental value.

4. The cost of capital to SDG&E on the net proceeds from the sale will be more than 9.19 percent and not more than approximately 11.3 percent. SDG&E incurred a capital cost of 10.9 percent on its seven year, first mortgage bonds issued May 6, 1975.

5. SDG&E cannot issue mortgage bonds at this time due to the debenture indenture restriction requiring that recorded earnings for a recent 12 months period be twice the annual interest charges on all outstanding debt, including the interest on proposed new debt.

Conclusion

The application should be granted as set forth in the order which follows.

O R D E R

IT IS ORDERED that:

1. On and after the effective date of this order, San Diego Gas & Electric Company (SDG&E) is authorized to sell and lease back its office building as requested in its application herein.

2. Within ninety days after consummation of the sale authorized herein, SDG&E shall file its proposed accounting entries to record the sale and lease-back transactions with this Commission. Such entries should be in a form acceptable to the Commission's Finance and Accounts Division.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 24th day of JUNE, 1975.

Vernon L. Sturgeon
President

Leonard Ross

Robert Batinovich
Commissioners

Dissenting
Robert Batinovich
Commissioner

Commissioner William Symons, Jr., being necessarily absent, did not participate in the disposition of this proceeding.

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COMMISSIONER BATINOVICH, CONCURRING.

I concur. Though applicant has failed to make a strong showing on the issue of the cost to the ratepayers of the granting of this application, none of the other parties was able to show that there would be a definite, certain substantial adverse effect. Thus, I reluctantly approve the application, on the basis that the applicant does have a genuine financial need and that it can apply the proceeds to capital investment. I would be more impressed by the financial need if the broker, who is on the board of directors, were to be willing to take the broker's commission on a deferred basis rather than in cash.

Dated: June 24, 1975

San Francisco, California

Respectfully submitted,

Robert Batinovich, Commissioner