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Decision 90-04-028 April 11, 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

Glen J. Sullivan, and Woodrow D. Smith, Attorneys at Law, Roy M. Rawlings, for Southern California Gas Company, applicant.

Roger J. Peters and Mark R. Huffman, Attorneys at Law, for Pacific Gas and Electric Company; Ronald R. McClain, Attorney at Law, for Pacific Bell; Brobeck, Phleger & Harrison, by Robert N. Lowry, Attorney at Law, for California Water Association; John W. Witt, City Attorney, by William S. Shaffran and Leslie V. Girard, Deputy City Attorneys, for the City of San Diego; Mark Urban, Deputy Attorney General, for John K. Van de Kamp, California Attorney General; Barbara Kirschner, for Southern California Water Company; and Sylvia M. Siegel, for Toward Utility Rate Normalization; interested parties.

Ida M. Passamonti, Attorney at Law, and K.C. Chew, for the Division of Ratepayer Advocates.

I N D E X

I N D E X

O P I N I O N

I. Summary

This decision finds that it was reasonable for Southern California Gas Company (SoCalGas) to sell its Flower Street headquarters in 1987, and that the terms of the that sale (including the interim leaseback) were reasonable.

The decision also sets forth a clear and narrowly defined policy applicable to the sale and replacement of a headquarters building. This policy is based on ratepayer indifference to the sale and replacement and an incentive for the utility to put assets to their highest economic use.

This decision allocates $13.483 million to ratepayers as their share of the net proceeds. This is based on the expenses SoCalGas will face to replace the services Flower Street would have provided over its expected life. Ratepayers are made whole as if the sale had never occurred. The remaining net gain (including interest from the date of the sale) is allocated to SoCalGas shareholders, and it represents the value of the more efficient use to which the Flower Street property will now be put by its new owners.

This decision also determines that a risk-sharing analysis would produce a comparable allocation of the gain for ratepayers based on the risks they bore through the ratemaking process for the occupancy of Flower Street. The risk-sharing analysis confirms the magnitude of the allocation to ratepayers.

Parties are directed to develop a specific means for refunding the $13.483 million to ratepayers in the subsequent phase of A.88-12-047, where the reasonableness of the Grand Place expenses will be determined.

II. Procedural History

On July 28, 1987, SoCalGas filed A.87-07-041 seeking the Commission's authorization to sell its Flower Street Headquarters, as required by Public Utilities (PU) Code § 851.

Interim Decision (D.) 87-09-076

Aware that the delay occasioned by the time necessary to process and decide an application to sell under PU Code § 851 could hamper or prevent a sale in a fast moving market or affect the price, the Commission on September 27, 1987 by interim decision granted authority to sell. The reasonableness of the sale, all ratemaking consequences flowing from such sale, leaseback, and associated activities, including gain from sale, were deferred to a Phase II proceeding of A.87-07-041 wherein SoCalGas would bear the risk of demonstrating the cost-effectiveness of any sale and leaseback, as well as the leasing of a new headquarters facility. In addition, it was understood that leaseback costs exceeding costs already provided in rates set for attrition years 1988 and 1989 would be absorbed by SoCalGas; if less, the difference would be subject to refund.

D.88-03-075

On October 30, 1987 the utility petitioned to modify Interim D.87-09-076, asking to defer review of the cost-effectiveness of the new Grand Place headquarters to a future rate proceeding wherein SoCalGas would seek to recover in rates its costs associated with the new headquarters.

The Division of Ratepayer Advocates (DRA) opposed any separation of issues, stating that the reasonableness of the new lease was directly related to disposition of the gain, and that any reasonableness review of the new lease should determine whether the ratepayers had been harmed by the sale of used and useful property.

By D.88-03-075 issued March 23, 1988, the Commission modified Ordering Paragraph 4 of Interim D.87-09-076 to read as follows:

> "4. SoCalGas will bear the risk of demonstrating the cost effectiveness of any

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

Left undisturbed was the provision in Interim D.87-09-076 Ordering Paragraph 2 that the gain on sale issue be considered in the Phase II proceedings of A.87-07-041.

The April 7, 1988 SoCalGas Amendment to A.87-07-041

On April 7, 1988 SoCalGas filed its amendment to A.87-07-041, addressing its proposed ratemaking and capital gain treatment of the consequences of the sale of its property. This launched Phase II proceedings for A.87-07-041.

The gas company calculated its gain on sale to be $57,636,000 net after its share of the selling expenses and the original cost of the land was subtracted from its $63,817,000 share of the gross proceeds. SoCalGas concluded that its after tax gain would be $32,648,000.

Attempts at Reconsolidation

DRA made a number of attempts to convince the Commission to consider the reasonableness and cost effectiveness of the sale and leaseback of SoCalGas's headquarters in the same proceeding that evaluated the reasonableness of SoCalGas's replacement headquarters arrangements and determined whether or not the gain on sale should be used to offset costs associated with the replacement headquarters. The Commission rejected DRA's petitions for modification of its earlier decisions, and the ALJ tabled DRA's August 4, 1988 motion seeking such consolidation for disposition in the final decision in this proceeding.

Consistent with the policy articulated later in this decision, it is more appropriate to consolidate the review of an asset that is sold with the determination of the reasonable level of expenses for its replacement. In the future, we will so structure our proceedings. In this case, the record is sufficient to determine the appropriate disposition of the gain on sale without reviewing the prudency of Grand Place, because the detailed feasibility studies conducted by SoCal's consultants contain sufficient information to permit the required calculations as set forth herein.

In late 1988, SoCalGas filed its test year 1990 general rate proceeding, A.88-12-047. Issues associated with SoCalGas's replacement headquarters decision will be addressed in that proceeding.

The Hearing and Briefing

There were seven days of hearings before ALJ Weiss between January 9 and January 18, 1989. The issues ordered for hearing in Phase II by Commission Interim D.87-09-076 (as modified by D.88-03-075) were thoroughly covered. Closing briefs were received February 11, 1989 from SoCalGas, PG&E, Pacific, City of San Diego, and DRA, and reply briefs on March 9, 1989 from the same parties. Phase II of A.87-07-041 was submitted for decision on March 9, 1989.

III. Discussion

This decision resolves four basic issues:

1. Was the SoCalGas sale of its Flower Street headquarters reasonable?
2. What is the net gain on the sale of SoCalGas's Flower Street headquarters.
3. How should the gain on sale be distributed?
4. Was there an over or undercollection of headquarters expenses during the leaseback period?

These issues will be addressed in order.

1. Was the SoCalGas Sale of its Flower Street Headquarters Reasonable?

SoCalGas's principal place of business, three interconnected office structures, and a parking and vehicle service facility, are situated on an approximate 161,000 square foot parcel of land within the block bounded by Flower, Hope, 8th, and 9th Streets in downtown Los Angeles. The balance of the block, an approximate 32,500 square foot parcel, was owned by Pacific.

SoCalGas purchased the first segment of its parcel in 1923, and acquired additional segments in 1939, 1940, 1944, 1945, 1948, 1956, 1958, 1965, 1970, and 1971. The acquisition cost for the entire parcel was $1,895,000. The initial office structure was constructed in 1924. The others followed respectively in 1941, 1953, and 1960. The vehicle service facility was added in 1979. The original cost plus the total of capitalized improvements to September 30, 1987 was $23,885,000 for the structures.

<u>Position of SoCalGas</u>

SoCalGas claims that the sale of its Flower Street Headquarters is resonable for several reasons. First, SoCalGas submits that it had outgrown the facilities. Headquarters functions and staff personnel were dispersed to facilities scattered around the greater metropolitan area. This dispersion was inconvenient and inefficient.

SoCalGas also claims that its headquarters facilities were obsolete and increasingly difficult to maintain. Space utilization was hampered by building columns, excessive stairwells, low ceilings, window dispositions, and compartmentation forced by individual buildings. Even though some space had been remodeled, full advantage could not be made of modern office layout. Elevators, plumbing, electrical, hardware, roofing, heating, and air conditioning were worn out or wearing out rapidly.

According to the utility, the cost of continuing to operate and maintain its Flower Street complex was uneconomic. The utility presented a projection of the costs for remaining in its Flower Street headquarters. These costs included operating and maintenance (O&M); moderate, on-going space renovations; and other necessary work which would be required if the utility were to stay such as the removal of asbestos. These projections did not incorporate the costs associated with major building renovations and reconstructions required if SoCalGas were to remain for any substantial length of time. These included new roofs, plumbing, structural work, and other work to bring the structures up to current building, fire and safety, earthquake, and handicapped access requirements codes and requirements. The utility found that not only would the costs for remaining in the existing structures be quite significant, but that even after updating it would still have a second class office facility, one that would continue to be inefficient in layout and appearance, and inadequate to house all headquarters' personnel and functions.

To support its position that the sale of its Flower Street complex was reasonable, SoCalGas submitted four studies by consultants retained to review alternatives.

The Landauer Appraisal

In 1984 Landauer Associates, real estate counselors, was engaged to evaluate the headquarters facility and to do a market value appraisal of the headquarters land and buildings. Landauer found that the four office buildings were well maintained, but varied considerably in modernization and appearance. Piecemeal additions and alterations resulted in inefficiencies and functional obsolescence. Landauer concluded that the buildings did not provide a reasonable return on the land value and that a complete redevelopment of the total site would reflect the best use of the property. Landauer estimated the market value of the land and buildings as of February 15, 1985 to be $54,600,000.

The Becket and Associates Study

Early in 1986 SoCalGas asked the architectural firm of Becket and Associates (Becket) to examine alternate strategies for retaining all or part of the existing structures at Flower Street in conjunction with a larger feasibility study for possible renovation or redevelopment. Becket concluded that it would not be feasible either technically or economically to bring the existing buildings up to the standards of current building codes, and recommended that the buildings be completely removed. Becket identified the major disadvantages of the old buildings as the low ceilings and irregular structural bays and windows which complicate systematic modular space planning, partitioning, air conditioning and heating. Becket reported that the buildings contain an excessive number of structural columns, elevator shafts, stairwells, equipment rooms, wide corridors, and unusable open space areas. They provide usable space to rentable space building efficiency ratios in the low 80% range, whereas well-planned new high rise office buildings provide comparable efficiency ratios between 92 to 95%.

The Cushman Realty Corporation Real Estate Study

During this same period, the utility retained Cushman Realty Corporation (Cushman) to explore alternative occupancy strategies and to evaluate the development potential on the Flower Street site. Early on, Cushman's advised SoCalGas and Pacific to split tenancies and each go its own way in solving its office space problems.

In a July 1986 report, Cushman concluded that the most costly option for SoCalGas involved a continued use of the existing buildings while meeting consolidation and growth needs either by construction of still another office building at Flower Street, or by leasing space nearby. Cushman found the existing buildings to be inefficiently designed with poor space layout possibilities and O&M expenses considerably higher than those in new downtown office buildings. Cushman also concluded that the cost to update the existing structures could be significant.

Cushman also studied at prospects for complete redevelopment of the entire Flower Street block, with and without tenancy with Pacific, and including large scale mixed use (including office, hotel, and retail components) and high and low density proposals. It concluded that development of the full block could present greater financial risk than would relocation to a newly constructed facility which could be obtained under lease at below market rates.

According to Cushman, the 19% vacancy rate showed the softness of the then current downtown office market, which created an excellent opportunity for SoCalGas to negotiate favorable lease terms downtown. Cushman foresaw "a window of opportunity for tenants seeking new facilities in the 1989 to 1990 period", since significant amounts of new first class sublease space would be added to that market.

Cushman concluded that the strategy resulting in the lowest occupancy costs and least risk involved selling the Flower Street property with a leaseback, and relocation upon completion to one of the new downtown projects. Such strategy would avoid a double move for SoCalGas, and if Pacific were to move out immediately it would also free up some space in the interim leaseback period to allow some consolidation of present off-location SoCalGas headquarters' personnel.

Cushman also estimated "a very conservative value" of $60,000,000 in 1986 dollars for the 3 downtown parcels owned by SoCalGas and Pacific. This estimate was based on the assumption that downtown core land was worth $30 per square foot of buildable density allowed, and assumed a minimum allowable density for the 3 parcels of approximately 2 million square feet. It was Cushman's statement that excellent opportunities then existed to sell the

Flower Street land to a developer, or to sell the land with existing improvements on a parcel basis to one or more developers.

The Stegeman and Kastner, Inc. Study

SoCalGas engaged Stegeman and Kastner, Inc. (Stegeman), project management consultants, to make a final determination of the cost of updating the Flower Street buildings to meet minimally acceptable architectural and functional office requirements were SoCalGas to remain another 20 years. Stegeman's final report, issued in July, 1987, concluded that updating the Flower Street structures would necessitate stripping the buildings to their structural frames and exterior skins. It would be necessary to rebuild the elevators, replace all plumbing and toilet facilities, mechanical systems, all secondary electrical, and all windows. The buildings would require new roofs, all asbestos would have to be removed, and the structural steel refireproofed. The most cost-effective approach would necessitate relocation of all operations to outside locations for 18 months. Stegeman noted that the renovated buildings would still lack some fundamental advantages inherent in a modern structure, and that the remaining deficiencies would translate into higher occupancy costs over the life of the buildings. The conceptual cost estimate of such a renovation was $83,000,000.

SoCalGas's Decision to Relocate its Headquarters

Based on its own studies coupled with expert outside professional opinion, SoCalGas concluded that continuing at Flower Street was no longer economically justifiable, and that it was time to obtain new headquarters. It also decided to remain in the old buildings pending construction of the new facilities. Beyond this holdover period it would have no reasonable basis to retain the to-be-vacated property for any possible future utility use. Rather than wait until it vacated the property before selling it, the gas company determined to take advantage of a favorable window of opportunity in the real estate market to sell it immediately, subject to a limited term leaseback.

Relying upon Cushman and Richard Volpert, their real estate consultants, SoCalGas concluded that the value of the property would be maximized if SoCalGas and Pacific consolidated their properties and sold Flower Street as an entire block. Faced with the need for a headquarters site for use while any new headquarters facility was being made ready, SoCalGas included in its sales offering a requirement for a temporary leaseback.

In early in 1987 a detailed prospectus for the Flower Street property was circulated to about 50 potential purchasers with perceived capability for such a large transaction. This brochure resulted in more than 15 serious inquiries, and in 3 written offers.

The Shuwa offer emerged as the most attractive, not only in offering the best price in cash, but also in Shuwa's willingness to accept the lowest return for the first four years of a necessary leaseback while waiting for removal of the buildings so that Shuwa could develop the site. Shuwa also offered the most flexibility on holdover if necessary.

In the summer of 1987, SoCalGas (in association with Pacific) decided it would be advisable to sell Flower Street immediately rather than hold off until SoCalGas would be able to move to new facilities. The principal reasons were the strong Los Angeles market then available, the Japanese interest in the property influenced by the relative value of the dollar to the yen, and the potential for development restrictions in subsequent years. Accordingly, SoCalGas and Pacific on August 13, 1987 signed a letter of intent with Shuwa for the sale of the entire Flower Street block, and the Pacific property across Hope Street.

Under the sale agreements the gas company is obligated to demolish and remove all improvements, up to a total of $2,200,000, at the end of the leasebacks. (Since Pacific has previously demolished the old church property on its parcel, the remaining demolitions will be virtually all SoCalGas's responsibility.)

The agreements with Shuwa provided a leaseback arrangement structured to dovetail with the gas company's interim needs of another approximate four years (1987-1991) before the newly leased facilities would be available for move in. The leaseback agreements are for an initial term of five years, but are cancellable at the end of four years - the estimated time by which SoCalGas's new headquarters are to be completed. The leases can be extended annually for up to an additional five years. SoCalGas has and will continue to lease the Pacific parcel, using it to help meet its headquarters parking needs.

The leaseback rental cost to SoCalGas is $319,083 per month for the first five years. After that the cost escalates sharply upwards to discourage any holdover. The leases obligate the gas company to pay all operating and maintenance expenses, as well as property taxes, during the leaseback.

With 423,124 square feet of rentable space, the $4,347,000 cost for rent and taxes works out to an annual cost of $10.27 per square foot for the leaseback. This compares to the $11.56 cost of headquarters ownership by the gas company of the same space for 1986, and with the $19.62 and $24.25 per square foot cost for downtown Los Angeles office space for 1986 as reported respectively by Building Owners and Managers Associates International, and Coldwell Banker Real Estate Service.

DRA's Position Regarding SoCalGas's
Decision to Sell Flower Street

DRA believes that SoCalGas's decision to move from Flower Street was unreasonable, and was based on profit maximization motives rather than sound business judgment.

DRA asserts that the buildings are still useful and have value as represented by the almost $15,000,000 of capitalized improvements added to rate base since 1970. It contends that the buildings cannot be peremptorily called "obsolete" and deemed valueless to maximize cash flow from the sale. It contends the buildings have not lost their usefulness, do not have economic in utility arising from external causes, or disappearing usefulness resulting from invention, change of style, legislation, or other causes. It argues that the buildings have not been condemned and are not suffering from exhaustion, wear and tear, deterioration, or change in physical condition.

Discussion

There can be no doubt that the Flower Street headquarters buildings had reached the point where they were no longer suitable for long-term use by the gas company. The buildings are less seismically safe, contain substantial amounts of asbestos, and do not meet fire codes, lacking sprinklers, and fire-rated stairwells. In recent years legislation on earthquake resistance, asbestos removal, handicapped access, and fire safety has been enacted, and code compliance is required with major renovations.[1] Because of old and piecemeal construction they have inefficient design requiring about 25% more floor space per employee than a modern building. Mechanical systems, plumbing, electrical, and elevators are worn and obsolete. Even if renovated, the buildings would not have enough space for all of SoCalGas's headquarters functions and personnel since the density level of the existing buildings would not change.

Given the physical problems associated with the Flower street headquarters, we do not believe that the desire to realize appreciation was the primary motivation for SoCalGas's decision to

1 We note that a tenant with fewer personnel, and thus less need to engage in major renovations in order to maximize space utilization, might find it possible to make these buildings habitable without confronting the new code restrictions.

move from Flower Street. Based on our examination of the evidence, we conclude that the gas company's decision to move was reasonable.

The sale price of $76,680,000, well in excess of the March 18, 1985 appraisal estimate of $54,600,000 by Landauer, appears to reflect fair market value (also confirmed by Cushman's assumption that downtown land is worth $30 for each square foot of buildable density that can be placed upon it. As the Flower Street land carries a minimum 2 million square foot allowable density, this would indicate at least a $60,000,000 valuation).

The division of these proceeds between SoCalGas and Pacific, based as it was upon the ratio of their perspective square footage, appears a fair apportionment. SoCalGas's share of the gross proceeds was $63,816,566.

The gas company's decision to lease back Flower Street for the anticipated four years until Grand Place could be prepared for occupancy allowed it to take advantage of the propitious real estate situation then prevailing and sell Flower Street immediately without facing a series of expensive interim moves.

We conclude that SoCalGas's decision to sell the Flower Street property, and to sell when it did, was reasonable; that it was also reasonable and profitable to sell it packaged in association with the Pacific property; that the method of offering and selling was reasonable; and that the price obtained was reasonable - the parties obtaining fair market value for the property. We also conclude that SoCalGas's share of the proceeds was reasonable.

We also conclude that the leaseback for a four year period is a reasonable and cost-effective resolution to meet the interim requirements of the utility. Not only are the leaseback costs, for the four year period, less than the revenue requirement associated with SoCalGas's own continued ownership of the buildings, but the leaseback arrangement also enables the utility to avoid the costly disruptions of interim short term moves during the period between its favorable sales opportunity and its projected occupancy of its new quarters.

2. **What is the Net Gain on the Sale of SoCalGas's Flower Street Headquarters?**

The total purchase price for the Flower Street facilities was $76,680,000. SoCalGas's share of the gross proceeds is $63,816,516, based on the ratio of footage owned by SoCalGas and Pacific, respectively.

The original cost of the land was $1,895,000. The undepreciated cost of the buildings is $15,025,000. We have computed that SoCalGas has realized, over the years it has held the headquarters in rate base, an after tax return of about $32,000,000 (through 1987).

The agreements between SoCalGas and Shuwa require SoCalGas to pay up to $2,200,000 to demolish the headquarters buildings once SoCalGas's leaseback tenancy ends. SoCalGas and DRA disagree as to how this demolition expense should be accounted for.

SoCalGas and DRA also disagree as to how the undepreciated building costs should be accounted for. SoCalGas would place these costs in the depreciation reserve, whereas DRA would return the capital represented by those undepreciated costs to the utility through a deduction from the gross proceeds.

We will address the demolition costs first, and then the undepreciated building costs.

Demolition Costs

SoCalGas has also proposed that the costs of demolishing and removing the buildings at Flower Street be borne by the ratepayers through a charge to the depreciation reserve account. Its authority for this disposition is the FERC Uniform System of Accounts, Account 108 - Accumulated Provision for Depreciation of Gas Utility Plant (Major Only), where Paragraph B states:

> "At the time of retirement of depreciable gas utility plant, this account shall be charged with the book cost of the property retired and

> the cost of removal and shall be credited with the salvage value..."

Normally, cost of removal is estimated when an asset is placed into service and adjusted at times along with the depreciation schedule. This "negative salvage" is thus reflected over the life of the depreciable asset. In the case of buildings, zero salvage value is usually assumed (as with these buildings) so that over the life of these buildings there has been no allowance. Here the utility asserts it will not have been paid a full return on its buildings investment unless or until the removal costs are charged to Account 108 along with the undepreciated book cost.

DRA disagrees, contending that the costs to demolish and remove should be a "cost of the sale"; that had the property not been sold these costs would not have arisen; that they are not costs of utility operations, but are costs generated substantially at the discretion of the gas company.

In its negotiations with Shuwa, the gas company agreed to accept responsibility for the $2,200,000 estimated cost of removal. Clearly, the demolition costs were an element in determining the purchase price. It is also anticipated there will be salvage. We agree with DRA that these costs should be offset against the sales proceeds, thus protecting the ratepayers from paying the capitalization costs of this nonoperational "cost of sale" item.

<u>Treatment of the Undepreciated Building Costs</u>

SoCalGas believes the gain on sale of its Flower Street headquarters should be allocated entirely to the land, and contends that the headquarters buildings themselves should be treated as utility plant prematurely retired by reason of obsolescence. SoCalGas argues that under the uniform system of accounts it is entitled to earn a return on the undepreciated value of the buildings, to receive the income tax "gross-up" associated with that return, and to receive depreciation flowing from the depreciation schedule associated with the buildings.

DRA does not agree. DRA contends that the headquarters sale represented a consolidated sale of both the headquarters land and the headquarters buildings, and that it is neither possible nor appropriate to allocate one portion of the gain to the land and another to the buildings. DRA proposes that the undepreciated value of the buildings, and the cost of demolishing the buildings when the leaseback ends, be subtracted from the gross sale proceeds during our determination of the amount of gain on sale associated with this transaction. DRA points out that the amount of gain on sale can only be determined after the original property costs and sales transaction costs are subtracted from the sales proceeds.

DRA notes that under SoCalGas's approach, the undepreciated cost of the buildings as of October 7, 1987, and the cost of demolishing the buildings at the end of the leaseback period, would be charged as a retirement to the depreciation reserve account. Since the depreciation reserve for these buildings is not sufficient to cover the retirement and demolition costs, SoCalGas's rate base would increase. Ratepayers would have to absorb the undepreciated building costs and the demolition expenses from the date of sale as part of the utility's revenue requirement even though the utility will continue to occupy the same building under the leaseback arrangement. If SoCalGas recovers its lease costs through its revenue requirement at the same time it earns a return on the buildings as if they were truly retired utility plant, ratepayers would pay twice for the same plant. DRA concludes that SoCalGas should not be able to maximize its return on the headquarters sale by allocating all the gain to land and to shareholders at the same time it allocates all the burden of the undepreciated building value to ratepayers.

We agree with DRA that the headquarters sale was a consolidated sale of both land and buildings and that the undepreciated value of the buildings should be subtracted from the gross proceeds as part of the process of determining the extent of gain realized on the headquarters transaction.

Both land and buildings were in existence at time of sale; clearly both were sold. Furthermore, the buildings had value for both the buyer and the seller. SoCalGas's accounting approach improperly ignores the buildings' value. Also, DRA is correct in pointing out that the FERC adopted USOA is really a record keeping system, and that it is not a ratemaking treatise that is controlling on the issue before us. This is addressed at length, with citation to a long line of Commission precedent, in DRA's briefs and comments to the ALJ's proposed decision.

The buildings had value to the purchaser, because they result in the purchaser receiving substantial lease-back payments for up to ten years, and because they provide a return on the headquarters site until future development plans are set in motion. If SoCalGas occupies the buildings for four years it will pay a total of $15,315,984 in lease payments (48 X $319,083.) This is not an insignificant return on a $76 million investment, especially since the lease provides that SoCalGas will also pay all taxes and maintenance associated with the headquarters during the leaseback period, thus enabling Shuwa to avoid the costs normally incurred by those leasing property. Furthermore, given the "buyers' market" for Los Angeles office space in 1987, the benefits of deferring development may have been substantial. In any event, we do not believe that SoCalGas is correct in asserting that the buildings, if anything, lowered rather than raised the value of the land to potential buyers.

The buildings have value to SoCalGas since they provide a headquarters space for SoCalGas until the new headquarters building is ready to lease and thus preclude the need for the utility to rent and move into temporary office space during the period between the "window of opportunity" for a good sales price and the date the new headquarters is ready. SoCalGas would have found it expensive and time consuming to find alternate headquarters during this interim period. Furthermore, since SoCalGas requires a great deal of floor space not easily found at a single location, Socal would almost certainly have had to divide up its headquarters personnel and to incur the inefficiencies inevitably associated with such an action. We note that the existing division of personnel was one of the primary reasons SoCalGas wished to move into a consolidated headquarters in the first place. Indeed, SoCalGas found the leaseback arrangement so valuable that its request for bids on the Flower Street property was qualified by the inclusion of the leaseback provision.

Since both seller and buyer benefit from the buildings' continuing existence, it cannot be said the buildings had no value. It is safe to assume that the value of the buildings was taken into account during the sales negotiations. Since all bids received by SoCalGas reflect the leaseback provision required by SoCalGas, there is no way to measure precisely the value of the buildings alone or the land alone on the open market. Any attempt at such quantification would at this late date be highly speculative and unrealistic.

If SoCalGas had offered to sell the property both with or without the buildings, we would perhaps have been able to determine whether razing the buildings could have raised the value of the land itself, as SoCalGas impliedly asserts. And if SoCalGas had actually razed the buildings before selling the land, we could have determined the market value of the land alone. But these hypotheticals are not before us today. Instead, we are confronted by a clearly consolidated sale of both land and buildings, and by the absence of any basis or compelling rationale for allocating the gain between that associated with the sale of the buildings and that associated with the sale of the land upon which the buildings sit. For this reason we will look to Commission precedent regarding consolidated transactions involving both depreciable and non-depreciable property rather than to the precedent dealing with land alone.

Our decision to consider the sale proceeds on a consolidated basis essentially resolves the issue of proper treatment of the undepreciated building costs. Had we adopted SoCalGas's approach, there would have been no depreciable property proceeds from which to subtract these undepreciated costs, and the utility's ratepayers would have faced the prospect of paying a return, depreciation, and taxes associated with the soon to be demolished buildings under traditional accounting principles on "premature retirements". SoCalGas's approach would also have resulted in the utility's retaining as "gain on sale of land" its entire gross proceeds of the sale minus only the relatively small commission and consulting costs associated with the transaction.

By allocating the sale proceeds to both the land and the buildings, we allow for the direct up front return to shareholders of both their original land investments and their undepreciated building investment. Shareholders are made whole for their utility investment, and ratepayers are freed from the need to pay a return, taxes, and depreciation on buildings that will soon be no longer used for utility purposes. We think this result is fair to both ratepayers and shareholders.

Accordingly, the Commission will not authorize any return on the remaining $15,025,000 undepreciated portion of the costs of the headquarters improvements, or depreciation, or allowance for income taxes associated with these improvements after October 7, 1987. Instead, the $15,025,000 of undepreciated building improvements will be deducted from the proceeds of the sale in determining the gain realized.

Consulting Fees, Sales Commissions, and Tax Impacts

SoCalGas states that it paid $3,000,000 for feasibility studies, $1,286,000 for sales commissions, and $24,988,000 in taxes associated with the sale of its Flower Street headquarters.

DRA disputes only the tax impacts. Because it assumes that the undepreciated buildings costs should be deducted from the gross proceeds during our determination of the gain on sale, and that therefore the taxable gain on sale will be lower, it arrives at a tax impact figure of $16,220,000.

We agree with SoCalGas that its consulting fees and sales commissions were reasonable expenses incurred during the sale of Flower Street.

Since we agree with DRA regarding the proper treatment of the undepreciated building costs, we find that the DRA's tax impact calculation is appropriate. We note SoCalGas's contention regarding the proper basis for calculating the capital gains tax with respect to the flow through of accelerated depreciation prior to 1981. However, SoCalGas presented no evidence regarding how this figure should be adjusted, and our final disposition of the gain does not depend directly on this calculation. Even if we were able to adjust the capital gains tax per SoCalGas's position, it would not affect the amount allocated to ratepayers.

Our final determination of the gain on sale attributable to the sale of SoCalGas's Flower Street headquarters is set forth in the following table.

TABLE I

Calculation of Gain on Sale

(Dollars in Thousands)

Gross Sales		$76,680
Allocated @ 83% (SoCalGas Sq. Ft. Percentage: 161389/193920)		63,817
Less:		
Sales Commission	$ 1,286	
Feasibility Studies	3,000	
Cost of Land	1,895	
Undepreciated Cost Of Buildings	15,025	
Demolition (tentative)	2,200	
Total Deducts	23,406	
Gain on Sale	40,411	
Capital Gains Tax @ 40.138%	16,220	
Net Gain On Sale After Tax	$24,190	

3. <u>How should the Gain on Sale be Distributed?</u>

The sale of the Flower Street headquarters owned by SoCalGas resulted in a very substantial gain over original cost. Disposition of that capital gain is disputed.

<u>Position of the Utilities</u>

The utilities make three basic arguments why SoCalGas is entitled to the gain on the sale of its headquarters. One argument holds that since the utility itself, and not its ratepayers, originally purchased and holds title to its rate base assets, then the utility, and not the ratepayers, is entitled to the gain on the sale of those assets.

A second argument is based on a "regulatory compact" theory that since under original cost ratemaking investors agree to receive a return on the original cost, and not on the current market value, of their investment, they are entitled to all the gain when the assets purchased by their investment are taken out of rate base and sold.

A third argument is based on the characterization of the present sale as one of land only, and on the contention that the FERC USOA, this commission, and some high courts in other jurisdictions have traditionally treated gains on the sale of rate base land used to provide utility service differently than gains on the sale of depreciable rate base property and land held in plant held for future use accounts. This argument is based in part on the contention that the utility has always borne the risk of any decline in the value of the land between the time it was placed in rate base and the time its was ultimately sold.

SoCalGas argues that to apply the gain to the utility's future revenue requirements, as DRA proposes, would be an opportunistic and unconstitutional confiscation of the proceeds legally and equitably belonging to SoCalGas.

Position of DRA

DRA contends that the capital gain proceeds should be used to offset the cost of replacement headquarters facilities. DRA would require that the net gain, plus interest since close of escrow, be placed in a deferred credit account and amortized over a nine-year period as a reduction of the gas company's revenue requirements.

DRA observes that investors in regulated utilities are not entitled to and should not expect more than a return of their original cost and a just and reasonable return on their original cost investment. DRA argues that the Commission is not legally or equitably required to assign any increase in the value of a utility asset when that land is ultimately sold since the total the utility would then receive would be over and above the just and reasonable return guaranteed the utility under original cost ratemaking.

DRA regards this transaction as a sale of both land and buildings. DRA points out that SoCalGas would never have purchased the land that has increased in value had that land not been necessary as a site for the utility buildings constructed upon it. DRA argues that since ratepayers have paid in rates for operation and maintenance expenses, depreciation, and taxes associated with the headquarters, plus an after-tax return on investors' original cost basis in the land, the net proceeds from the retirement of the land from used and useful status should be applied to offset the utility's cost of service. DRA further argues that because capitalized expenditures on the buildings since 1969 equalled the depreciated book cost of the buildings at time of sale of the land in 1987, some of the sales gain must be attributable to their value at time of the sale.

DRA asserts that gains from the sale of nondepreciable assets should be allocated the same as gains from the sale of depreciable assets, and that ratepayers' interests and obligations are the same for both classes of asset. Both the depreciable buildings and the nondepreciable land, while necessary or useful, are included in rate base, and the rate of return on rate base is applied without regard to the character of the asset. It asserts that there exists a long line of Commission decisions which hold that whether the property was depreciable or nondepreciable, when maintenance and taxes were included in rates, capital gains were flowed back to reduce rates, particularly where replacement property was purchased.

<u>Discussion</u>

This is admittedly a complicated situation, and the record reflects a wide range of concerns that parties believe ought to bear on its disposition. The issue cuts to the heart of the relationships between investors, the utility as a corporate entity, the ratepayers, and this Commission. The numerous citations to precedent of all vintages are hardly surprising given the fundamental nature of the question.

Here we have an asset used and useful in utility service whose market value has diverged greatly from its book value. The utility has sold the asset and secured the use of a substitute to provide an essential component of utility service.

First, we are not convinced that utility investors are automatically entitled to the proceeds of such an extraordinary gain due solely to their ultimate claim on the assets of the corporation. The utility corporation acts as a legal intermediary between the investors and the assets, and that corporation's conduct of its affairs is fundamentally constrained by our jurisdiction to determine just and reasonable rates. To regulate the terms of utility service and the reasonableness of rates requires us to make decisions as to signigicant aspects related to the utility's acquisition, use, and disposition of capital and capital assets. We determine which assets are used and useful in utility service, and what constitutes prudent investment in those assets. We approve the issuance of stock and debt, and must approve the encumbrance of utility assets for any purpose. We must approve the sale of any used and useful utility asset, as we did in this case in a prior decision. These and other regulatory responsibilities are intimately related to the disposition and replacement of used and useful assets.

The sale of a headquarters property with entry into a replacement lease is distinguished from a liquidation, as in our Redding case (D.89-07-016). In the Redding case the sale of all assets coincides with an end to the utility corporation's obligation to serve.

Relative to the distinguishing facts of a liquidation is the axiom that the market value of assets in utility service will sometimes differ from their book values under original-cost ratemaking. The rate of return paid to investors is market-based and thereby ensures a reasonable return on investment. Investors do not reasonably expect a corporation to be able to liquidate any asset whose market value exceeds book value and retain the proceeds. We could scarcely avoid the most detailed form of micromanagement of utility operations were such a rule extant, because the incentive to sell appreciated assets would be substantial and in conflict with the obligation to minimize the cost of service. Further, the policy as enunciated in this case is narrowly and expressly limited to the sale and replacement of a headquarters property.

Second, we are not convinced that the distinction between depreciable and nondepreciable assets is necessary in this case. Whether an asset is depreciated for ratemaking purposes or not, ratepayers commit to paying a return on its book value for as long as it is used and useful. Depreciation simply recognizes the fact that certain assets are consumed over a period of utility service while others are not. The basic relationship between the utility and its ratepayers is the same for depreciable and non-depreciable assets.

The facts of this case also demonstrate that the utility regarded this sale of its headquarters building and site as a unified transaction, as did its purchaser. Upon the headquarters sale, SoCal secured new facilities on the same unified basis. It is clear that the building required some land on which to rest, and that the land had no use to SoCal other than as a headquarters site. These reasons are all consistent with our calculation of the gain on a consolidated basis.

Third, parties have presented various precedents that relate to other gains on sale and which are cited for the proposition that a clear policy has existed and should be followed. From our review we are unconvinced that such clarity exists and we are unpersuaded that the weight of precedent is so great as to dictate a result.

Let us turn to the concerns motivating us to articulate a policy that should apply to the sale of a headquarters building.

There are circumstances when the utility should sell an and replace its headquarters building. Likewise, contrary circumstances may prevail, where the existing headquarters is best left in place.

A utility headquarters building <u>should</u> be sold when its value in some other economic use exceeds its value in utility service. This promotes the overall economy, as it permits a maximization of the goods and services which can be produced from limited resources. Our ratepayers also consume and produce other (non-utility) goods and services as well as invest in the suppliers of non-utility products. Ratepayers are better served when the overall economy is working efficiently and growing faster. We have consistently cited the welfare of the state's economy in general as an important concern in our decisions.

The facts of this case illustrate this principle clearly. SoCal has been occupying an undersized building of obsolete design on a prime piece of real estate. Such land is among the most scarce of economic resources, as evidenced by its high market value. Shuwa will be able to provide substantially more office space of higher quality on the same piece of land. The economy places a high value on that office space, which is reflected in Shuwa's expectation for its revenues from leasing out the space once built. In turn, Shuwa's revenue expectations led it to pay SoCal a high price for the buildings and the land. As described below, SoCal will be able to replace its need for space for less money than Shuwa was willing to pay for the Flower Street asset.

The result is that more office space is provided on the same amount of land. This office space can be viewed as instrumental in the production of other goods and services, or it can be viewed as a product in its own right. Either way, the outcome is the same - more is produced with the same resources. This is an essential objective of the goal of promoting the state's economy to increase the wealth, income and welfare of all Californians.

A utility headquarter building <u>should not</u> be sold when its value in some other economic use is no greater than its value in utility service. In that case the utility will need to acquire the same, or even more, resources to replace what the sold building provided. No greater productivity occurs as a result, and the transaction itself may be costly. Ratepayers may be disadvantaged by the replacement of an original cost-valued building with a comparable or inferior replacement added to the books at current market value. The result is no better quality of service and higher rates.

Indeed, ratepayers ought not be disadvantaged in any way due to a sale that should be made. By the above analysis, a good sale should produce gains over and above the value of the headquarters building in utility service. These gains provide the means to keep ratepayers whole, suggesting a calculation by which to make a disposition of the sale proceeds that keeps ratepayers indifferent to the transaction. The same calculation also reveals the proper incentives to offer utility management and shareholders to make only good sales of utility assets.

We encourage putting assets to their best economic use by allocating to shareholders that portion of the gain that reflects the difference between the market value (sale price) of the building and the building's value in utility service. We discourage poor sales and maintain ratepayer indifference by allocating to ratepayers that portion of the gain that reflects the remaining value the asset would have had in utility service. If a utility sells a headquarters building for less than it was worth in utility service, we should penalize the utility by making rates as if the sale had yielded the asset's full value and that value had been allocated to ratepayers.

In this framework, the headquarter's value to ratepayers is calculated with respect to its remaining economic life in utility service. This value follows from current forecasts of how long the asset will last, combined with any relevant factors (such as high or low associated operating or maintenance costs) that would determine when the headquarters ought to be retired on an economic basis. For example, headquarters buildings are worth more to ratepayers than book value because the building's operating costs are much lower than the operating costs of available alternatives. One would determine how much ratepayers would be willing to pay for an asset of this type given its expected life and the costs of available alternatives for utility service. That is the figure to subtract from the sales price to determine whether there is a gain to allocate to investors.

In other words, because a headquarters building is included in rate base at its original or historical cost, ratepayers are guaranteed the use of an asset at a fixed price. If sold, that asset must be replaced at a cost set in the current market. To keep ratepayers indifferent to the transaction, we need to allocate to them enough of the gain on sale to compensate for the difference between what the old building would have cost had it continued in rate base, and what the new asset will actually cost. Because new and old assets usually have different operating expenses, we should consider the total costs of the service provided by the asset in calculating what portion of the gain will make ratepayers whole. In this case, we are speaking of the need for space to house headquarters employees. We will consider what the new headquarters will cost minus what the old would have cost for as long as it would have lasted, and assign that amount to ratepayers.

To the extent that a portion of the gain on sale is left over after ratepayers are made whole, and kept indifferent, that portion represents the higher value of the asset when devoted to some non-utility use. We will give that higher value to utility shareholders as a reward and incentive for seeing that headquarter sites are put to their highest and best use in the economy.

Such a rule for allocating the gains from sale mirrors decisions that private businesses should and do make regarding assets. To an unregulated firm, a headquarters building's value to the firm, in fact, is far more important than its value on the books in determining whether it is sensible for the firm to sell. If someone else will pay more for the asset than it is worth to the firm, then it is rational to sell regardless of what the book value is. The asset's worth is again a function of what it can provide to the firm at what overall cost, as compared to alternative ways to provide the same headquarters function.

It is this policy we wish to articulate for the sale and replacement of utility headquarter buildings.

We recognize that this policy is a departure from the risk-sharing approach we have used in many previous gain on sale decisions. However, both the risk-sharing policy and this new policy share a common objective, that of assuring that ratepayers continue to receive a fair and appropriate share of the capital gain yielded from the sale of an asset that must be replaced in utility service. This policy represents an improvement in our ability to quantify what the allocation should be. Further, this new policy gives a clear signal to utility management as to when headquarters sales are beneficial to the economy and when they are not. It provides a corresponding incentive to utility management to help assure that they will act without disadvantaging ratepayers in any way. It also informs utilities and other parties about the specific information we will be seeking in future cases so that the record may be well-developed.

Based on the record developed in this phase of the proceeding, we find that risk-sharing would produce an allocation of about fifty percent of the net gain on sale to ratepayers. However, our review of the record also reveals that the information needed to implement our new policy is also available. Rather than rely solely on an imprecise judgment regarding risk-sharing, we will develop the calculations needed to allocate the gain using the principles we have articulated herein.

This calculation requires several steps. As with many of the calculations that are required in our decisions, there are a number of alternative assumptions that can be used and which affect the outcome. The following scenario is one we find to be based on the record before us.

We start with the after-tax gain of $24.190 million. Next we ask whether the sale price of the property exceeds the value it had to ratepayers as a utility asset continuing in rate base. If so, then there is a portion of the gain that should be allocated to shareholders. If not, then the transaction would be imprudent and ratepayers would need to be made whole through an allocation that preserved the property's value in rate base.

Stated another way, ratepayers were paying a certain set of costs for the occupancy of Flower Street as a building owned and operated by SoCal, including a rate of return and depreciation on the building and a rate of return on the land, both based on original cost. Ratepayers will be paying a different set of costs for the headquarters function based on the continuing lease of Flower Street followed by the occupancy of Grand Place. To the extent that (and for as long as) staying at Flower Street on an ownership basis was cheaper than the alternative (going to the real estate market to obtain replacement space), ratepayers are entitled to service at the lower stream of costs. The present value of the difference between the new and old costs is the portion of the gain we will allocate to ratepayers.

In making this calculation we must be careful to treat depreciation appropriately. In calculating the costs ratepayers would have incurred by SoCal's continued ownership and occupancy of Flower Street, we include a full depreciation of the building's remaining book value and of any capital additions. This is appropriate as ratepayers would have had to bear these costs had SoCal remained in the Flower Street property. We must compare on a consistent basis the alternatives of remaining at Flower Street or of moving to another location. This is consistent with our subtraction of the remaining depreciation on the building from the gross sale proceeds in calculating the net gain. We did so because the sale was a unified transaction, but this treatment is also consistent with a proper comparison of the asset that was sold to what it will cost to replace that asset.

The first calculation involves the most likely scenario under which SoCal would have stayed at Flower Street. We find that SoCal most likely would have remained for 20 years, based on the testimony of SoCal witness Harrington, with incremental capital additions as needed to maintain the building's usefulness. Previously, SoCal owned and occupied only a portion of Flower Street; however, Pacific Lighting has vacated its part of the building and we assume that SoCal would have occupied the entire structure. We therefore base our estimates on the use of 423,000 square feet of office space.

Next, we must consider the likely costs to SoCal of staying at Flower Street, and discount them to the present. There are two distinct periods to consider. First, SoCal will continue to occupy Flower Street under an interim lease. Second, SoCal will presumably vacate Flower Street and move to Grand Place after some period.

Starting with the interim period at Flower Street, we note that we have already found the terms of that lease to be reasonable. On further examination, we note that the costs of the lease arrangement are quite similar to the revenue requirement that would have been required for SoCal to continue owning the building. Under the lease, SoCal is responsible for all operating expenses and capital additions, just as SoCal was responsible for those costs when it owned Flower Street. Therefore, we can compare the lease payments to the rate of return and depreciation cash flow that SoCal would have been entitled to for owning Flower Street. The negative balance in this balancing account confirms that the cost of the lease to the ratepayers is actually less than the ownership-related cash flow would have been.

In other words, SoCal's leaseback of Flower Street will cost ratepayers no more (and probably less) during its first four years than ratepayers would have paid if SoCal still owned the building. Therefore, there is no need to compensate ratepayers for increased costs during that period.

We turn our attention to the remaining sixteen years during which SoCal would have occupied Flower Street. We need to forecast the costs of Flower Street and the appropriate market value of the services Flower Street provides.

We use a number of assumptions based on the record to calculate what Flower Street would have cost ratepayers in years five through twenty. The incremental capital additions needed to keep the building usable are based on Harrington's testimony, with the exception that recorded actual figures are used for years one and two and a reduced amount of $500,000 per year is used for the last three years because it is reasonable to assume that SoCal would minimize the capital additions towards the end of its occupancy. These capital additions are fully depreciated over the remainder of the twenty-year period. Operation and maintenance expenses and property taxes increase at the rate projected in the Cushman study. SoCal incurs moving expenses when it leaves Flower Street at the end of the twenty-year period. Cash flows are discounted at SoCal's after-tax cost of capital.

The result is displayed in Table II. The present value cost to ratepayers of headquarters expenses is $108.363 million if SoCal had stayed at Flower Street instead of selling the building and moving. As explained, these calculations are made with respect to 1990 dollars.

For the other side of the calculation we need to estimate what ratepayers will pay for SoCal's requirement for office space as an alternative to Flower Street. For this purpose we will not use forecasts of Grand Place expenses. We have not reviewed the prudency of Grand Place yet, and Grand Place also involves a larger facility than simple replacement of Flower Street. We will estimate the likely costs of replacing Flower Street without prejudging the reasonableness of Grand Place. Parties should not offer this estimate as evidence in A.88-12-047 as to whether a particular level of expenses for Grand Place is reasonable.

Table II

Present Value Calculated for 1990
Year 3 in the Table

Yr	Adds	Depr	1/2 Yr Convention	Depr	EOY Plant	Def Taxes	Avg Ratebase	RB* ROR	ROR* NTG	Rimking Tx Effect (Interest)	Depr	PropTx	O&M	Moving Costs	In Rates	Present Value	Cumulative PV
				$751	$16,920	$584											
1	700	35	18	769	16,851	555	16,316	0	0	0	0	417	3,779		0	0	0
2	350	18	9	795	16,406	526	16,088	0	0	0	0	425	3,968		0	0	0
3	4,320	240	120	925	19,801	497	17,592	0	0	0	0	434	4,166		0	0	0
4	5,040	296	148	1,193	23,648	467	21,243	0	0	0	0	443	4,375		0	0	0
5	5,293	331	165	1,507	27,435	438	25,089	2,697	4,747	(528)	1,507	451	4,593		10,770	8,781	8,781
6	5,557	370	185	1,857	31,134	409	28,861	3,103	5,461	(607)	1,857	460	4,823		11,994	8,829	17,610
7	5,250	375	188	2,230	34,155	380	32,250	3,467	6,102	(679)	2,230	470	5,064		13,187	8,765	26,375
8	5,513	424	212	2,629	37,038	351	35,231	3,787	6,666	(742)	2,629	479	5,317		14,350	8,613	34,988
9	5,789	482	241	3,083	39,744	321	38,055	4,091	7,200	(801)	3,083	489	5,583		15,554	8,429	43,417
10	3,989	363	181	3,505	40,228	292	39,680	4,266	7,507	(835)	3,505	498	5,862		16,538	8,093	51,509
11	4,189	419	209	3,896	40,521	263	40,097	4,310	7,586	(844)	3,896	508	6,156		17,302	7,645	59,154
12	4,398	489	244	4,350	40,569	234	40,297	4,332	7,624	(848)	4,350	518	6,463		18,108	7,224	66,378
13	4,618	577	289	4,883	40,305	204	40,218	4,323	7,609	(847)	4,883	529	6,787		18,961	6,830	73,208
14	2,853	408	204	5,375	37,702	175	38,854	4,177	7,351	(818)	5,375	539	7,126		19,574	6,366	79,574
15	2,996	499	250	5,829	34,950	146	36,206	3,892	6,850	(762)	5,829	550	7,482		19,949	5,859	85,433
16	2,546	509	255	6,333	31,163	117	32,925	3,539	6,229	(693)	6,333	561	7,856		20,287	5,380	90,812
17	2,673	668	334	6,922	26,914	88	28,936	3,111	5,475	(609)	6,922	572	8,249		20,609	4,934	95,747
18	500	167	83	7,339	20,075	58	23,422	2,518	4,431	(493)	7,339	584	8,662		20,523	4,437	100,184
19	500	250	125	7,547	13,028	29	16,508	1,775	3,123	(347)	7,547	596	9,095		20,013	3,907	104,090
20	500	500	250	11,633	1,895	0	7,447	801	1,409	(157)	11,633	607	9,549	1200	24,242	4,273	108,363

We will rely on the lower end of the rent estimate provided in the Building Owners and Managers Associates International study to forecast what ratepayers will pay to replace Flower Street for years five through twenty. It is appropriate to use the lower end of the range because the services that Flower Street would have provided would have been of less than average quality due to its physical shortcomings; for the same reason, we escalate the rent at somewhat less than the Cushman study would have suggested for market alternatives. We include an allowance for providing parking for SoCal's fleet autos and for its employees per the Cushman study. Operation and maintenance expenses and property taxes are based on an average of rentals in the Cushman study and escalated from year to year, based on the projected rate of increase in the Cushman study.

This calculation reveals a present value cost to ratepayers of replacing Flower Street at the market of $121.846 million. Table III illustrates this calculation. By subtracting the projected cost of replacing Flower Street from the projected cost of keeping Flower Street as a SoCal owned-and-occupied property, we determine that ratepayers will need to be allocated $13.483 million from the gain on sale to remain indifferent.

Table III

Present Value Calculated for 1990
Year 3 in the Table

Yr	Lease	Parking Fleet	Parking Employee	PropTx	Moving Costs	O&M	In Rates	Present Value	Cumulative PV
1	8,299	592	1,036	1,184		2,750	0	0	0
2	8,548	610	1,067	1,208		2,887	0	0	0
3	8,805	628	1,099	1,232		3,031	0	0	0
4	9,069	647	1,132	1,257		3,183	0	0	0
5	9,341	667	1,166	1,282	1,200	3,342	15,956	13,009	13,009
6	9,621	687	1,201	1,308		3,509	15,253	11,228	24,237
7	9,910	707	1,237	1,334		3,685	15,767	10,480	34,717
8	10,207	728	1,274	1,361		3,869	16,301	9,783	44,501
9	10,513	750	1,312	1,388		4,062	16,853	9,133	53,634
10	10,829	773	1,352	1,415		4,265	17,426	8,527	62,161
11	11,154	796	1,392	1,444		4,479	18,020	7,962	70,123
12	11,488	820	1,434	1,473		4,703	18,636	7,435	77,558
13	11,833	844	1,477	1,502		4,938	19,274	6,943	84,501
14	12,188	870	1,521	1,532		5,185	19,936	6,484	90,985
15	12,553	896	1,567	1,563		5,444	20,623	6,057	97,041
16	12,930	923	1,614	1,594		5,716	21,335	5,657	102,699
17	13,318	950	1,662	1,626		6,002	22,073	5,285	107,984
18	13,717	979	1,712	1,658		6,302	22,839	4,938	112,922
19	14,129	1,008	1,764	1,692		6,617	23,634	4,614	117,535
20	14,553	1,038	1,817	1,725		6,948	24,458	4,311	121,846

Finally, we note the correspondence of this precise calculation of the allocation of the gain to what risk-sharing yields in this case. Ratepayers are allocated $13.483 million as of today based on what it will cost to replace the services that Flower Street would have provided. However, SoCal has had the use of the proceeds from the sale from late 1987. Using SoCal's after-tax rate of return, the value of the use of this money has been approximately $4 million. Thus, the credit to ratepayers' share represents approximately half of the net proceeds from the sale to date, and corresponds to what risk-sharing would have suggested as an allocation.

In conclusion, we note that the issue of the reasonableness of Grand Place headquarters expenses remains as an outstanding issue in A.88-12-047. As stated previously, we direct parties to disregard the specific replacement estimates included herein for Flower Place when presenting evidence as to the reasonableness of Grand Place. We will also direct parties to propose an appropriate means of returning to ratepayers their allocation from the gain as an offset to the prudent expenses associated with Grand Place. The allocation should be multiplied by SoCalGas's authorized net-to-gross multiplier to insure that ratepayers receive the benefit of any reduction in SoCalGas' tax expense.

4. Was there an Over- or Undercollection of Headquarters Expenses during the Leaseback Period?

We will now address the adjustments that need to be made as a result of our comparison of the expenses SoCalGas actually incurred during 1988 and 1989 as a result of its leaseback arrangements with the headquarters expenses SoCalGas received through its last authorized revenue requirement.

Table IV which follows sets forth the Commission determination of the appropriate memorandum account required under D.87-09-076 for years 1987 and 1988. It appears that for the approximate 15-month period this table applies, and subject to adjustment for actual rather than estimated figures for the last three months of 1988, SoCalGas overcollected in revenues $640,000. Similarly, it would appear there will be an overcollection for 1989, 1990 and that part of 1991 leading up to the move to Grand Place.

However, we must view this overcollection or expense reduction in terms of our policy set forth in the discussion section on the allocation of gain. We have found, earlier in this decision, that the sale and leaseback were prudent and that is exemplified here by the fact that the leaseback over the first four years is less expensive than SoCalGas's adopted expense for the same level of service.

One of our goals in this decision is to keep the ratepayer indifferent to the sale and replacement of SoCal's headquarters. In our calculation achieving that goal, we showed ratepayer indifference through the first 4 years of the leaseback because the leaseback is actually less expensive than SoCal's continued ownership of the building would have been. However, ratepayers were not indifferent but actually benefited, by paying reduced expenses for the same service, due to the leaseback.

In calculating what ratepayers should be allocated to keep them indifferent to the results of the sale, we should consider aspects of the transaction that reduced ratepayer costs as well as those that increased costs. Rather than factor the memorandum account explicitly into the calculation of what ratepayers should be allocated, we achieve the same result by relieving SoCal of its obligation to refund the account's contents.

TABLE IV

Memorandum Account - Adopted
($ in Thousands)

	Item	1987	1988	Totals
(1)	Return on Undepreciated Costs of Headquarters Improvements	0	0	0
(2)	Expenses:			
	Lease Payments	$ 863	$3,829	$4,692
	Building Operations	811	2,827	3,638
	Building Maintenance	206	952	1,158
	Ad Valorem	100	518	618
	Depreciation	0	0	0
(3)	Income Taxes	0	0	0
(4)	Total Costs	1,980	8,126	10,106
(5)	Less Rental Income	62	177	239
(6)	Cost of Service	1,918	7,949	9,867
(7)	Revenue authorized without Franchise & Uncollectibles	2,035	8,472	10,507
(8)	Under (Over) Collection	(117)	(523)	(640)

(Red Figure)

Notes:

1. 1987 amounts are prorated to reflect the sale and leaseback on October 7, 1987.

2. 1988 amounts are recorded through September 1988 with estimated for October, November, and December 1988.

Similarly, we will allow SoCalGas to continue to collect its current rates with respect to Flower Street until the end of the fourth year of the lease. This does not presume the reasonableness of future O&M, increases in rent, or other expenses for Flower Street for which SoCalGas's responsibility is unchanged by the change from ownership to the leaseback.

Other Matters

Late in the seven-day hearing process, San Diego, a participating interested party to the proceeding, moved to argue the matter orally before the Commissioners en banc after the ALJ's proposed decision was issued, and before the Commission decides the matter. In response, SoCalGas joined in the request. The ALJ took the motion under submission without making a ruling.

The application in this matter was filed July 28, 1987. An interim ex parte decision, D.87-09-076 was issued September 27, 1987, modified by D.88-03-075 issued March 23, 1988. In accordance with the latter's requirements on April 7, 1988 SoCalGas filed its amendment launching Phase II of this proceeding. Seven days of hearings began on January 9, 1989, resulting in 975 pages of transcript and 24 exhibits. The parties have had ample opportunity to present their arguments. Accordingly the motion, and any other motions that may not have been ruled upon, are denied.

Comments

SoCalGas, DRA, PG&E, and Pacific Bell submitted comments on the proposed decision. We have made substantial changes to the proposed decision in response to these comments. These changes appear in the text of the decision and will not be repeated here.

Findings of Fact

1. Between 1923 and 1971, SoCalGas purchased land parcels which by 1987 comprised the major portion of the downtown Los Angeles city block bounded by Flower and Hope, 8th and 9th Streets. In 1924 SoCalGas constructed a corporate headquarters building on the first parcel, followed in 1941, 1953, and 1960 by three

additional interconnected office structures on other parcels. In 1979 SoCalGas built a parking and vehicle service facility. Over a number of years Pacific acquired the balance of the block.

2. The original cost of the land parcels totaled $1,895,000. The undepreciated cost of the headquarters buildings is $15,025,000. Over the years, through the end of 1987, SoCalGas has realized, after taxes, about $32,000,000 from its investment from the Flower Street property.

3. Although originally constructed in compliance with building codes applicable at the time of construction, the buildings when sold in 1987 could not meet codes applicable to new construction.

4. By the 1980's, the buildings lacked efficient layout and space utilization now attainable in new construction. Also, they were inadequate to accommodate all headquarters functions and staff, forcing dispersal of some personnel and functions to leased facilities elsewhere, with attendant loss of communications and efficiency and higher costs.

5. Outside consultants engaged to study the problems concluded that despite a high degree of maintenance, the aging buildings reflected a great deal of both technological and functional obsolescence derived from the piecemeal additions and alterations over the years.

6. Beginning in 1983, capital and maintenance costs for the aging buildings began to escalate, largely because of duplicative elevator, heating and cooling, and mechanical systems.

7. By the second half of the 1980's, it was estimated that for continued use into the next several decades, major renovation would be required, at a cost estimated to exceed $80,000,000. Work would include seismic strengthening; asbestos removal; renovation and replacement of elevators; and replacement of present toilet and plumbing facilities, mechanical cooling and heating systems, fireproofing, roofing, and all secondary electrical distribution.

8. Even if these renovations were made, the utility would still end up with modernized old buildings with sub-optimal column spacing, stairways and corridors, and ceiling heights. Moreover, even if these renovations were made, the renovated buildings would not constitute the optimal utilization of the property from a societal standpoint. The renovated buildings would contain a fraction of the allowable square feet that could be developed at the Flower Street site, consistent with current zoning.

9. SoCalGas retained outside real estate consultants, who compared renovation of the existing buildings with rebuilding on the site or complete redevelopment of the site, as contrasted with moving to either utility-owned or leased facilities elsewhere.

10. SoCalGas' decision to move from Flower Street was reasonable because of the physical, functional, and technological obsolescence of the buildings and the unsatisfactory alternatives involved in remaining there. From a social standpoint, the move is desirable to achieve the optimal utilization of the property.

11. Real estate consultants advised SoCalGas and Pacific that the Flower Street property would bring the best price if sold as an entire block parcel, rather than piecemeal. They also advised that certain favorable conditions, such as an abundance of available newly constructed or under construction office space, existing early in 1987 in the downtown real estate market, made it advisable to sell immediately.

12. The most economic and practical resolution of the time bridging problem pending occupancy in Grand Place was a leaseback provision for an interim period to be included in any immediate sale agreement.

13. SoCalGas' offer to sell the Flower Street property was conditioned on the availability of a leaseback. All offers received by SoCalGas reflected the requirement that it be able to leaseback the buildings until its new Grand Place headquarters was ready for occupancy.

14. D.87-09-076 authorized SoCalGas to sell the Flower Street property. The utility was to track revenues and costs associated with any sale and/or leaseback, and to absorb any revenue deficiency or refund any excess collection from those previously authorized for 1988 and 1989, and would be required in a Phase II proceeding to demonstrate the cost-effectiveness of any sale and leaseback as well as of the leasing of the new headquarters facility. Disposition of any capital gain was reserved for the same Phase II proceeding.

15. SoCalGas and Pacific accepted Shuwa's offer of $76,680,000 for the Flower Street property subject to a utility leaseback for up to five years at a monthly cost of $319,083, with holdover provisions. The sellers are obligated to demolish and remove the buildings at end of the leaseback. Escrow was closed on October 7, 1987. The leaseback requires SoCalGas to pay operation and maintenance expenses and taxes associated with the Flower Street property.

16. Acceptance of Shuwa's offer came after the sellers considered their respective space needs and interim requirements, optimal timing of the sale, estimation of the property's market value and different ways to package the sale, and other relevant factors. The sellers also conducted a broad solicitation of potential buyers. These were commercially reasonable procedures for offering and concluding the sale, and the resulting sale price was a reasonable price for the Flower Street property.

17. The sale price of $76,680,000 was shared by SoCalGas and Pacific based on the ratio of the square footage of land sold, and SoCalGas' $63,817,000 share represented a fair apportionment of the proceeds.

18. SoCalGas spent or committed the following sums during its sale of its Flower Street headquarters: (1) $1,286,000 sales commission; (2) $3,0000,000 for feasibility studies; and (3) up to

$2,200,000 for future demolition of buildings. These costs total $6,486,000.

19. Both SoCalGas and Shuwa treated the sale of the Flower Street property and its buildings as a unified transaction.

20. In order to determine the extent of the gain SoCalGas received on the sale of its Flower Street property, it is necessary to subtract from SoCalGas' $63,817,000 share of the gross proceeds the $1,895,000 original cost of the land and the $15,025,000 undepreciated cost of the buildings. SoCalGas' $6,486,000 costs of the sale must be subtracted from the $46,897,000 in remaining proceeds to arrive at a taxable gain of $40,411,000. Finally, the capital gains tax of $16,220,000 (40.138%) must be subtracted from the taxable gain to arrive at a net gain on sale after taxes of $24,190,000.

21. The not fully depreciated buildings on the property had and continue to have value to both SoCalGas and Shuwa.

22. The leaseback terms for the Flower Street property are cost-effective, and reasonable, and for 1987 and 1988 the appropriate costs associated with the leaseback are less than the revenue previously authorized the utility for these years.

23. Of the $15,025,000 remaining in rate base for the Flower Street buildings when the sale occurred in 1987, almost $11,000,000 had been spent on capitalized repairs and improvements during the last 10 years before the sale.

24. SoCalGas sold its Flower Street property subject to a leaseback provision whereby the utility will be able to occupy and use the property for the anticipated four years pending completion of Grand Place, and with further holdover provisions if needed.

25. Ratemaking treatment of future leaseback costs, including lease payments, operation and maintenance expense, and ad valorem taxes, but less any rental income derived, should continue in accordance with D.89-09-076.

26. If a risk sharing analysis is used to allocate the proceeds from a sale and replacement of a utility asset, the source of capital for a utility's investment in real estate necessary or useful in providing utility service is a significant factor in determining eventual disposition of gain or loss on sale of that real estate when no longer necessary or useful. Another significant factor is whether the contributors of that capital had assumed the general financial risks associated with such investment. In this case, SoCalGas' shareholders have contributed the capital but have benefitted from a significant sharing of those risks by ratepayers through our ratemaking treatment of the assets.

27. Since all bids received by SoCalGas reflect the leaseback provision required by SoCalGas, there is no way to measure precisely the value of the buildings alone or the land alone on the open market.

28. A risk analysis would also consider the fact that ratepayers paid all operations and maintenance expenses, depreciation, taxes, and a rate of return associated with the headquarters property while the Flower Street headquarters was in rate base.

29. Based on the relevant facts applied to a risk analysis, ratepayers are entitled to half of the net proceeds from the sale of the headquarters building and property.

30. The general strength of California's economy has been a continuing concern to the Commission as reflected in numerous decisions regarding regulated industries. The strength of the economy is usually increased when assets are put to their highest and best use.

31. Under original-cost ratemaking, the market or replacement value of utility assets will often diverge from their book value as determined by original cost minus accumulated depreciation.

32. Where the replacement cost, including operating expenses, of a utility headquarters building is higher than its book value,

ratepayers have an implicit financial stake in the continued use of that asset in utility service. This implicit financial stake is a necessary byproduct of our regulatory procedures and original-cost rate base rate-of-return ratemaking. In that case, an identical replacement asset would, if acquired today, provide no more service to ratepayers but would increase the book value of utility plant in service and/or operating expenses and hence would raise rates.

33. A calculation of the implicit ratepayer financial stake in the asset described in the previous finding can be made by comparing the present value of the revenue requirement associated with the continued use of that asset over its economic life with the present value of the revenue requirement associated with the use of a replacement asset over the same period.

34. It may occur that utility headquarter buildings are underutilized relative to what they could produce when dedicated to a non-utility purpose. In that case, a utility should be able to sell the asset at market value, compensate ratepayers for any lost implicit financial stake they held in the asset, and have money left over from the sale proceeds.

35. If a utility headquarters building is sold for no more, or less, than its book value plus the implicit financial stake that ratepayers have in the asset, then the asset will not be dedicated to a more productive use than utility service. Such a sale would be an imprudent act by the utility for which ratepayers should be compensated.

36. Based on the most likely scenario for the continued occupancy of Flower Street by SoCalGas if the sale had not occurred, the implicit ratepayer financial stake was $13.483 million. If ratepayers are allocated $13.483 million from the net sale proceeds, they will be indifferent to the transaction and will have had their interests appropriately protected.

37. The additional net proceeds of the sale should be retained by SoCalGas shareholders as an appropriate incentive for

having sold an underutilized utility asset to permit the asset's more beneficial use elsewhere in the economy.

38. The alternative methods of risk-sharing and the calculation of ratepayer indifference to the sale and replacement yield similar if not identical allocations of the net gain. It is more precise to make the final allocation based the ratepayer indifference calculation.

39. The policy and accompanying quantitative method set forth herein is intended to apply only to the sale and replacement of a utility's headquarters building.

40. The memorandum account that tracks the costs of the Flower Street leaseback versus the costs of continued rate base treatment of Flower Street has a negative balance. This shows that ratepayers have paid lower costs for the Flower Street leaseback than they would have paid had the Flower Street building and land not been sold.

41. In allocating the net gain, ratepayers are compensated for increased costs and loss of value due to the sale. In calculating that compensation, reduced costs due to the sale should be subtracted. The most direct approach to accomplish this is to relieve SoCalGas of its obligation to refund the negative balance in the leaseback memorandum account.

42. The reasonableness of Grand Place costs remains an issue in A.88-12-047 and is not prejudged in any way by the calculations in this decision.

43. A decision as to how to return the ratepayers their allocation of the net gain, with appropriate interest from the effective date of this decision, will be made in A.88-12-047.

44. While SoCalGas has acted reasonably and prudently with regard to its leaseback of Flower Street to date, the terms of the leaseback become less attractive over time and the reasonableness of ScCalGas's actions in eventually vacating Flower Street are not prejudged.

Conclusions of Law

1. PU Code § 851 requires that a utility obtain prior authorization from this Commission before selling any of its property which has been dedicated to public use so long as that property remains necessary or useful.

2. A wide variety of ratemaking approaches are constitutionally permissible, so long as they provide utility shareholders with a fair return on their overall capital investment and do not jeopardize the financial integrity of the utility. Constitutionally required compensation for the public's use of utility property may be based on original cost rather than on changing current market values. Rates which enable a utility to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed cannot be condemned as invalid.

3. The sum of $13,483,000 should be refunded to ratepayers out of the proceeds from the sale of the Flower Street land and buildings. Allocation of this sum to ratepayers will compensate them for the fact that while the Flower Street headquarters was in rate base ratepayers paid all operations and maintenance expenses, depreciation, and taxes associated with the headquarters property, provided SoCalGas with a fair return on the capital it invested in the headquarters, and bore a substantial share of the risks associated with the investment. It will also compensate ratepayers for the increased rates that will be needed to replace the services that Flower Street provided as an asset in rate base at original cost.

4. The allocation of $13,483,000 to ratepayers will not prevent SoCalGas from operating successfully, reduce SoCalGas's ability to attract capital, jeopardize SoCalGas's financial integrity, prevent SoCalGas from compensating investors for risks taken, or "destroy the value of the property for all the purposes

for which it was acquired" and thus deprive the owners of property without due process of law.

5. It is reasonable and appropriate for SoCalGas to be relieved of its obligation to refund cost savings associated with the leaseback for 1987 and 1988 that were tracked in a memorandum account pursuant to provisions of D.87-09-076.

O R D E R

IT IS ORDERED that:

1. SoCalGas shall recover from the net proceeds of the sale the costs of its headquarters sale, i.e., (1) the $3,000,000 it spent on feasibility studies; (2) the $1,286,000 it paid in sales commissions; and (3) the $2,200,000 it is obligated to pay for the future demolition of the Flower Street headquarters buildings. SoCalGas shall also recover the $15,025,000 undepreciated balance of the costs of these buildings and capitalized improvements and the $1,895,000 original cost of the headquarters land from the net proceeds of the sale.

2. Ratepayers shall be refunded $13,483,000.

3. Within 20 days from the effective date of this order, SoCalGas shall record into Account 253 - Other Deferred Credits - the ratepayers' allocation of the gain ($13,483,000), multiplied by SoCalGas's authorized net-to-gross multiplier. This amount shall accrue interest at the three-month commercial paper rate from the effective date of this order. This amount shall be trued up in subsequent proceedings to reflect SoCalGas's current authorized net-to-gross multipliers.

4. The amount of the gain allocated to the ratepayers, multiplied by the authorized net-to-gross multiplier as described in the prior ordering paragraph, plus any accrued interest, shall be used to offset the prudent expenses associated with Grand Place in a manner to be decided in the next phase of A.88-12-047.

5. The Phase II proceeding of A.87-07-041 as ordered by D.87-09-076 and D.88-03-075 is closed

This order becomes effective 30 days from today.

Dated April 11, 1990, at San Francisco, California.

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

I will file a written dissent.

/s/ FREDERICK R. DUDA
Commissioner

I will file a written concurrence.

/s/ STANLEY W. HULETT
Commissioner

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

Neal J. Shulman

NEAL J. SHULMAN, Executive Director

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STANLEY W. HULETT, Commissioner, Concurring:

While I concur in the result reached in this decision, I believe it is important to state that I do not see this decision as setting any precedent for the treatment of future gain on sale cases. As the many cases cited by the various parties to this proceeding demonstrate, each major gain on sale case has brought with it a unique set of circumstances that have required the Commission to fashion a just and reasonable result to fit that particular set of circumstances.

The one set of circumstances in which the Commission has been able to set forth a general rule to govern gains on sale has been where the utility sells a part of its utility system, transferring ratepayers and the obligation to serve to a local governmental entity, commonly referred to as the Redding situation. Last year, after careful consideration in a rulemaking proceeding (R.88-11-041), we adopted D. 89-07-016, which set forth a rule for treating gains on sale in that very limited circumstance.

In other cases, the Commission has appropriately resisted efforts to adopt generic treatments of gains on sale. For example, in the most recent Pacific Gas & Electric Company (PG&E) general rate case, PG&E sought to have the Commission consolidate the issue of gain on sale in that case with this SoCal Gas headquarters sale case. The Commission declined to consolidate the cases, stating that each case is to be decided on its own record. (D. 89-12-057, mimeo, page 133.)

Because of the complex interactions of the facts in each major gain on sale case (excluding the Redding situation), I expect that the Commission will continue to examine and decide these cases in the manner best suited to achieve a fair and reasonable result based on the circumstances of each case.

Stanley W. Hulett
Stanley W. Hulett, Commissioner

San Francisco, California
April 11, 1990

A.87-07-041
D.90-04-028

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FREDERICK R. DUDA, Commissioner, dissenting.

Although I appreciate my fellow Commissioners' effort to clarify our treatment of the gains earned by utilities upon the sale and replacement of their headquarters facilities, I cannot support their decision in this case. In the name of clarity, it raises as many questions as it answers and sets the stage for the Commission to become involved in contentious and cumbersome proceedings to determine the amount of gain on sale each time a utility headquarters is sold. Furthermore, it involves the Commission in a form of societal economic engineering that is beyond the scope of our legitimate regulatory interest. Finally, on my analysis, the new incentive policy lacks a strong legal foundation.

First, I don't believe the Commission should base its decisions on a policy designed to achieve a theoretically optimal economic result from an overall societal perspective. Such an approach requires the Commission to engage in a great deal of society wide economic research to determine what the highest and best use of a piece of property is, or to engage in a great deal of speculation on the subject.

For example, in this case the Commission concludes that a modern high density office development to replace the existing Flower Street Headquarters building represents the highest and best use of the land upon which the current headquarters sits. This conclusion appears to be based on the fact that SHUWA is willing to pay more for the headquarters building than the theoretical value of the building to ratepayers, on representations that SHUWA intends to tear down the current buildings, on the assumption that SHUWA will build a higher density office facility, and on the assumption that a higher density office facility is worth more to society than the present relatively low density office building.

The record shows, however, that there is currently a glut of new office space in downtown Los Angeles. This, states SoCalGas, is one of the reasons the utility could get a good deal on its new headquarters facility.

As for incentives, I am sure SoCalGas based its decision to sell Flower Street to SHUWA not on SHUWA's plans for the property, but rather on the price SHUWA was willing to pay. SHUWA's plans were irrelevant, except insofar as they required negotiations over potential demolition costs. SoCalGas needs no additional incentives for seeking the highest price.

The point is not so much that denser office space is or is not more valuable than the present office space, but rather that there are a many factors that must be taken into account when one makes such a judgment.

The simple fact that someone is willing to pay more money than the difference between some hypothetical alternative headquarters cost and the likely cost of staying in the existing headquarters over time is not sufficient reason to conclude that society will be better off if the utility sells the property. Yet that is what the decision states:

> "To the extent that a portion of the gain on sale is left over after ratepayers are made whole, and kept indifferent, that portion represents the higher value of the asset when devoted to some non-utility use. We will give that higher value to utility shareholders as a reward and incentive for seeing that headquarters sites are put to their highest and best use in the economy." (p. 30)

Perhaps the use of a current laughingstock will place this issue in perspective. Would the majority reach the same conclusion if Donald Trump bought the headquarters site for a gambling casino or a posh resort? If the land was well located, he might be willing to pay a lot for it, but not everyone would conclude that the use he might choose for the land would benefit society. From a theoretical economics standpoint, the highest price someone offers for a property may bear some relationship to society's highest and best use of the property. But all the highest price shows me is that the person that offered that price valued the property more, or at least had more money than, those who offered less or did not bid at all. Society's good has nothing to do with it.

An incentive policy based on the false assumption that the highest purchase price leads to the best use of property will not further the Commission's ability to meet its obligations to make sure that utility rates are just and reasonable.

Second, I think that the development and implementation of the incentive formula in today's decision is inadequate. The elements of the formula are presented in a manner so conclusionary that the basis for the numerical inputs used is unclear. If an incentive approach must be used, it should be based on a solid, comprehensible, and objective analytic foundation.

One of my biggest concerns regarding the implementation of the formula in this case is the use of the Building Owners and Managers Associates International ("Building Owners") rental data rather than actual Grand Place cost data in estimating the costs SoCalGas's ratepayers would face if the Flower Street headquarters were no longer used. Assuming for the moment that the formula itself is valid, it is clear that unless actual Grand Place data is used, SoCalGas's ratepayers will be harmed by, and not indifferent to, the headquarters transaction.

The Building Owners study yields no relevant data concerning the value to ratepayers of SoCalGas's continued occupancy of Flower Street, and is bound to skew the formula's results. After all, ratepayers will not pay the Building Owners estimated rental costs, but rather the actual Grand Place costs. Unless you compare the actual replacement costs to the cost of continued occupancy at Flower Street, then you cannot truly determine the value of staying put.

The incentive formula adopted today states that the ratepayer value of the utility's staying put in the existing headquarters equals the cost of replacing the headquarters minus the expected cost of staying put. Thus, the higher the replacement cost, the greater the value of staying put. The formula allocates to ratepayers gain equal to this value in staying put. The higher the value of staying put, the greater the ratepayer benefits from the sale. And vice versa.

If the actual headquarters replacement costs precisely match the replacement costs used in the formula to determine the ratepayers' share of the gains on sale, ratepayers may indeed be indifferent to the transaction (although they will be worse off than under the Commission's past gain on sale policies), but if the actual replacement costs exceed those used in the formula, ratepayers will clearly be worse off.

In the present case, the majority uses the low end of the rental costs set forth in the Building Owners study because it believes it is unfair to use the replacement costs associated with Grand Place since Grand Place is a better quality building than the present headquarters. This approach implicitly assumes that Grand Place costs will exceed the rental costs used in the formula. Although our unwise bifurcation of this proceeding prevents us from having access to actual Grand Place data at this time, it does seem reasonable to assume that a new building will cost more to lease than the lower end buildings studied by the Building Owners.

Unfortunately, this assumption also leads me to conclude that ratepayers will be disadvantaged by today's decision. To the extent that the cost of Grand Place exceeds the rental costs used to determine the value of Flower Street to ratepayers, the actual value of staying put exceeds that used in the gain on sale allocation calculation. Since ratepayers will pay the actual Grand

Place costs, and not the lower rental data costs, but will receive a gain on sale adjustment based on the rental cost data, they will be harmed to the extent that the real replacement costs exceed those used in the formula used to determine ratepayers' share of the gain on sale. This is a mathematical inevitability, not a theoretical belief.

I have not overlooked the majority's conclusion that the difference in quality between Flower Street and Grand Place dictates the use of a lower cost proxy replacement cost, I simply disagree with that conclusion.

The difference in building quality is significant in terms of how it affects the actual replacement costs ratepayers will incur as a result of the headquarters sale and replacement. But the difference in quality should not affect the rationale behind, or the application of, the majority's formula.

The formula is designed to make ratepayers indifferent to the headquarters move. Ratepayers are supposed to receive a share of the gain sufficient to compensate them for any difference between the actual replacement cost and the cost they would incur if the utility stayed put in its current headquarters. Unless actual costs are used, ratepayer indifference is not possible.

If the replacement cost input used in the formula (e.g., the lower rental data proxy) represents the cost of the functional equivalent of the existing headquarters instead of the higher expected actual replacement costs, it will result in an unrealistically low ratepayer compensation adjustment. It does not matter if the higher actual replacement cost arises because the replacement building is of higher quality, if it arises because of the building's more favorable location, or if it arises for some other reason. What does matter is that the actual replacement cost be used in the incentive formula. Ratepayers will be harmed if their gain on sale adjustment is based on unrealistically low replacement cost estimates.

The risk ratepayers face that the actual replacement costs may exceed the projections could be alleviated somewhat by allowing them to share in any gains remaining after theoretical ratepayer indifference is achieved.

It may be that the majority used the rental data as a proxy for the real replacement cost simply because the Grand Place information will not be available until Phase 2 of SoCalGas's general rate case is completed. If this true, we should have consolidated this proceeding with that one so that we would have had all necessary information.[1] Prudence tells me it is be better to issue an accurate, fact based, decision than to rely on a proxy at all. The absence of relevant information is not a good excuse for the use of irrelevant information.

I am puzzled by the majority's injunction against the use of this proceeding's replacement cost data in the proceeding concerning the reasonableness of SoCalGas's decision to lease Grand Place. If the data used in today's decision is accurate, why not use it in that proceeding? And if the data is inaccurate, why use it in this proceeding?

I am also puzzled by the majority's statement that the result reached by today's decision is similar to that which would be reached under a risk/reward analysis. Although there are several findings regarding risk/reward analysis, there is nothing in either the text or the findings to suggest what reasoning led to those findings.

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1 DRA was right to seek consolidated review of the sale of the old headquarters and the leasing of the new. Consolidated review has been our standard practice, and allows us to view utility headquarters decision-making in a more complete context. In this proceeding, for example, we cannot truly evaluate the cost-effectiveness of SoCalGas's move until we directly compare the new lease costs to the old headquarters ownership costs.

I am similarly puzzled by the statement that this incentive approach is an improvement over traditional risk/reward analysis. How can implementation of a policy seeking ratepayer indifference be considered a step forward from a policy providing clear ratepayer benefits? Is this approach simpler? Not to me. Will it be easier to implement? I doubt it; the determination of the expected cost of staying put and the actual cost of replacing a headquarters will provide fertile grounds for disagreement between ratepayer and utility advocates. If the new formula is better than the risk/reward approach, why trumpet the fact that both approaches yield similar results? Shouldn't the new results be better?

Will it provide utilities with clear decision making guidelines or incentives to take proper action in the future? Only if they are confident in second guessing the decisions the Commission will ultimately reach concerning the cost of staying put and the cost of moving. Without knowing the sum the Commission would allocate to ratepayers, it would seem difficult for a utility to determine an appropriate sales price for its headquarters. If it guessed wrong, the amount needed to make ratepayers whole might exceed the gain it made on the sale.

Next, I think the majority's decision to allow SoCalGas to keep the overcollection recorded in a memorandum account pursuant to D.87-09-076 is wrong. Early on, SoCalGas agreed to refund to ratepayers the difference between the actual leaseback costs and the revenue we previously authorized for its headquarters expenses. $640,000 was overcollected for 1987 and 1988 alone, and continued overcollections are anticipated for 1989, 1990, and the part of 1991 leading up to the move to Grand Place. By giving SoCalGas a gift of the overcollection simply because its new incentive formula shows ratepayer indifference for the first four years after the headquarters sale, the majority once again ensures that ratepayers are worse off than they would have been without the new policy. This gift unnecessarily changes the prior agreement between SoCalGas and the Commission regarding the treatment of such overcollections. We should rarely give utilities more than they ask for.

Finally, I am dismayed by the effect today's decision will have on ratepayers' rights to the gain on the sale of depreciable property. In the past, Commission policy, the FERC USOA and the FCC USOA consistently held that ratepayers are entitled to such gains. Even the utility parties to this proceeding were in accord with this policy. Now, the majority parts company with the past and adopts a policy that presumes shareholders have a right to all gains on the sale of headquarters property above the level needed to make ratepayers theoretically indifferent to a headquarters sale and replacement. Since headquarters consist of both depreciable and nondepreciable components, ratepayers will suffer from this reversal of past presumptions regarding depreciable property gains. It is naive to think utilities will not seek to extend this new presumption to other areas.

Calculations designed to show the value of an existing headquarters to ratepayers should be solidly based on verifiable evidence. Such calculations are complex, and invite complex and cumbersome proceedings. Given the formulaic complexities involved, the difficulty in acquiring good and undisputable data, and the absence of a good ratemaking justification for such broad socioeconomic speculation, I cannot support the incentive program adopted in today's decision.

I prefer a more traditional and dependable approach to gain on sale analysis. My view of this transaction follows.

After a careful review of the record and the arguments on both sides of the gain on sale issue, I conclude that there should be a sharing of net benefits derived from the gain between both ratepayers and shareholders.

Ratepayers deserve a share of the gain because they bore the operation and maintenance expenses, depreciation and taxes associated with the headquarters during the time it was devoted to public utility service and also provided a rate of return on those investments.

Shareholders deserve a share of the gain because they bore the risk that the land component of the Flower Street headquarters property would lose value between the date it was placed in rate base and the date it was sold.

In my alternative decision I proposed what I believe would have been a reasonable allocation of the benefits of SoCalGas's headquarters sale and leaseback between shareholders and ratepayers. I would have benefited ratepayers by requiring SoCalGas to refund the $24,190,000 net gain to ratepayers over a four year period. I would have benefited shareholders by allowing SoCalGas to: 1) retain the $10,400,000 tax benefit that will be realized from refunding $24,190,000 to ratepayers; 2) retain the estimated $448,000 benefit of the franchise fee expense reduction and uncollectibles adjustment that will result from the refund; 3) retain the investment income it has earned on the sales proceeds from the date of the sale (Oct. 7, 1987) to date; and 4) retain any income it is able to earn on the unamortized balance of the $24,190,000 over the refund period.

Ratepayers would have received a net benefit of $24,190,000 over a four year period. Shareholders would have received net benefits of approximately $17,848,000 over this same period.

The three arguments that SoCalGas alone is entitled to the gain on the sale of its headquarters are not entirely consistent. The property ownership and regulatory compact arguments conflict with the argument based on a distinction between depreciable and non-depreciable property because they depend on logic which should apply with equal force no matter what type of property is involved. If ownership is the basis for a utility's receipt of gains on sale, then gains from the sale of depreciable and non-depreciable property should be treated the same since the utility's ownership interest in both types of property is the same. Similarly, if utilities are entitled to gains because they put up with original cost based returns over the years then they must be entitled to the gains on the sale of all utility property since utilities receive the same return on both types of property. I fail to see how the utilities can seriously assert their third argument without first abandoning their other two arguments.

Yet SoCalGas and PG&E place great emphasis on the distinction between depreciable and non-depreciable rate base property, and on the distinction between land for future use and other land. They argue that although both the FERC USOA and standard Commission practices clearly give the gain on sale of depreciable rate base property and non-depreciable property held in plant held for future use accounts to ratepayers, utility investors traditionally receive the gains from the sale of rate base land alone. They argue that the present sale is of land only, and that only investors are entitled to the gain.

I will address the three utility arguments in order.

A. Ownership Rights

Ownership alone does not determine who is entitled to the gain earned when utility property providing service when it is removed from rate base and sold. No one argues that ratepayers acquire title to the physical property assets used to provide utility service; DRA argues that ratepayers are entitled to the gain on sale not because they own the property, but rather because they paid the costs and faced the risks associated with that property while it was in rate base providing public service.[2]

I note that utility shareholders must also base their claim to the gain on sale of rate base assets on grounds other than property ownership. Investors invest capital in a utility, they do not purchase specific rate base assets. Capital provided by shareholders and bondholders cannot be traced to specific assets, nor can their relative legal interests in such property be pinpointed precisely. Although shareholders own a security of the corporation, they have no legal or equitable title to the corporate assets in their individual capacities. They merely have an expectancy which ripens into ownership of a portion of the assets when the corporation is liquidated. (Miller v. McColgan (1941) 17 C. 2d 432, 436.)

It is clear that neither ratepayers nor shareholders "own" utility assets. The property ownership issue serves mainly to distract from the fundamental question of whether our system of

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2 Utilities frequently cite Board of Public Utilities Commissioners v. New York Telephone Company (1926) 272 U.S. 23, 32 for the proposition that: "

> "Customers pay for service, not the property used to render it. These 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."

While the statement regarding depreciation and operating expenses may have been true under ratemaking which based rates on the continually adjusted "fair market value" of the company, it is not true under original cost ratemaking as practiced in California. Here, ratepayers clearly pay depreciation and operating expenses through their rates. For this reason, we agree with DRA that New York Telephone is somewhat anachronistic, and therefore inconclusive regarding ratepayers' acquisition of an equitable interest in utility property. In any event, New York Telephone is not dispositive of DRA's claims, which are based on ratemaking equity not property ownership.

ratemaking offers utility investors an opportunity to earn a fair return on their overall capital investment.

In its most recent decision addressing an allegedly confiscatory state ratemaking policy, Dusquene Light Company and Pennsylvania Power Company v. Barasch, et al. (January 11, 1989) 488 U.S. ___; 102 L. Ed. 2d 646; (Daily Appellate Report, January 13, 1989, pages 451-456) the Supreme Court quoted with approval the following passage from Justice Brandeis' concurring opinion in Missouri, ex rel Southwestern Bell Telephone Company v. Public Service Commission (1923) 262 U.S. 276, at 290:

> "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility an opportunity to earn a fair return." "

The Court in Dusquene reaffirmed the principles set forth in Federal Power Commission v. Hope Natural Gas (1943) 430 U.S. 591, 605 that "rates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid." The court went on to note that "The economic judgements required in rate proceedings are often hopelessly complex and no not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." (Dusquene, at 454.) Dusquene notes that "the Constitution protects utilities from being limited to a charge for their property serving the public which is so "unjust" as to be confiscatory," and provides the example of a rate which is so low that it destroys "the value of [the] property for all the purposes for which it was acquired," and in so doing "practically deprive[s] the owner of property without due process of law." (Id., at 454, quoting FPC v. Natural Gas Pipeline Co., (1942) 315 U.S. 575, 585.)

The point is simply that a wide variety of ratemaking approaches are constitutionally permissible, so long as they provide utility shareholders with a fair return on their overall investment and do not jeopardize the financial integrity of the utility. The Constitution does not require that the appreciated value of rate base property be given to shareholders.

I believe that the economic tradeoffs involved in the regulation of monopoly utilities providing essential services justify the receipt by ratepayers of a portion of the benefits from the sale of rate base assets. Ratepayers have an equitable interest in the gain on the sale of rate base property because they pay operation, maintenance, depreciation expenses, taxes, and other carrying costs while the property is in rate base, and because they insulate utility investors from most other risks and expenses associated with property ownership.

After the tax benefits I would have allocated to SoCalGas are taken into account, the refund to ratepayers of $24,190,000 over four years represents less than three-tenths (0.3) of one percent of SoCalGas's current annual revenue requirements. The allocation of this amount of gain to ratepayers would not prevent SoCalGas from operating successfully, reduce SoCalGas's ability to attract capital, jeopardize SoCalGas's financial integrity, prevent SoCalGas from compensating investors for risks taken, or "destroy the value of the property for all the purposes for which it was acquired" and thus deprive the owners of property without due process of law.

SoCalGas presented no evidence that our past decisions allocating gains to ratepayers had any adverse impact on SoCalGas's present or prospective investors. The financial community views California regulation favorably, and the allocation to ratepayers of a portion of the benefits of the headquarters transaction would be unlikely to cause this to change.

A finding that ratepayers have an equitable interest in the gains on the sale of utility property would not conflict with investor property rights.

B. The Regulatory Compact

Nor does any implicit regulatory compact require that SoCalGas be given the gain on the sale of its headquarters. Utilities invest in land and depreciable rate base plant because those items are necessary for the utility to meet its half of the regulatory bargain, that is, to provide utility service to customers. In exchange, they are entitled to the opportunity to earn a fair return on the original cost of their investment, and to a return of their investment either through depreciation accounting or through an offset to the gross proceeds obtained upon the sale of the assets purchased with their investment.

If utility investors had invested in speculative real estate transactions or in other sectors of the economy, they would have borne the carrying costs of their property over time, and foregone the depreciation benefits and constitutionally guaranteed opportunity to earn a fair return on their investment in a company providing essential monopoly services. They would also have borne the risk that their assets might become obsolete or might be prematurely retired for other reasons before being fully depreciated, and that they might have to absorb such sunk investment as a cost of doing business. If they had paid the expenses and borne the risks associated with non-regulated property ownership, they would have been entitled to the gain on sale.

Instead, the investors chose to invest in a utility operation. Although shareholders and bondholders provided the initial capital investment, the ratepayers paid the taxes, maintenance and other costs of carrying the utility property in rate base over the years, paid the utility a fair return on this land while it was in rate base, compensated SoCalGas for the diminishment of the value of its depreciable property over time through depreciation accounting, and bore the risk that they must pay depreciation and a return on prematurely retired rate base property.

If we allowed utilities to receive the gain as if the rate base assets sold had been speculative investments, while allowing them to burden ratepayers with the costs they would otherwise have borne as speculative investors, we would be giving them the best of two investment decisions. They would get the reward of speculative investing without the risk that their costs would substantially offset that reward; in addition, they would have already received the reward of the investment choice they actually did make - a fair return on a safe monopoly utility investment. This double reward, without any real risk, is not fair to ratepayers.

Actually, SoCalGas seeks a triple reward. In addition to the benefits just mentioned, SoCalGas would gain the opportunity to update its rate base with higher cost replacement property and thus gain through the back door benefits available through "fair value" ratemaking. I do not oppose the replacement of worn out or obsolete utility facilities; I do, however, recognize that allocating gains to shareholders could provide incentives to replace rate base for the financial gain of the company rather than the interests of the ratepayers. Although our reasonableness reviews provide some protection against utility misbehavior, our accounting requirements should be self-contained, and not dependent upon such reviews to avoid ratepayer harm.

SoCalGas's complaint that it earned over time a lower return on the original cost of the headquarters than it would have earned on the current market value of that asset, and that therefore it is entitled to the gain upon the sale of that asset, is not well taken. One of the tradeoffs of original cost ratemaking is that the regulators agree to allow utilities to place all prudently invested utility plant into rate base in exchange for the utilities' agreement to be satisfied with a safe, secure, and reasonable return on the original cost of that rate base.[3] As Dusquene reaffirmed, there is no necessary connection between rate regulation and the current value of a utility's property.

PG&E's citation to the Brandeis concurrence in Southwest Bell, supra, is not compelling. Although Brandeis justified original cost ratemaking partly on the ground that investors would receive the market value of their investment when it was no longer used for utility service, Brandeis also pointed out that investors invest in capital, not specific rate base assets. I agree that shareholders are entitled to the market value of the assets paid for by their capital investments when an entire utility is sold.

C. Depreciable vs. nondepreciable property; plant held for future use vs. plant in service

Finally, I address the argument that the gain on the sale of non-depreciable land should be treated differently than the gain on the sale of depreciable rate base assets and land in plant held for future use accounts.

First, I find references to the FERC USOA unpersuasive. While the Uniform System of Accounts for gas utilities serves a useful purpose in assuring consistency in utility bookkeeping, ratemaking drives accounting, and not vice versa. As we stated in D.89-12-057: "The USOA is a bookkeeping system, not a ratemaking policy. When we established this system of accounts we stated explicitly that the Commission does not commit itself to approve or

3 Original cost ratemaking insulates both ratepayers and shareholders from any risk associated with variations in the market value of utility assets. Under fair value ratemaking, ratepayers suffered when utility property increased in value, and shareholders suffered when the reverse occurred. Both sides suffered from the interminable and inconclusive proceedings required to establish fair market value - an ever moving target. Original cost ratemaking represents a careful balancing of interests, and is not weighted unfairly toward either ratepayers or shareholders.

accept any item set out in any account for the purpose of fixing rates or determining other matters which may come before it." (p. 129, quoting D.42068, 48 CPUC 252,257.) The Commission may go beyond the USOA whenever necessary to strike the proper balance between the interests of ratepayers and shareholders.

Nor am I convinced by arguments based on the difference between the FERC USOA (which gives gain on sale of non-plant held for future use land to shareholders) and FCC USOA (which gives such gain to ratepayers). I believe that the difference in tax accounting, whereby FCC regulated utilities receive the benefit of tax normalization, is irrelevant. I do not believe that FERC allocates gain on sale of energy utility rate base land to investors in order to provide them with a source of capital to make up for the potential source of capital represented by the tax benefits received by FCC utilities. Nor do I believe that utilities depend on the rare potential distributions of relatively small amounts of capital gains to finance their operations.

In any event, the FCC's decision to allocate gains on the sale of nondepreciable property to ratepayers does not mention tax impacts; instead, it focuses on a straightforward financial risk-reward analysis:

> "With respect to non-depreciable property, particularly land, it is not as reasonable to talk of risk of loss...In this situation, it is necessary to turn to the financial burden test to determine to whom the gain should go. Applying that test here, we conclude again, that it is the ratepayers who have borne the financial burden during the service life of the land and so should enjoy the gain." (In the matter of American Telephone and Telegraph Companies, (1977) 64 F.C.C. 2d 1, 68.)

Second, references to the weight of judicial opinions in other jurisdictions are unpersuasive. While these decisions may be informative they are not dispositive of the allocation question. (D.82-12-121.) I prefer to rely on our own past decisions.

Third, while I recognize that SoCalGas and other utilities have often passed the gains on the sale of utility land to shareholders we believe that this most often occurred without Commission oversight. PU Code § 851, which requires Commission approval of utility sales of property necessary or useful in providing utility service, also states that no approval is required of property that is not necessary or useful. Unfortunately, § 851 does not contain a requirement that utilities notify the Commission when they determine that a particular rate base asset is no longer useful. Utilities commonly use this gap in the law to transfer plant from rate base accounts to a non-rate base, or "below the line" accounts, to sell the plant without seeking our approval, and then to retain any gain for their own benefit. The resulting accounting entries appear to reflect a standard procedure approved by the Commission, but instead reflect only the fact that our attention has not always been focused on such generally small rate base adjustments. Indeed, in D.83160 the Commission expressed its concern over such transfers by requiring SoCalGas to notify it of any transfer of rate base plant with a value of $100,000 or more. While the Commission appears to have occasionally responded to such notifications by acquiescing in the utilities' recommended accounting for particular rate base items, I do not find the consistent approval cited by the utilities.

Fourth, the Commission has not traditionally maintained a clear distinction between depreciable and nondepreciable property.

In D.82-05-038 (Citizens Utilities Felton District), we cited Democratic Central Committee vs Washington Metropolitan Area Transit Commission 485 F.2d 786 (D.C. Cir.1973, cert. denied., 415 U.S. 935), for the proposition that "If ratepayers have assumed the expenses of ordinary maintenance and depreciation, and the risks of loss from casualty and obsolescence," combined with favorable tax accounting for investors of rate base, depreciation and tax items, then ratepayers are entitled to all gains attributable to the removal from rate base <u>of both depreciable and nondepreciable assets</u>." (9 CPUC 2d 197, at 206, emphasis added.) Previously, in D.89517 (<u>SoCalGas Blythe-Moreno pipeline withdrawal</u>), we quoted <u>Democratic Central Committee</u>, supra, as follows: "The allocation between investors and consumers of capital gains on in-service utility assets ... rests essentially on equitable considerations." (<u>Democratic Central Committee</u>, supra, 584 F.2d at 821.) We then recognized that "as the court stated, there is no impediment, constitutional or otherwise, to recognition of a ratemaking principle enabling ratepayers to benefit from appreciations in value of utility property accruing while in service. ..." and that "The equities dictate that the economic benefit should follow the economic burden. It is the ratepayer who bears the expenses of ordinary operation and maintenance and depreciation, including obsolescence and depletion. Fairness requires that consumers, whose payments reimburse investors for all wear, tear, and waste of utility assets in service, should benefit where gain occurs and to the full extent of that gain. Investors who are afforded the opportunity of a fair return on a secure investment in utility property cannot claim that they have not received their just due." (Id., at 420-421.) There, the Commission addressed a pipeline (presumably primarily depreciable property except for the land underlying the pipeline), but did not draw a line between depreciable and nondepreciable property.

In D.82-12-121 (10 CPUC 2d 647), which addressed the gain on PG&E's sale of its Utah coal reserves and associated water rights, rights of way, and improvements, we analyzed the risks borne by ratepayers and shareholders and concluded that: "There is no question that the amount of the gain allocated to the rate base property should be returned to ratepayers." (10 CPUC 2d at 663.) Again, no distinction was drawn between depreciable and nondepreciable property.

And our 1986 Pacific Bell general rate case decision D.86-01-026, which compared the gains on the sale of depreciable property to those on the sale of nondepreciable property, found no reason to treat the gains differently:

> "...the gain from the sale of real estate which has been in rate base should accrue to ratepayers. The situation is so similar to the retirement of depreciable utility property where gross salvage is maximized and routinely credited to ultimately reduce rate base, that it cannot be meaningfully distinguished. Since ratepayers bear the economic brunt of utility property which has a diminishing market value, which is far and away the usual circumstance, it is logical and fair that the occasional upside gain from the disposal of land accrue to them." (slip opinion at page 3)

Past Commission decisions simply do not support a ratemaking distinction between the gain on the sale of depreciable property and the gain of nondepreciable property.

Having disposed of the arguments that our past requires us to treat depreciable property different than nondepreciable property, I will address the philosophical issues involved.

All parties to this proceeding agree that ratepayers are entitled to the gain on the sale of depreciable rate base assets. The utilities argue that the ratepayers' entitlement to such gains is based on the fact that ratepayers return to the investors the capital invested in depreciable rate base assets through their depreciation payments designed to make the investors whole for the wear and tear suffered by the property while in utility service. Because ratepayers do not pay depreciation on nondepreciable rate base, the utilities argue, they are not entitled to the gain on the sale of such rate base.

The fact that ratepayers return to investors the capital invested in depreciable rate base assets through depreciation accounting does not provide a meaningful basis for distinguishing depreciable and non-depreciable assets. When an asset is sold, it may or may not be fully depreciated. If the "depreciation investment" by ratepayers were the key reason why they are entitled to the gains on sale of depreciable property, then the relative proportions of gain received by ratepayers and shareholders should vary with the percent of investment. Neither our traditional practices nor the USOA provide for a proportional allocation of gain; instead, the "gain on sale" of a depreciable rate base asset is allocated entirely to ratepayers.

Usually, depreciable rate base assets are sold at a loss, with the loss being offset by whatever salvage value is obtained upon sale. Ratepayers continue to pay depreciation, and a return on the undepreciated value of any prematurely retired assets. Thus, depreciable asset losses are allocated entirely to ratepayers, absent unusual circumstances. This risk of loss provides a better "risk analysis" justification for giving depreciable asset gains to ratepayers than does the "return of capital" through depreciation justification.

I see no reason why land sales should be treated differently because investors receive no depreciation on land. Clearly, the original land cost must be subtracted from the gross proceeds and returned to the investors before the amount of "gain on sale" can be determined. It matters little, in terms of investment risk analysis, whether an investor is repaid by ratepayers over time through depreciation accounting or is repaid out of the gross proceeds of the sale. In either event, the investor is made whole. Thus, the fact that depreciation repays investors in one circumstance while gross proceeds repay shareholders in another circumstance is not sufficient to justify a different disposition of the gain on sale.

Utilities argue that they face the risk that nondepreciable assets will lose value between the time they are placed in rate base and the time they are sold, and that this risk entitles them to the gain on sale. This risk may be the only significant factor that distinguishes depreciable from nondepreciable property, since all other risks appear to apply equally to both classes of property; e.g., the risk of earning less than the return they might earn on the current market value of the asset, and the risk of earning less than the authorized return.

In the rare situation in which rate base land sells at a loss, the shareholders bear the loss, since there is no depreciation adjustment established to deal with prematurely retired land. On the other hand, ratepayers pay a fair return on the entire original cost of land while it is in rate base, whereas they pay a diminishing overall return on depreciating assets as those assets depreciate. If the land actually does depreciate in value below its original cost, then the steady rate of return they have paid for the land over time has actually overcompensated investors. Thus, there is symmetry of risk and reward associated with rate base land just as there is with regard to depreciable rate base property.

The absence of ratepayer responsibility for losses on land sales is not as troubling as it may appear at first glance, when one recognizes that ratepayers have been made to bear the financial burden of cleaning up land contaminated with toxic materials during its service to ratepayers, and the burden of paying for certain utility plant abandoned prior to rendering utility service.[4] Not every single risk of loss is offset by a directly connected opportunity for gain, but taken as a whole our ratemaking system amply rewards and protects utility investors.

Nonetheless, I would compensate SoCalGas for the risk it bore that the land component of its headquarters might decline in value between the date it was ratebased and the date it was sold.

Land held for future use vs. land in service

The utilities contend that ratepayers are entitled to the gains from the sale of rate base land held in "plant held for future use" accounts because they bear the risk that the land will never actually provide utility service. They argue that ratepayers have no such claim regarding other land.

I do not believe that PHFU status can be used to distinguish one type of land from another for gain on sale purposes.

Utilities acquire land for future use because they believe that the cost of carrying the land prior to its actual use is likely to be less expensive than the cost of acquiring the land later on when it is actually needed. Utilities may err in buying such land, or in refraining from buying such land. The real risk

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4 In the late 1970's and early 1980's, a number of utility projects had to be abandoned before providing utility service because of unforeseen economic or other changes beyond the utilities' control. Under traditional ratemaking, the utilities would have recovered nothing for these projects since they were never used or useful in providing utility service.

Noting that many of these projects had been undertaken in good faith during a time of great energy uncertainty, the Commission developed a risk sharing policy which relieved utilities of a great deal of the risk associated with both the depreciable and nondepreciable components of such projects, even though ratepayers received no benefits from them. See eg. D.92497 (4 CPUC 2d 725, at 772-783) (SoCalGas WESCO coal venture); D.90405 (1 CPUC 2d 644, at 650-664)(SDG&E Sundesert Nuclear Plant abandonment); D.87639 (SDG&E Sycamore Canyon Combined Cycle Plant abandonment); and D.89711 and D.97639 (Southern California Edison Kaiparowits Coal Plant abandonment).

ratepayers face is the risk of a poor management decision regarding the acquisition, disposition, or use of the PHFU land; this risk also applies to rate base land already in service.

Commission decisions do not generally distinguish between land in plant held for future use accounts and land in other rate base accounts. For example, D.85-06-023 found that "It is reasonable to require San Jose Water to flow through to its ratepayers ... any gain in appreciation over original book cost of those parcels which are now or were at any time included in its rate base or in plant held for future use which are transferred to an affiliated corporation." (Emphasis added.) D.85-06-023 cited D.82-12-121, which dealt with the gains on the sale by PG&E of certain real property in Carbon County, Utah, for the conclusion that "gain allocable to rate base property should be refunded to ratepayers." (Id. at 2, emphasis in original)

Similarly, in Pacific Gas & Electric Co. (1983) 11 CPUC 2d 86 (D.83-03-062, p. 2) we noted the PHFU status of the property sold, but reached a more general conclusion: "the risk of loss question was settled once the property was placed in rate base."

In any event, since the sale of SoCalGas Flower Street headquarters represents a consolidated sale of both land and buildings, I need look no further than our previous decisions concerning headquarters transactions to determine the proper allocation of the gain on sale here.

Headquarters transactions

We have in the past often used the gain on the sale of headquarters to offset the cost of replacement facilities. Ratepayers benefit from the reduction in the rate base associated with the new facilities. Shareholders benefit by obtaining necessary utility plant without putting up as much new capital.

For example, in decisions concerning SDG&E's sale and leaseback of its headquarters building in 1975 (D.84600) and its Encina 5 generating plant in 1978 (D.89067), the Commission reduced

SDG&E's revenue requirement by amortizing the gains on these sales over the lifetimes of the leases. In these decisions, the Commission made certain ratemaking adjustments to compensate the then poorly managed utility for removal of these large assets from rate base. The Commission did not wish to punish the utility through revenue requirement adjustments for what it considered an innovative financing approach, with benefits for both shareholders and ratepayers, taken in response to the utility's inability to raise needed capital through traditional methods.

In D.82-06-061 the Commission accepted the proposal of Southwest Gas Corporation that the gain derived from the sale and leaseback of its Las Vegas headquarters building and 13 acres of land be amortized to reduce lease costs.

And in D.88-06-036 the Commission determined that the gain from the sale of American Telephone and Telegraph Company of California's headquarters property, both land and buildings, should be recorded in a memorandum account and used to reduce rate base.

Again, in D.86-12-063 the Commission accepted SoCalGas's proposal that the gain on the sale of its old San Fernando Valley headquarters land and buildings be used to reduce for ratemaking purposes the acquisition cost of land upon which it intended to construct a new headquarters, noting that the proposal was in accord with the Commission's treatment of similar gains realized by SoCalGas on the sale of its El Monte and Pasadena offices, D.84-12-069 and D.82-12-054 (these transactions also involved both depreciable and non-depreciable property). SoCalGas contended that rejection of its proposal would result in economic and rate inequities between present and future ratepayers.

SoCalGas now characterizes the San Fernando transaction as one that merely deferred the gain its investors would receive when the new property was eventually sold, and did not actually represent a transfer of gain to ratepayers. This characterization is curious in light of the utility's contention that depreciable property gain should be treated differently than nondepreciable property gain. The gain on the sale of the old San Fernando headquarters, which consisted of both land and buildings, was used to reduce the rate base value of a new parcel of land alone. If upon the sale of the new headquarters SoCalGas received all the gain from the new rate base land, it would capture the deferred gain on the sale of the old depreciable property gain that clearly belongs to the ratepayers. If, on the other hand, the ratepayers were to receive the gain on the portion of the new headquarters land purchased by the deferred depreciable property gain they were entitled to upon sale of the old headquarters, a great deal of complicated accounting would be required.

Attempts to allocate gain between depreciable and non-depreciable property components of a consolidated asset as the asset is sold, the gain reinvested in a replacement facility, the replacement facility sold, and so on, would be cumbersome at best. A "gain deferral" system allocating depreciable gains to ratepayers and non-depreciable gains to investors is not realistic or practical.

When General Telephone moved its headquarters to Thousand Oaks in 1985, the Commission followed the approach it took for Pacific Bell in D.86-01-023 and flowed the gain from the sales transactions to ratepayers. The Commission offset the gain with the expenses incurred in the move.

The primary difference between the General Telephone situation and the situation faced by SoCalGas is that SoCalGas is leasing its new headquarters, not purchasing it. I do not find this difference significant. Whether the the replacement facility is purchased or leased, there is a gain or loss to be allocated and a cost to be paid for the replacement facilities. From a ratemaking perspective, capital gains could offset the costs of leased or purchased facilities equally well.

To summarize, the utilities' contention that SoCalGas alone should get the gain on sale is wrong. In the past, we have generally offset the cost of replacement headquarters with the gain earned on the old headquarters. This benefits both ratepayers and shareholders. Since we could not do this here because of our bifurcated proceedings, we had to craft another approach, preferably one which also benefits both ratepayers and shareholders. I feel that the alternative decision I proposed to the Commission properly balanced the interests of ratepayers and shareholders in a manner philosophically consistent with our past decisions and principles.

Conclusion

Regulatory decision making should be clear, instructive, well balanced and have a sound legal foundation. In the majority opinion I find these elements lacking. Unfortunately, the attempt clearly falls short. For all of the above reasons I would issue the decision based upon my proposed alternate and avoid the uncertainties, pitfalls, and problems of the majority opinion.

Frederick R. Duda

Frederick R. Duda, Commissioner

April 11, 1990
San Francisco, California