ALJ/jt/bg

Decision 84 08 126 August 7, 1984

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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| Application of PACIFIC GAS AND ELECTRIC COMPANY and the CITY OF REDDING for an order authorizing the former to sell and convey to the latter certain electric distribution facilities, in accordance with the terms of an agreement dated September 17, 1982. (Electric) | Application 83-04-37 (Filed April 13, 1983) |

INTERIM OPINION

Statement of Facts

Pacific Gas and Electric Company (PG&E) since October 10, 1905 has been an operating public utility corporation organized under the laws of the State of California. PG&E is engaged principally in the business of furnishing electric and gas services in California, although it also distributes and sells water in some cities, towns, and rural areas, and produces and sells steam in certain parts of the City of San Francisco.

The City of Redding (the city), located in Shasta County, is a municipal corporation existing under the laws of the State of California. For some time the city has owned and operated an electric distribution system located within its corporate limits. From this system the city furnishes electric service to its residents and inhabitants.

During the 12-month period ending July 31, 1982, in accordance with its obligation as a public utility, PG&E supplied electric services to 172 residential customers in a formerly unincorporated area outside the city's boundaries. In addition, PG&E had certain through circuit facilities in three other formerly unincorporated areas outside the city's boundaries, but noncontiguous to the before mentioned residential area. In recent years the city has exercised its powers of annexation and these same four areas were annexed to the city on the dates shown.

| Annexation | Date of Annexation |
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| 80-6 | October 17, 1980 |
| 80-7 | October 17, 1980 |
| 80-8 | December 18, 1980 |
| 80-10 | April 10, 1981 (the residential services) |

Following these annexations the city desired to acquire PG&E's electric distribution facilities which served, or might in the future service the areas, to incorporate them into its municipal distribution system, but not to acquire PG&E's through circuit facilities in Areas 80-6, 80-7, and 80-8. Accordingly, the city and PG&E on September 17, 1982 executed an agreement whereby the city would purchase the poles, conductors, conduits, meters, transformers, fixtures, street light and signal systems, etc. involved within annexed Area 80-10.

By this application PG&E and the city seek an ex parte order of the Commission authorizing the sale and transfer of PG&E's electric facilities, including any additions and betterments, within annexed Area 80-10 to the city. Upon acquiring these properties, the city intends to furnish the electric service presently supplied by means of these facilities, charging and collecting rates and charges not in excess of those presently paid to PG&E by the customers

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1 One of these customers is a master meter account with 138 mobile home spaces.

involved, and to provide such electric service as may be required in the future in all four of the annexed areas. Concurrent with the connection of the customers in annexed Area 80-10 to the city's facilities, PG&E also seeks to be relieved of its public utility obligations within all four annexed areas.

The purchase price for the facilities purportedly reflects replacement cost less depreciation, and is in the amount of $378,063.[2] In addition, the city will pay to PG&E its severance costs of $2,297. Further, as to any additions to and retirements that may be made subsequent to June 25, 1981 and prior to conveyance, the city will pay PG&E:

a. The net value of the facilities (as determined under the practice set forth in the Uniform Systems of Accounts),

b. 15% of such net value, and

c. Any applicable severance costs.

The current ad valorem taxes for the tax year in which the facilities and any additions and betterments are conveyed will be prorated as of the conveyance date.

The city has been advised that certain of the facilities involved contain polychlorinated biphenyls (PCBs), and the city has agreed to hold PG&E harmless for any and all liability arising from such substances, or from any failure of the city to perform its utility obligations to customers in the areas. PG&E will assign all private grants of rights of way and easements for the facilities concurrently with delivery of the deed(s).

For the 12-month period ending July 31, 1982, PG&E derived a gross annual revenue from these 172 customers of approximately $158,000. As of October 25, 1982, PG&E held line extension deposits of three customers involved in this application amounting to

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[2] The historical book cost, less depreciation, of the facilities involved is $196,455.

$11,958.17. Balances remaining after the city assumes ownership of the facilities will be returned to the customers. Notice of the application appeared in the Commission's Daily Calendar of April 15, 1983. No protest has been received.

While most California communities obtain their electric services from privately owned public utility corporations such as PG&E, some cities prefer and are able to invest in the acquisition of their own electric distribution facilities and thereby are able to take advantage of the low wholesale power rates available to cities under preferential allocations from federally owned hydroelectric projects. Having lower financing costs than do privately owned public utility corporations and not having to pay income taxes, cities are sometimes able to deliver electricity to the residents and businesses within their boundaries at rates lower than those that the public utility must charge. But to be eligible for preferential allocations from federal power projects, a municipality must own its own distribution facilities, and must accept utility responsibility to serve all present and future customers in the area it will serve. Lacking its own transmission lines, a city usually pays the area public utility to wheel the federal power from the federal project source to the city's distribution lines. Then, to fully meet its utility responsibility the city further contracts with the area public utility for a wholesale purchase to make up any supplemental power supply it will require over and above its federal allocation. In many instances this places upon the area public utility the requirement that it have available peaking period capability.

In California a municipal corporation is empowered to acquire, construct, own, operate, or lease any public utility (West's Ann. Pub. Util. Code § 10002). Thus, Redding has the power of eminent domain to acquire by court action the electric distribution and street lighting facilities within any area annexed to the city. Furthermore, each annexation and acquisition of electrical facilities entitles the city to a larger share or allocation of any federal power which becomes available the next contract period. Under such circumstances, in order to avoid condemnation suits, and to compromise possible expensive litigation, the public utility corporation involved with an annexation area similar to the present situation is often willing to sell its involved facilities to the city by direct negotiation and contract.

Such is the procedure being followed here. Rather than proceeding by eminent domain, in the interest of saving both time and legal expense Redding and PG&E have agreed upon the price and have contracted to perform accordingly. There having been no opposition to the application, Administrative Law Judge (ALJ) ~~Weiss~~ proceeded ex parte and, after close of the protest period in the Commission's Rules of Practice and Procedure, submitted his proposed decision to the Commission.

Incidental to the transfer transaction was the fact that the purchase price contracted upon between Redding and PG&E included a substantial increment over the net book or depreciated rate base value of the property to be transferred. We determined that the issue of who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base should be addressed more fully. Accordingly, in a companion matter involving the same issue, Application (A.) 83-06-11, in Decision (D.) 83-06-096 dated June 29, 1983 (Arcata-PG&E), we deferred resolution of the issue and directed that this Redding-PG&E proceeding be reopened and the issue be addressed after providing opportunity for briefing. Thereupon, the ALJ issued his Ruling Reopening the Proceeding to Obtain Briefing on July 26, 1983 in this Redding-PG&E proceeding.

In addition to the parties directly involved, an invitation for amicus briefs was mailed on July 26, 1983 to a broad array of organizations and entities who it was believed might participate.[3] Briefs were requested by August 19, 1983. The Commission received briefs from eight respondents.[4] Although specifically invited and urged to participate, a half dozen cities and one county joined by the League and the Streetlighting Association elected as an alternative to write letters to the Commission voicing objection to the decision by the Commission in this proceeding to avoid over-

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[3] Apart from the immediate parties, invitees included all major California gas, electric, and water utilities; the California Water Association; the League of California Cities; the California Streetlighting Association; the offices of the city attorneys of San Francisco, Ukiah, Arcata, and San Mateo; Toward Utility Rate Normalization (TURN); the Pacific Legal Foundation; and the County of San Mateo.

[4] Six respondents took the position that as a matter of law, fairness and logic, utility property belongs to the utility and its investors, and that any determination to the contrary would inhibit sales of utilities as well as seriously and adversely affect sales of utility stock and bonds. Two of these ask that the Commission reaffirm continued adherence to the time tested principles codified in Uniform Systems of Accounts. One of these recognized that special circumstances could require departure from those principles and accordingly recommended disposition on a case-by-case basis where such circumstances were present to arrive at an equitable resolution.

Two respondents (one a joint response by two cities) registered objection to what they considered to be an inappropriate vehicle to determine these issues, and then, after contending that eminent domain was not relevant, proceeded independently. The joint response, relying upon a 1973 federal decision, contended that rate base property gains should go to ratepayers, except in special circumstances, while pointing up the question of which ratepayers. The second had no position how proceeds should be treated under different circumstances, but objected to sale of dedicated facilities to public entities at reproduction cost new less depreciation, contending unjust enrichment.

Participating respondents were: California City/County Street Light Association, Southern California Edison Company, PG&E, California Water Service Company, San Gabriel Valley Water Company, California Water Association, Great Oaks Water Company, and the City and County of San Francisco/City of San Diego.

judicialization in favor of proceeding under its rulemaking authority by way of briefs. Upon receipt of the briefs the matter was submitted.

Subsequently, at its regularly scheduled meeting on August 1, 1984 the Commission had before it for consideration both a proposed decision by ALJ Weiss, and an alternate decision proposed by the assigned Commissioner to this proceeding, Donald Vial. Consideration was carried over to the continuation session on August 7, 1984.

Discussion:

Public Utilities (PU) Code § 851 provides that no public utility other than a common carrier by railroad may sell the whole or any part of its system or property useful in the performance of its public duty without first obtaining authorization to do so from this Commission. In transfer proceedings the function of the Commission is to protect and safeguard the interests of the public. The concern is to prevent the impairment of the public service by the transfer of utility property into the hands of companies incapable of performing an adequate service at reasonable rates or upon terms which will bring about the same undesirable result (So. Cal. Mountain Water Co. (1912) 1 CRRC 520). Therefore, we want to be certain that the purchaser is financially capable of the acquisition and satisfactory operation thereafter. But where a municipal corporation or other public entity is the purchaser, these considerations are less compelling. Public agencies may be entitled to the presumption that they are creditworthy and will operate the public utility system in a manner consistent with the public interest. However, that presumption, if applied in any given matter, is rebuttable and we retain the vital and substantial authority of approving the transaction. If necessary, this Commission may grant its approval subject to conditions reasonably calculated to protect the public interest. Tustin Water Works, D.92360, A.59571, 4 CPUC 2d 427 (1980), slip opinion at 12 (Limitation on rate increases and rate [illegible] design).[5] And we may certainly examine the price agreed upon between the public utility and the public agency to determine its reasonableness.

In this proceeding, the city has agreed to assume the utility obligation to provide electric service in the annexed areas. The city will hold PG&E harmless from any and all liability arising from any failure of the city to perform these utility obligations. The city also accepts responsibility for any liability arising out of the latent PCB potential. Those customers with line extension deposits will have the balance returned by PG&E after the city assumes ownership. The through circuit lines of PG&E in the 80-6, 80-7, and 80-8 areas annexed remain unaffected.

The purchase price reflects replacement cost less depreciation of the facilities being sold, and was agreed between the parties. The parties asserted that their agreement is fair, just and reasonable both as to the parties and to the customers affected. We have examined the record before us and hold that the purchase price is fair, reasonable, and adverse to ratepayers.

<u>The Capital Gains Issue</u>

There remains the issue which we directed to be briefed in this proceeding: who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base? It became apparent from the briefs that resolution of the issue necessarily involves consideration of the interrelationship of fundamental concepts involved in ratemaking and ownership of property, and their application to a spectrum of situations.

Our review of the proposed decision and alternate presently

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[5] One court has held that a public agency may pursue a condemnation action should the Commission impose conditions unacceptable to it. People ex rel. Public Utilities Commission v. City of Fresno, 254 Cal. App. 2d 76, 88 (1967). The California Supreme Court has yet to consider this question. But cf., PU Code § 1759.

before us, and our discussion here today, leads us to the conclusion that possibly we would benefit from oral argument on this remaining issue. Accordingly, to that purpose we will set aside submission and direct ALJ Weiss to set en banc hearing of oral argument from the parties to this proceeding for a time and place to be set in October. A list of specific issues to be addressed will be included with the notice of hearing. Copies of the proposed decision and alternate presently before us will be attached to this interim opinion as Appendixes A and B, respectively, to acquaint the parties with the present extent of our deliberations and to assist them in their preparation for this oral argument.

Rather than further delay approval of the sale and transfer transaction between Redding and PG&E, by this interim decision we will authorize its consummation while reserving disposition and accounting of the $181,608 gain over depreciated original cost for our decision following oral argument. There was no opposition entered to the sale and transfer aspect and there is no need to set that matter for public hearing. The information contained in the application provides sufficient basis for our approval of the sale and transfer, and the sooner the sale and transfer are approved, the sooner the customers directly involved can obtain the lower rates and charges promised them. Accordingly, this interim order will be made effective immediately.

Findings of Fact

1. PG&E provides public utility electric service in many areas of California, including areas in and about Redding.

2. The city, a California municipal corporation, for some time has owned and operated an electric distribution system in areas within municipal limits.

3. At different times within the past years, the city has annexed unincorporated areas, including the specific four areas which

are the subject of this application, wherein the electric service or the obligation to provide electric service was the obligation of PG&E.

4. In the interim since annexation, PG&E has continued to provide Area 80-10 with electric service, and was ready if requested to provide Areas 80-6, 80-7, and 80-8 with electric service.

5. The city itself has plans to provide the electric service in these four areas, and has contracted with PG&E to purchase the existing distribution and streetlighting facilities in Area 80-10 from PG&E and will incorporate these facilities into the city's electric distribution system.

6. The purchase price negotiated between the city and PG&E for the facilities, the proposed payment of net value plus 15% for additions, the proposed payment of applicable severance costs, and the proposed proration of current ad valorem taxes constitute a just and reasonable compensation for the transfer.

7. PG&E will continue to own, maintain, and operate certain through circuit lines in the 80-6, 80-7, and 80-8 areas.

8. The furnishing of electric service in the four annexed areas by the city will not result in rates and charges to the customers of these areas in excess of those paid to PG&E.

9. There is no known opposition to the proposed sale and transfer.

10. It can be seen with reasonable certainty that there is no possibility that the sale and transfer of these particular facilities alone may have a significant effect on the environment.

11. The proposed sale and transfer of these particular facilities, under all the conditions applicable, would not be initially adverse to the public interest.

12. Line extension balances to the three customers involved will be refunded by PG&E after the city assumes ownership.

13. The transaction which is the subject of A.83-04-37 involves a substantial increment over the net book or depreciated rate base value of the property to be transferred.

14. There is no reason to further delay authorization for the sale and purchase.

15. The gain in the sale price over net book value when realized by PG&E should be held in a suspense account pending resolution by the Commission of the issue who is entitled to the gains or responsible for the losses accruing from sales of utility property.

Conclusions of Law

1. Upon completion of the sale and transfer PG&E should be relieved of its electric public utility obligations in the four annexed areas.

2. PG&E should be required to defer classification of the gain realized over depreciated book value of the electric systems involved in this sale and transfer until further order of the Commission.

3. A public hearing on the sale and transfer aspect of the application is not necessary.

4. The application should be granted as provided in the following order.

INTERIM ORDER

IT IS ORDERED that:

1. Within six months after the effective date of this order, Pacific Gas and Electric Company (PG&E) may sell and transfer to the City of Redding the electrical distribution and streetlighting facilities set forth in their September 17, 1982 agreement annexed to and made a part of their application as Exhibit B.

2. Within 10 days of the actual transfer PG&E shall notify the Commission in writing of the date on which the transfer was consummated. A true copy of the instrument of transfer shall be attached to the written notification.

3. Within 90 days after the date of actual transfer, PG&E shall advise the Commission's Evaluation and Compliance Division, in writing, of the adjustments for additions and betterments made in

accordance with Exhibit B annexed to and made a part of the application.

4. Within 90 days after the date of actual transfer, PG&E shall make refund of all line extension balances outstanding applicable to these facilities, and when these refunds are completed, shall advice the Commission's Evaluation and Compliance Division, in writing, of the fact.

5. Within 10 days of the actual transfer, PG&E shall record the gains accruing from this sale and transfer in an appropriate suspense account and retain them in that account until further Commission order.

6. Upon compliance with this order, PG&E shall stand relieved of its public utility obligations in connection with electric service in the four areas which are the subject of this application.

7. The issue pertaining to the disposition of the gains accruing from this sale and transfer is reopened to allow oral argument by the parties before the Commission en banc at a time and place to be set.

This order is effective today.

Dated August 7, 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

Commissioner Priscilla C. Grew, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz, Executive Director

Decision ____________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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These four areas are shown on the Appendix A map.

[1] One of these customers is a master meter account with 138 mobile home spaces.

Following these annexations the city desired to acquire PG&E's electric distribution facilities which served, or might in the future service the areas, to incorporate them into its municipal distribution system, but not to acquire PG&E's through circuit facilities in Areas 80-6, 80-7, and 80-8. Accordingly, the city and PG&E on September 17, 1982 executed an agreement whereby the city would purchase the poles, conductors, conduits, meters, transformers, fixtures, street light and signal systems, etc. involved within annexed Area 80-10.

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The purchase price for the facilities purportedly reflects replacement cost less depreciation, and is in the amount of $378,065.[2] In addition, the city will pay to PG&E its severance costs of $2,297. Further, as to any additions to and retirements that may be made subsequent to June 25, 1981 and prior to conveyance, the city will pay PG&E:

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Incidental to the transfer transaction was the fact that the purchase price contracted upon between Redding and PG&E included a substantial increment over the net book or depreciated rate base value of the property to be transferred. We determined that the issue of who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base should be addressed more fully. Accordingly, in a companion matter involving the same issue, Application (A.) 83-06-11, in Decision (D.) 83-06-096 dated June 29, 1983 (Arcata-PG&E), we deferred resolution of the issue and directed that this Redding-PG&E proceeding be reopened and the issue be addressed after providing opportunity for briefing. Thereupon, the ALJ issued ~~his~~ Ruling Reopening the Proceeding to Obtain Briefing on July 26, 1983 in this Redding-PG&E proceeding.

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[4] Six respondents took the position that as a matter of law, fairness and logic, utility property belongs to the utility and its investors, and that any determination to the contrary would inhibit sales of utilities as well as seriously and adversely affect sales of utility stock and bonds. Two of these ask that the Commission reaffirm continued adherence to the time tested principles codified in Uniform Systems of Accounts. One of these recognized that special circumstances could require departure from those principles and accordingly recommended disposition on a case-by-case basis where such circumstances were present to arrive at an equitable resolution.

Two respondents (one a joint response by two cities) registered objection to what they considered to be an inappropriate vehicle to determine these issues, and then, after contending that eminent domain was not relevant, proceeded independently. The joint

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urged to participate, a half dozen cities and one county joined by the League and the Streetlighting Association elected as an alternative to write letters to the Commission voicing objection to the decision by the Commission in this proceeding to avoid over judicialization in favor of proceeding under its rulemaking authority by way of briefs. Upon receipt of the briefs the matter was submitted.

Discussion

Public Utilities (PU) Code § 851 provides that no public utility other than a common carrier by railroad may sell the whole or any part of its system or property useful in the performance of its public duty without first obtaining authorization to do so from this Commission. In transfer proceedings the function of the Commission is to protect and safeguard the interests of the public. The concern is to prevent the impairment of the public service by the transfer of utility property into the hands of companies incapable of performing an adequate service at reasonable rates or upon terms which will bring about the same undesirable result (So. Cal. Mountain Water Co. (1912) 1 CRRC 520). Therefore, we want to be certain that the purchaser is financially capable of the acquisition and satisfactory operation thereafter. But where a municipal corporation or other

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4 (FOOTNOTE CONTINUED) response, relying upon a 1973 federal decision, contended that rate base property gains should go to ratepayers, except in special circumstances, while pointing up the question of which ratepayers. The second had no position how proceeds should be treated under different circumstances, but objected to sale of dedicated facilities to public entities at reproduction cost new less depreciation, contending unjust enrichment.

Participating respondents were: California City/County Street Light Association, Southern California Edison Company, PG&E, California Water Service Company, San Gabriel Valley Water Company, California Water Association, Great Oaks Water Company, and the City and County of San Francisco/City of San Diego.

public entity is the purchaser, our consideration and approval essentially and necessarily are a ministerial act.[5] And where the public entity and the public utility have contracted under a shadow of eminent domain for a voluntary sale and transfer, and have agreed upon a purchase price, that agreed upon purchase price will be accepted in our resulting § 851 transfer proceeding pertaining to that sale and transfer as fair and just compensation.

In this proceeding, the city has agreed to assume the utility obligation to provide electric service in the annexed areas. The city will hold PG&E harmless from any and all liability arising from any failure of the city to perform these utility obligations. The city also accepts responsibility for any liability arising out of the latent PCB potential. Those customers with line extension deposits will have the balance returned by PG&E after the city assumes ownership. The through circuit lines of PG&E in the 80-6, 80-7, and 80-8 areas annexed remain unaffected.

The purchase price reflects replacement cost less depreciation of the facilities being sold, and was agreed between the parties. The parties assert that their agreement is fair, just, and reasonable both as to the parties and to the customers affected. We accept the purchase price as fair and just compensation.

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[5] See People ex rel. PUC v City of Fresno (1967) 254 CA 2d 76. The Court observed that if a city and a public utility are in agreement on the terms of a proposed sale, they may seek Commission approval rather than resort to condemnation proceedings. But if the Commission imposes terms or conditions not acceptable to the city, the proposed voluntary sale may be abandoned and the city may resort to eminent domain proceedings, using either the Superior Court or the Commission under PUC §§ 1401-1421 to determine the just compensation. The Commission cannot compel the owners of a public utility property to sell (P.T. Duffy (1914) 4 CRRC 447), and the Legislature intended to involve the Commission in a condemnation proceeding only with the consent of the city, and then, only on the limited question of setting just compensation.

I. The Capital Gains Issue

There remains the issue which by D.83-06-096 we directed to be briefed in this proceeding: who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base? It became apparent from the briefing that resolution of the issue necessarily involves consideration of the interrelationship of fundamental concepts involved in ratemaking and ownership of property, and their application to a spectrum of situations.

In the private or free enterprise sector, although absolute economic freedom is not possible, generally speaking, the owners of a business are free to set prices and dispose of their property as they choose, subject only to the constraints of competition and compliance with antitrust laws. The full risk of gain or loss from the enterprise lies with the entrepreneur. He sets prices to recover not only all his costs, depreciation, and taxes, but also a return on his investment. Furthermore, he expects to earn on the changing current fair value of that investment. If there is inflation, his prices advance more or less commensurately with the increasing value of his investment and are set to also recover his increasing inflated costs. Should he sell all or part of his business or its assets, after he pays the taxes, any gain or loss is exclusively his. His customers have no right, claim, or obligation to share in the profits, gains, or losses which may result. The risks are all his. That is free enterprise.

On the other hand, where public utility enterprises are involved, we deal with business ventures which, although privately owned and managed, operate in a monopolistic setting. And long ago experience demonstrated that these cannot be left free to operate unrestrictedly under the price-profit system. In the public interest they must be regulated, and the key to such regulation rests in the authority of a regulatory body such as this Commission to determine the rates they will charge. However, this regulatory power is not unlimited. It is a well-established principle that rates of a public utility must be set at levels which provide a reasonable return to its investors. The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. (Smyth v Ames (1898) 169 US 466, 545-546).[1] The Fifth Amendment to the Federal Constitution provides that private property cannot be taken for public use without just compensation.

While in the early days of regulation compensation for the use of property devoted to the public service was deemed to be reasonable so long as it permitted a fair return on a rate base which represented the "fair value" of that property, taking into consideration original cost as well as reproduction cost (Smyth v Ames, supra, at 546-547), this fair value test soon made every rate proceeding an almost interminable and labyrinthine inquiry involving endless conflict between experts.

Change came slowly, even though as early as 1923 Justice Brandeis in his famed dissent to Southwestern Bell Tel. Co. v Public Service Commission (1923) 262 US 276, characterized the "fair value" concept as applied to rate base determinations as being legally and economically unsound. In its stead he advocated the concept that rate of return to investors should be based upon the value of the capital prudently invested in the enterprise.

Nonetheless, for years thereafter the federal Supreme Court continued to uphold various replacement cost formulae as being the appropriate constitutional measure of rate base for setting rates. As time passed, however, the disadvantages of reproduction cost eventually combined with developments during the Great Depression, leading to a reexamination by the Supreme Court. This reexamination was sparked to a considerable degree by the Federal Power Commission (FPC) administration of the 1938 Natural Gas Act (Gas Act).

A. Supreme Court Guidelines

In its administration of the Gas Act, the FPC disregarded existing Supreme Court pronouncements of what constituted acceptable rate base determinations and adopted original cost less depreciation as the criterion to apply to utility rate base determinations.[6] Soon tested, the FPC position was upheld in Federal Power Commission v Natural Gas Pipeline Co. (1942) 315 US 575, and Federal Power Commission v Hope Natural Gas Co. (1944) 320 US 591. In these landmark cases, the Court held that investors had no constitutional right to have their rates based upon any increasing value of their rate base assets (as would be represented by reproduction cost), and upheld FPC's use of original cost less depreciation as the measure of rate base.

It must be noted that these decisions applied only to federal judicial consideration of rate case appeals by utility companies. Otherwise, they did not interpose rate base criteria in regard to federal or state legislation, commission standards and procedures, or state judicial decisions on state constitutional or statutory terms. They left those responsible for utility rate regulation free to establish their own objectives, standards, rules, and procedures in the fixing of reasonable rates. They merely cleared away federal rate base and rate of return obstructions in future reviews of rate case orders. They left the FPC, and implicitly all state regulatory commissions, free of prior federal constitutional prescriptions as to how these regulatory bodies could determine reasonable rates. These bodies were left free to adopt regulatory standards and procedures to conform to their respective statutory powers and duties in rate setting, subject only to the end result that the utilities must be maintained as viable enterprises. In setting rates, a Commission need only assure the "financial integrity" of the utility, providing for an ability to attract capital and compensate its investors for the risks assumed, even

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6 The Supreme Court had already in Lindheimer v Illinois Bell Telephone Co. (1934) 292 US 151 limited depreciation to original cost rather than reproduction cost.

though the rates it approves may "produce only a meager return on the so-called 'fair value' rate base." (Fed. Power Comm. v Hope, supra, at 605.)

Thus, Hope dealt with permissible constitutional bases for determining a rate base upon which just and reasonable rates could be set. But Hope did not address ownership of the property which was dedicated to public service by investors. That property is held in private ownership, and it is that property and not the original cost of it, of which the owner may not be deprived without due process of law. Nothing in Hope in any way served to change the fact that the investor continues to be the owner of the utility property. While it is property employed in a public calling and subject to governmental regulation, it may not under the guise of such regulation be confiscated, although there is attached to it the condition that charges to the public based upon it shall not be unreasonable. And nothing in Hope served in any way to change the crystal clear distinction made earlier by the Supreme Court in Board of Public Utility Commissioners v New York Telephone Company (1926) 271 US 23, at 32, when it described the respective rights of investors and ratepayers in a public utility as follows:

> "Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stock."

Nor did Hope discuss or change the Court's observation earlier in McCardle v Indianapolis Water Company (1926) 272 US 400, that as the owners of utility property must bear any decline resulting from fluctuations of utility property values, they are also entitled to any increases.

It is also significant that six years after Hope, the California Supreme Court in Pacific Telephone and Telegraph Company v. Public Utilities Commission (1950) 34 C 2d 822, at 828, reaffirmed the inviolability of the investor's ownership of his property which he had dedicated to a public use by repeating:[7]

> "And, finally, it may not be amiss to point out that the devotion to a public use by a person or corporation of property held by them in ownership does not destroy their ownership and does not vest title to the property in the public..."

B. Depreciation

While the basic principle to be drawn from these federal and California high court decisions is that utility property belongs to the investors, from time to time the erroneous view still is expressed that given the fact that certain utility property is included in rate base, through the payment of depreciation expense, the public, on some sort of installment plan, is in effect buying the property from the utility as it is used up, and therefore, if this property is sold, the ratepayers are entitled to have the sale treated as though it were a sale of the ratepayers' property. This argument conveniently overlooks the fact that, properly computed, depreciation does no more than cause ratepayers to reimburse the investors the original cost portion alone of the value of utility property being consumed in the ratepayers' service.

Broadly speaking, there are three general types or categories of assets or property:

First, those items such as fuel or lubricants which are entirely used up or consumed during the accounting period as an incident of doing business. As consumed they are charged off directly as an operating expense. They are not in rate base and

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[7] From Pacific Telephone etc. Co. v Eshleman (1913) 166 C 640 at 665.

are not depreciated. They belong to the utility and its investors until consumed.

Second, those assets which are used up or worn out gradually over a period of time, such as buildings, machinery, poles, lines, pipes, mains, autos, meters, etc. Although carried as capital assets their service life gradually expires despite repairs from time to time. As their service life expires an allowance predicated on the expired portion is charged as depreciation. As the service life winds down, the investor is in the process of being made whole by means of this depreciation expense paid by the ratepayer for the expired portion of the service life, but he still owns the remaining unexpired service life. Assuming proper depreciation accounting, the depreciated portion of the asset has ceased to exist - having to that extent been consumed. When the service life is concluded, the investor will have recovered the original cost, and the asset, save for any salvage, will have ceased to have any value. It has been consumed and there is nothing left for the ratepayer to own. The process of depreciation ceases.[8]

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[8] Again, it is significant to note that the depreciation was based only on original cost. The investor, during the depreciation period, receives nothing from depreciation or rate of return for use of any enhanced value of the undepreciated portion of the asset still remaining at any given point. It is also sometimes argued that when depreciable property is retired before the end of its physical life because of functional obsolescence or similar cause, ratepayers bear the loss because the undepreciated balance of its original cost is amortized by charges against depreciation reserve. Contending that ratepayers have borne this risk it is assumed that accordingly they should receive any gains on depreciable property. But this contention overlooks the fundamental fact that one of the functions of depreciation expense is to reflect the effects of both physical and obsolescence caused loss. Physical caused loss results from wear, exposure, deterioration, and similar causes tending to reduce the physical capacity or life of the asset during which it can render service. Functional causes relate to an inadequacy to perform the function expected, usually resulting from obsolescence, technical progress, or change in regulatory standards (For example, the CPUC (CONTINUED)

Third, are those assets which are never used up, never suffer loss of their service life. The chief example is land. Normally, it is neither consumed nor made useless by its service. Although carried as fixed capital at original cost if used or useful in providing utility service, and constituting a part of rate base upon which a return is paid, there is no depreciation applicable. Taxes are an operating expense paid by the ratepayer. We will return to a consideration of land shortly.

Customers of any business enterprise, whether regulated or private enterprise in nature, ultimately must bear the costs incurred by the use of the investors' property which is engaged in the enterprise. Investors of a public utility are merely made whole, and the integrity of the original value portion of their initial investment maintained when a utility is permitted to recover through depreciation for the gradual wasting or wearing out of that initial investment in service to the public. There is no recovery through depreciation for increases in value or loss in purchasing power attributable to that original investment during the wasting period of the asset. Depreciation accounting is no more than an allocation of the correct proportion of this long-range wasting expense based only upon the original investment value assigned under original cost

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8 (FOOTNOTE CONTINUED)

Uniform System of Accounts for Classes A, B and C Water Utilities, effective January 1, 1955, under definitions, states that among the causes to be given consideration in determining depreciation are: "wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities).

Thus, any alleged "loss" reflects nothing more than the accounting failure in that instance of remaining-life depreciation to have estimated accurately the service life of the property under actual circumstances. But to that extent the ratepayers have already benefited from less depreciation expense and lower rates than the economic reality would have justified.

concepts to the correct accounting period. In Hope, the U.S. Supreme Court merely upheld use in federal jurisdictions of depreciation and depletion allowances based on the original cost ascribed to the property in rate base. As we observed in Pacific Telephone and Telegraph Co. (1954) 53 CPUC 275, at 293: "The primary objective of depreciation, in our opinion, is to recover during its useful service life, the original cost of plant, not more, not less..."

But this concept cannot be stretched to mean that the payment of depreciation expense serves to sell the rate base property in installments to the ratepayers. A customer acquires no more interest in utility property by paying his utility bill than does a patient acquire an interest in his doctor's office or equipment by paying his doctor's bill.

C. Uniform Systems of Account

In California, pursuant to the provisions of the Public Utilities Act (see §§ 791, et seq.), the Commission has adopted and prescribed various uniform systems of account to be applicable to the various classes of utilities. (Indeed, as pertinent to the energy utilities, California has adopted the FPC Uniform System of Accounts Prescribed for Public Utilities and Licensees.) In doing so, the Commission has not committed itself to approve or accept any item in determining matters which may come before it, but generally the instructions contained in such systems recognize the principle that investors will receive the gains and bear the losses attending sales of utility property.

More specifically, these uniform systems of account generally provide that when land is sold as part of an operating unit or system,[9] or sold immediately after being taken out of rate base, or sold subsequently after being carried as non-operating property, all gains or losses are allocated to the investors from that sale. When depreciable plant facilities are sold or disposed of as part of an operating unit or system, the gain or loss from that sale is also allocated to the investors. And similarly, if depreciable plant facilities are retired from operations, taken out of rate base, held against future use, and then subsequently sold, the proceeds are allocated to the investors. These rules are consistent with the principle that gain should follow risk and the original cost concept. Under the Uniform Systems of Account, a utility purchasing an operating unit or system is allowed to include on its books, and receive a return only on original cost less depreciation. The ratepayer pays through the return component only for the original cost less depreciation. His rates have reflected only the original cost of the rate base property and did not increase when it appreciated in value. Thus, Uniform System treatment of any gain realized from the sale of an operating unit or system as non-utility income is consistent.

But if depreciable plant facilities are sold immediately after being removed from rate base, the proceeds are allocated to the ratepayers through the depreciation reserve. (For example, if an

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[9] To avoid undue refinements in accounting, these systems distinguish between minor items of property, and operating units or systems. For example, the Federal Energy Regulatory Commission (FERC) distinguishes "operating units or systems" as usually being "property acquired or sold with customers attached," such as a distribution system, a transmission line, a substation or a generating station. But isolated purchases or sales of poles, parcels of land, meters, transformers, etc. do not come with this scope. Transfers are to be viewed both from the functional use and the amount of property involved. Small rural line extensions, unless the area is of some size or embraces several such areas, are not considered operating units or systems (see PG&E brief: January 15, 1952 letter from FPC to Pennsylvania Electric Company relative to the Ridgway-Warren transmission line).

individual rate base asset, i.e., a truck, is sold for an amount in excess of its depreciated book cost, the resulting book gain is considered an operating gain; the same principle would apply to a single asset sold at a loss.) And if land is acquired, held for future use, and included in rate base, all the gain or loss would be allocated to the ratepayers. An example of this Commission's application of this latter rule, and a recent rationale, is available from D.83-03-062, p. 2, wherein we stated:

> "By permitting PG&E to place the cost of the rate base property into Account 105, Plant Held For Future Use, and continue that treatment of those costs until January 1, 1982, we effectively insulated PG&E's shareholders from a risk of loss. Moreover for years the ratepayers have carried the burden of providing a return to PG&E on this property at the risk that no additional utility service might ever result. This, of course, is what did occur. Accordingly, we conclude the risk of loss question was settled once the property was placed in rate base. This conclusion is based upon equitable considerations. The accounting regulations which provide that gain or loss from property on [FERC] Account 105 [for PHFU property] be allocated to the ratepayers are likewise based upon such considerations."[10]

D. Potential Impact of Change to the Investment Community

Obviously, such uniform systems of account reflect years of fine tuning premised upon expert views about balancing the interests of ratepayers and investors. These rules, while not binding, are significant, not as the determinants of regulation, but rather as the embodiment of long accepted regulatory policy and principles.

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[10] Electric Plant Instruction 7.E from FERC's Uniform System of Accounts was revised by FPC Order No. 420 (1971) 45 FPC 106, to allocate exclusively to ratepayers any gain or loss on the sale of property previously classified as property held for future use. In part, the change was made to deter utilities from abusing the concept by using ratepayer financing of the cost of taxes, etc. to engage in land speculation.

compelling evidence of the fundamental concepts they codify, principles from which we should authorize departure only in compelling and inequitable circumstances. In this latter context we are well aware that it is the investment community which continuously determines the future of the privately financed public utilities system in California. The uncommitted investor is always free to invest his funds wherever he perceives security and reasonable opportunity. His compensation for use of his money and property is the prospect of dividend income, enhancement of the book value of the utility's assets through retained earnings, and the expectation that the market value of his shares and their underlying assets will at least offset the effects of inflation. We also recognize that the perceptions of the investment community to a substantial extent are shaped and influenced by the depth and consistency of our adherence to the principles we codified in the uniform systems of accounts we adopted and prescribed for the utilities under our jurisdiction. If without good equitable reasons, we were to disregard past history and the provisions of these uniform systems of account to classify capital gains as operating income, a classification that incidentally cannot be rationally supported, the marketability and value of California utility securities necessarily would decline. Investors would only perceive this Commission as inconsistent, inequitable, and prepared to disregard well-established principles for ad hoc expedience. Today's price of California public utility stock reflects an appropriate investor expectation of entitlement to any gain realized in accord with the uniform system of account provisions upon the disposition of a utility property. The general rationale of this latter observation was explained and sustained by the District Court decision in Washington Public Interest Organization v Public Service Commission, Order No. 7411, Public Service Commission of the District of Columbia, dated October 6, 1981, affd. (1982) 446 A 2d 28. There the Court concurred with Commission rejection of a request to reverse a long-standing ratemaking policy and to award to ratepayers the gain on the sale of certain utility property. The Commission had said:

> "The evidence supports the conclusion that this long-standing accounting and ratemaking treatment [to allocate gain and loss on such disposition to shareholders], so commonly followed by this and many other regulatory Commissions, is within the knowledge of informed utility investors and that any reversal thereof which would result in a reduction of non-jurisdictional earnings would be a changed factor to be taken into account by such investors in evaluating the utility as an investment opportunity and the rate of return required to secure their investment (both new investment capital and retention of existing investment in the particular company).
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> "The evidence establishes that investors have expected and will continue to expect that [such] gains...will inure to the shareholders' benefit. These expectations have been fully taken into account in the prices that investors pay for the stock of [the selling utilities], and consequently, a change in the allocation of these gains from the stockholders to the ratepayers would adversely affect the ability of [the selling utilities] to attract capital at reasonable rates and cause a fall in stock prices." (Order No. 7411, at p. 20; see also 445 A 2d at 30.)

If an investor's appreciation rights are to be limited to book value, a prudent investor would be unlikely to pay anywhere near, yet alone above, book value for public utility stock. A ruling allocating to ratepayers any share of the gain from the sale of utility systems could also impair the security and value of debt securities.[11] Heretofore, it has always been assumed that upon a default by the utility its bondholders could seize the utility's assets, sell them,

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[11] And in some instances violate standard trust indenture provisions which require that such gain proceeds be reinvested in utility plant or delivered to the trustee to repay debt or secure its payment (see trust indentures of Southern California Water Company, California-American Water Company, Dominguez Water Corporation, and San Gabriel Valley Water Company).

and apply the entire proceeds, if necessary, to satisfy the debt. Any allocation to ratepayers would imply diminution of the bondholders' rights with serious legal and constitutional questions, negatively impacting marketability and value of California public utility bonds.

Retained earnings are an important source to fund capital improvements, especially for water utilities.[12] If capital gains were to be passed through to ratepayers, current investors would demand higher dividend payouts (very probably to be reinvested in other non-regulated enterprises offering comparable earnings as well as opportunity for capital appreciation), forcing public utilities to enter the finance markets for capital improvement funds--the very marketplace whose interest in such investment would have been chilled by the very regulatory policy which made recourse to them necessary. The result would be a higher cost of money to be borne by the ratepayers in the rate of return.

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[12] Apart from a handful of Class A utilities, regulated water companies generally are unable to make public offerings of securities and cannot borrow from institutional lenders or banks. Accordingly, they must rely upon present investors and retained earnings for new capital. To deny such investors at least the infrequent opportunity to offset the erosion of their investment from inflation through the receipt of capital gains would be a strong deterrent to the reinvestment of retained earnings and to the attraction of new capital.

E. Ratepayer's Indifference to Rate Base Fluctuations in Value

In California, since its inception over seventy years ago, this Commission has adhered to the original cost concept which is designed to leave the ratepayer insulated from and indifferent to changes in the value of the rate base property upon which we predicate the rates paid by consumers (see California Water Service (1971) 72 CPUC 751, 756). We have followed this concept fully aware that the value thereby assigned to the rate base property does not always reflect current market or exchange value of that property. But we do it to determine and affix a convenient and constant value for ratemaking purposes. Absent additions or retirements, that value is the rate base upon which we determine just and reasonable returns. We are well aware that inflation has been an economic fact of life for over the past half century. Consequently, ratepayers very commonly enjoy daily use (or the hire) of assets with a current market value far beyond their original cost rate base valuation. But the original cost concept restricts the investor's rate of return computation to original cost. The ratepayer pays nothing for the continued use of the appreciated portion of the value of the investor's asset. The investor has carried the risk of inflation or of a changing market. Therefore, retention by the investor of any appreciation in value over original cost upon sale of those assets poses neither a legal problem nor an administrative burden. To deny the investor the appreciation at time of sale of his property would at the least be unfair.

These principles have particular validity with respect to the allocation to be made of gains realized on the sale of land, an entire utility system, or major operating component. Usually land is a non-depreciable capital asset. It is not unlike a catalyst in a chemical reaction; it is necessary but not consumed by the event. While used or useful in utility service it is in rate base and taxes paid on it are an allowable operating expense. But ratepayers in essence are merely renting its use while it is in service, incur no risk, and have no basis to claim a share of any appreciation obtained on its sale. As the Kentucky Court of Appeals in City of Lexington v Lexington Water Company (Ky App 1970) 458 SW 2d 778, at 779, stated, quoting with approval from the lower court's opinion:

> "Having contributed nothing to its acquisition and having acquired no interest therein, the ratepayers assumed no risk in its disposition whether it be profit or loss. The statement...of the commission that future ratepayers could be compelled to reimburse the company if such property had been sold at a loss borders on the ridiculous. Having assumed no risk in the loss on the sale of the property, conversely the ratepayers acquired no claim to the profits therefrom."

Other jurisdictions are in agreement (for example see: Pa. Gas and Water Co. v Pa. PUC (1983) 456 A 2d 1126; Philadelphia Suburban Water Co. v Pa. PUC (1981) 427 A 2d 1244, 1247 (where the Pennsylvania Commonwealth Court stated:

> "The ratepayer, although bearing the cost of taxes, pays only for the use of land, but gains no equitable or legal rights thereto. As the ratepayer would not pay the loss on any sale of land, neither should he receive the gain.");[13]

City of Nashua (N.H. 1981) 435 A 2d 1126, 1128 (where the New Hampshire Supreme Court, reaffirming its holdings in prior cases held:

> "...under the Commission's accounting rules and as a 'matter of general equity', the profits realized from the sale of fixed capital belong to the stockholders rather than the ratepayers because any loss realized from the sale of such assets could not be charged to future consumers.")

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[13] It is noteworthy that in this case the Commonwealth Court of Pennsylvania, with exclusive appellate jurisdiction of appeals from the State Public Utility Commission, also relied upon and cited the 1926 U.S. Supreme Court Board of Public Utility Commissioners v N. Y. Tel. Co. statement that "Customers pay for service, not for the property used to render it..." (271 US 23, 32).

and see Boise Water Corporation v Idaho Public Utilities Comm. (Ida 1978) 578 P 2d 1089 (where the Idaho Supreme Court held that the ratepayers were not entitled to the gains on the sale of unimproved real property).

In each of these cases it was a significant factor that the respective Commissions had adopted a uniform system of accounts which served to allocate gains and losses on sales of utility property to the utility's surplus account. It is also worthy of note that these same general principles allocating capital gains to investors have long been accepted by the FPC and are incorporated into its accounting procedures pertaining to dispositions of land or operating systems.[14] In 1973 they were reiterated in FPC Order No. 473 which terminated a rulemaking proceeding which had under consideration amendment of the federal commission's procedures for recording gains and losses on the sale or other disposition of utility property and non-utility property that had previously been recorded in the utility plant accounts. In Order No. 473 the FPC stated:

> "After careful consideration of the comments received, we have concluded that no change should be made in the accounting treatment of the gains and losses on the sale or other disposition of utility property. We shall therefore continue the current procedure of recording them as non-utility operating income and deductions or, in other words, "below the line".

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[14] The Federal Power Act was administered by the FPC until that agency ceased to exist on October 1, 1977. On that date all functions of the FPC under the Act were transferred to the FERC, 42 USC Section 7172 (Supp III 1979). Consistent with its Uniform System of Accounts, the FPC (and the FERC) has treated acquisitions and dispositions the same. The original cost concept is applied equally in setting rates, acquiring systems, and conveying systems. Its Uniform System of Accounts (18 CFR Part 101 - Uniform System of Accounts Prescribed for Public Utilities) Electric Plant Instruction 5.F. (Electric Plant Purchased or Sold) provides that any gain or loss on the disposition of an operating Electric System should be credited to FERC Accounts Nos. 421.1 (gain) or 421.2 (loss) as non-utility income benefiting or burdening the shareholder.

"In our recent opinion No. 641, Duke Power Company, Docket No. E-7557, issued December 18, 1972, 48 FPC 1384, we dealt with the question of "whether the customers...have any rights in property or revenues derived from property owned by the utility. (Opinion No. 641 and 1394.) Our resolution of the question was reached against a claim that since [ratepayers are required to finance (the utility's transactions...(they) should share in any profits derived from the appreciation and development of...real estate (id at 1394). We concluded that ratepayers have no interest, legal or equitable, in the property of the utility, relying upon Board of Public Utility Commissioners v New York Telephone Co., 271 US 23 (1926)."

This FPC decision continues in effect today.

At this point we note that the joint brief submitted by the two city respondents in response to our solicitation of briefs, would have us conclude to the contrary. They contend that allocation of any profit in sale of utility property is simple. They correctly note that this Commission has held that consumers become entitled to appreciations in value of rate base assets when these consumers have discharged the burden of preserving the financial integrity of the investors' investment. Obviously in such instances the consumers have carried the risk of capital loss. But as we have pointed out, the consumers do not normally preserve the financial integrity of the investors' continuing investment, only the original valuation. But from our holding they jump to the oversimplistic notion that once utility property is in rate base, the ratepayer has paid for it in the form of depreciation and rate of return. They reach this conclusion, despite the clear holdings of both the U.S. and California Supreme Courts that utility property continues to be the property of the utility and its investors and not of the consumers, by reliance upon a very unique decision by a federal appeals court based upon special facts.

In Democratic Central Committee v Washington Metropolitan Area Transit Commission (D.C. Cir. 1973) 485 2d 786, cert. den. (1974) 415 US 935, the Washington Transit Commission was directed to give the ratepayers the benefit of an appreciation in value of land transferred from operating to non-operating status. But in that case the ratepayers were providing the capital by which the utility financed the acquisition of both real property and other capital expenditures. In view of the fact that the utility's farepayers were providing the capital, in contrast to the usual situation where capital is provided by the utility shareholders, the court applied a rule which it styled the "benefits follows the burden",[15] and

[15] This case involved unique circumstances which literally demanded judicial pursuit of retributive justice, and the D.C. Circuit Court in a split decision (2-1) obliged. The egregious facts were that as a result of an earlier congressional mandate by which the transit utility had abandoned streetcar operations for all bus service, the farepayers had borne the expense of streetcar track removal and paving while the undepreciated portion of the streetcars and tracks rendered obsolete (of a value alone totaling in excess of 5 million dollars) had been charged to depreciation reserve, with the result that the shareholders had been reimbursed by the farepayers. In addition, because the purchase price paid by the investors for the capital assets from the utility's predecessors had been more than 10 million dollars below book value the investors' acquisition cost also had reflected the conversion costs (estimated at almost 10 million dollars). With fares set on a different and higher basis than original cost, the investors, on a minimal capital outlay, had received within ten years a return on equity of 830%. As a result of the conversion, street railway properties consisting of terminals and repair shops purchased many years earlier, and which in the interim had experienced substantial appreciation in value, were retired to non-operational status. The D.C. Commission had determined with respect to this non-depreciable property, that the entire net amount of the appreciation should be credited to earned surplus.

The Court, with appellate jurisdiction over the D.C. Commission, remanded. Stating that the teachings of modern cases is plain (but citing none), the Court held that the investors' legally protected interest in such assets under such circumstances does not inexorably extend to the appreciation in value; that the benefit of capital gains accompanies the risk of loss, and then, measuring the reasonableness of the Commission's practices and procedures against "risk of loss" and "economic burden" doctrine standards, brushed aside the uniform system of account procedures to subjectively hold that where risk of loss of value of land was unlikely and farepayers

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awarded the gains to the ratepayers. The few judicial decisions involving appreciation in value issues appearing since show that the majority conclude that while Democratic Central Committee reflects its peculiar facts, it provides no precedent for change. Most note the reliance upon unusual circumstances, uniqueness, the windfall aspect, all in opposition to the usual case. The few cases following it also base their determinations upon special facts or circumstances, or are devoid of analysis.

While the concepts relied upon in Democratic Central Committee might be appropriate and have relevance in our jurisdiction under certain special circumstances, as for example where gross inequities and unique circumstances team up to create a situation demanding strong equitable intervention, they do not recommend themselves as concepts to be adopted as our standard in the usual case. We should not lightly abandon the time tested, constitutionally accepted precepts which lie behind the allocations codified in the uniform systems of accounts. There is no need to do so and it would be unfair to do so. Over the years this Commission has reserved for itself very considerable discretion to characterize and approve particular utility accounting entries associated with purchase, sale, or other dispositional transactions. These entries determine whether a particular transaction involves operating or non-operating facilities, the inclusion or removal of land from rate

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[15] (FOOTNOTE CONTINUED)

had shouldered significant financial onus with respect to such lands, and investors had already uniquely benefited in their ownership, the ratepayers were entitled to all the windfall appreciation in value of the properties at issue. While achieving equity, the decision was severely criticized in one penetrating law review note as "clearly contrary to all precedent and tends to both expand and derogate judicial review as a protection to both the investor and ratepayer interests." (Awarding In-Service Appreciation to Public Utility Ratepayers—Windfall or Prediction? 11 Cal. Western Law Review 160, 168, 173-74 (1974-1975).

base, including retired land held in the future use account. These determine whether retired property may be transferred to non-utility property accounts. We also have discretion to allocate extraordinary losses. We recognize that there may well be unique circumstances where the ratepayers indeed have borne the risks, or instances where the capital at risk has actually been provided by the ratepayers. In some instances, as for example when a public utility has been unable to attract or raise capital from conventional sources for projects deemed essential to the continued availability of utility service, we have ordered that funds for these purposes be provided from operating revenues (see Southern California Gas Co. (1972) 74 CPUC 30, 55; Pacific Lighting Service Co. (1973) 75 CPUC 604, 616; and the GEDA and EEDA Programs). In such special circumstances we have not hesitated to apply equitable principles to order either a sharing of gains or full allocation to the ratepayers. When egregious circumstances present themselves, "we cannot emphasize too strongly the necessity of examining each case on an individual basis to arrive at a equitable decision" (Southern California Gas Co. (1980) 4 CPUC 2d 725, 777).

As previously set forth, since Hope, state regulatory bodies are free to establish their own objectives, standards, rules, and procedures in the fixing of reasonable rates. The Supreme Court has stated that the power of federal judicial review in these matters should not superimpose a court's conceptions upon a regulatory commission so long as the commission has kept within the bounds of its delegated authority, and its ultimate actions do not impugn either the Constitution or the law (Northwestern Electric Co. v FPC (1944) 321 US 119). In California, the valuation concept we adopted is original cost, and that original cost valuation once set for rate base property does not change, whatever happens to the current valuation or market worth of that property. The Commission has repeatedly stated its policy to fix rates on the basis of original cost rate base and any excess in purchase price over original cost is not included as an element in such a rate base. Thus, if a utility purchases the operating system or property of another utility, and continues use of these purchased properties in service to the public, the purchasing utility is permitted to include only the predecessor's original cost less any retirements and depreciation in its rate base (San Diego Consolidated Gas and Electric Company (1917) 12 CRC 481, 485-486; Tuolumne County Electric Power and Light Company (1928) 31 CRC 189, 191; California Water Serv. Co. (1928) 31 CRC 327; Great Western Power Co. (1928) 31 CRC 718; Southern Cal. Edison Co. (1928) 31 CRC 615, 618-619; and California Cities Water Co. (1972) 73 CPUC 597, 607-608). Moreover, in disallowing any such premium paid by the purchasing utility from its rate base, we have required the purchaser to charge that excess over the seller's depreciated original cost against the purchaser's surplus so that it is paid for by the purchaser's shareholders in the form of diminished dividends (San Diego Consolidated Gas & Electric Co., supra, at 485-486; California Water & Tel. Co. (1966) 65 CPUC 281; Pacific Gas & Elec Co. (1950) 49 CPUC 386; and Pacific Gas & Elec. Co. (1954) 53 CPUC 573). In addition, should assets be purchased by a utility at a discount below the seller's depreciated original cost, the purchaser utility's resulting rate base is reduced by the amount of that discount (San Gabriel Valley Water Co. (1974) 77 CPUC 541). But further, the shareholders of the utility selling a utility system below depreciated original cost must themselves assume the loss (Pacific Gas & Elec. Co. and Tuolumne County (D.83-12-064 dated December 20, 1983 in A.83-08-13, and Pacific Gas & Elec Co. and Placer County Wtr. Agency (D.83-12-051 dated December 20, 1983 in A.83-08-05).[16]

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[16] The sale price in these two PG&E cases reflected a total book loss of approximately $4,000,000. Pursuant to traditional ratemaking, accounting, and constitutionally accepted practices, this loss would be allocated to PG&E's shareholders. Were we to revise our principles and hold that gain on sale of a utility system is

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From these foregoing cases dealing with the valuation of transferred utility systems for ratemaking purposes, it is evident that the economics of each transaction were such as always to insure that the ratepayer was left indifferent to the result. Always he was assured of continued utility service with a rate based solely upon the unchanged original cost less depreciation. Furthermore, despite any appreciation in the value of those assets, his rates would continue to be based upon original cost less depreciation. Rigid adherence to this fundamental concept has assured that it would be the investors who bore the entire risk that the market value of utility property, whether determined in a resale market, or as reflected on the stock exchange, might be different than his investment as reflected on the utility books. From our early days this Commission, following original cost, has left the market valuation risk with the investor, but consistently we have also classified the consequences as non-utility income or loss.

To be fair and consistent, were we in the future, absent a need to rectify some grossly inequitable situation, to disregard these long-standing regulatory concepts and principles, and order the allocation of all or any portion of the capital gain obtained from the sale of utility land or systems to the ratepayers, we would have to reject the original cost valuation concept for rate base property and adopt a fair market valuation concept. But if fairly and consistently implemented, the alternative fair market value concept would expose ratepayers to many risks heretofore borne exclusively by shareholders and would cause rates to rise significantly to reflect the actual market value of the property providing utility service.

16 (FOOTNOTE CONTINUED)

either exclusively or partially to be allocated to ratepayers, consistency and equity would require that this $4,000,000 loss on the sale of the Placer County and Tuolumne County systems should also be commensurately allocated to their ratepayers. But the ratepayers involved will no longer be under our jurisdiction.

Indeed, to truly preserve the integrity of the investor's investment against declines in the economic value of the dollar, depreciation accruals for ratemaking purposes would have to be based upon current fair market value or replacement cost rather than original cost. At present, under original cost concepts, the ratepayer carries none of the risk of inflation in the rate base property. Nor should he except in exceptional instances including those we mentioned. As the Supreme Court stated, "The relationship between the company and its customers is not that of partner, agent and principle, or trustee and beneficiary" (Board of Public Utility Commissioners (supra, at 31).

F. Risks

Another argument frequently advanced is that utility investors are adequately compensated by their authorized return on rate base; that because public utilities operate in a sheltered environment they are so shielded from loss that there is little or no risk borne by the investor.[17] Accordingly, so we earlier noted, the argument goes that any gains on sale of appreciated utility property should at least be shared with those ratepayers who paid the costs and provided a return on the investment. If this argument were valid, then the utility investors would have been guaranteed their authorized return on the original cost portion of their investment, and also guaranteed commensurate increases to provide for the inflationary increases in the value of their rate base property. But this is not the case. While it is true that investors are allowed an opportunity to recover costs and earn some return, repeatedly it has been made clear that there is no guarantee that a utility will actually achieve its authorized return (see Southern California Edison Co. v PUC (1978) 20 C 3d 813, at 821 note 8). And, that there is a plethora of risk apart from the risk of inflation remaining for the investor to bear was extensively pointed up in the briefing on

[17] The recent insolvency of Washington Public Power Supply System should provide a current illustration of the fallacy of that argument.

this matter. As stated by the briefing parties, these risks include:

Loss of earnings on funds invested in failed or abandoned projects (San Diego Gas & Elec Co. (1979) 1 CPUC 2d 596, 601 (the Sundesert project), and Southern Cal. Gas Co. (1980) 4 CPUC 2d 725, 778 (Western Coal Gasification Co. project)).

Exclusion from rate base of inoperative electric generating plants (Pacific Gas & Elec Co. (1979) 2 CPUC 2d 596, 624-625, and San Diego Gas & Elec Co. (1980) 5 CPUC 2d 208, 258).

Failure of management to aggessively pursue development of cogeneration projects (Pacific Gas & Elec. Co. (1979) 3 CPUC 2d 1, 32).

Subsequent determination that a capital expenditure was excessive or imprudent (Washington Water & Light Co. (1978) 84 CPUC 551, and Continental Tel. Co. of Calif. (1981) 5 CPUC 2d 677, 719).

Improvident management of fuel oil exchange contracts resulting in losses (San Diego Gas & Elec. Co. D.82-08-018 dated August 4, 1982).

Failure of recorded experience to meet test year assumptions on which rates were based (Pacific Gas & Elec Co. (1980) 3 CPUC 2d 552, 559).

Failure of market price of stock to reflect book value and the effects of inflation (Cal. Water Service Co. (1981) 5 CPUC 2d 551, 568).

Nonetheless, the argument persists that shareholders receive adequate compensation from return on rate base to compensate them for all their risks, and that therefore gains on sales of utility assets would be merely windfalls to them, windfalls which should at least be shared.

But it is just plain hard fact that rates paid for service do not compensate for all the risks carried by the investor. Utility rates are predicated on two elements: first, directly ascertainable costs of record such as operating expenses, current plant depreciation and permissible taxes, and second, the rate of return which represents payment of interest on capital debt, preferred stock dividends and return on common equity. But as stated before, there is no guarantee that a utility will achieve its authorized return. The equity owner is entitled only to the residual earnings, that which is left over after all expenses, taxes, and fixed charges have been paid. His return is at best uncertain. He does not know how much he will get, if anything. Nowhere in the rate of return mechanism based on the original cost concept is the investor protected from the risk, or more properly, as it has developed over the past half century, the actuality, of loss in the purchasing power of the dollar value of the property and assets that the investors have invested as rate base property.[18] It was never intended that they should be so protected. The inflationary risk was always a risk that the investor alone was intended to bear.[19] We must not forget that the original cost concept assigned a valuation to the investor's property for our convenience and consistency in ratemaking, but while

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[18] As one respondent pointed out in this regard, asserting that the recent experience of one water utility is illustrative: between 1977 and 1982 the bank prime interest rate increased by 164%, the discount rate increased by 129%, and the yield on newly issued Class A utility bonds increased by 96%. During the same period the return on equity which the utility was authorized to earn increased by 12.9%, a rate of appreciation of less than 2.6% per year (D-82-09-069 dated September 22, 1982 in A.82-01-22, See Exhibit 16).

[19] All investors are constantly faced with variations in price levels. They make their investments in terms of the dollar value as of the time they invest capital or property in the enterprise and take the risk in regard to future changes in the dollar's purchasing power. But bondholders and preferred stockholders agree at the beginning to a fixed dollar return; they gain or lose as the price level changes, while common stockholders make their investments in terms of the instant dollar value and have no fixed dollar return agreements. They accept the risk of a regulated return in the case of public utilities. But they also assume price level risks which never have been definitely and separately defined, recognized, and provided for. Price index ratios have not been applied to the equity investment; and the risk of price level variations remains with the investor. The Commission has made it clear that the risk of changes in the purchasing power of the dollar, as represented by the investor's rate base plant, rests solely with the common shareholder (So. Cal. Edison Co. (1954) 53 CPUC 385, 389-391).

under that concept the consumer may also enjoy the usufructs of that property, he does not acquire the substance of it. It is that property which remains private property, not the valuation we assign to it. It is that property which under both the federal and state constitutions the owners may not be deprived of without due process of law and full compensation. And those constitutional protections also extend to any emoluments of that property which accrue to it while it is dedicated to the public service. As we have seen, the investor may have sustained a loss to initially acquire either that property or other property from another public utility, and he alone absorbs that loss. He alone must absorb inflation risks to the market value of his rate base and other property.[20] The original cost concept restricts earnings of the owners of the utility property to a depreciated rate base with no provision to offset possible ravages to the purchasing power of that rate base resulting from inflation, or to compensate for possible other appreciations in the value of that rate base property. Accordingly, it is only when utility property is sold that the owner investors are able to realize compensation for the inflationary risks that they alone have carried. And unless the owner investors are permitted to retain this appreciation at time of sale, they will not receive the total return to their capital to which as owners they are entitled.

G. Impact to Desirable Transfers of Utility Systems

To hold otherwise than to allow the owner investors to retain appreciations on sales of utility property would serve to block desirable transfers of utility systems. If we were to require that a selling utility must pass through to its ratepayers such gains

20 In terms of present-day dollars the true value of the investors' investment has been severely eroded. This is best illustrated by the fact that the replacement cost less depreciation of the facilities is often a substantial multiple of the rate base original investment on which utility earnings are based.

instead of allowing the investors to retain them, a sale simply would not go forward; a selling utility would be deprived of its incentive to sell. Desirable transfers frequently provide mutual benefits to both the buyer and seller utilities, but in addition such transfers may achieve efficiencies of significant benefit to the ratepayers, as in Associated Telephone Co. (1939) 42 CRC 441, where the transfer of utility properties reduced operating expenses, increased available technical staff and facilitated supply of equipment. To require the gain realized on a sale to go to the ratepayers of the selling utility would be unfair. They would receive a double benefit. They have already enjoyed the benefit of free usage of that portion of the property value represented by the fair market price premium over original cost; their rates have been based only on original cost. Now they would receive more -- the windfall represented by the gain. And that gain would represent plant not even employed in the service of the remaining customers; plant the expenses of which were not borne in their rates.

Another factor worthy of consideration arises out of Section 1033 of the Internal Revenue Code (26 U.S.C. Section 1033), which provides that gains on sale or transfer of property pursuant to or under threat of condemnation are not recognized for income tax consequences if the proceeds are reinvested in similar or related property within prescribed time limits. It is the general practice of California utilities to take advantage of these provisions. The deferred tax status is a strong incentive to reinvest the proceeds in additional or replacement utility plant. These tax provisions enable utilities to purchase smaller, less efficient systems and to offset at minimum cost the shrinkage in their service areas and in the number of customers, permitting economies of scale by distributing relatively fixed operating costs and overhead over the largest possible customer base.

E. Sales of Contributed Property

Remaining are issues associated with utility property which was acquired without cost to the utility and its investors, that is, donated or contributed facilities, property which subsequently is included in a sale of all or a part of the utility. Traditional regulatory concepts contemplate that utility company shareholders and not the consumers should furnish the capital necessary for operation of business; consumers should pay the costs of operation and a fair return on the shareholders' investment as rates paid for service. But it was early recognized that there would be instances in which the expenditure necessary to serve some specific area would be so large or in which other special conditions or requirements would be such as to make it unreasonable, both from the view of the utility and of its other subscribers, to require that the particular extra or special additions be made or facilities furnished solely at the cost of the utility. It was recognized that while beneficial to the utility as a whole, making such additions at the utility's expense would use up the limited utility capital available and might readily result in poor service conditions to existing consumers, placing overbalancing burdens upon the public.

In some such situations, extension agreements, where the benefited property owner advances the required funds against subsequent reimbursement from subsequently achieved revenues from the improvement, were the answer. In others, the proponent, usually a real estate developer, wanted, local governmental entities required, or Commission General Orders specified, special non or above standard facilities, modifications or additions. And the proponent agreed to pay the extra cost to get his project realized. The special facilities or the difference in cost were given to the utility, either as contributions in aid of construction or outright donations.[21]

21 Under provisions of the California Subdivision Map Act (Gov.

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Under exercise of our regulatory authority to set rates of public utilities, while such property is carried on the utility's books as contributed property, we have disallowed it in calculating rate base.[22] And although this donated property is legally still the property of the utility, and belongs to the utility's investors just as in the case of any private citizen or corporation counting gifts made to them among their lawfully acquired capital assets, under our uniform systems of accounts applicable for water utilities, we require that it continue on the utility books as a deferred credit against the investors' equity. If the property is plant or other facilities with limited useful life, this credit is reduced annually (much as depreciation would be applied to reduce a rate base asset's book value) as its useful life is expended. When its useful life is expended, the credit disappears. If the property is land, the deferred credit continues indefinitely at its original value on the

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21 (FOOTNOTE CONTINUED)

Code Section 66410 et seq.; before 1975 Bus. & Prof. Code Section 11500 et seq.), land developers may be required to dedicate easements and rights of way (and in some circumstances reasonable on- and off-site improvements) to the community for public utility use. Under the terms of their respective franchises, while acquiring no fee interest, the public utilities involved may use these.

22 Most jurisdictions exclude it. In Priest, "Principles of Public Utility Regulation", p. 177, it is said: "Court and Commission decisions holding that contributions in aid of utility construction must be excluded from rate base have been so uniform as probably not to require detailed citation." In essence the rationale is that it would be inequitable to require consumers to pay a utility a return on property which in virtually all cases they, not the utility, have really paid for. It makes no difference whether the contribution is made by the developer: any such costs originally laid out by the developer are passed on to lot purchasers in the form of increased prices for lots, and these lot purchasers, or their successors in interest, are the persons who must pay the utility rates. To allow a rate of return would provide the utility with income on an investment it did not make. California is in accord (Del Este Water Co. (1953) 52 CPUC 479, 482).

books. However, if the recipient utility is an electric or gas utility, the applicable uniform system of accounts specifies that the donated property, land, or plant, upon receipt be immediately netted on the books against the utility's plant in service, thereby reducing the utility's plant in service by the amount of donated property. Regardless of the class of utility, however, all the incidents of ownership devolve upon the utility relative to such donated property; the need to pay taxes, maintain it, assume liability for damage, and responsibility ultimately to replace it when it wears out in the case of plant or facilities. But as long as it is used or useful in public service, the taxes paid on it and the maintenance and other costs expended on it are recoverable to the utility as allowed operating expenses charged to <u>all</u> of the utility's ratepayers, not merely those immediately benefited, as for example those in the subdivision. The utility can hypothecate the property or sell it (subject to the limitations of § 851 et seq. of the PU Code). The Commission is not concerned, because of want of jurisdiction, with the purchase price,[23] although it is concerned with the amounts that might be charged to the utility's fixed capital accounts (<u>American States Water Co.</u> (1930) 35 CRRC 659). As long as the negotiations are carried on at arm's length, each side determined to consummate as good a bargain as obtainable, a public utility, as with any corporation in this state, may sell its properties at the best price obtainable (<u>Northern California Power Co.</u> (1919) 17 CRRC 279).

When utility property which consists of or includes donated property, either land or facilities, is sold to another public utility, the purchaser obtains the included donated property as its property, free of any encumbering deferred credit limitations.

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[23] In the past this Commission has repeatedly stated (apart from the limited specific authority contained in Chapter 8 of the PU Code) that it was doubtful whether the Public Utilities Act confers any such jurisdiction to determine sale-purchase prices on the Commission (<u>Truckee Electric Light & Power Co.</u> (1932) 37 CRRC 255).

Similarly, when donated property is taken by eminent domain or under the shadow of eminent domain, the acquiring public entity receives it free of any restrictions or accounting encumbrances. (In a transfer of public utility properties to a public entity, the Commission is not concerned with how the public entity will finance the acquisitions or record the transactions on its books. We have no jurisdiction over such public entities. (East Bay Water Co. (1928) 32 CRRC 436). In either instance the ratepayers transferred with the property are economically indifferent to the result. They will continue to receive service, and the acquiring entity, whether a public utility or a public entity, also has acquired the obligation of replacement of the specific donated facilities now being transferred, when they eventually wear out. The selling public utility owes nothing further to its former ratepayers who transferred with the property. Its obligations are prospective and only to its remaining ratepayers. In City of Fresno, supra, see Footnote 5, the Court also stated that the law is well settled that customers of a public utility company do not have any interest in the property being taken in eminent domain; that their only right is to continue to receive service. And for that they must look to the public entity.

As we discussed in D.83-02-044 dated February 16, 1983 in A.82-11-27 (PG&E and the City of Redding), sales and transfers of utility property to public entities, usually accomplished under shadow of eminent domain, are rarely beneficial to the coerced public utility and its remaining customers. These transfers mean fixed costs to be all too often spread over fewer customers, lost expansion opportunities which might have brought economies of scale, curtailed operations, employee layoffs, and a generally weaker utility. Often it is the cream that has been skimmed. It may take time and more than one or two such losses before serious detriment results to the ability of the utility to serve its remaining customers, but often higher costs must result, at the least. There is no reason an acquiring public entity should not pay fair value for contributed property that it is acquiring.[24] The public entity always has the choice of proceeding under eminent domain or of avoiding that expenditure of time and money by negotiating a sale and price with the public utility directly in an arm's length negotiation. As we stated in D.84-03-018 dated March 7, 1984 in A.83-12-42 (PG&E, the City of Mendota and Mendota Redevelopment Agency):

> "While PU Code § 851 provides that no public utility other than a common carrier by railroad may sell the whole or any part of its system or property useful in the performance of its public

24 In D.82-01-62 dated January 19, 1982 in Case 9902 (Uniform Main Extension Rules for Water Utilities), we noted as persuasive reasons including:

- Absent the possibility of compensation in event of condemnation for the added risk and responsibility of operating and managing the contributed plant, a utility would have no incentive for accepting such plant.

- In the few instances the Commission has required that contributed plant be transferred to a public agency without compensation, special circumstances prevailed.

- Excluding contributed plant from just compensation would encourage condemnation proceedings by offering public agencies the opportunity to acquire public utility property at considerably less than its replacement cost less depreciation.

Also see City of Los Angeles (1916) 11 CRRC 83 at 87 where the Commission stated:

> "If the investor is assured that he will continue to receive fair treatment in California, he will continue to invest vigorously in our public utilities, even though he realizes that our cities have the power to condemn existing public utility properties, for he will know that on such condemnation he will receive compensation which in law and in fact is a 'just compensation.' But if the state tribunals in such eminent domain proceedings make awards which are unfairly and unjustly low, so that the property is taken from its owner and given to a municipality for a sum which is less than a 'just compensation,' the investor will, of course, seek other states for his investments."

> duty without first obtaining authorization to do so from this Commission, under present operation of law, where a municipality is involved and with its abeyant eminent domain powers at mind, the approval of this Commission is substantially a ministerial act so long as there is fair and just compensation provided to the public utility for the voluntary sale."

A purchase price determined between the parties involved, by arm's length bargaining, is ordinarily accepted as being a proper price (Pacific Tel. & Tel. Co. v Public Utilities Commission (1950) 34 C 2d 822). In a proceeding where a public entity is the purchaser, the purchase price no longer will have any relevance as a claimed basis of value in any Commission order relating to rates or involving the issuance of stock or other securities. Accordingly, the amount of the purchase price is best left to negotiation and resolution between the parties, and we will accept the price which results as just compensation.

II. Conclusions

After consideration of the foregoing, it appears clear to us that the investors' entitlement to capital gains from the sale of utility property generally rests upon firm constitutional as well as upon strong equitable and practical considerations. While the treatment to be accorded such book gains should be considered on an individual basis to allow for application of equitable principles to avoid egregious situations, we intend as a general rule to be guided by the original cost ratemaking policies and accounting instructions embodied in the various applicable uniform systems of account to find that these gains do not represent income from utility operations and must therefore inure to the investors.

As regards donated property subsequently sold, we determine that if the selling public utility transfers only part of its public utility property, while continuing in public service with the remainder, proceeds from the sale of any donated property included in that transfer transaction, whether land or facilities, and including any gains realized on the sale on the book value of such transferred donated property, should be retained by the seller as a donated property fund for future expenditure by and at the utility's discretion to replace remaining or acquired other donated property as the useful service life of that other donated property is used up.

If the selling utility transfers all of its public utility property, including any donated property it holds, and leaves public service with no further public utility obligation, the proceeds of the sale of that donated property, including accretions realized on its book value on the sale, are its property since it is the legal owner, and it has no remaining ratepayers to whom it has any further obligation.

II. Application to This Proceeding

By this sale PG&E is transferring operating systems, with 172 residential customers attached, to the city. Acquisition of these systems by the city will enable the purchaser to obtain, transmit, and sell electricity to these present and all future customers in the annexed areas involved. All the customers presently attached to the systems will become attached to the Redding system and hereafter will be served by the city. The severance between PG&E and these particular customers is evidenced by the joint request in the application that PG&E be relieved of all electric public utility responsibilities within the annexed areas.

The purchase price of $378,063 being paid by the city to PG&E for these operating systems includes a gain on disposition of property of $181,608 over the depreciated original cost of the operating systems. The systems being transferred are the property of the utility, and thus belong to the utility's investors. Except indirectly as regards the poles discussed below, ratepayers have contributed nothing to the acquisition of this property, and having contributed nothing they have no interest in it; they assumed no risk while it was in rate base, and have acquired no legal or equitable interest in the gain being realized on the sale of the property to the city.[25] Accordingly, pursuant to ratemaking policies and practices long followed by this Commission and codified in the instructions contained in FERC's Uniform System of Accounts' Electric Plant Instruction 5-F, adopted and prescribed by this Commission, this gain, with the exception applicable to the $6,452 discussed below relative to the poles, should be classified as non-utility income. As such it is the property of the utility and its investors. This transaction and the property involved in it reflect no special circumstances, such as were prevalent in Democratic Central where gross inequities and unique circumstances coalesced to create a situation that demanded equitable intervention. Therefore, when recording this transaction on its books, PG&E should credit to its plant accounts the historical cost (plus that of any additions or betterments), and debit its depreciation reserve account with the amount representing depreciation accrued at the time of transfer. Any increase realized from the sale between the historical cost and the purchase price should in turn be credited to the capital surplus account. Excluded, of course, is the $6,492 discussed below.

Included in the purchase of these operating systems are 18 steel and 16 concrete poles. These are poles which exceed utility standards in strength, ornamentation, etc. When these poles were originally installed PG&E was responsible for that share of their cost which represented the cost for standard utility pole installations. Developers contributed that share which represented cost exceeding standard utility pole installation. The extra costs

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25 Also included in the purchase price is $460 representing costs at today's level for PG&E's survey costs and recording fees incurred for recording a ½-mile long easement obtained years ago from a customer. PG&E records any such easements or rights of way acquired when installing facilities for customers, and places the cost of such surveys and recording into rate base. If the system is subsequently sold, these survey and recording costs are recovered as part of the purchase price. No land where PG&E held fee rights was involved in the present transaction.

contributed originally by developers toward these poles was $6,452 (S114 for each of the 18 steel poles and $275 for each of the 16 concrete poles). It is possible that in the years intervening since original installation some of these special poles would have required replacement. When such replacements are made PG&E provides the full cost of such replacement. Such replacement investment by PG&E would lessen the amount of donated property involved here, but the costs involved to trace such replacements are substantial, and PG&E has furnished no evidence of such replacements.

Obviously PG&E will continue operations in furnishing public utility service elsewhere in its extensive service territory. Accordingly the $6,452 proceeds from the sale of donated property included in the transfer to the city should be retained by PG&E as a donated property fund to be used for future replacements by and at the utility's discretion of any other donated property, acquired before or after, as the useful life of such other donated property is used up.

There was no opposition to the instant application and there is no need to set the matter for public hearing. The information contained in the application, obtained from the briefing, and supplied by the utility, and the decades of ratemaking principle and practice, particularly with reference to the uniform systems of account which we are substantially simply reaffirming, provide solid ground for the present decision. The sooner the sale and transfer are approved, the sooner the customers directly involved can obtain the lower city rates and charges promised them. The application will be approved as set forth herein.

Findings of Fact

1. Both the federal and the California Supreme Courts hold that private property does not cease to be private property when put to a public use, and it can be taken only by due process of law.

2. California is a public utility original cost jurisdiction, limiting valuation for ratemaking purposes of rate base property to depreciated acquisition cost or cost when first placed in public service, whichever is the lesser.

3. The federal Supreme Court holds that customers of a public utility pay for service, not for the property used to render it.

4. Under the original cost concept while the consumer may enjoy the usufructs of the investors' property, he does not acquire the substance of it.

5. Depreciation maintains the integrity of the investors' property investment to the extent of the original cost valuation placed upon it when first placed in public service, but not the current actual value of that property.

6. Under well-accepted and long-standing accounting procedures of the FERC Uniform System of Accounts prescribed by this Commission and applicable to California electric utilities, appreciations in value of utility systems while in service, as relevant to this proceeding, do not represent income from utility operations, and therefore inure to the investors. Other California uniform systems of account are in accord.

7. To deviate from uniform systems of account policies and practices now to deny investors gains which in effect they had bargained for earlier when they invested and assumed the risk of loss, would result in a substantial negative impact on the investment community, which necessarily must translate into additional risk - risks for which the investor in the future, free to choose his ventures, would require additional compensation.

8. The economics of utility acquisitions and divestments under the requirements imposed by this Commission, whether the transaction

involved a discount or a premium, are always such as to leave the ratepayer economically indifferent; he is assured continued service and the rates will continue to be based upon original cost less depreciation.

9. Deviations from uniform systems of account policies and practices to deny investors gains upon sale of their utility property would remove the incentive for desirable transfers, including those sought by the Commission.

10. PG&E provides public utility electric service in many areas of California, including areas in and about Redding.

11. The city, a California municipal corporation, for some time has owned and operated an electric distribution system in areas within municipal limits.

12. At different times within the past years the city has annexed unincorporated areas, including the specific four areas which are the subject of this application, wherein the electric service or the obligation to provide electric service was the obligation of PG&E.

13. In the interim since annexation, PG&E has continued to provide Area 80-10 with electric service, and was ready if requested to provide Areas 80-6, 80-7, and 80-8 with electric service.

14. The city itself has plans to provide the electric service in these four areas, and has contracted with PG&E to purchase the existing distribution and street lighting facilities in Area 80-10 from PG&E and will incorporate these facilities into the city's electric distribution system.

15. The purchase price negotiated between the city and PG&E for the facilities, the proposed payment of net value plus 15% for additions, the proposed payment of applicable severance costs, and the proposed proration of current ad valorem taxes constitute a just and reasonable compensation for the transfer.

16. PG&E will continue to own, maintain, and operate certain through circuit lines in the 80-6, 80-7, and 80-8 areas.

17. The furnishing of electric service in the four annexed areas by the city will not result in rates and charges to the customers of these areas in excess of those paid to PG&E.

18. There is no known opposition to the proposed sale and transfer.

19. It can be seen with reasonable certainty that there is no possibility that the sale and transfer of these particular facilities alone may have a significant effect on the environment.

20. The proposed sale and transfer of these particular facilities, under all the conditions applicable, would not be initially adverse to the public interest.

21. The sooner the sale and transfer can be consummated, the sooner the customers in the areas involved may be able to obtain the lesser rates and charges the city plans to offer them.

22. Line extension balances to the three customers involved will be refunded by PG&E after the city assumes ownership.

23. Upon completion of the sale and transfer PG&E should be relieved of its electric public utility obligations in the four annexed areas.

24. PG&E should be permitted to classify the gain realized over depreciated book value of the electric systems involved in this transaction, except for $6,452, as non-utility income.

25. $6,452 of the gain to be realized by PG&E on this transaction, representing facilities acquired without cost by PG&E, should be set aside as a donated property fund for future expenditure by and at the utility's discretion to replace remaining or other acquired donated property as the useful life of such other donated property is used up.

Conclusions of Law

1. Investors' entitlement to capital gains from the sale of utility property rests upon firm constitutional as well as upon strong equitable and practical considerations.

2. Only in egregious situations where ratepayers in fact have advanced the capital at risk, in whole or part, or have assumed or shared the risk of immediate loss, should we determine that the ratepayer is entitled to all or part of the benefit accruing out of appreciation in value of utility property while that property was in service.

3. Long experience demonstrates that the original cost ratemaking policies embodied in the uniform systems of account most properly balance the interests of ratepayers and investors in the variety of circumstances and transactions that confront us these days. Accordingly, we should reaffirm our adherence to the general policy that the uniform systems of account will govern these sales transactions and allocations of gain presently and in the future.

4. A public hearing is not necessary.

5. The application should be granted as provided in the following order.

**O R D E R**

IT IS ORDERED that:

1. We affirm adherence to the general policy that accounting procedures of the uniform systems of accounts prescribed by this Commission for California public utilities will continue to govern sale transactions of all or a part of a public utility, including allocations of gains realized on a sale, except in egregious circumstances wherein the ratepayers have advanced the capital at risk, or have assumed the risk of immediate loss.

2. Within six months after the effective date of this order Pacific Gas and Electric Company (PG&E) may sell and transfer to the City of Redding the electrical distribution and street lighting facilities set forth in their September 17, 1982 agreement annexed to and made a part of their application as Exhibit B.

3. Within 10 days of the actual transfer PG&E shall notify the Commission in writing of the date on which the transfer was consummated. A true copy of the instrument of transfer shall be attached to the written notification.

4. Within 90 days after the date of actual transfer, PG&E shall advise the Commission's Revenue Requirements Division, in writing, of the adjustments for additions and betterments made in accordance with Exhibit B annexed to and made part of the application, except that these adjustments shall reflect the setting apart of a donated property fund to be used hereafter at the discretion of PG&E to replace remaining or other acquired donated property as the useful service life of such other donated property is used up.

5. Within 90 days after the date of actual transfer, PG&E shall make refund of all line extension balances outstanding, and when these refunds are completed, shall advise the Commission's Revenue Requirements Division, in writing, of the fact.

6. Upon compliance with this order, PG&E shall stand relieved of its public utility obligations in connection with electric service in the four areas which are the subject of this application.

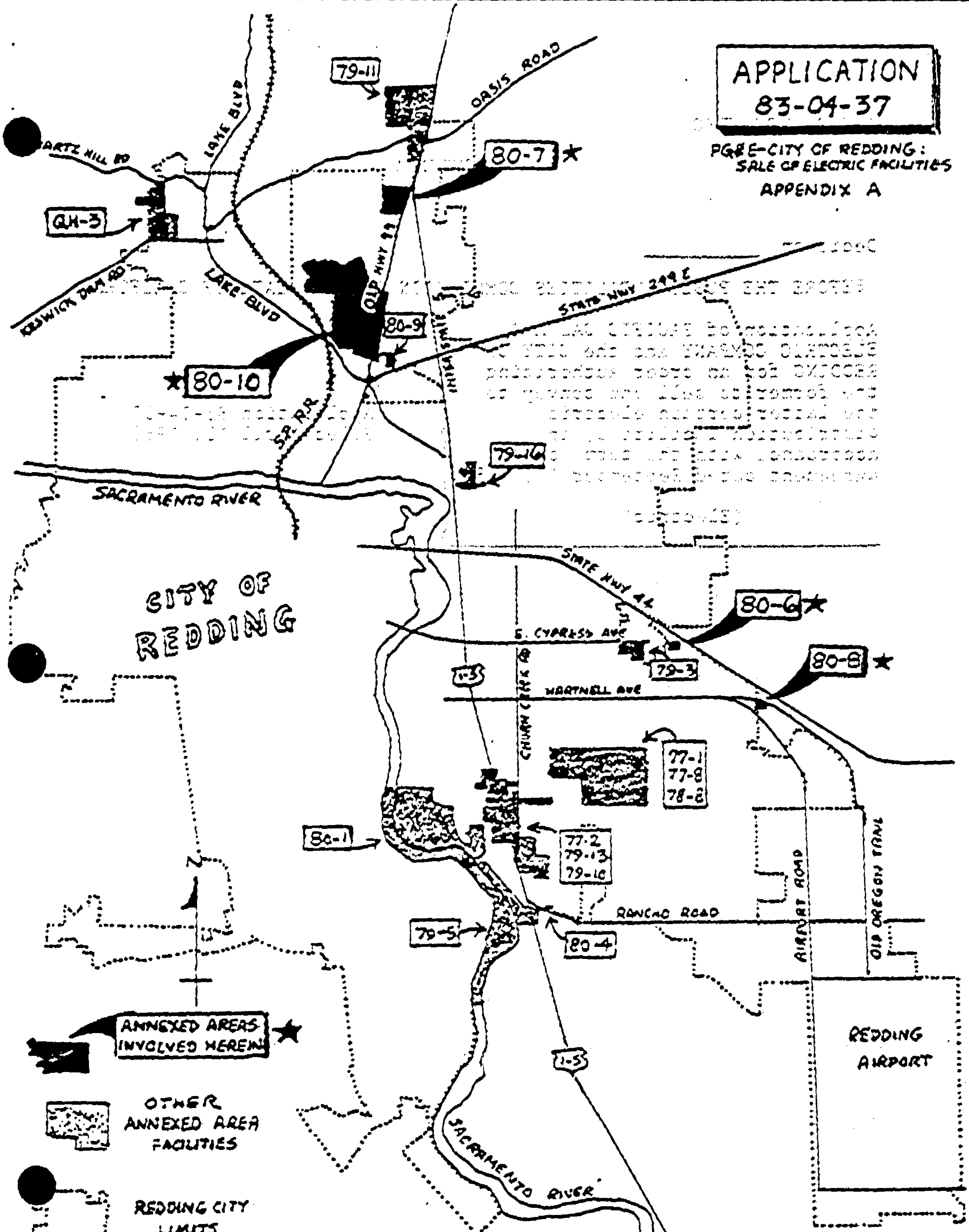
This order becomes effective 30 days from today.

Dated ______________, at San Francisco, California.

APPLICATION
83-04-37

PG&E-CITY OF REDDING:
SALE OF ELECTRIC FACILITIES

APPENDIX A



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Decision ____________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

| | |
|---|---|
| Application of PACIFIC GAS AND ELECTRIC COMPANY and the CITY OF REDDING for an order authorizing the former to sell and convey to the latter certain electric distribution facilities, in accordance with the terms of an agreement dated September 17, 1982. (Electric) | Application 83-04-37 (Filed April 13, 1983) |

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I N D E X

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# O-P-I-N-I-O-N

## Statements of Facts

Pacific Gas and Electric Company (PG&E) since October 10, 1905 has been an operating public utility corporation organized under the Laws of the State of California. PG&E is engaged principally in the business of furnishing electric and gas services in California, although it also distributes and sells water in some cities, towns, and rural areas, and produces and sells steam in certain parts of the City of San Francisco.

The City of Redding (the city), located in Shasta County, is a municipal corporation existing under the laws of the State of California. For some time the city has owned and operated an electric distribution system located within its corporate limits. From this system the city furnishes electric service to its residents and inhabitants.

During the 12-month period ending July 31, 1982, in accordance with its obligation as a public utility, PG&E supplied electric services to 172 residential customers in a formerly unincorporated area outside the city's boundaries.1/ In addition, PG&E had certain through circuit facilities in three other formerly unincorporated areas outside the city's boundaries, but noncontiguous to the before mentioned residential area. In

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1/ One of these customers is a master meter account with 138 mobile home spaces.

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recent years the city has exercised its powers of annexation and these same four areas were annexed to the city on the dates shown.

| Annexation | Date of Annexation |
|---|---|
| 80-6 | October 17, 1980 |
| 80-7 | October 17, 1980 |
| 80-8 | December 18, 1980 |
| 80-10 | April 10, 1981 (residential services) |

These four areas are shown on the Appendix A map.

Following these annexations the city desired to acquire PG&E's electric distribution facilities which served, or might in the future service the areas, to incorporate them into its municipal distribution system, but not to acquire PG&E's through circuit facilities in Areas 80-6, 80-7, and 80-8. Accordingly, the city and PG&E on September 17, 1982 executed an agreement whereby the city would purchase the poles, conductors, conduits, meters, transformers, fixtures, street light and signal systems, etc. involved within annexed Area 80-10.

By this application PG&E and the city seek an ex parte order of the Commission authorizing the sale and transfer of PG&E's electric facilities, including any additions and betterments, within annexed Area 80-10 to the city. Upon acquiring these properties, the city intends to furnish the electric service presently supplied by means of these facilities, charging and collecting rates and charges not in excess of those presently paid to PG&E by the customers involved, and to provide such electric

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service as may be required in the future in all four of the annexed areas. Concurrent with the connection of the customers in annexed Area 80-10 to the city's facilities, PG&E also seeks to be relieved of its public utility obligations within all four annexed areas.

The purchase price for the facilities purportedly reflects replacement cost less depreciation, and is in the amount of $378,063.[2/] In addition, the city will pay to PG&E its severance costs of $2,297. Further, as to any additions to and retirements that may be made subsequent to June 25, 1981 and prior to conveyance, the city will pay PG&E:

a. The net value of the facilities (as determined under the practice set forth in the Uniform Systems of Accounts),

b. 15% of such net value, and

c. any applicable severance costs.

The current ad valorem taxes for the tax year in which the facilities and any additions and betterments are conveyed will be prorated as of the conveyance date.

The city has been advised that certain of the facilities involved contain polychlorinated biphenyls (PCBs), and the city has agreed to hold PG&E harmless for any and all liability arising from such substances, or from any failure of the city to perform its

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2/ The historical book cost, less depreciation, of the facilities involved is $196,455.

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utility obligations to customers in the areas. PG&E will assign all private grants of rights of way and easements for the facilities concurrently with delivery of the deed(s).

For the 12-month period ending July 31, 1982, PG&E derived a gross annual revenue from these 172 customers of approximately $158,000. As of October 25, 1982, PG&E held line extension deposits of three customers involved in this application amounting to $11,938.17. Balances remaining after the city assumes ownership of the facilities will be returned to the customers. Notice of the application appeared in the Commission's Daily Calendar of April 15, 1983. No protest has been received.

While most California communities obtain their electric services from privately owned public utility corporations such as PG&E, some cities prefer and are able to invest in the acquisition of their own electric distribution facilities and thereby are able to take advantage of the low wholesale power rates available to cities under preferential allocations from federally owned hydroelectric projects. Having lower financing costs than do privately owned public utility corporations and not having to pay income taxes, cities are sometimes able to deliver electricity to the residents and businesses within their boundaries at rates lower than those that the public utility must charge. But to be eligible for preferential allocations from federal power projects, a

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municipality must own its own distribution facilities, and must accept utility responsibility to serve all present and future customers in the area it will serve. Lacking its own transmission lines, a city usually pays the area public utility to wheel the federal power from the federal project source to the city's distribution lines. Then, to fully meet its utility responsibility the city further contracts with the area public utility for a wholesale purchase to make up any supplemental power supply it will require over and above its federal allocation. In many instances this places upon the area public utility the requirement that it have available peaking period capability.

In California a municipal corporation is empowered to acquire, construct, own, operate, or lease any public utility (West's Ann. Pub. Util. Code Sec. 10002). Thus, Redding has the power of eminent domain to acquire by court action the electric distribution and street lighting facilities within any area annexed to the city. Furthermore, each annexation and acquisition of electrical facilities entitles the city to a larger share or allocation of any federal power which becomes available the next contract period. Under such circumstances, in order to avoid condemnation suits, and to compromise possible expensive litigation, the public utility corporation involved with an

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annexation area similar to the present situation is often willing to sell its involved facilities to the city by direct negotiation and contract.

Such is the procedure being followed here. Rather than proceeding by eminent domain, in the interest of saving both time and legal expense, Redding and PG&E have agreed upon the price and have contracted to perform accordingly. There having been no opposition to the application, Administrative Law Judge (ALJ) Weiss proceeded ex parte and, after close of the protest period in the Commission's Rules of Practice and Procedure, submitted his proposed decision to the Commission.

Incidental to the transfer transaction was the fact that the purchase price contracted upon between Redding and PG&E included a substantial increment over the net book or depreciated rate base value of the property to be transferred. We determined that the issue of who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base should be addressed more fully. Accordingly, in a companion matter involving the same issue, Applicatiion (A.) 83-06-11, in Decision (D.) 83-06-096 dated June 29, 1983 (Arcata-PG&E), we deferred resolution of the issue and directed that this Redding-PG&E proceeding be reopened and the issue be addressed after providing opportunity for briefing.

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Thereupon, the ALJ issued his Ruling Reopening the Proceeding to Obtain Briefing on July 26, 1983 in this Redding-PG&E proceeding.

In addition to the parties directly involved, an invitation for amicus briefs was mailed on July 26, 1983 to a broad array of organizations and entities who it was believed might participate.3/ Briefs were requested by August 19, 1983. The Commission received briefs from eight respondents.4/ Although specifically invited and urged to participate, a half dozen cities

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3/ Apart from the immediate parties, invitees included all major California gas, electric, and water utilities; the California Water Association; the League of California Cities; the California Streetlighting Association; the offices of the city attorneys of San Francisco, Ukiah, Arcata and San Mateo; Toward Utility Rate Normalization (TURN); the Pacific Legal Foundation; and the County of San Mateo.

4/ Six respondents took the position that as a matter of law, fairness and logic, utility property belongs to the utility and its investors, and that any determination to the contrary would inhibit sales of utilities as well as seriously and adversely affect sales of utility stock and bonds. Two of these ask that the Commission reaffirm continued adherence to the time tested principles codified in Uniform Systems of Accounts. One of these recognized that special circumstances could require departure from those principles and accordingly recommend disposition on a case-by-case basis where such circumstances were present to arrive at an equitable resolution.

Two respondents (one a joint response by two cities) registered objection to what they considered to be an inappropriate vehicle to determine these issues, and then, after contending that eminent domain was not relevant, proceeded independently. The joint response, relying upon a 1973 federal decision, contended that rate base property gains should go to ratepayers, except in special circumstances, while pointing up the question of which ratepayers. The second had

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and one county joined by the League and the Streetlighting Association elected as an alternative to write letters to the Commission voicing objection to the decision by the Commission in this proceeding to avoid over judicialization in favor of proceeding under its rulemaking authority by way of briefs. Upon receipt of the briefs the matter was submitted.

<u>Discussion</u>

Public Utilities (PU) Code Section 851 provides that no public utility other than a common carrier by railroad may sell the whole or any part of its system or property useful in the performance of its public duty without first obtaining authorization to do so from this Commission. In transfer proceedings the function of the Commission is to protect and safeguard the interests of the public. The concern is to prevent the impairment of the

4/ (FOOTNOTE CONTINUED) no position how proceeds should be treated under different circumstances, but objected to sale of dedicated facilities to public entities at reproduction cost new less depreciation, contending unjust enrichment.

Participating respondents were: California City/County Street Light Association, Southern California Edison Company, PG&E, California Water Service Company, San Gabriel Valley Water Company, California Water Association, Greak Oaks Water Company, and the City and County of San Francisco/City of San Diego.

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public service by the transfer of utility property into the hands of companies incapable of performing an adequate service at reasonable rates or upon terms which will bring about the same undesirable result (So. Cal. Mountain Water Co. (1912) 1 CRRC 520). Therefore, we want to be certain that the purchaser is financially capable of the acquisition and satisfactory operation thereafter. But where a municipal corporation or other public entity is the purchaser, these considerations are less compelling. Public agencies may be entitled to the presumption that they are creditworthy and will operate the public utility system in a manner consistent with the public interest. However, that presumption, if applied in any given matter, is rebuttable and we retain the vital and substantial authority of approving the transaction. If necessary, this Commission may grant its approval subject to conditions reasonably calculated to protect the public interest. Tustin Water Works, Decision 92360, Application 59671, 4 CPUC 2d 427 (1980), slip opinion at 12 (limitation on rate increases and rate design) 5/ And we may certainly examine the price agreed upon between the public utility and the public agency to determine its reasonableness.

5/ One court has held that a public agency may pursue a condemnation action should the Commission impose conditions unacceptable to it. People ex rel. Public Utilities Commission v. City of Fresno, 254 Cal. App. 2d 76, 88 (1967). The California Supreme Court has yet to consider this question. But cf., PU Code Section 1759.

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In this proceeding, the city has agreed to assume the utility obligation to provide electric service in the annexed areas. The city will hold PG&E harmless from any and all liability arising from any failure of the city to perform these utility obligations. The city also accepts responsibility for any liability arising out of the latent PCB potential. Those customers with line extension deposits will have the balance returned by PG&E after the city assumes ownership. The through circuit lines of PG&E in the 80-6, 80-7, and 80-8 areas annexed remain unaffected.

The purchase price reflects replacement cost less depreciation of the facilities being sold, and was agreed between the parties. The parties assert that their agreement is fair, just, and reasonable both as to the parties and to the customers affected. We have examined the record before us and hold that the purchase price is fair, reasonable and not adverse to ratepayers.

I. <u>The Capital Gains Issue</u>

There remains the issue which we directed to be briefed in this proceeding: who, the investor or the ratepayer, should receive any gains which may be realized on disposition of utility property which is or has been in rate base? It became apparent from the briefs that resolution of the issue necessarily involves consideration of the interrelationship of fundamental concepts involved in ratemaking and ownership of property, and their application to a spectrum of situations.

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A. General Principles

In the private or free enterprise sector, although absolute economic freedom is not possible, generally speaking, the owners of a business are free to set prices and dispose of their property as they choose, subject only to the constraints of competition and compliance with antitrust laws. The full risk of gain or loss from the enterprise lies with the entrepreneur. He sets prices to recover not only all his costs, depreciation, and taxes, but also a return on his investment. Furthermore, he expects to earn on the changing current fair value of that investment. If there is inflation, his prices advance more or less commensurately with the increasing value of his investment and are set to also recover his increasing inflated costs. Should he sell all or part of his business or its assets, after he pays the taxes, any gain or loss is exclusively his. His customers have no right, claim, or obligation to share in the profits, gains, or losses which may result. The risks are all the entrepreneur's.

On the other hand, many public utility enterprises are, although privately owned and managed, monopolies operating free from competition and antitrust constraints. And long ago experience demonstrated that these enterprises cannot be left free to operate unrestrictedly under the price-profit system. In the public interest they must be regulated, and the key to such

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regulation rests in the authority of a regulatory body such as this Commission to determine the rates they will charge and the profits which they may reasonably earn.

Rate regulation has received both criticism and plaudits from the investment community. On the one hand, ratemaking is criticized as a constraint on earnings, a constraint which is anathematic to the fundamental principles of free enterprise. On the other hand, ratemaking is credited with providing investors with some reasonable assurances that earnings and dividends will be reliable and constant, assurances not ordinarily available in free markets buffeted by supply and demand shocks, competition and a host of other variables. We have recognized in our decisions that utility investors, as compared to the general aggregate body of investors, are more conservative and to a greater degree seek to avoid or minimize their investment risks. Southern California Gas Co. Test Year 1981 Rates, Decision 92497, Application 59316, 4 CPUC2d 725, 777 (1980); San Diego Gas & Electric Co., Decision 90405, Application 58067, 1 CPUC2d 644, 660 (1979). Thus, these investors seek the relatively safe harbors of utility investments.

Under our scheme of regulation, it is not true that the full risk of gain or loss lies with the entrepreneur or investor. The utility ratepayer bears a substantial portion of the risks of doing business which are ordinarily the responsibility of the entrepreneur. In the usual case, the utility's bondholders and

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shareholders provide the monies which are used to capitalize the utility's investments in plant. However, assuming that a particular capital asset passes a reasonableness and cost prudency review, ratepayers inherit the responsibility for the risk of the investment. Ratepayers pay for the depreciation on the investment which represents the return of capital to the utility's bondholders and shareholders. Ratepayers also bear the responsibility for write-offs of plant. In many cases, depreciation is "represcribed" to reflect an earlier-than-anticipated retirement of plant. Represcription is one accounting method by which write-offs are accommodated. In some cases, we have permitted amortizations of plant balances (plant-in-service costs less depreciation reserve) associated with prematurely retired plant to reflect the complete write-off of plant no longer useful to the provision of utility services. In summary, the ratemaking recognition of depreciation expense and write-offs demonstrates that ratepayers generally bear the risks of investment with respect to most utility plant.

B. The Risk of Theory of Allocations

In determining whether ratepayers or shareholders are entitled to the gains or responsible for the losses accruing from sales of utility plant, we have applied a risk analysis. Essentially, the risk theory of allocations calls for the apportionment of capital gains between ratepayers and shareholders

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depending upon the extent to which each would have borne the risks of investment or "unreturned capital" had the property never been sold. The "risks of investment" refer to which group would have borne the responsibility for the write-off of a capital asset. Since ratepayers, as noted above, ordinarily bear that responsibility, they are generally entitled to the benefits of any capital gains accruing from a sale of utility assets and, conversely, are responsible for capital losses as well.

This approach was adopted in the leading case of Democratic Central Committee etc. v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir., 1973), rehearing denied, cert. denied, 415 U.S. 935 (1973). That case involved the sale of real property owned by a regulated, investor-owned transit district. The district had withdrawn the parcels from service, recorded them "below-the-line", and sold them at a substantial profit. The regulatory commission approved the district's allocation of the gains to capital surplus accounts, i.e., to investors. Appeals were taken and the court of appeals reversed the commission's ruling.

The court required the gains to be recorded to operating revenue accounts, i.e., given to ratepapers. The court's reasoning followed the risk of investment principles described above. Finding that investors in regulated utilities had no constitutional or equitable claims to any appreciation in the value of the

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utility's assets, the court noted that investors and ratepayers started on equal footing and went on to compare the risks borne by each group. It held that investors bore few risks of investment or had otherwise been compensated for their risks:

> "A factor strongly influencing the rate of return to which the utility investor becomes entitled is the magnitude of the risk which his investment encounters. High risks justify larger returns, while low risks more nearly guarantee the investment, and so may warrant smaller returns.
>
> Similarly, an investor can hardly muster any equitable support for a claim to appreciation in asset value where he has been shielded against the risk of loss on his investment, or has already been rewarded for taking on that risk."

Id. at 806 [footnotes omitted]. Conversely, the court noted, ratepayers bore substantial capital risks:

> "[G]rave risks associated with utility assets are commonly thrust upon consumers. Many are susceptible to loss or damage from acts of nature and man, and risks of such casualties are usually passed on to consumers. The risk of loss from premature retirement of assets because of obsolescence, as a general rule, also falls on consumers."

Id., at 807 [footnotes omitted]. The court concluded that justice required the benefits of any gains to follow the burdens of capital losses and that, therefore, ratepayers were ordinarily entitled to the gains from the sale of utility assets. Id., at 811. We have previously adopted the principles enunciated in Democratic Central Committee. See Re PG&E Utah Coal Reserves, Decision 82-12-121, OII 82-05-01, ________ CPUC ________ (1982). In that

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case, PG&E through its subsidiary, Eureka Energy Company, had sold various coal properties acquired as a fuel source for the now-cancelled Montezuma electric generating station in Solano County. We held that, since ratepayers would have borne the risks of loss had the sale been at a price below book value, ratepayers were entitled to the gains which in fact accrued from the sale. *Id.*, slip opinion at 23-24; accord in principle, *San Diego Gas and Electric Test Year 1984 Rates*, Decision 83-12-065, Application 82-12-57, ______ CPUC ______ (1983), slip opinion at 87-88; also, *Southern California Gas Co. Facilities Lease*, 84 CPUC 405, 420-421 (1978). We find no good reason to depart from our precedents in this case.

Various parties have argued that the risk analysis approach constitutes poor regulatory policy. We will here address the three principal criticisms presented by those parties: first, that the risk theory ignores the accounting rules set forth in the Commission-adopted Uniform System of Accounts (USOA); second, that the ratepayers are responsible only for original cost, which limits the risks which they face; and, third, that shareholders rely upon the gains associated with the sale of assets in deciding whether and at what price to invest in utility stocks.

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First, the USOA provides a reasonable framework in which to assess ratemaking issues. However, the USOA rules are merely accounting rules and do not otherwise represent rules of law or equity. As the court so aptly noted,

> "Accounting procedures are not self-justifying; like other regulatory action of the Commission, they must reflect a rational allocation of economic rights and responsibilities between a utility's investors and consumers. The simple fact that an agency treats an item a certain way for purposes of its uniform system of accounts does not mark the end of judicial scrutiny; on the contrary, a reviewing court must assure itself that the accounting practice prescribed is consistent with underlying substantive principles of public utility laws. To permit an accounting device to dictate the rule of law is to allow the tail to wag the dog."

Democratic Central Committee, supra, at 819-820 (footnotes omitted). Also Federal Power Commission v. Hope Natural Gas Co. 320 U.S. 591, 645 (1944).

Second, the fact that original cost is the upper bound to the losses ratepayers face[6] does not and should not mean that the gains to which they are entitled should be limited to original cost as well. Courts have pointed out that the use of original cost for the purpose of fixing rate base is constitutionally permissible since (a) original cost represents the maximum extent of their investment risks and (b) shareholders have no constitutional

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6/ This is not always true in any event. A negative salvage value, i.e., where costs of removal exceed the salvage value of fully depreciated plant, could result in ratepayers bearing <u>more</u> than the plant's original costs. As in the instance of nuclear plant decommissioning, this excess could be substantial.

entitlement to the value of their property beyond its original cost. See Democratic Central Committee, supra, at 802, also, Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944). More importantly, to say that ratepayers' risk is limited to original cost begs the allocation question. Under that analysis, ratepayers are saddled with all losses and precluded from sharing in any gains. That hardly comports with equity, fairness or this Commission's precedents.

Third, we are not convinced that shareholders rely upon gains from the sale of utility properties in considering whether or at what price to invest in a particular utility's stock. Sales are extraordinary events. There is no certitude that such gains will occur or that they will be of a magnitude sufficient to affect either the market price of the utility's stock or dividend distributions. Utility investors are not speculators; rather, they in large part rely upon evaluations of a utility's earnings and dividends performance in adjudging whether to invest in that particular utility. While this conservative strategy limits the potential for growth in their investment portfolios, utility investors also limit the risk that they will suffer any capital losses. It is because the utility investors are less likely to lose their invested capital than investors who play in growth stocks that the former seek out utility investments in the first place. Thus, it is often said that the utility shareholder is more like the bondholder who primarily seeks income rather than growth from investments.

C. Exceptional Cases

As previously noted, a distribution of gains and losses based upon the distribution of risk between ratepayers and shareholders will *ordinarily* require that ratepayers bear the burden of all losses and receive the benefit of all gains. However, there are some cases in which this would not be true. Several of these cases were cited by various parties as arguments against the application of our risk analysis. Upon closer examination, we simply conclude that those cases are exceptional and distinguishable. Different rules would therefore pertain.

1. Abandonments of Preoperational Plant

It is our normal practice to disallow the recovery of investments in failed and abandoned projects. See *Southern California Gas Co.*, *supra*, 4 CPUC2d at 781. However, because of the uncertainties of the past decade and the magnitude of the losses utilities stood to suffer as a result of abandonments, we adopted a policy of shared risks for such periods of uncertainty. We found that investors were not adequately compensated for the increasing risks associated with abandonments which resulted from market disruptions rather than imprudent planning (*Id.*, at 782.) but that ratepayers, who were not compensated at all and became

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"captive" investors, should not bear the entire loss from failed projects (Id., at 781-782).

Under recent precedents, we adopted a policy whereunder ratepayers have been held to be responsible for accrued prudent expenditures[7] while shareholders have borne allowances for funds used during construction (AFUDC) which represent the carrying costs of those expenditures. Thus, as in the PG&E Utah coal reserves sale, it was appropriate to require a sharing of the gains received as between ratepayers and shareholders since the risks of investment were likewise shared. A comparison of investment risks (risks of loss) borne by ratepayers and shareholders provides the risk ratio which should be used to allocate losses or gains upon the sale of any abandoned assets. In the usual case, that ratio may be represented as follows:

$$\frac{\text{Risk Ratepayer}}{\text{Risk Shareholder}} = \frac{\text{Prudent Capital Expenditures}}{\text{AFUDC Associated with Prudent Capital Costs}}$$

Applying the risk ratio to gains and losses upon sale provides the amounts of either allocable to ratepayers and shareholders. Re PG&E Utah Coal Reserves, supra.

7/ Disallowances for imprudent expenditures are discussed below.

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2. Liquidations

Liquidations involve the complete sale of a utility's plant and the termination of the obligations of a public utility placed upon the utility's owners. See, e.g., PG&E Tuolumne County Purchase Agreement, Decision 83-12-064, Application 83-08-13, _____ CPUC _______ (1983). Upon such a sale, there is no legal, logical or equitable basis upon which to hold the company's former ratepayers responsible for capital losses which might accrue. Since shareholders bear the entire risk of loss, they are entitled to the entirety of any gains as well under a risk analysis.

As an example, a public entity condemnor may purchase the utility's assets at a fair market value established under just compensation precepts. If the price paid is below book value, the utility's investors have no basis upon which to require their former ratepayers to compensate them for the loss. The sale has completely severed the relationship between the shareholder and the ratepayer. Consequently, shareholders are entitled to the full extent of any capital gains accruing from a liquidation since they bear the entire burdens of the risks of investment in that circumstance.

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3. Adjustments to Original Cost

In some instances, rate base is computed upon original cost after certain adjustments are made. Eminent among such adjustments are disallowances for imprudent expenditures, i.e., expenditures which could have and should have been avoided or reduced through the exercise of due managerial care and expertise. Since disallowances are wholly borne by utility's shareholders, the question arises as to whether shareholders are entitled to capital gains allocable upon the basis of these manifested risks of investment. Framed another way, the question is, "Do the equitable principles which form the basis of the risk theory of allocations require shareholders to be compensated for disallowances?" Clearly, the answer is no.

In the disallowances case, it can hardly be said that shareholders are entitled to some reward for managerial imprudence. Such a conclusion removes one incentive to act prudently. Moreover, a disallowance in this context is intended to be a harsh and exacting penalty. It represents the complete exclusion of capital from the company's operating results for the company's entire history. There is simply no good reason to save investors from the intended effect of the disallowance. No gains need equitably be distributed to shareholders who have borne the disallowance.

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There are cases which may justifiably be treated differently from the disallowance example. In some cases, utilities are bought and sold at a price greater than book value. In those cases, the Commission has held that rate base and rates should not be affected by the transaction and that, therefore, the new owner's "original cost" should be disregarded in favor of historical cost less depreciation. The difference, or "premium", between the two values is recorded as an "acquisition adjustment" and thereafter ignored for regulatory purposes. Although not given ratemaking recognition, it cannot always be said that this premium is imprudent. Thus, upon a subsequent sale of assets, we could equitably permit the new group of shareholders to receive gains commensurate with their risks of investment, i.e., the premium justifies shareholders partaking of some part of the gains from a sale of assets.

4. Summary

From the above discussion, we intend to make clear that risk analysis requires a case-by-case assessment of whether it was ratepayers or shareholders that bore the risks of investment. That inquiry is one of facts and facts will differ from sale to sale. Clearly that inquiry will require the exercise of this Commission's judgment in balancing the equities of the facts at hand. We will expect the parties involved to address special facts and circumstances bearing on the risk issue (such as unorthodox

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3. <u>Adjustments to Original Cost</u>

In some instances, rate base is computed upon original cost after certain adjustments are made. Eminent among such adjustments are disallowances for imprudent expenditures, i.e., expenditures which could have and should have been avoided or reduced through the exercise of due managerial care and expertise. Since disallowances are wholly borne by utility's shareholders, the question arises as to whether shareholders are entitled to capital gains allocable upon the basis of these manifested risks of investment. Framed another way, the question is, "Do the equitable principles which form the basis of the risk theory of allocations require shareholders to be compensated for disallowances?" Clearly, the answer is no.

In the disallowances case, it can hardly be said that shareholders are entitled to some reward for managerial imprudence. Such a conclusion removes one incentive to act prudently. Moreover, a disallowance in this context is intended to be a harsh and exacting penalty. It represents the complete exclusion of capital from the company's operating results for the company's entire history. There is simply no good reason to save investors from the intended effect of the disallowance. No gains need equitably be distributed to shareholders who have borne the disallowance.

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financing arrangements or disposition of major portions of systems) in order to assist us in this task. It is not our intent in this decision to adopt a rigid policy; we are merely confirming an existing policy of risk analysis and requesting that these issues be addressed in applications filed pursuant to PU Code Section 851. Furthermore, we do not reach the question of whether the utility should be awarded some increment or fee for successful negotiations resulting in a gain or penalized for unsuccessful ones resulting in a loss. The issue was not addressed by any party to this case or filing a bri[illegible]

D. Disposit[illegible]

The Ci[illegible]tric service to customers in ar[illegible] proposing to purchase distribution f[illegible]SE's transmission facilities whi[illegible] utility's hands. Service to cust[illegible] subject distribution facilities would [illegible] of the City of Redding. Under these circumst[illegible] transfer of customers, the question arises as to whe[illegible] sale constitutes a sale of property or a liquidation. We conclude that it is a sale of property and that, therefore, ratepayers should receive the entire gains accruing from the transaction.

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As noted above, the severance of the relationship between a utility and its former customers which marks a liquidation ordinarily leaves the utility's investors at risk for any losses accruing from the sale of assets. Although in this case certain customers will leave PG&E's system, we do not find this to be dispositive. The que[redacted]ther it was solely these ratepayers who bo[redacted]. The answer is no.

The f[redacted] of PG&E's integrated electric syste[redacted]screte system with separate reven[redacted]ter, as part of the whole, these fa[redacted]E's electric ratepayers in genera[redacted] just those who will be transferred to the[redacted] at risk for the investment in them or for their e[redacted]or retirement. Consequently, we hold that the general body of PG&E's electric ratepayers are entitled to the gains accruing from the instant sale. PG&E will be required to record the gains accruing from this transaction in an appropriate operating revenue account to reflect the ratepayers' entitlement to these gains.

Findings of Fact

1. PG&E provides public utility electric service in many areas of California, including areas in and about Redding.

*CORRECTION*

# CORRECTION

THIS DOCUMENT

HAS BEEN REPHOTOGRAPHED

TO ASSURE LEGIBILITY

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financing arrangements or disposition of major portions of systems) in order to assist us in this task. It is not our intent in this decision to adopt a rigid policy; we are merely confirming an existing policy of risk analysis and requesting that these issues be addressed in applications filed pursuant to PU Code Section 851. Furthermore, we do not reach the question of whether the utility should be awarded some increment or fee for successful negotiations resulting in a gain or penalized for unsuccessful ones resulting in a loss. The issue was not addressed by any party to this case or filing a brief.

D. Disposition of the Case

The City of Redding provides electric service to customers in and about the city. It is here proposing to purchase distribution facilities from PG&E, leaving PG&E's transmission facilities which run through the city in the utility's hands. Service to customers currently served by the subject distribution facilities would become the responsibility of the City of Redding. Under these circumstances involving the transfer of customers, the question arises as to whether this sale constitutes a sale of property or a liquidation. We conclude that it is a sale of property and that, therefore, ratepayers should receive the entire gains accruing from the transaction.

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As noted above, the severance of the relationship between a utility and its former customers which marks a liquidation ordinarily leaves the utility's investors at risk for any losses accruing from the sale of assets. Although in this case certain customers will leave PG&E's system, we do not find this to be dispositive. The question remains whether it was solely these ratepayers who bore the risks of investment. The answer is no.

The facilities to be sold were part of PG&E's integrated electric system. They do not constitute a discrete system with separate revenue requirements and rates. Rather, as part of the whole, these facilities were supported by PG&E's electric ratepayers in general and those ratepayers, not just those who will be transferred to the City of Redding, were at risk for the investment in them or for their early write-off or retirement. Consequently, we hold that the general body of PG&E's electric ratepayers are entitled to the gains accruing from the instant sale. PG&E will be required to record the gains accruing from this transaction in an appropriate operating revenue account to reflect the ratepayers' entitlement to these gains.

Findings of Fact

1. PG&E provides public utility electric service in many areas of California, including areas in and about Redding.

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2. The city, a California municipal corporation, for some time has owned and operated an electric distribution system in areas within municipal limits.

3. At different times within the past years, the city has annexed unincorporated areas, including the specific four areas which are the subject of this application, wherein the electric service or the obligation to provide electric service was the obligation of PG&E.

4. In the interim since annexation, PG&E has continued to provide Area 80-10 with electric service, and was ready if requested to provide Areas 80-6, 80-7, and 80-8 with electric service.

5. The city itself has plans to provide the electric service in these four areas, and has contracted with PG&E to purchase the existing distribution and street lighting facilities in Area 80-10 from PG&E and will incorporate these facilities into the city's electric distribution system.

6. The purchase price negotiated between the city and PG&E for the facilities, the proposed payment of net value plus 15% for additions, the proposed payment of applicable severance costs, and the proposed proration of current ad valorem taxes constitute a just and reasonable compensation for the transfer.

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7. PG&E will continue to own, maintain, and operate certain through circuit lines in the 80-6, 80-7, and 80-8 areas.

8. The furnishing of electric service in the four annexed areas by the city will not result in rates and charges to the customers of these areas in excess of those paid to PG&E.

9. There is no known opposition to the proposed sale and transfer.

10. It can be seen with reasonable certainty that there is no possibility that the sale and transfer of these particular facilities alone may have a significant effect on the environment.

11. The proposed sale and transfer of these particular facilities, under all the conditions applicable, would not be initially adverse to the public interest.

12. Line extension balances to the three customers involved will be refunded by PG&E after the city assumes ownership.

13. The transaction which is the subject of A.83-04-37 involves a substantial increment over the net book or depreciated rate base value of the property to be transferred.

14. In determining whether ratepayers or shareholders are entitled to the gains or responsible for the losses accruing from sales of utility plant, this Commission, historically, has applied a risk analysis, focusing on which group would have borne the responsibility for write-off of a capital asset on a case-by-case basis.

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15. The instant transaction is a sale of property, rather than a liquidation; the facilities being sold were supported by PG&E's electric ratepayers as a whole, not just those ratepayers in the areas being transferred. This general body of ratepayers was at risk for the early retirement or write-off of these facilities.

16. Ratepayers are entitled to the gains accruing from the instant sale.

Conclusions of Law

1. Upon completion of the sale and transfer PG&E should be relieved of its electric public utility obligations in the four annexed areas.

2. PG&E should be required to classify the gain realized over depreciated book value of the electric systems involved in this transaction, except for $6,452, as operating revenue.

3. $6,452 of the gain to be realized by PG&E on this transaction, representing facilities acquired without cost by PG&E, should be set aside as a donated property fund for future expenditure by and at the utility's discretion to replace remaining or other acquired donated property as the useful life of such other donated property is used up.

4. A public hearing is not necessary.

5. The application should be granted as provided in the following order.

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O R D E R

IT IS ORDERED that:

1. Within six months after the effective date of this order, Pacific Gas and Electric Company (PG&E) may sell and transfer to the City of Redding, the electrical distribution and street lighting facilities set forth in their September 17, 1982 agreement annexed to and made a part of their application as Exhibit B.

2. Within 10 days of the actual transfer, PG&E shall notify the Commission in writing of the date on which the transfer was consummated. A true copy of the instrument of transfer shall be attached to the written notification.

3. Within 90 days after the date of actual transfer, PG&E shall advise the Commission's Revenue Requirements Division, in writing, of the adjustments for additions and betterments made in accordance with Exhibit B annexed to and made part of the application, except that these adjustments shall reflect the setting apart of a donated property fund to be used hereafter at the discretion of PG&E to replace remaining or other acquired donated property as the useful service lift of such other donated property is used up.

4. Within 90 days after the date of actual transfer, PG&E shall make refund of all line extension balances outstanding, and when these refunds are completed, shall advise the Commission's Revenue Requirements Division, in writing, of the fact.

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5. Within 10 days of the actual transfer, PG&E shall record the gains accruing from this transaction in an appropriate operating revenue account to reflect the ratepayers entitlement to these gains.

6. Upon compliance with this order, PG&E shall stand relieved of its public utility obligations in connection with electric service in the four areas which are the subject of this application.

This order becomes effective 30 days from today.

Dated ________________, at San Francisco, California.