ALJ/JBW/jt

Decision 88 03 075 MAR 23 1988

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company for Authority pursuant to Public Utilities Code Section 851 to sell and lease back its Headquarters Property in Los Angeles, California. (U 904 G)	Application 87-07-041 (Filed July 28, 1987)

OPINION ON SOUTHERN CALIFORNIA GAS COMPANY'S PETITION TO MODIFY DECISION 87-09-076

Statement of Facts

Southern California Gas Company (SoCalGas) in 1987 owned a large parcel of land in downtown Los Angeles on which were located four contiguous interconnected buildings between 27 and 63 years old; buildings which constituted the SoCalGas headquarters and principal place of business. SoCalGas alleges that antiquated and inefficient, with inadequate space and high maintenance expense, these buildings, were SoCalGas to continue in occupancy, would require substantial capital improvements including earthquake strengthening and asbestos removal.

Accordingly, in association with its corporate parent Pacific Lighting Company (which owned adjacent properties which the parent had also determined to sell), SoCalGas determined to sell its parcel and relocate within four years to leased quarters in a new and larger downtown facility yet to be constructed. Pending this anticipated relocation, SoCalGas planned to lease back its existing buildings; such lease-back to be part of any sale agreement.

Pursuant to the requirements of Public Utilities (PU) Code § 851, on July 28, 1987 SoCalGas applied for a Commission order authorizing it to sell its downtown property which was then used and useful in the performance of its duties to the public. It and the Pacific Lighting property were to be sold in association, the combined unit constituting a larger and more desirable entity. Citing the exigencies of the local real estate market, SoCalGas asked for expeditious Commission authorization without hearing, with any rate and capital gain issues to be considered after close of a sale.

By Decision (D.) 87-09-076 issued ex parte on September 23, 1987 the Commission gave its authorization for a sale to proceed, reserving for a second phase proceeding all ratemaking consequences flowing from such sale, lease-back and associated activities, including gain from sale. On September 29, 1987 SoCalGas (and Pacific Lighting) entered an agreement with Shuwa Investment Corporation for conveyance of the property. Title was transferred on October 7, 1987.

By letter dated November 2, 1987, SoCalGas advised the Commission that it had signed an agreement, still subject to certain contingencies prior to construction, for a long-term lease in a new office building to be constructed in downtown Los Angeles. It anticipates relocation in late 1990 or in 1991.

On October 30, 1987, facing a six-month from date of sale deadline to file its Phase II Application, SoCalGas, pursuant to Rule 43 of our Rules of Practice and Procedure, filed the present petition seeking modification of D.87-09-076 to remove the present Ordering Paragraph 4 requirement that in that Phase II proceeding it demonstrate the "cost-effectiveness" of the lease applicable to its new headquarters facility, asking that the Commission provide instead that the utility must justify the cost of its new headquarters facilities in a future rate proceeding before the Commission allows recovery of these costs through rates. The Commission's Division of Ratepayer Advocates (DRA) objects by a filing made November 30, 1987. We have considered both parties' arguments.

SoCalGas' Position

In seeking modification of D.87-09-076, SoCalGas asserts that the matter of what constitutes a reasonable cost for SoCalGas' new headquarters is entirely severable from the capital gain issue arising from sale of the old property; that the issue of whether the utility should be allowed to recover in rates any increase in costs created by its relocation should be considered in that appropriate future rate proceeding in which SoCalGas requests such recovery. Accordingly, SoCalGas asks modification of Ordering Paragraph 4 of D.87-09-076 from:

> "SoCalGas will bear the risk of demonstrating the cost effectiveness of any sale and lease-back, as well as the leasing of a new headquarters facility, in the Phase II Application proceeding.",

to

> "SoCalGas will bear the risk of demonstrating the cost-effectiveness of any sale and lease-back in the Phase II Application. SoCalGas must justify in a future rate proceeding the cost of its new headquarters facilities before the Commission will allow any increased costs to be recovered through rates."

DRA's Position

In opposing modification of D.87-09-076 DRA asserts that the reasonableness of SoCalGas' lease for the new facilities is directly related to the gain realized on the sale of the property; contending that if the lease on the new facilities should be determined to be unreasonable, that fact would be a factor directly related to disposition of the gain. DRA states that it did not oppose ex parte treatment of the sale because it assumed that the entire transaction would be reviewed in Phase II, not dissected into several phases. DRA further argues that the function of the reasonableness review of the lease on the new facilities is to determine if the ratepayers have been harmed or benefited by the sale of used and useful property, not to determine the amount of future rates. DRA also fears that as SoCalGas' last rate case was "settled" last year, its next rate case may also be settled without consideration of the reasonableness of the new lease.

SoCalGas' Reply

On December 17, 1987 SoCalGas filed a reply to DRA, pointing out that if in a future rate case the cost of the lease on the new facilities is determined to be unreasonable, the Commission has full power to disallow any unreasonable part in the rates it approves. SoCalGas states that in neither its application nor its informal discussions with DRA did it ever state that the cost-effectiveness of the new facilities lease should be part of Phase II; that it always intended that the Commission should review the cost-effectiveness of the lease in a rate case in which the utility would seek to recover such cost. It further notes that the Commission ordered that the respective costs were to be tracked and if they prove to be less than presently allowed, they are subject to refund. SoCalGas finally observes that settlement of any future rate case will be entirely up to the Commission to approve, and in passing on any proposed settlement the Commission would necessarily have to consider the new headquarters lease cost issue. The utility points out that until the time when such costs are incurred and are known, the issue is simply not ripe.

Discussion

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 as property useful in the performance of its public duty without first obtaining authorization to do so from this Commission. The Commission's power to deny a sale is to prevent the impairment of the public service and to protect the rights of the public served by that utility. If a proposed sale cannot be seen as injurious to that service and those rights, the owner may be authorized to make the sale (Hanlon v Eshleman (1915) 169 C

200). In this instance in issuing D.87-09-076 we perceived no impact on service to the customers because SoCalGas would continue to provide the same service downtown, continuing on a lease-back basis to occupy the same downtown headquarters facility until relocation in approximately four years to a new leased headquarters facility, also downtown. Indeed, a more modern, consolidated and efficient headquarters facility and operation should mean enhanced service to its customers. In that SoCalGas assumed the risk should the interim lease-back arrangement result in higher costs, and the Commission always has the power to disallow unreasonable costs in a future rate case should the lease of the new facilities produce unreasonable costs when implemented, there appears to be no possibility of injury to the rights to service of the consumers. And whether SoCalGas owns or leases its headquarters facilities is a business determination which is the primary responsibility of management. As observed by the Supreme Court of California in Pac. Tel. & Tel. Co. v P.U.C. (1950) 34 C 2d 822 at 828:

> "Almost every contract a utility makes is bound to affect its rates and services. Moreover, the question whether a contract is reasonable is one on which, except in clear cases, there is bound to be conflicting evidence and considerable leeway for conflicting opinions. The determination of what is reasonable in conducting the business of the utility is the primary responsibility of management. If the Commission is empowered to prescribe the terms of contracts and the practices of utilities and thus substitute its judgment as to what is reasonable for that of management, it is empowered to undertake the management of all utilities subject to its jurisdiction. It has been repeatedly held, however, that the Commission does not have such power." (Emphasis added.)

By its application filed July 28, 1987, SoCalGas asked that we approve both the sale and the proposed lease-back for an interim period. This we did by D.87-09-076 although any sale and lease-back almost certainly had to result in some impact relative to rates. However, since SoCalGas accepted the obligation to absorb any net increase in related costs until 1989, and since we ordered tracking in memorandum accounts so that if there were post-sale recorded headquarter costs less than those now allowed in rates, these would be refunded, the ratepayers appeared effectively to be rate neutral by the transaction. Since the lease-back terms are now known and provide for a monthly rental of $319,083 (for the first four years of the lease-back), it appears there is no substantial impediment to proceeding in Phase II to determine whether the lease-back provisions for the interim period are reasonable. In addition, disposition of the net proceeds from the sale of the headquarters property to Shuwa Investment Corporation will be determined in Phase II of this proceeding, subject, of course, to some provision being made for the ultimate demolition and removal of all improvements from the property at termination of the interim lease-back.

However, we see the logic in SoCalGas' request to defer for a future ratemaking proceeding any reasonableness review applicable to the lease for the future new headquarters facility. Until all costs are known relative to this future occupancy, any such reasonableness review necessarily would be drawn-out and piecemeal. The cost-effectiveness of the lease for the new headquarters facility is to be examined for the purpose of determining its impact in setting future reasonable rates. This is most appropriately done in a case where SoCalGas seeks to reflect in its rates the costs attributable to this new facility. As stated before, if the costs derived from this new lease are found to be unreasonable, the Commission will have full power to disallow them in ratemaking to the extent they are found to be unreasonable. And certainly the reasonableness of these costs must be considered and addressed in any settlement that may be proposed in any future SoCalGas general rate case. DRA and other interested parties will have ample opportunity in such future proceedings to address the issue. At this time it is premature.

Accordingly, Ordering Paragraph 4 of D.87-09-076 should be modified to read as follows:

> "4. SoCalGas will bear the risk of demonstrating the cost effectiveness of any sale and lease-back in the Phase II Application. SoCalGas must justify in a future general rate case proceeding the cost of its new headquarters facility before the Commission will allow the costs for this facility to be recovered through rates."

Because of the limited time remaining for SoCalGas to file its Phase II Application in this proceeding, this decision should be made effective immediately.

Findings of Fact

1. By Application 87-07-041 filed July 28, 1987, to meet the exigencies of the real estate market SoCalGas sought Commission authorization pursuant to PU Code § 851, on an expedited basis without hearing, to sell and lease back its Los Angeles headquarters property.

2. By D.87-09-076 issued September 23, 1987, the Commission authorized this sale and lease-back, but required that SoCalGas would be required to demonstrate the cost-effectiveness of such sale and lease-back, as well as the leasing of new headquarters facilities for the future, in a Phase II Application proceeding, when any gain on sale issues would also be addressed.

3. The Los Angeles headquarters property was sold and the property conveyed to Shuwa Investment Corporation on October 7, 1987. As part of the transaction SoCalGas leased back the property for an initial term of five years with right to terminate earlier or to extend later. Upon termination SoCalGas is required to demolish and remove all improvements on the property.

4. By a petition filed October 30, 1987, SoCalGas seeks modification of D.87-09-076 to defer the issue of the cost-effectiveness of the lease of a new headquarters facility from Phase II of this proceeding to a future rate case in which the utility will seek to reflect in rates the cost of the new headquarters facility.

5. The cost-effectiveness of the lease on the new headquarters facility is to be examined for the purpose of determining its impact in setting future reasonable rates.

6. Until costs associated with the lease of the new headquarters facility are known with more exactness, it appears premature to attempt to determine their impact in setting future reasonable rates.

7. The cost-effectiveness of the lease for the new headquarters facility and the reasonableness of the costs associated with the facility should be examined in a future SoCalGas rate proceeding when the utility seeks to reflect such costs in rates.

<u>Conclusion of Law</u>

To the extent provided in the following order, the petition of SoCalGas to modify Ordering Paragraph 4 of D.87-09-076 should be granted.

ORDER ON PETITION TO MODIFY DECISION 87-09-076

IT IS ORDERED that Ordering Paragraph 4 of Decision 87-09-076 is modified to read as follows:

> "4. SoCalGas will bear the risk of demonstrating the cost-effectiveness of any sale and lease-back in the Phase II Application. SoCalGas must justify in a future general rate case proceeding the cost of its new headquarters facility before the Commission will allow the costs for this facility to be recovered through rates."

This order is effective today.

Dated MAR 23 1988, at San Francisco, California.

STANLEY W. HULETT
President
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

I will file a written dissent.

DONALD VIAL
Commissioner

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

Victor Weisser, Executive Director

DONALD VIAL, Commissioner, Dissenting:

The majority blithely characterizes this decision as an endorsement of a scheduling change. I strongly disagree. The order sets the stage for liquidating assets used to provide utility service and handing the proceeds over to utility shareholders.

By previous order in this case, SoCal was required in Phase 2 to demonstrate the cost effectiveness of the sale and leaseback, as well as the leasing of new headquarters facility. I acknowledge that the unavailability of final lease costs is a good reason for postponing review of the long term lease. However, the proceeds of sale should be disposed of at the same time that the costs of the new lease are reviewed. I would have limited Phase 2 to an inquiry into the reasonableness of the interim leaseback arrangement.

Despite the majority's assertions to the contrary, this is not merely a timing issue. It is improper to sever the ratemaking treatment of the sales proceeds from that of the long term lease. The two are inextricably linked because they comprise the cost of service to ratepayers from the utility's decision to sell its headquarters property. The characterization of the proceeds as a "gain on sale", which is subject to allocation between either ratepayers or shareholders, is misguided.

My colleagues have lost sight of the primary issue. SoCal has applied for authorization to sell its headquarters building. Our final approval of the sale must be based on a finding that the sale is in the best interest of the ratepayers. In proceedings to review the reasonableness of a sale of utility property, we have consistently applied cost of service analysis. That is, the cost of service under the "sell" scenario is compared with the cost of service of the "retain" scenario. The utility's actions meet the prudency standard if they result in the lowest cost of service to ratepayers. (See, eg. D.85-11-065, OII into disposition of GEDA program).

Under accounting convention established in numerous Commission decisions on the sale of utility property, the proceeds of the sale are amortized in rates. In Decision no. 84600 (June 24, 1975), the Commission considered the sale and leaseback by SDG&E of its headquarters building. The proceeds of sale were recorded in a deferred account and amortized as a reduction in lease expense over the life of the lease.[1] To be consistent with the treatment permitted by the Commission in similar sale and leaseback situations, the profits from the sale of the SoCal headquarters should be flowed through to ratepayers.

"Gain on sale" is not an issue in this case. An allocation of gain between shareholders and ratepayers, based on the relative risks assumed by each party, is appropriate only when the utility has ceased to provide utility service to some portion of its service territory and liquidates its facilities. To date, this situation has arisen only when those facilities were the subject of condemnation proceedings. In such cases, the utility has no choice but to cease service. It clearly divests itself of any further obligation to serve its ratepayers; there is no alternative cost of service scenario.

In sharp contrast to a condemnation sale, SoCal's sale of headquarters property "to concentrate capital investment in its operating system" does not result from abandonment of utility service to a portion of its franchise. A business headquarters is indispensable to the utility's provision of service. The method by which occupancy is secured, whether by ownership or rental of the building, does not alter the fact that this is an ongoing cost of

1 Similar treatment has been accorded the proceeds of the sale of SDG&E's Encina 5 generating unit (D.89067 and D.90405). In cases where the asset was only partially ratebased, a proportionate amount of the proceeds was flowed through in rates. See, for example, PG&E's Utah coal properties (D.82-12-121), SDG&E's potential power plant site (D.83-12-065).

utility service that will inevitably be included in the revenue requirement.

By embracing the possibility that the proceeds from sale will be allocated to shareholders, the majority creates an environment for an epidemic of corporate buy-outs of utilities. It signals that shareholders may extract the market value of utility plant which is currently necessary to provide ongoing service to ratepayers. This would enable shareholders to reap the appreciation in the value of utility plant and deny ratepayers the use of those proceeds to replace those facilities.

This Commission must ask itself, "What distinguishes a headquarters building from other ratebased facilities which ratepayers have financed in rates to provide service? What is there to prevent an electric utility from sellings its hydroelectric generating facilities for shareholder profit?" Such a sale would make eminent business sense as a means of freeing up capital to enhance share value. A hydroelectric generating facility would have been acquired at a low basis and be fully depreciated. Its high replacement cost and uniqueness of hydroelectric generating resources virtually guarantee a high market value.

The shareholders could realize a quick profit from the sale of such an asset. However, the generation from the facility would have to be replaced. When the need for substitute capacity arises, it would be purchased at an inflated price, reflective of the market conditions that made the sale of the generating unit so lucrative. In other words, if the proceeds of sale are allocated to shareholders, then management would have an incentive to liquidate the utility's assets. While shareholders would receive the cash proceeds and be insulated from the consequent increase in the cost of services, ratepayers would suffer from a higher revenue requirement.

This policy is dangerous. While in the short term it appears to increase the value of utility stock, in the long run it leads to a decline in the value of utility assets and undermines productivity. The market value of utility stock would be inflated based on the potential for liquidating the utility's assets, rather than on the long-term potential of growth of the utility's market.

I realize that the potential for growth in the utility market is limited by increased competition from alternative generating sources. However, the bolstering of returns on shareholder equity by the sale of assets is a myopic solution to the limits of utility growth. As soon as capacity need and availability reach equilibrium, the marginal cost of generation will exceed the embedded cost of generation. This inevitably leads to an increase in the system average cost. And an increase in cost will fuel the incentive to bypass the utility system. In the long run, the utility's ability to retain present load, let alone opportunities for real growth, will decline as a result of this blundering strategy.

I am certainly not suggesting that the Commission substitute its judgment for the wisdom of utility management in all cases. The scenario which I describe must be confronted inevitably. However, the majority is only hastening the day and compounding the problem by its actions. I will not be a party to this caper to liquidate utility facilities for shareholder profit.

Clearly, extracting capital from an on-going utility service in the manner contemplated by this so-called "timing" decision will lead inevitably to building higher facility costs into the operation of the utility. The long-term consequences will serve neither the shareholders nor the ratepayers.

/s/ DONALD VIAL
Donald Vial, Commissioner

San Francisco, California
March 24, 1988

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March 24, 1988