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Decision 89-07-016 July 6, 1989

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking concerning the ratemaking treatment of capital gains derived from the sale of a public utility distribution system serving an area annexed by a municipality or public entity.	R.88-11-041 (Filed November 23, 1988)

OPINION

We opened this rulemaking proceeding to reconsider the rule of Decision 85-11-018 (City of Redding), regarding the ratemaking treatment of gains realized in certain sales of utility property to a municipality or other public entity. By our decision today, we change the City of Redding rule and find that, for sales of utility assets within the scope of this rulemaking, any gain on the sale should accrue to the utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and any adverse effects on the selling utility's remaining ratepayers are fully mitigated.

BACKGROUND

In establishing this rulemaking proceeding, we restricted our review to the allocation of gains (and, implicitly, losses) which are realized when all of the following circumstances exist:

1. A distribution system of a public utility (i.e., gas, electric, or water utility) is sold to a municipality or some other public or governmental entity, such as a special utility district;

2. the distribution system consists of part or all of the utility operating system (system) located within a geographically defined area;

3. the components of the system are or have been included in the rate base of the utility; and

4. the sale of the system is concurrent with the utility being relieved of and the municipality or other agency assuming the public utility obligations to the customers within the area served by the system.

We sought comments from interested parties on the ratemaking treatment of the gain within the framework we have described, with particular attention given to the following questions:

1. What definition of liquidation or partial liquidation should the Commission use?

2. What significance should the Commission place on the source of contributions to the value of the property sold, including the initial capital investment, the payment of carrying costs, and other financial support given to the property while it was in rate base?

3. What should be the appropriate accounting for liquidations?

4. What is the effect on a utility's ability to attract capital if the gain is allocated to ratepayers? What has been the effect, for example, of our prior decision in City of Redding on Pacific Gas and Electric Company's (PG&E) securities?

5. What, if any, risks should the Commission consider in balancing risk and rewards between ratepayers and shareholders (e.g., risk of loss of original capital investment; risk of loss of increased value)?

6. Should the analysis of risks be retrospective or prospective? Should we consider who has borne the risks or who bears them at the time of the sale and after the sale?

7. What should be the ratemaking treatment of a gain realized in a transaction which meets the adopted definition of a liquidation, whether partial or total? By way of comparison, what treatment is accorded such transactions in other jurisdictions?

8. On what basis could the gain be allocated between ratepayers and shareholders?

Comments were filed by the California Water Association, Pacific Gas and Electric Company, Southern California Gas Company, Southern California Edison Company, San Gabriel Valley Water Company, Suburban Water Systems, California Water Service Company, San Jose Water Company, Del Este Water Company, Dominguez Water Corporation, the California City-County Street Light Association, Park Water Company, the National Association of Water Companies, Pacific Power and Light Company, San Diego Gas & Electric Company, Southern California Water Company, the Cities of San Diego, San Francisco, and Los Angeles, and the Division of Ratepayer Advocates of the Commission (DRA).

POLICY OVERVIEW

We are convinced that in the circumstances contemplated in this rulemaking (sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system), gains or losses from the sale should be allocated to the shareholders of the public utility, provided that the ratepayers have not contributed capital to the distribution system and are not adversely affected by the transfer of the system.

We note that we have always allocated to shareholders the gains or losses from the total liquidation of a public utility. The transfer of distribution facilities together with the assumption of the responsibility to serve customers is essentially a partial liquidation of the public utility which transfers the facilities. Thus, the rules on liquidation logically should cover the narrowly defined circumstances we have described. However, we make one exception, when the transferring utility continues to serve those of its ratepayers that are not served by the transferred distribution system. Where the transfer is shown to have an adverse impact on cost or quality of service to the remaining ratepayers, we will change the allocation to the extent necessary to mitigate such impact.

We arrive at this conclusion through a two-step analysis. First, we should consider the welfare of the ratepayers whose service will now be provided by the acquiring municipal utility. In the case of a transfer from one regulated privately-owned utility to another, our policy has been clear: the assets in question continue in the rate base at their previously-determined value without any consideration for a premium above book value that might have been paid in the acquisition. In that way the gain on sale is implicitly awarded to the (transferred) ratepayers, since increase in value above book of the distribution plant is not reflected in rates. Here, the acquiring municipal utility is beyond our jurisdiction. However, the legislative scheme by which our jurisdiction is avoided presumes that public oversight, e.g., through the election of board members and/or local officials, will prove an effective substitute for our regulatory oversight. Where the purchasing utility is a municipality, we are precluded from offering any particular protections to the ratepayers who are being transferred, but the statutory scheme provides them an alternate recourse to resolve any such issues.

Second, when we consider the welfare of ratepayers who remain with the privately-owned utility, we find that, in the circumstances of this rulemaking, they will be in the same position before and after the transfer. There have been many attempts to describe the regulatory compact between ratepayers and shareholders; probably no description is entirely satisfactory.

There are many kinds of facilities and types of risk in utility service, and in future cases involving other types of sales of utility assets, we believe that risk analysis will always be pertinent to deciding how to allocate the gains or losses from these sales. It is clear, however, that in the circumstances we address here, our allocation would not abridge the regulatory compact. The ratepayers who remain with the privately-owned utility continue to be served through the same facilities before and after other facilities are transferred through municipalization. Absent a showing of adverse impact on the remaining ratepayers, the intervening transfer should not change the relative risks previously assumed by ratepayers and shareholders regarding those facilities. As we have indicated, we would first require a full alleviation of such an impact before ruling on a municipalization transaction. We need not specify the entire regulatory compact in any detail here to conclude that it is fair and reasonable to preserve the relative positions of utility shareholders and ratepayers who remain under our jurisdiction.

Given that we will exercise our authority to protect the interests of the ratepayers who remain on the privately-owned utility system, and given that the interests of those ratepayers who have been transferred to a municipal utility are beyond our jurisdiction, it is appropriate to allocate any gain (or loss) of this sale to the utility shareholders once full mitigation of any adverse impacts on remaining ratepayers has occurred.

DISCUSSION

The comments filed on this rulemaking reveal a sharp division of opinion among the parties as to how gains on sales should be allocated. The DRA asserts that the capital gain resulting from the sale of a distribution system should be applied to reduce the revenue requirement of the selling utility, that is, go to the ratepayers. This position is supported by the Cities and the California City-County Street Light Association. All other commenters assert that the gain on sale accrues to the shareholders of the selling utility. We hold that the gain on sale of a distribution system, as defined in our Order Instituting Rulemaking, accrues to the utility and its shareholders to the extent that (1) the remaining ratepayers on the selling utility's sytem are not adversely affected and (2) the ratepayers have not contributed capital to the distribution system.

In reaching our decision we have considered the comments on the eight questions posed in the Order Instituting Rulemaking (OIR), and we address each one below.

1. **What definition of liquidation or partial liquidation should the Commission use?**

The DRA distinguishes between a liquidation and a partial liquidation. It says that a liquidation is the essential process of winding up a corporation and distributing assets among creditors and stockholders, resulting in the dissolution of the business. For assets to be considered liquidated, according to DRA, all liabilities and other obligations connected with those assets must be paid, discharged, settled, or transferred with the assets. In this kind of liquidation, DRA recognizes, any gain on sale of the assets (net of payments to creditors and preferred stockholders) would inure to the common stockholders. Anything short of this is a partial liquidation. The DRA, however, claims that a partial liquidation is a misnomer since, in its opinion, assets cannot be partially liquidated although a business can be partially dissolved. The DRA concludes that for equitable reasons when a sale of rate-based utility assets occurs without liquidation, the capital gain net of all costs of sale should be applied to reduce the revenue requirement of the selling utility, i.e., the gain would be recognized as utility income and thus go to the ratepayers.

Utility commentors say that the DRA has confused the liquidation of assets with the winding up and dissolution of a corporation. The DRA in its reply comments apparently dropped its reference to dissolution as a requirement of liquidation and defined a liquidation as the sale of an entire, separately rate-based distribution system with the transfer of all the ratepayers of the system. This would have been a partial liquidation under the DRA's original definition.

We believe that a lengthy discussion of the various comments on what is or is not a liquidation or a partial liquidation would be merely an exercise in legalisms. All parties have agreed that in a total liquidation and dissolution any gain on sale belongs to the utility stockholders, rather than the ratepayers. The question before us is when a distribution system of a utility is sold, and customers are transferred with the facilities, what should be the ratemaking treatment of the net capital gain or loss, realized in the sale.

Our concern is to recognize the rights of the shareholders without disregarding adverse impacts on ratepayers and the continuing obligation of the selling utility to provide reliable service at reasonable rates. The concept of both the partial liquidation of assets and a partial dissolution of a company are relevant. The sale of a distribution system with customers attached represents a dissolution of a significant part of a utility's total operating system. The utility's business diminishes in terms of assets and customers. This loss of part of its customer base and ongoing business value is tantamount to a dissolution, although only a partial one. In such cases, we will recognize the right of the utility to the net capital gain resulting from the sale, a gain which can be distributed to shareholders, as well as the obligation of the utility to absorb any capital loss.

On the other hand, there may be related debts and liabilities that are not satisfied upon the sale of a distribution system, and thus the assets are not completely liquidated, leaving a burden for the remaining ratepayers. Accordingly, it is our conclusion that in the circumstances of a sale as described in our OIR, a capital gain or loss, net of costs of sale, should be assigned to the utility, thus making it assignable to shareholders. However, the amount of the net capital gain allocated to the utility should be reduced by an amount commensurate with any burden left with the remaining customers of the selling utility.

For ease of reference within the bounds of this rulemaking (and with due recognition that the terminology we use is more convenient than precise), we will use the term "liquidation" to mean the sale of all or part of any distribution system of a utility, consisting of part or all of the utility operating system located within a geographically defined area, to a municipality or other governmental entity as a consequence of which the utility is relieved of, and the municipality or other governmental entity assumes, the service obligations to the customers served by the distribution system. This definition is for clarity, so that parties will not confuse what we are dealing with in this opinion with the same terms when used in other contexts such as corporate dissolutions or bankruptcy. Our conclusion on how to distribute the gain on sale does not turn on the particular term used.

2. **What significance should the Commission place on the source of contributions to the value of the property sold, including the initial capital investment, the payment of carrying costs, and other financial support given to the property while it was in rate base?**

The DRA places great significance on this question, arguing that because the ratepayer pays the return on investment, the return of the investment (depreciation), plus all reasonably incurred expenses to maintain and operate the utility assets, the ratepayer has an equitable interest in the gain on sale of assets that have been in rate base. This is especially so because the embedded and fixed costs formerly shared by the transferred customers will have to be borne by the remaining ratepayers.

The commenting utilities view the question from a different perspective. They start from the undisputed fact that it is the investor who provides the capital for the venture, and contend that the customer merely pays for service, not the property used to render it. These principles are expounded in a series of cases from the United States Supreme Court and the California Supreme Court. For example, the United States Supreme Court said in Board of Public Utility Commissioners v. New York Telephone Company (1926) 271 US 23 at 31:

> "The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary."

The Court continued, 271 US at 32:

> "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."

The California Supreme Court in Pacific Tel. & Tel. Co. v. Eshleman (1913) 166 Cal 640, 665, propounded similar principles, stating 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...." Eshleman was quoted with approval in Pac. Tel & Tel v. PUC (1950) 34 C 2d 822, 828.

In instances where public utilities have been unable to attract sufficient capital from conventional sources for projects which the Commission deemed essential, the Commission has ordered funds for such purposes to be provided from operating revenues. (See e.g., Southern Calif. Gas Co. (1972) 74 CPUC 30, 55; Pacific

Lighting Service Co. (1973) 75 CPUC 604, 616; the GEDA and EEDA Programs (1977) 83 CPUC 16, 19-21; funds received under a Public Utilities (PU) Code § 454.3 program or comparable program.) In those instances any gain on the sale of the property purchased with such funds should go to the ratepayers. (See, Committee of Consumer Services v. PSC of Utah (1979) 595 P 2d 871, 876.)

To answer the question which began this section, the Commission considers significant the source of the investment, usually the stockholder, sometimes the ratepayer. Rates are paid for service received and include a return to compensate investors for their investment. Assertions of ownership of assets and capital contributions do not resolve the questions before us in this proceeding, however. Since a regulated utility is a monopoly granted authority to serve the public trust, it is an entity whose income and expenses are subject to the ratemaking authority of the Commission. As the United States Supreme Court recently affirmed, though the assets of a utility that are employed in the public interest are owned and operated by private investors, the "partly public, partly private status of utility property creates its own set of questions under the Taking Clause of the Fifth Amendment." (Duquesne Light Co. v. Barasch (1989) 488 US ___, 102 L. Ed.2d 646, 657.)

3. What should be the appropriate accounting for liquidation?

When a utility distribution system is sold under the circumstances covered in this rulemaking, the assets comprising that system should be removed from rate base. As our order provides, the net capital gain or loss realized as a result of the sale should be allocated to the utility, and thereby be made available for assignment to its shareholders. If, however, an adverse impact on the remaining ratepayers is found by the Commission, that impact must be mitigated.

Under normal circumstances the Uniform System of Accounts would require that the gain or loss on sale of depreciable assets would be charged to a depreciation reserve account and thus would flow through to ratepayers. For non-depreciable assets the net gain or loss on sale might be flowed through to ratepayers by a rate base offset or to shareholders by a below-the-line credit.

In the circumstances of this rulemaking net gains or losses on sale (whether of depreciable or non-depreciable property) should be assigned to shareholders by transferring the plant accounts and related depreciation reserve accounts to non-utility plant at the time of sale.

We leave the accounting implications of mitigating adverse impacts on remaining ratepayers to the appropriate individual proceedings.

4. **What is the effect on a utility's ability to attract capital if the gain is allocated to ratepayers? What has been the effect, for example, of our prior decision in City of Redding on Pacific Gas and Electric Company's (PG&E) securities?**

To answer the second question first - PG&E says that it is "hard if not impossible to quantify the decision's effect on PG&E's securities." The DRA believes that there was no effect. We concur with the DRA.

But the more general question can be answered in a general way. If gain on sale is allocated to ratepayers where ratepayers have not contributed capital and where gain was previously allocated to shareholders, there could be an adverse effect on a utility's ability to attract capital. In addition to the liquidation of the asset, the utility also loses the stream of income, customer goodwill, and going business value of the territory transferred, all of which may have an adverse effect on the utility's ability to attract capital.

To deny utility investors the opportunity to offset the erosion of their investment through the receipt of capital gains would be a deterrent to the reinvestment of retained earnings and to the attraction of new capital. Were we to allocate the gain on sale from sale of distribution systems to ratepayers as a general proposition, we would expect the financial markets over time to compare this result to that applicable to competing investments, and adjust accordingly.

5. **What, if any, risks should the Commission consider in balancing risks and rewards between ratepayers and shareholders (e.g., risk of loss of original capital investment; risk of loss of increased value)?**

We will not attempt to completely describe the regulatory compact between ratepayers and shareholders, but it does include assignment of investment rewards or losses to the party that takes the investment risk. At the time a utility makes an investment the assignment is most often implicit, not explicit. Recent regulatory actions have made more explicit the assignment of specific risks (e.g. the ratemaking settlement for PG&E's Diablo Canyon Power Plant approved in D.88-12-083, or cost caps applied in certification proceedings for new power plants), but electric distribution systems have usually if not always entered utility rate bases without such explicit assignment.

Before assigning the gain or loss on the sale of distribution systems, we must first determine the implicit risks associated with those systems. When utilities operate efficiently and the various forecasts inherent in setting rates are reasonably accurate, then ratepayers receive reliable service and the utility earns the authorized rate of return. That rate of return is based on an averaging of individual risks over the entire utility system.

There are many ways to describe the elements of utility risk, but for present purposes we make the following distinctions:

- The risk of poor service falls largely on ratepayers. The value of utility service is not naturally symmetrical, and only in unusual circumstances can the costs of poor service be offset by the superior benefits of better than average service.

- Business risk affects both ratepayers and shareholders. Weak utility management or unmanageable business conditions can induce poor service as well as failure to earn authorized rate of return, or even reduction of authorized rate of return due to poor service. Risk of inaccurate ratemaking forecasts is an element of business risk.

- Apart from operational business risk is financial risk that affects shareholders. In the long run common share prices should reflect a utility's ability to earn a return, but in the short run utility stock prices must drift up and down with financial markets and the general state of the economy. Such variability is eventually built into authorized rate of return, but short term effects are assigned to shareholders. This financial risk is the general risk that goes along with contribution of capital, independent of specific capital projects.

- Specific investment risk is associated with financial risk but differs in that it attaches to individual investments. For example, for electric utilities there are different risks for generation, transmission, distribution and customer investments.

- Regulatory risk flows from decisions by this and other regulatory bodies and affects both ratepayers and shareholders. For example, in the present investigation this includes the assignment of the gain or loss on sale of a distribution system.

Although it is not necessary to this analysis, we observe that utility investment in distribution systems is generally less risky than investment in larger individual assets, such as generating plant or other major assets dedicated to serving all customers.

The implicit risks associated with investment in distribution systems are poor service to local ratepayers within the distribution system, and general financial risks that attach to any investment, which are assigned to shareholders, to the extent that they have contributed capital to the distribution system. The other risks listed above are much less important to capitalization of distribution systems. Business risk impacts utility rate of return through variability of operating expenses more than through direct return on capital investment. Forecasts of distribution system costs or utilization have far less impact on all parties than forecasts of sales and operating expenses. Distribution systems seem to be among the least risky individual investments by electric utilities, due to their relatively small scale, conventional technology and natural monopoly characteristics.

In summary, the risks that are relevant to liquidation of a distribution system are the risk of poor service to local ratepayers, general financial risk to shareholders to the extent that they have contributed the capital and risk of increased burden on remaining ratepayers.

6. **Should the analysis of risks be retrospective or prospective? Should we consider who has borne the risks or who bears them at the time of the sale and after the sale?**

In determining how to allocate the gain or loss on sale of a distribution system risks should be analyzed prospectively from the time the investment is made, but should generally not depend on actual events during the investment lifetime except to the extent that those events may point out the risks that were inherent in the initial investment decision.

During the investment lifetime shareholders earn a rate of return that includes a risk premium, even though the premium on the particular investment may be subsumed in the averaging process by which the Commission authorizes overall utility rate of return. We cannot blindly assume that all investments are equally risky.

In the case of distribution systems we have seen that very little investment risk attaches to individual projects, but ratepayers and shareholders are exposed to other risks. In general, at the end of the utility's investment lifetime, the parties that assumed the risks should receive the rewards, and all other parties should be held indifferent. Thus in the type of sale considered in this rulemaking we allocate the gain or loss to the shareholders, but only after ensuring that remaining ratepayers are not harmed by the transfer.

7. **What should be the ratemaking treatment of a gain realized in a transaction which meets the adopted definition of a liquidation, whether partial or total? By way of comparison, what treatment is accorded such transactions in other jurisdictions?**

In the event of liquidation and acquisition of the distribution system by a municipality or other governmental entity, the utility's local customers and obligations to serve those customers leave the utility. Thus the risk of poor service to the transferred customers also leaves both the utility and this Commission's jurisdiction. We cannot assign the rewards to the departing customers because they are no longer in our jurisdiction. Our concerns are limited to shareholders and remaining customers.

We have assigned the gain or loss on sale of a distribution system within the scope of this rulemaking to shareholders, who have assumed the general financial risk of making the investment. Because they assumed the risk, they should be assigned the rewards, in this case the gain on sale, so long as remaining utility ratepayers, who took very little risk, are left indifferent. Thus the ratemaking treatment of a gain is to award it to the utility shareholders to the extent that the remaining ratepayers are not adversely affected.

The treatment that other jurisdictions have accorded to the allocation of the capital gain (or loss) on the sale of a utility asset, not necessarily a distribution system as we have defined it, is not consistent. Selected cases are briefly analyzed in Appendix A to this decision.

8. **On what basis could the gain be allocated between ratepayers and shareholders?**

As discussed above, allocation of gain depends in general on the explicit and implicit risks taken by ratepayers and shareholders at the time an investment is made. For the liquidations considered herein, the risks are poor service to local ratepayers, general financial risk to shareholders, and risk of reduced level of service or increased rates to remaining ratepayers. The rewards and losses induced by sale of assets should accrue to the parties taking or assigned the risks.

Protecting remaining ratepayers from adverse effects, as we will order in this decision, is also consistent with Public Utilities (PU) Code Section 851, which requires Commission authorization of the sale or disposal of property necessary or useful in performance of a utility's public obligations. The concern of Section 851 is to assure that upon the sale of a utility asset, the ability of the utility to provide reliable service at fair rates is not jeopardized. For example, pursuant to Section 851, the Commission considers whether the sale of a utility would place the property in the hands of persons incapable of delivering adequate service at reasonable rates (e.g., SoCal. Mt. Water Co. (1912) 1 CRC 520). The Commission may also prohibit or condition the transfer when the nontransferred portion of the utility property would be rendered inadequate to deliver adequate service at reasonable rates (e.g., App. of Dyke Water Co. (1964) 63 CPUC 641; App. of Plunkett Water Co. (1966) 65 CPUC 313; App. of Kentwood in the Pines (1963) 61 CPUC 629). In Plunkett Water Co. we denied a transfer when we found, among other things, that the rates of the selling water utility would be increased if the sale were approved.

The case of Dyke Water Co. is particularly instructive. Dyke Water Company sought to sell a major portion of its water system in Orange County to the City of Garden Grove Water Corporation, a nonprofit corporation, which would then lease the system to the City of Garden Grove. The Commission, in approving the sale, conditioned its approval by impounding part of the sales price to protect remaining customers and commented:

> "Among the duties of this Commission, when public utility properties are to be transferred, is that of assuring that the transfer will not be adverse to the public interest and, in cases like the present where a partial disposition of operating properties is proposed, that the utility's application of funds received from the disposition are made in such a manner as to appropriately discharge its public utility obligations consistent with the utility's continuing obligation to render adequate service to the public with its remaining properties. Dyke Water Company, after the transfer proposed in this proceeding, will have fewer than 4,500 customers remaining and something less than 19 percent of its original plant. This is of significance in several respects, the most important of which is that the remaining system operations must not be so financially burdened, as the result of partitioning, that the utility may not meet its obligations to its remaining creditors or that its remaining customers will be unreasonably charged or receive less than adequate service. In the authorization hereinafter granted, suitable provisions will be made to assure protection of the public interest in such respects." (Dyke Water Company, supra, at 644, 645.)

In applying the principles of section 851, as expressed in Dyke Water Company, we hold that the gain on sale of a distribution system, as defined in our OIR, accrues to the utility as non-utility income to the extent that the remaining ratepayers of the selling utility's system are not adversely affected. We believe that it should not be difficult to determine the effect on remaining ratepayers. It was done in Dyke, Plunkett, and Kentwood, supra, and other applications before the Commission. The utility would have to demonstrate not only that quality of service would not be impaired, but that the remaining ratepayers would not be economically harmed. To the extent an adverse impact is found by the Commission, that much of the capital gain needed to offset this effect would be applied to reduce the utility's revenue requirement.

We believe that our concept is not a departure, radical or otherwise, from more traditional analysis. Our ruling also meets the concerns of the DRA by providing for alleviation of adverse consequences. The rule is not all or nothing.

In its Comments, PG&E distinguishes the case where the sale is carried out under the threat of condemnation rather than voluntarily, and asserts that in the case of a condemnation the gain belongs to the shareholders regardless of the impact on ratepayers. We do not make that distinction.

In both voluntary and involuntary transfers of distribution systems, the ratepayers could be at risk. Our protection of ratepayers should not turn on whether a sale is under threat of condemnation. The narrow factual situation with which we are dealing in this decision can always be characterized as being under the threat of condemnation. That alone cannot make our approval automatic with no concern for ratepayer burden. When our approval is required, we must consider the burden on ratepayers and condition our approval if necessary.

All parties have devoted considerable effort to answer the question whether allocating any portion of the gain on sale of a capital asset to the ratepayers violates the constitutional prohibition on taking property for public use without just compensation. The utilities say it does; the DRA says it does not. We will not discuss the arguments pro and con because, under the view we take of the matter, when property dedicated to a public use is transferred our authority to condition the transfer is statutory (PU Code § 851 and § 701) and well settled. A public utility cannot transfer its property dedicated to public use without the consent of the Public Utilities Commission.[1] (Crum v. Mt. Shasta Power Co. (1934) 220 C 295, 30 P 2d 30; South Bay Irrigation Dist. v. Cal-American Water Co. (1976) 61 CA 3d 944, 133 Cal Rptr 166; Richmond & San Rafael Ferry (1953) 52 CPUC 420; Azuza Valley Water Co. (1972) 73 CPUC 664.)

Findings of Fact

1. The assignment of gain or loss on the sale of utility property to a municipality or other public entity does not turn on the distinction between liquidation or partial liquidation of the utility or its assets.

2. The source of capital for a utility investment is significant in determining eventual disposition of gain or loss on sale because contributors of capital, whether shareholders or ratepayers, assume the general financial risks associated with an investment. However, other risks associated with capital investment are also significant and should be considered.

3. In the circumstances of this rulemaking net gains or losses on sale should be assigned to shareholders by transferring the plant accounts and related depreciation reserve accounts to non-utility plant at the time of sale, with appropriate mitigation of identified adverse impacts on remaining ratepayers.

4. The general impact of the Commission's allocation of gain or loss on sale upon a utility's ability to attract capital has not

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1 However, as we noted in the City of Redding decision, "At least one court has held that a public agency may pursue a condemnation action should the Commission impose conditions unaccepatable to it. People ex rel. Public Utilities Commission v. City of Fresno, 254 Cal. App. 2d 76, 99 (1967). The California Supreme Court has yet to consider this question. But cf., PU Code Section 1759." D.85-11-018, mimeo. p. 10, n.4.

been accurately quantified. Whatever is the impact, financial markets will over time weigh and adjust capital costs accordingly.

5. The risks that should be considered for distribution system investments are poor service to ratepayers and general financial risk to shareholders, to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the remaining ratepayers have not contributed capital to the distribution system.

6. Risks should be analyzed prospectively from the time an investment is made. At the time of sale, risk analysis should consider who has borne the risks during the investment lifetime.

7. The gain on sale, under the circumstances considered in this OIR, should accrue to the utility, and thereby be made assignable to its shareholders, to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the remaining ratepayers have not contributed capital to the distribution system.

Conclusions of Law

1. In determining the allocation of the gain on sale of a distribution system under the circumstances covered by this rulemaking, the Commission should apply the principles which guide decisionmaking under P.U. Code § 851 and condition approval of the sale, if appropriate.

2. This order should be made effective today to expeditiously deal with those proceedings in which the issues determined in today's decision were reserved pending this rulemaking.

ORDER

IT IS ORDERED that:

1. Our findings and conclusions and the scope of this decision are limited to the following circumstances:

   a. a distribution system of a public utility (i.e., gas, electric, or water utility) is sold to a municipality or some other public or governmental entity, such as a special utility district;

   b. the distribution system consists of part or all of the utility operating system (system) located within a geographically defined area;

   c. the components of the system are or have been included in the rate base of the utility; and

   d. the sale of the system is concurrent with the utility being relieved of and the municipality or other agency assuming the public utility obligations to the customers within the area served by the system.

2. The capital gain or loss, net of costs of sales, realized from the sale of a distribution system, under the circumstances described in Ordering Paragraph 1, shall accrue to the utility and its shareholders to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the ratepayers have not contributed capital to the distribution system.

3. All proceedings in which the issue of the disposition of the gain on sale of a distribution system, as defined in this rulemaking, has been reserved, shall be disposed of in accordance with the findings, conclusions, and order of this decision.

4. Consistent with the Order Instituting Rulemaking, this decision shall be applied prospectively, with the exception of those cases in which the issue was specifically reserved.

5. Consistent with the Order Instituting Rulemaking, this decision shall not apply to the sale of utility assets that do not meet the criteria set forth in Ordering Paragraph 1.

6. This proceeding is closed.

This order is effective today.

Dated July 6, 1989, at San Francisco, California.

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

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

Victor Weisser, Executive Director

I. Cases Allocating Gain on Sale to Shareholders

Maine Water Co. v. Public Utilities Comm'n. (Me. 1984) 482 A 2d 443. The court reversed the commission and ruled that gain on sale of two geographical utility divisions to a municipal district should be retained by the utility and not used to reduce rates to customers in the remaining districts. The property transferred included both depreciable and nondepreciable assets.

Associated Natural Gas Company (1983) 55 PUR 4th 702. The Missouri Public Service Commission held that, where the utility proposed to apply the proceeds of the sale to a municipality of a gas distribution system to the retirement of bonds and to investment in new plant, resulting in a reduction in interest expense and increased debt coverage, the gain need not be allocated to ratepayers. In rejecting the staff's argument based upon Democratic Central Committee that the gain should accrue to ratepayers, the commission concluded that the proposed disposition of the sale proceeds would result in a sharing of benefits to both the ratepayers and the shareholders, and that ratepayers would benefit from the reduction in interest expense and the increase in interest coverage.

City of Lexington, et al. v. Lexington Water Company (Ky. Ct. App., 1970) 458 SW 2d 778. This case involved the sale of watershed land no longer needed by a water utility because it had obtained a different source of water. The court held that the utility was entitled to retain the gain on sale of land no longer used in serving customers.

Boise Water Corp. v. Idaho Public Utilities Comm'n. (Idaho 1978) 578 P 2d 1089. The court reversed a decision allocating gain on transfer of utility watershed land to utility customers. The land had been in utility service about 90 years, and had appreciated to a value about 80 times its original cost. The court relied on the fact that the capital had been supplied entirely by the utility investors, that there had been no depreciation paid in rates, that the utility had earned a return only on its original cost and, therefore, that utility customers should not be treated as equitable owners of the property. In dicta, however, the court said that on a transfer of depreciable property the gain on sale should be "treated as if it were the sale of the ratepayer's property." (578 P 2d at 1092.)

<u>Appeal of City of Nashua</u> (N.H. 1981) 435 A 2d 1126. The court upheld a decision of the New Hampshire commission that allowed a water utility to retain the gain on sale of land held for 50 years but now no longer needed to provide utility service.

<u>Philadelphia Suburban Water Co. v. Pennsylvania Public Utility Comm'n.</u> (Pa. Commw. Ct. 1981) 427 A 2d 1244. The court reversed the Pennsylvania commission's decision reducing rates of a utility by the current market value of land upon dividend of the land to its parent company. The land had been in service for over 50 years and had appreciated more than tenfold. The court found the commission's action constituted confiscation without due process and just compensation. The court relied on the concepts that the investors had not recovered any of their investment through depreciation, that they had earned through rates only on the original cost of the land for 50 years, and that utility customers pay only for the use of land, but do not gain equitable or legal rights therein.

<u>Washington Public Interest Org. v. Public Service Comm'n. of D.C.</u> (DC Ct. App. 1978) 446 A 2d 28. The court upheld the action of the commission in allowing gain on sale of land by a gas

utility and by an electric utility to be retained by the respective utilities and not to be used to reduce rates. The court relied on the commission's findings that depriving the utilities of the gain on sale, both in terms of effect on expected earnings and on investor assessment of the regulatory climate, would increase the cost of capital to the utilities to the ultimate detriment of their customers.

II. Cases Allocating Gain on Sale to Ratepayers

Democratic Central Committee v. Washington Metro Transit (DC Cir. 1973) 485 F 2d 786. Upon the conversion of the transit system to an all-bus operation, the ratepayers had borne the cost of retirement of equipment and facilities and the cost of removal of street car tracks. The ratepayers had also paid for the acquisition of capital assets. This action rendered certain parcels of property formerly used as trolley-car barns surplus to the requirements of the transit system and made possible their sale for entirely different and more valuable uses at a substantial gain. The court found that, as ratepayers had borne the unique and substantial burden of the retirement of equipment and of track removal, they were entitled to share in the gains from the sale of property which this conversion program had made possible. It was an allocation which rested "essentially on equitable considerations." (485 F 2d at 821.)

Re Tampa Electric Co. (Fla. PSC 1982) 49 PUR 4th 547. Gain from sale of corporate headquarters recognized above the line pursuant to prior commission determination that the treatment of gain from the sale of property dedicated to or formerly dedicated to public service should reflect that ratepayers paid capital costs and depreciation expense when property was in rate base.

Casco Bay Lines v. PUC (Me. 1978) 390 A 2d 483. 90% of gain from sale of appreciated utility vessels allocated to ratepayers, reserving 10% to shareholders to create incentives to dispose of or productively employ assets that in effect are excess capacity.

Arizona Public Service Company (Az. Corp. Comm'n. 1988) 91 PUR 4th 337. Gain on sale/leaseback of depreciable asset (Palo Verde Unit 2) amortized against annual lease payments over life of the lease, and unamortized balance removed from rate base. But on the sale of a distribution system the Commission divided the gain on sale 50/50 between the ratepayers and the shareholders because the sale "was not in the best interest of APS's remaining customers." (91 PUR 4th at 362.)

Re Carolina Power & Light Co. (NC UC 1983) 55 PUR 4th 582. Gain from the sale of interests in generating units should be used to benefit ratepayers through a reduction in rate base amortized over a particular period.

Re New York Teleph. Co. (NY PSC 1983) 54 PUR 4th 220. Gain from the sale of customer premises equipment should flow through to ratepayers by treating the gain as an above-the-line item as a credit to depreciation expense.

Re El Paso Nat. Gas Co. (FERC 1977) 23 PUR 4th 66. Part of the gain resulting from the abandonment of a natural gas pipeline was allocated to ratepayers by reducing rate base and accordingly reducing cost of service as to return, taxes, and depreciation. Ratepayers were found to have assumed greater risk because of the abandonment. (23 PUR 4th at 95.)

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Detroit Edison Co. (Mich. PSC 1977) 20 PUR 4th 1. Gain on sale of property, consisting of land and building, added to utility income since customers were charged for the property while it was in rate base and should therefore receive the benefit of the gain on the sale.

Boston Gas Co. (Mass. DPU 1982) 49 PUR 4th 1. Treatment of land as an above-the-line item and its inclusion in rate-base warrants above-the-line treatment of the net proceeds from its sale, amortized over a period of ten years rather than applied in full to the company's test-year cost of service since the sale of utility land is an extraordinary, non-recurring event in the operations of the company.

Washington Gas Light Co. v. Pub. Serv. Com'n. (DC 1982) 450 A 2d 1187. Court of Appeals held that the net gain from the sale of propane which had been stockpiled should be allocated to ratepayers. Court states that the validity of each allocation of profits and losses depends upon the factual situation and the equities involved.

Committee of Consumer Services v. Utah Pub. Service Commission (Utah 1979) 595 P 2d 871. When assets are utility property, any transfer should be at fair market value so an appropriate benefit thereof will redound to the credit of the ratepayers.

New York Water Service Corporation v. Public Service Comm's. (1960) 208 NYS 2d 857, 863-864. Gain from sale of land no longer useful as storage reservoir should be passed on to the customers. The utility is protected from a loss in the sale of land in its operations; it seems reasonable it should pass on a profit to the customer.

(END OF APPENDIX A)

Decision 89 07 016 JUL 6 1989

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking concerning the ratemaking treatment of capital gains derived from the sale of a public utility distribution system serving an area annexed by a municipality or public entity.	R.88-11-041 (Filed November 23, 1988)

OPINION

We opened this rulemaking proceeding to reconsider the rule of Decision 85-11-018 (City of Redding), regarding the ratemaking treatment of gains realized in certain sales of utility property to a municipality or other public entity. By our decision today, we change the City of Redding rule and find that, for sales of utility assets within the scope of this rulemaking, any gain on the sale should accrue to the utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and any adverse effects on the selling utility's remaining ratepayers are fully mitigated.

BACKGROUND

In establishing this rulemaking proceeding, we restricted our review to the allocation of gains (and, implicitly, losses) which are realized when all of the following circumstances exist:

1. A distribution system of a public utility (i.e., gas, electric, or water utility) is sold to a municipality or some other public or governmental entity, such as a special utility district;

2. the distribution system consists of part or all of the utility operating system (system) located within a geographically defined area;

3. the components of the system are or have been included in the rate base of the utility; and

4. the sale of the system is concurrent with the utility being relieved of and the municipality or other agency assuming the public utility obligations to the customers within the area served by the system.

We sought comments from interested parties on the ratemaking treatment of the gain within the framework we have described, with particular attention given to the following questions:

1. What definition of liquidation or partial liquidation should the Commission use?

2. What significance should the Commission place on the source of contributions to the value of the property sold, including the initial capital investment, the payment of carrying costs, and other financial support given to the property while it was in rate base?

3. What should be the appropriate accounting for liquidations?

4. What is the effect on a utility's ability to attract capital if the gain is allocated to ratepayers? What has been the effect, for example, of our prior decision in City of Redding on Pacific Gas and Electric Company's (PG&E) securities?

5. What, if any, risks should the Commission consider in balancing risk and rewards between ratepayers and shareholders (e.g., risk of loss of original capital investment; risk of loss of increased value)?

6. Should the analysis of risks be retrospective or prospective? Should we consider who has borne the risks or who bears them at the time of the sale and after the sale?

7. What should be the ratemaking treatment of a gain realized in a transaction which meets the adopted definition of a liquidation, whether partial or total? By way of comparison, what treatment is accorded such transactions in other jurisdictions?

8. On what basis could the gain be allocated between ratepayers and shareholders?

Comments were filed by the California Water Association, Pacific Gas and Electric Company, Southern California Gas Company, Southern California Edison Company, San Gabriel Valley Water Company, Suburban Water Systems, California Water Service Company, San Jose Water Company, Del Este Water Company, Dominguez Water Corporation, the California City-County Street Light Association, Park Water Company, the National Association of Water Companies, Pacific Power and Light Company, San Diego Gas & Electric Company, Southern California Water Company, the Cities of San Diego, San Francisco, and Los Angeles, and the Division of Ratepayer Advocates of the Commission (DRA).

POLICY OVERVIEW

We are convinced that in the circumstances contemplated in this rulemaking (sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system), gains or losses from the sale should be allocated to the shareholders of the public utility, provided that the ratepayers have not contributed capital to the distribution system and are not adversely affected by the transfer of the system.

We note that we have always allocated to shareholders the gains or losses from the total liquidation of a public utility. The transfer of distribution facilities together with the assumption of the responsibility to serve customers is essentially a partial liquidation of the public utility which transfers the facilities. Thus, the rules on liquidation logically should cover the narrowly defined circumstances we have described. However, we make one exception, when the transferring utility continues to serve those of its ratepayers that are not served by the transferred distribution system. Where the transfer is shown to have an adverse impact on cost or quality of service to the remaining ratepayers, we will change the allocation to the extent necessary to mitigate such impact.

We arrive at this conclusion through a two-step analysis. First, we should consider the welfare of the ratepayers whose service will now be provided by the acquiring municipal utility. In the case of a transfer from one regulated privately-owned utility to another, our policy has been clear: the assets in question continue in the rate base at their previously-determined value without any consideration for a premium above book value that might have been paid in the acquisition. In that way the gain on sale is implicitly awarded to the (transferred) ratepayers, since increase in value above book of the distribution plant is not reflected in rates. Here, the acquiring municipal utility is beyond our jurisdiction. However, the legislative scheme by which our jurisdiction is avoided presumes that public oversight, e.g., through the election of board members and/or local officials, will prove an effective substitute for our regulatory oversight. Where the purchasing utility is a municipality, we are precluded from offering any particular protections to the ratepayers who are being transferred, but the statutory scheme provides them an alternate recourse to resolve any such issues.

Second, when we consider the welfare of ratepayers who remain with the privately-owned utility, we find that, in the circumstances of this rulemaking, they will be in the same position before and after the transfer. There have been many attempts to describe the regulatory compact between ratepayers and shareholders; probably no description is entirely satisfactory. There are many kinds of facilities and types of risk in utility service, and in future cases involving other types of sales of utility assets, we believe that risk analysis will always be pertinent to deciding how to allocate the gains or losses from these sales. It is clear, however, that in the circumstances we address here, our allocation would not abridge the regulatory compact. The ratepayers who remain with the privately-owned utility continue to be served through the same facilities before and after other facilities are transferred through municipalization. Absent a showing of adverse impact on the remaining ratepayers, the intervening transfer should not change the relative risks previously assumed by ratepayers and shareholders regarding those facilities. As we have indicated, we would first require a full alleviation of such an impact before ruling on a municipalization transaction. We need not specify the entire regulatory compact in any detail here to conclude that it is fair and reasonable to preserve the relative positions of utility shareholders and ratepayers who remain under our jurisdiction.

Given that we will exercise our authority to protect the interests of the ratepayers who remain on the privately-owned utility system, and given that the interests of those ratepayers who have been transferred to a municipal utility are beyond our jurisdiction, it is appropriate to allocate any gain (or loss) of this sale to the utility shareholders once full mitigation of any adverse impacts on remaining ratepayers has occurred.

DISCUSSION

The comments filed on this rulemaking reveal a sharp division of opinion among the parties as to how gains on sales should be allocated. The DRA asserts that the capital gain resulting from the sale of a distribution system should be applied to reduce the revenue requirement of the selling utility, that is, go to the ratepayers. This position is supported by the Cities and the California City-County Street Light Association. All other commenters assert that the gain on sale accrues to the shareholders of the selling utility. We hold that the gain on sale of a distribution system, as defined in our Order Instituting Rulemaking, accrues to the utility and its shareholders to the extent that (1) the remaining ratepayers on the selling utility's sytem are not adversely affected and (2) the ratepayers have not contributed capital to the distribution system.

In reaching our decision we have considered the comments on the eight questions posed in the Order Instituting Rulemaking (OIR), and we address each one below.

1. What definition of liquidation or partial liquidation should the Commission use?

The DRA distinguishes between a liquidation and a partial liquidation. It says that a liquidation is the essential process of winding up a corporation and distributing assets among creditors and stockholders, resulting in the dissolution of the business. For assets to be considered liquidated, according to DRA, all liabilities and other obligations connected with those assets must be paid, discharged, settled, or transferred with the assets. In this kind of liquidation, DRA recognizes, any gain on sale of the assets (net of payments to creditors and preferred stockholders) would inure to the common stockholders. Anything short of this is a partial liquidation. The DRA, however, claims that a partial liquidation is a misnomer since, in its opinion, assets cannot be partially liquidated although a business can be partially dissolved. The DRA concludes that for equitable reasons when a sale of rate-based utility assets occurs without liquidation, the capital gain net of all costs of sale should be applied to reduce the revenue requirement of the selling utility, i.e., the gain would be recognized as utility income and thus go to the ratepayers.

Utility commentors say that the DRA has confused the liquidation of assets with the winding up and dissolution of a corporation. The DRA in its reply comments apparently dropped its reference to dissolution as a requirement of liquidation and defined a liquidation as the sale of an entire, separately rate-based distribution system with the transfer of all the ratepayers of the system. This would have been a partial liquidation under the DRA's original definition.

We believe that a lengthy discussion of the various comments on what is or is not a liquidation or a partial liquidation would be merely an exercise in legalisms. All parties have agreed that in a total liquidation and dissolution any gain on sale belongs to the utility stockholders, rather than the ratepayers. The question before us is when a distribution system of a utility is sold, and customers are transferred with the facilities, what should be the ratemaking treatment of the net capital gain or loss, realized in the sale.

Our concern is to recognize the rights of the shareholders without disregarding adverse impacts on ratepayers and the continuing obligation of the selling utility to provide reliable service at reasonable rates. The concept of both the partial liquidation of assets and a partial dissolution of a company are relevant. The sale of a distribution system with customers attached represents a dissolution of a significant part of a utility's total operating system. The utility's business diminishes in terms of assets and customers. This loss of part of its customer base and ongoing business value is tantamount to a dissolution, although only a partial one. In such cases, we will recognize the right of the utility to the net capital gain resulting from the sale, a gain which can be distributed to shareholders, as well as the obligation of the utility to absorb any capital loss.

On the other hand, there may be related debts and liabilities that are not satisfied upon the sale of a distribution system, and thus the assets are not completely liquidated, leaving a burden for the remaining ratepayers. Accordingly, it is our conclusion that in the circumstances of a sale as described in our OIR, a capital gain or loss, net of costs of sale, should be assigned to the utility, thus making it assignable to shareholders. However, the amount of the net capital gain allocated to the utility should be reduced by an amount commensurate with any burden left with the remaining customers of the selling utility.

For ease of reference within the bounds of this rulemaking (and with due recognition that the terminology we use is more convenient than precise), we will use the term "liquidation" to mean the sale of all or part of any distribution system of a utility, consisting of part or all of the utility operating system located within a geographically defined area, to a municipality or other governmental entity as a consequence of which the utility is relieved of, and the municipality or other governmental entity assumes, the service obligations to the customers served by the distribution system. This definition is for clarity, so that parties will not confuse what we are dealing with in this opinion with the same terms when used in other contexts such as corporate dissolutions or bankruptcy. Our conclusion on how to distribute the gain on sale does not turn on the particular term used.

2. <u>What significance should the Commission place on the source of contributions to the value of the property sold, including the initial capital investment, the payment of carrying costs, and other financial support given to the property while it was in rate base?</u>

The DRA places great significance on this question, arguing that because the ratepayer pays the return on investment, the return of the investment (depreciation), plus all reasonably incurred expenses to maintain and operate the utility assets, the ratepayer has an equitable interest in the gain on sale of assets that have been in rate base. This is especially so because the embedded and fixed costs formerly shared by the transferred customers will have to be borne by the remaining ratepayers.

The commenting utilities view the question from a different perspective. They start from the undisputed fact that it is the investor who provides the capital for the venture, and contend that the customer merely pays for service, not the property used to render it. These principles are expounded in a series of cases from the United States Supreme Court and the California Supreme Court. For example, the United States Supreme Court said in <u>Board of Public Utility Commissioners v. New York Telephone Company</u> (1926) 271 US 23 at 31:

> "The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary."

The Court continued, 271 US at 32:

> "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."

The California Supreme Court in <u>Pacific Tel. & Tel. Co. v. Eshleman</u> (1913) 166 Cal 640, 665, propounded similar principles, stating 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...." Eshleman was quoted with approval in Pac. Tel & Tel v. PUC (1950) 34 C 2d 822, 828.

In instances where public utilities have been unable to attract sufficient capital from conventional sources for projects which the Commission deemed essential, the Commission has ordered funds for such purposes to be provided from operating revenues. (See e.g., Southern Calif. Gas Co. (1972) 74 CPUC 30, 55; Pacific Lighting Service Co. (1973) 75 CPUC 604, 616; the GEDA and EEDA Programs (1977) 83 CPUC 16, 19-21; funds received under a Public Utilities (PU) Code § 454.3 program or comparable program.) In those instances any gain on the sale of the property purchased with such funds should go to the ratepayers. (See, Committee of Consumer Services v. PSC of Utah (1979) 595 P 2d 871, 876.)

To answer the question which began this section, the Commission considers significant the source of the investment, usually the stockholder, sometimes the ratepayer. Rates are paid for service received and include a return to compensate investors for their investment. Assertions of ownership of assets and capital contributions do not resolve the questions before us in this proceeding, however. Since a regulated utility is a monopoly granted authority to serve the public trust, it is an entity whose income and expenses are subject to the ratemaking authority of the Commission. As the United States Supreme Court recently affirmed, though the assets of a utility that are employed in the public interest are owned and operated by private investors, the "partly public, partly private status of utility property creates its own set of questions under the Taking Clause of the Fifth Amendment." (Duquesne Light Co. v. Barasch (1989) 488 US ___, 102 L. Ed.2d 646, 657.)

3. What should be the appropriate accounting for liquidation?

When a utility distribution system is sold under the circumstances covered in this rulemaking, the assets comprising that system should be removed from rate base. As our order provides, the net capital gain or loss realized as a result of the sale should be allocated to the utility, and thereby be made available for assignment to its shareholders. If, however, an adverse impact on the remaining ratepayers is found by the Commission, that impact must be mitigated.

Under normal circumstances the Uniform System of Accounts would require that the gain or loss on sale of depreciable assets would be charged to a depreciation reserve account and thus would flow through to ratepayers. For non-depreciable assets the net gain or loss on sale might be flowed through to ratepayers by a rate base offset or to shareholders by a below-the-line credit.

In the circumstances of this rulemaking net gains or losses on sale (whether of depreciable or non-depreciable property) should be assigned to shareholders by transferring the plant accounts and related depreciation reserve accounts to non-utility plant at the time of sale.

We leave the accounting implications of mitigating adverse impacts on remaining ratepayers to the appropriate individual proceedings.

4. What is the effect on a utility's ability to attract capital if the gain is allocated to ratepayers? What has been the effect, for example, of our prior decision in City of Redding on Pacific Gas and Electric Company's (PG&E) securities?

To answer the second question first - PG&E says that it is "hard if not impossible to quantify the decision's effect on PG&E's securities." The DRA believes that there was no effect. We concur with the DRA.

But the more general question can be answered in a general way. If gain on sale is allocated to ratepayers where ratepayers have not contributed capital and where gain was previously allocated to shareholders, there could be an adverse effect on a utility's ability to attract capital. In addition to the liquidation of the asset, the utility also loses the stream of income, customer goodwill, and going business value of the territory transferred, all of which may have an adverse effect on the utility's ability to attract capital.

To deny utility investors the opportunity to offset the erosion of their investment through the receipt of capital gains would be a deterrent to the reinvestment of retained earnings and to the attraction of new capital. Were we to allocate the gain on sale from sale of distribution systems to ratepayers as a general proposition, we would expect the financial markets over time to compare this result to that applicable to competing investments, and adjust accordingly.

5. **What, if any, risks should the Commission consider in balancing risks and rewards between ratepayers and shareholders (e.g., risk of loss of original capital investment; risk of loss of increased value)?**

We will not attempt to completely describe the regulatory compact between ratepayers and shareholders, but it does include assignment of investment rewards or losses to the party that takes the investment risk. At the time a utility makes an investment the assignment is most often implicit, not explicit. Recent regulatory actions have made more explicit the assignment of specific risks (e.g. the ratemaking settlement for PG&E's Diablo Canyon Power Plant approved in D.88-12-083, or cost caps applied in certification proceedings for new power plants), but electric distribution systems have usually if not always entered utility rate bases without such explicit assignment.

Before assigning the gain or loss on the sale of distribution systems, we must first determine the implicit risks associated with those systems. When utilities operate efficiently and the various forecasts inherent in setting rates are reasonably accurate, then ratepayers receive reliable service and the utility earns the authorized rate of return. That rate of return is based on an averaging of individual risks over the entire utility system.

There are many ways to describe the elements of utility risk, but for present purposes we make the following distinctions:

- The risk of poor service falls largely on ratepayers. The value of utility service is not naturally symmetrical, and only in unusual circumstances can the costs of poor service be offset by the superior benefits of better than average service.
- Business risk affects both ratepayers and shareholders. Weak utility management or unmanageable business conditions can induce poor service as well as failure to earn authorized rate of return, or even reduction of authorized rate of return due to poor service. Risk of inaccurate ratemaking forecasts is an element of business risk.
- Apart from operational business risk is financial risk that affects shareholders. In the long run common share prices should reflect a utility's ability to earn a return, but in the short run utility stock prices must drift up and down with financial markets and the general state of the economy. Such variability is eventually built into authorized rate of return, but short term effects are assigned to shareholders. This financial risk is the general risk that goes along with contribution of capital, independent of specific capital projects.
- Specific investment risk is associated with financial risk but differs in that it attaches to individual investments. For example, for electric utilities there are different risks for generation, transmission, distribution and customer investments.
- Regulatory risk flows from decisions by this and other regulatory bodies and affects both ratepayers and shareholders. For example, in the present investigation this includes the assignment of the gain or loss on sale of a distribution system.

Although it is not necessary to this analysis, we observe that utility investment in distribution systems is generally less risky than investment in larger individual assets, such as generating plant or other major assets dedicated to serving all customers.

The implicit risks associated with investment in distribution systems are poor service to local ratepayers within the distribution system, and general financial risks that attach to any investment, which are assigned to shareholders, to the extent that they have contributed capital to the distribution system. The other risks listed above are much less important to capitalization of distribution systems. Business risk impacts utility rate of return through variability of operating expenses more than through direct return on capital investment. Forecasts of distribution system costs or utilization have far less impact on all parties than forecasts of sales and operating expenses. Distribution systems seem to be among the least risky individual investments by electric utilities, due to their relatively small scale, conventional technology and natural monopoly characteristics.

In summary, the risks that are relevant to liquidation of a distribution system are the risk of poor service to local ratepayers, general financial risk to shareholders to the extent that they have contributed the capital and risk of increased burden on remaining ratepayers.

6. <u>Should the analysis of risks be retrospective or prospective? Should we consider who has borne the risks or who bears them at the time of the sale and after the sale?</u>

In determining how to allocate the gain or loss on sale of a distribution system risks should be analyzed prospectively from the time the investment is made, but should generally not depend on actual events during the investment lifetime except to the extent that those events may point out the risks that were inherent in the initial investment decision.

During the investment lifetime shareholders earn a rate of return that includes a risk premium, even though the premium on the particular investment may be subsumed in the averaging process by which the Commission authorizes overall utility rate of return. We cannot blindly assume that all investments are equally risky. In the case of distribution systems we have seen that very little investment risk attaches to individual projects, but ratepayers and shareholders are exposed to other risks. In general, at the end of the utility's investment lifetime, the parties that assumed the risks should receive the rewards, and all other parties should be held indifferent. Thus in the type of sale considered in this rulemaking we allocate the gain or loss to the shareholders, but only after ensuring that remaining ratepayers are not harmed by the transfer.

7. What should be the ratemaking treatment of a gain realized in a transaction which meets the adopted definition of a liquidation, whether partial or total? By way of comparison, what treatment is accorded such transactions in other jurisdictions?

In the event of liquidation and acquisition of the distribution system by a municipality or other governmental entity, the utility's local customers and obligations to serve those customers leave the utility. Thus the risk of poor service to the transferred customers also leaves both the utility and this Commission's jurisdiction. We cannot assign the rewards to the departing customers because they are no longer in our jurisdiction. Our concerns are limited to shareholders and remaining customers.

We have assigned the gain or loss on sale of a distribution system within the scope of this rulemaking to shareholders, who have assumed the general financial risk of making the investment. Because they assumed the risk, they should be assigned the rewards, in this case the gain on sale, so long as remaining utility ratepayers, who took very little risk, are left indifferent. Thus the ratemaking treatment of a gain is to award it to the utility shareholders to the extent that the remaining ratepayers are not adversely affected.

The treatment that other jurisdictions have accorded to the allocation of the capital gain (or loss) on the sale of a utility asset, not necessarily a distribution system as we have defined it, is not consistent. Selected cases are briefly analyzed in Appendix A to this decision.

8. On what basis could the gain be allocated between ratepayers and shareholders?

As discussed above, allocation of gain depends in general on the explicit and implicit risks taken by ratepayers and shareholders at the time an investment is made. For the liquidations considered herein, the risks are poor service to local ratepayers, general financial risk to shareholders, and risk of reduced level of service or increased rates to remaining ratepayers. The rewards and losses induced by sale of assets should accrue to the parties taking or assigned the risks.

Protecting remaining ratepayers from adverse effects, as we will order in this decision, is also consistent with Public Utilities (PU) Code Section 851, which requires Commission authorization of the sale or disposal of property necessary or useful in performance of a utility's public obligations. The concern of Section 851 is to assure that upon the sale of a utility asset, the ability of the utility to provide reliable service at fair rates is not jeopardized. For example, pursuant to Section 851, the Commission considers whether the sale of a utility would place the property in the hands of persons incapable of delivering adequate service at reasonable rates (e.g., SoCal. Mt. Water Co. (1912) 1 CRC 520). The Commission may also prohibit or condition the transfer when the nontransferred portion of the utility property would be rendered inadequate to deliver adequate service at reasonable rates (e.g., App. of Dyke Water Co. (1964) 63 CPUC 641; App. of Plunkett Water Co. (1966) 65 CPUC 313; App. of Kentwood in the Pines (1963) 61 CPUC 629). In Plunkett Water Co. we denied a transfer when we found, among other things, that the rates of the selling water utility would be increased if the sale were approved.

The case of Dyke Water Co. is particularly instructive. Duke Water Company sought to sell a major portion of its water system in Orange County to the City of Garden Grove Water Corporation, a nonprofit corporation, which would then lease the system to the City of Garden Grove. The Commission, in approving the sale, conditioned its approval by impounding part of the sales price to protect remaining customers and commented:

> "Among the duties of this Commission, when public utility properties are to be transferred, is that of assuring that the transfer will not be adverse to the public interest and, in cases like the present where a partial disposition of operating properties is proposed, that the utility's application of funds received from the disposition are made in such a manner as to appropriately discharge its public utility obligations consistent with the utility's continuing obligation to render adequate service to the public with its remaining properties. Dyke Water Company, after the transfer proposed in this proceeding, will have fewer than 4,500 customers remaining and something less than 19 percent of its original plant. This is of significance in several respects, the most important of which is that the remaining system operations must not be so financially burdened, as the result of partitioning, that the utility may not meet its obligations to its remaining creditors or that its remaining customers will be unreasonably charged or receive less than adequate service. In the authorization hereinafter granted, suitable provisions will be made to assure protection of the public interest in such respects." (Dyke Water Company, supra, at 644, 645.)

In applying the principles of section 851, as expressed in Dyke Water Company, we hold that the gain on sale of a distribution system, as defined in our OIR, accrues to the utility as non-utility income to the extent that the remaining ratepayers of the selling utility's system are not adversely affected. We believe that it should not be difficult to determine the effect on remaining ratepayers. It was done in Dyke, Plunkett, and Kentwood, supra, and other applications before the Commission. The utility would have to demonstrate not only that quality of service would not be impaired, but that the remaining ratepayers would not be economically harmed. To the extent an adverse impact is found by the Commission, that much of the capital gain needed to offset this effect would be applied to reduce the utility's revenue requirement.

We believe that our concept is not a departure, radical or otherwise, from more traditional analysis. Our ruling also meets the concerns of the DRA by providing for alleviation of adverse consequences. The rule is not all or nothing.

In its Comments, PG&E distinguishes the case where the sale is carried out under the threat of condemnation rather than voluntarily, and asserts that in the case of a condemnation the gain belongs to the shareholders regardless of the impact on ratepayers. We do not make that distinction.

In both voluntary and involuntary transfers of distribution systems, the ratepayers could be at risk. Our protection of ratepayers should not turn on whether a sale is under threat of condemnation. The narrow factual situation with which we are dealing in this decision can always be characterized as being under the threat of condemnation. That alone cannot make our approval automatic with no concern for ratepayer burden. When our approval is required, we must consider the burden on ratepayers and condition our approval if necessary.

All parties have devoted considerable effort to answer the question whether allocating any portion of the gain on sale of a capital asset to the ratepayers violates the constitutional prohibition on taking property for public use without just compensation. The utilities say it does; the DRA says it does not. We will not discuss the arguments pro and con because, under the view we take of the matter, when property dedicated to a public use is transferred our authority to condition the transfer is statutory (PU Code § 851 and § 701) and well settled. A public utility cannot transfer its property dedicated to public use without the consent of the Public Utilities Commission.[1] (Crum v. Mt. Shasta Power Co. (1934) 220 C 295, 30 P 2d 30; South Bay Irrigation Dist. v. Cal-American Water Co. (1976) 61 CA 3d 944, 133 Cal Rptr 166; Richmond & San Rafael Ferry (1953) 52 CPUC 420; Azuza Valley Water Co. (1972) 73 CPUC 664.)

Findings of Fact

1. The assignment of gain or loss on the sale of utility property to a municipality or other public entity does not turn on the distinction between liquidation or partial liquidation of the utility or its assets.

2. The source of capital for a utility investment is significant in determining eventual disposition of gain or loss on sale because contributors of capital, whether shareholders or ratepayers, assume the general financial risks associated with an investment. However, other risks associated with capital investment are also significant and should be considered.

3. In the circumstances of this rulemaking net gains or losses on sale should be assigned to shareholders by transferring the plant accounts and related depreciation reserve accounts to

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1 However, as we noted in the City of Redding decision, "At least one court has held that a public agency may pursue a condemnation action should the Commission impose conditions unaccepatable to it. People ex rel. Public Utilities Commission v. City of Fresno, 254 Cal. App. 2d 76, 99 (1967). The California Supreme Court has yet to consider this question. But cf., PU Code Section 1759." D. 85-11-018, mimeo, p. 10, n.4.

non-utility plant at the time of sale, with appropriate mitigation of identified adverse impacts on remaining ratepayers.

4. The general impact of the Commission's allocation of gain or loss on sale upon a utility's ability to attract capital has not been accurately quantified. Whatever is the impact, financial markets will over time weigh and adjust capital costs accordingly.

5. The risks that should be considered for distribution system investments are poor service to ratepayers and general financial risk to shareholders, to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the remaining ratepayers have not contributed capital to the distribution system.

6. Risks should be analyzed prospectively from the time an investment is made. At the time of sale, risk analysis should consider who has borne the risks during the investment lifetime.

7. The gain on sale, under the circumstances considered in this OIR, should accrue to the utility, and thereby be made assignable to its shareholders, to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the remaining ratepayers have not contributed capital to the distribution system.

Conclusions of Law

1. In determining the allocation of the gain on sale of a distribution system under the circumstances covered by this rulemaking, the Commission should apply the principles which guide decisionmaking under P.U. Code § 851 and condition approval of the sale, if appropriate.

2. This order should be made effective today to expeditiously deal with those proceedings in which the issues determined in today's decision were reserved pending this rulemaking.

ORDER

IT IS ORDERED that:

1. Our findings and conclusions and the scope of this decision are limited to the following circumstances:

a. a distribution system of a public utility (i.e., gas, electric, or water utility) is sold to a municipality or some other public or governmental entity, such as a special utility district;

b. the distribution system consists of part or all of the utility operating system (system) located within a geographically defined area;

c. the components of the system are or have been included in the rate base of the utility; and

d. the sale of the system is concurrent with the utility being relieved of and the municipality or other agency assuming the public utility obligations to the customers within the area served by the system.

2. The capital gain or loss, net of costs of sales, realized from the sale of a distribution system, under the circumstances described in Ordering Paragraph 1, shall accrue to the utility and its shareholders to the extent that (1) the remaining ratepayers on the selling utility's system are not adversely affected, and (2) the ratepayers have not contributed capital to the distribution system.

3. All proceedings in which the issue of the disposition of the gain on sale of a distribution system, as defined in this

rulemaking, has been reserved, shall be disposed of in accordance with the findings, conclusions, and order of this decision.

4. Consistent with the Order Instituting Rulemaking, this decision shall be applied prospectively, with the exception of those cases in which the issue was specifically reserved.

5. Consistent with the Order Instituting Rulemaking, this decision shall not apply to the sale of utility assets that do not meet the criteria set forth in Ordering Paragraph 1.

6. This proceeding is closed.

This order is effective today.

Dated JUL 6 1989, at San Francisco, California.

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

APPENDIX A
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I. Cases Allocating Gain on Sale to Shareholders

Maine Water Co. v. Public Utilities Comm'n. (Me. 1984) 482 A 2d 443. The court reversed the commission and ruled that gain on sale of two geographical utility divisions to a municipal district should be retained by the utility and not used to reduce rates to customers in the remaining districts. The property transferred included both depreciable and nondepreciable assets.

Associated Natural Gas Company (1983) 55 PUR 4th 702. The Missouri Public Service Commission held that, where the utility proposed to apply the proceeds of the sale to a municipality of a gas distribution system to the retirement of bonds and to investment in new plant, resulting in a reduction in interest expense and increased debt coverage, the gain need not be allocated to ratepayers. In rejecting the staff's argument based upon Democratic Central Committee that the gain should accrue to ratepayers, the commission concluded that the proposed disposition of the sale proceeds would result in a sharing of benefits to both the ratepayers and the shareholders, and that ratepayers would benefit from the reduction in interest expense and the increase in interest coverage.

City of Lexington, et al. v. Lexington Water Company (Ky. Ct. App., 1970) 458 SW 2d 778. This case involved the sale of watershed land no longer needed by a water utility because it had obtained a different source of water. The court held that the utility was entitled to retain the gain on sale of land no longer used in serving customers.

Boise Water Corp. v. Idaho Public Utilities Comm'n. (Idaho 1978) 578 P 2d 1089. The court reversed a decision allocating gain on transfer of utility watershed land to utility customers. The land had been in utility service about 90 years, and had appreciated to a value about 80 times its original cost. The court relied on the fact that the capital had been supplied entirely by the utility investors, that there had been no depreciation paid in rates, that the utility had earned a return only on its original cost and, therefore, that utility customers should not be treated as equitable owners of the property. In dicta, however, the court said that on a transfer of depreciable property the gain on sale should be "treated as if it were the sale of the ratepayer's property." (578 P 2d at 1092.)

Appeal of City of Nashua (N.H. 1981) 435 A 2d 1126. The court upheld a decision of the New Hampshire commission that allowed a water utility to retain the gain on sale of land held for 50 years but now no longer needed to provide utility service.

Philadelphia Suburban Water Co. v. Pennsylvania Public Utility Comm'n. (Pa. Commw. Ct. 1981) 427 A 2d 1244. The court reversed the Pennsylvania commission's decision reducing rates of a utility by the current market value of land upon dividend of the land to its parent company. The land had been in service for over 50 years and had appreciated more than tenfold. The court found the commission's action constituted confiscation without due process and just compensation. The court relied on the concepts that the investors had not recovered any of their investment through depreciation, that they had earned through rates only on the original cost of the land for 50 years, and that utility customers pay only for the use of land, but do not gain equitable or legal rights therein.

Washington Public Interest Org. v. Public Service Comm'n. of D.C. (DC Ct. App. 1978) 446 A 2d 28. The court upheld the action of the commission in allowing gain on sale of land by a gas utility and by an electric utility to be retained by the respective utilities and not to be used to reduce rates. The court relied on the commission's findings that depriving the utilities of the gain on sale, both in terms of effect on expected earnings and on investor assessment of the regulatory climate, would increase the cost of capital to the utilities to the ultimate detriment of their customers.

II. Cases Allocating Gain on Sale to Ratepayers

Democratic Central Committee v. Washington Metro Transit (DC Cir. 1973) 485 F 2d 786. Upon the conversion of the transit system to an all-bus operation, the ratepayers had borne the cost of retirement of equipment and facilities and the cost of removal of street car tracks. The ratepayers had also paid for the acquisition of capital assets. This action rendered certain parcels of property formerly used as trolley-car barns surplus to the requirements of the transit system and made possible their sale for entirely different and more valuable uses at a substantial gain. The court found that, as ratepayers had borne the unique and substantial burden of the retirement of equipment and of track removal, they were entitled to share in the gains from the sale of property which this conversion program had made possible. It was an allocation which rested "essentially on equitable considerations." (485 F 2d at 821.)

Re Tampa Electric Co. (Fla. PSC 1982) 49 PUR 4th 547. Gain from sale of corporate headquarters recognized above the line pursuant to prior commission determination that the treatment of gain from the sale of property dedicated to or formerly dedicated to public service should reflect that ratepayers paid capital costs and depreciation expense when property was in rate base.

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Casco Bay Lines v. PUC (Me. 1978) 390 A 2d 483. 90% of gain from sale of appreciated utility vessels allocated to ratepayers, reserving 10% to shareholders to create incentives to dispose of or productively employ assets that in effect are excess capacity.

Arizona Public Service Company (Az. Corp. Comm'n. 1988) 91 PUR 4th 337. Gain on sale/leaseback of depreciable asset (Palo Verde Unit 2) amortized against annual lease payments over life of the lease, and unamortized balance removed from rate base. But on the sale of a distribution system the Commission divided the gain on sale 50/50 between the ratepayers and the shareholders because the sale "was not in the best interest of APS's remaining customers." (91 PUR 4th at 362.)

Re Carolina Power & Light Co. (NC UC 1983) 55 PUR 4th 582. Gain from the sale of interests in generating units should be used to benefit ratepayers through a reduction in rate base amortized over a particular period.

Re New York Teleph. Co. (NY PSC 1983) 54 PUR 4th 220. Gain from the sale of customer premises equipment should flow through to ratepayers by treating the gain as an above-the-line item as a credit to depreciation expense.

Re El Paso Nat. Gas Co. (FERC 1977) 23 PUR 4th 66. Part of the gain resulting from the abandonment of a natural gas pipeline was allocated to ratepayers by reducing rate base and accordingly reducing cost of service as to return, taxes, and depreciation. Ratepayers were found to have assumed greater risk because of the abandonment. (23 PUR 4th at 95.)

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Detroit Edison Co. (Mich. PSC 1977) 20 PUR 4th 1. Gain on sale of property, consisting of land and building, added to utility income since customers were charged for the property while it was in rate base and should therefore receive the benefit of the gain on the sale.

Boston Gas Co. (Mass. DPU 1982) 49 PUR 4th 1. Treatment of land as an above-the-line item and its inclusion in rate-base warrants above-the-line treatment of the net proceeds from its sale, amortized over a period of ten years rather than applied in full to the company's test-year cost of service since the sale of utility land is an extraordinary, non-recurring event in the operations of the company.

Washington Gas Light Co. v. Pub. Serv. Com'n. (DC 1982) 450 A 2d 1187. Court of Appeals held that the net gain from the sale of propane which had been stockpiled should be allocated to ratepayers. Court states that the validity of each allocation of profits and losses depends upon the factual situation and the equities involved.

Committee of Consumer Services v. Utah Pub. Service Commission (Utah 1979) 595 P 2d 871. When assets are utility property, any transfer should be at fair market value so an appropriate benefit thereof will redound to the credit of the ratepayers.

New York Water Service Corporation v. Public Service Comm's. (1960) 208 NYS 2d 857, 863-864. Gain from sale of land no longer useful as storage reservoir should be passed on to the customers. The utility is protected from a loss in the sale of land in its operations; it seems reasonable it should pass on a profit to the customer.

(END OF APPENDIX A)