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Decision 90-11-031 NOVEMBER 9, 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)	ORIGINAL Application 87-07-041 (Filed July 28, 1987)

ORDER MODIFYING DECISION 90-04-028
AND DENYING REHEARING

The Southern California Gas Company (SoCalGas) and Toward Utility Rate Normalization (TURN) have filed applications for rehearing of Decision 90-04-028 (the Decision). In the Decision we: reviewed the reasonableness of SoCalGas's sale of its Flower Street headquarters; allocated the gain on sale of the headquarters between ratepayers and shareholders, based on a "ratepayer indifference" theory; and disposed of the memorandum account set up pursuant to Decision (D.) 87-09-076.

In its application for rehearing, SoCalGas argues that it is constitutionally entitled to keep all of the gain on sale of the Flower Street headquarters. Alternatively, SoCalGas argues that, if the Commission is going to apply "ratepayer indifference" methodology to apportion the gain, it must grant rehearing so that SoCalGas can submit evidence comparing: (i) the costs of moving to its actual new headquarters, with (ii) the costs of staying at its old Flower Street headquarters. Finally, SoCalGas argues that the Decision contains errors in its ratepayer indifference calculations.

In its application for rehearing, TURN also argues that, if the Commission is going to apply ratepayer indifference theory, it must grant rehearing and compare the actual costs of SoCalGas's new Grand Place headquarters with the costs SoCalGas would have incurred if it had remained at Flower Street. TURN further argues that the Decision erred in not returning to ratepayers the overcollection in the memorandum account set up pursuant to D.87-09-076.

Pacific Bell, Pacific Gas and Electric Company, and SoCalGas have each filed responses to one or more of the applications for rehearing.

We have carefully considered all of the issues and arguments raised in the applications for rehearing and the responses, and are of the opinion that our original Decision should be modified in several significant respects, and that, in light of these modifications, rehearing is not warranted. We are attaching to this decision a complete version of D.90-04-028 as modified today (the Modified Decision).

For the reasons explained in the Modified Decision, we do not agree with SoCalGas that it is entitled to all of the gain on sale of its Flower Street headquarters. However, we do agree with SoCalGas and TURN that <u>if</u> we were to continue to apply a ratepayer indifference methodology to apportion the gain, rehearing would be required. However, rather than further delay a decision on allocation of the gain realized when SoCalGas sold its Flower Street headquarters in 1987, we have instead chosen to use a more traditional risk and incentive analysis to apportion the benefit of the gain. This analysis is explained in the Modified Decision. Unlike the ratepayer indifference methodology employed in our original Decision, this analysis does not require comparing the costs of staying at Flower Street with the costs of moving out. Accordingly, it is not necessary to grant rehearing.

In the original Decision, we intended to include the overcollection in the memorandum account as part of the amount allocated to ratepayers by our ratepayer indifference calculations. Since the Modified Decision does not rely on ratepayer indifference methodology, it instead expressly orders the overcollection in the memorandum account to be returned to ratepayers.

The original Decision stated that its "ratepayer indifference" allocation of the gain on sale was about the same as would have occurred under a risk-sharing analysis. In light of this comment, we have compared the benefits allocated to shareholders under the original and Modified Decisions, and note that they are approximately the same. In order to make this comparison we have estimated the present value of these benefits as of early December 1990. In making these estimates of present value, we have assumed that SoCalGas could earn its currently authorized rate of return on money that it has available for investment. Similarly, we have used SoCalGas's currently authorized rate of return, net of tax, to discount the value of future income to early December 1990. Under the original Decision, SoCalGas would have received an approximately $10.7 million share of the net gain on sale, retained the balance being tracked in the memorandum account (which we estimate to be a little less than $1.2 million for the period 1987-1989), and had the opportunity to earn approximately $8.7 million[1] in investment income on the gain from the date of sale until early December 1990. The present value of these benefits as of early December 1990 would have totalled approximately $20 1/2 million. Under the modified Decision, the shareholder benefits are all in the form of the opportunity to earn income on the gain, from the date of sale and during an amortization period beginning in December 1990 and ending 11 years and 11 months later. We have estimated that the present value of

1 This figure differs from the figure mentioned in the original Decision, not only because of the different time periods involved, but also because the original Decision deducted tax twice from SoCalGas's opportunity income.

these benefits as of early December 1990 also totals approximately $20 1/2 million.[2]

In light of the extensive discussion of the issues included in the Modified Decision, no further discussion is required here.

Therefore, good cause appearing,

IT IS ORDERED that:

1. D.90-04-028 as approved on April 11, 1990 is modified and replaced by Modified D.90-04-028, Attachment 1 hereto.

2. Rehearing of D.90-04-028 as thus modified is denied.

This order is effective today.

Dated November 9, 1990, at San Francisco, California.

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

Commissioner Stanley W. Hulett, being necessarily absent, did not participate.

I will file a written concurrence.

/s/ FREDERICK R. DUDA
Commissioner

I will file a written concurrence.

/s/ JOHN B. OHANIAN
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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2 These are only estimates, for purposes of comparison, based on the above-stated assumptions, and are not meant to be precise figures. We are not guaranteeing shareholders these sums, but are only saying that they are roughly equal.

L/bjk

ATTACHMENT 1

Decision 90-04-028
as modified by Decision 90-11-031 on November 9, 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.

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OPINION

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 that sale (including an interim leaseback pending its move to a new headquarters) were reasonable. Our prior precedents have frequently applied gains on sale of utility assets to offset the costs of continuing utility service. Here we conclude that there are case-specific circumstances before us which warrant a reasonable allocation between shareholders[1] and ratepayers of the benefits of the gain on sale of the Flower Street land and buildings.

We do find that a portion of the benefits realized from this sale of SoCalGas's Flower Street property should be allocated to offset SoCalGas's headquarters costs. Ratepayers paid the taxes, maintenance and other costs of carrying the land and buildings in rate base over the years, and paid the utility a fair return on its unamortized investment in both land and buildings while they were in rate base. Furthermore, the ratepayers "compensated" SoCalGas for the diminishment of the value of its depreciable buildings - the lion's share of SoCalGas's investment in the consolidated headquarters - over time through depreciation accounting and the recovery of annual depreciation in utility rates.

Accordingly, consistent with our prior decisions, we will require SoCalGas to use the principal amount of its after-tax gain,

1 We understand that SoCalGas's corporate parent, Pacific Enterprises ("Pacific"), is technically SoCalGas's sole shareholder. Because Pacific's owners are more numerous, however, we will refer to them as "shareholder<u>s</u>."

$24,190,000, to offset its continuing costs for headquarters facilities. We will apply this sum over the course of an 11-year 11-month amortization period, beginning in December of this year. Use of this $24,190,000 to cover part of SoCalGas's cost of service will reduce SoCalGas's taxable income and therefore its tax liability, and will also impact SoCalGas's franchise fee expense and uncollectibles. Consistent with our standard practice we will pass these benefits through to ratepayers, by multiplying the principal amount to be amortized each year by SoCalGas's then current net-to-gross multiplier to determine the amount by which to reduce its annual revenue requirement.

While, as a strict matter of law and regulatory precedent, we could flow-back all proceeds or economic benefits to offset SoCalGas's headquarters costs, we do find that a portion of the benefits realized from this sale should be allocated to SoCalGas. We believe that under the circumstances present here it is reasonable to provide incentives for the utility to maximize the proceeds from selling its principal, corporate headquarters, thus benefiting both ratepayers and shareholders, and to seek a more suitable headquarters, where its old headquarters poses health and safety risks and is no longer suitable for long-term use. We emphasize that such incentives are not appropriate unless the corporate headquarters should be disposed of for reasons of sound utility planning. Otherwise, there would be a perverse incentive to replace depreciated assets, or assets with a low historical cost, with more expensive, newly-purchased assets, imposing higher costs on ratepayers without corresponding accompanying benefits. By allocating a portion of the benefits from the gain on sale to SoCalGas's shareholders, we also compensate them for the risks they bore in connection with the old headquarters property, in the event that our present ratemaking system has not already fully compensated them for those risks.

More specifically we will benefit shareholders by allowing SoCalGas to: (1) retain the investment income it has been able to earn on the sales proceeds from the date of the sale

(October 7, 1987) to date; and (2) retain the income it is able to earn on the unamortized balance of the $24,190,000 from now until the end of the 11-year 11-month amortization period.

Our holding today must not be misconstrued by any of the fixed utilities which we regulate. We are not reversing any of our prior precedents, which have frequently applied gains on sale of utility assets to offset the costs of continuing utility service.[2] We also, however, continue to believe that the issue of gain-on-sale of utility headquarters is best approached on a case by case basis, consistent with prior rulings of the Commission when similar factual circumstances may exist. This is a unique case -- the relocation of the principal headquarters of the nation's largest gas utility, and most importantly from a building that posed health and safety risks and was no longer suitable for long-term use by the utility.

In addition to deciding how the gain on sale of SoCalGas's Flower Street headquarters should be distributed, we also determine the proper disposition of the memorandum account required by D.87-09-076. That memorandum account tracked the difference between SoCalGas's authorized revenue requirement and its actual leaseback costs. Today's decision requires SoCalGas to refund the overcollection in that account consistent with D.87-09-076.

2 There are, of course, exceptions to this general rule. See, Re: Rate-making Treatment of Capital Gains Derived from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity, D.89-07-016, 32 Cal. P.U.C. 2d 233 (1989)(Redding II)(re: public utility sales of distribution systems to public or governmental agencies where the agency assumes, and the utility is relieved of, its public utility obligations to customers within the area served by the system).

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.

Because it wished to be able to move quickly to take advantage of developments in the fast paced Los Angeles real estate market, SoCalGas sought ex parte authorization to sell and requested that issues such as the reasonableness of the sales price, the ratemaking consequences, and the disposition of any capital gains be deferred for resolution in a later phase of the proceeding. SoCalGas said that it expected to lease back its Flower Street Headquarters for a period of approximately four years, until a new headquarters facility was available.

A. 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. The Decision further provided that SoCalGas would be at risk if leaseback costs exceeded costs already provided in rates; if leaseback costs were less, the difference would be subject to refund.

B. 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 utility pointed out that it would be more difficult to estimate those costs for ratemaking purposes until it got closer in time to actually incurring them.

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.

C. <u>The April 7, 1988 SoCalGas Amendment to A.87-07-041</u>

Interim D.87-09-076, which authorized sale of the Flower Street property, provided that, within six months after the sale, SoCalGas was to file a supplemental application to initiate Phase II of 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.

In its amendment the gas company reported that the $76,680,000 in proceeds from sale of the Flower Street headquarters block had been apportioned between SoCalGas and its corporate parent Pacific according to the ratio each owned of the total square footage. The utility ascribed all the proceeds to the land. SoCalGas contended that all interest in the property had been solely in its development potential as an entire city block of cleared land. According to SoCalGas, all three potential buyers making written offers were uninterested in the buildings, proposing demolition of all as soon as practicable. SoCalGas claimed that the ultimate buyer, Shuwa, viewed the existing improvements as having negative salvage value, and required by the sale contract that SoCalGas demolish the buildings or pay up to $2,200,000 to have Shuwa do it. Pacific's share of demolition costs will be minimal because Pacific in 1983 had demolished the First Methodist Church improvements which had occupied its parcel.

The gas company calculated its gain on sale to be $57,636,000 this being the 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, and proposed to assign this gain to its shareholders.

SoCalGas proposed to follow the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA) which -- while not binding on this Commission for ratemaking purposes -- generally assigns the gain on sale of rate-base land to shareholders. It proposed to book the proceeds - less original cost of the land, cost of the feasibility studies, the sales commission, and income taxes on the gain - to a below-the-line revenue account, and would remove the $1,895,000 original cost of the land from rate base.

In addition, SoCalGas proposed to apply the FERC Uniform System of Accounts procedures applicable to obsolescent major depreciable plant, using the depreciation mechanism, to allow it to continue to recover in rates the undepreciated portion of the original building costs, a return on those undepreciated costs, and the costs of removing the buildings. It proposed to transfer to the reserve for depreciation the remaining $15,025,000 undepreciated book costs of the improvements, as well as the anticipated $2,200,000 demolition and removal costs.

SoCalGas agreed, through the end of attrition year 1989, to absorb any excess costs of its leaseback from Shuwa over the utility's previously authorized revenue requirement.

D. 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 then determine whether or not the gain on sale should be used to offset costs associated with the replacement headquarters. These attempts were unsuccessful. In hindsight, we believe DRA was correct in seeking a consolidated review of issues associated with both the sale of the old headquarters and the leasing of the new. Consolidated review has been our standard procedure in other headquarters sales and replacement decisions, and allows us a more complete context within which to view utility headquarters decision-making. It is more appropriate to consolidate review of the sale of an asset with the determination of the reasonable level of expenses for its replacement. In the future, we will so structure our proceedings. In this proceeding, for example, it is obvious that we cannot evaluate the cost-effectiveness of SoCalGas's specific decision to move out of Flower Street to Grand Place until we directly compare the new lease costs to the old headquarters ownership costs. Rather than abandon the current proceeding at this late date, however, we will simply resolve the issue of whether it was reasonable for SoCalGas to sell its headquarters in the most narrow way possible.

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.

E. 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:

A. Was SoCalGas's sale of its Flower Street headquarters reasonable?

B. Was there an over or undercollection of headquarters expenses during the leaseback period?

C. What is the net gain on the sale of SoCalGas's Flower Street headquarters?

D. How should the gain on sale be distributed?

These issues will be addressed in order.

A. Was SoCalGas's 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 approximately 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 approximately 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.

1. <u>Position of SoCalGas</u>

SoCalGas claims that the sale of its Flower Street Headquarters was reasonable on several grounds. First, SoCalGas submits that it had outgrown the facilities. Some of its 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. Even though some space had been remodeled, mechanical systems had been updated or replaced, and some elevators had been retrofitted with control systems, full advantage could not be made of modern office layout. Space utilization was hampered by building columns, excessive stairwells, low ceilings, window dispositions, and compartmentation forced by individual buildings. The inefficiencies of the existing layout were compounded by the locations of the existing elevator systems. Elevators, plumbing, electrical, hardware, roofing, heating, and air conditioning all 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. Company records showed that beginning in 1983, capital and maintenance costs for the then 23 to 59 year old structures were escalating, largely because of duplicative elevator, heating, cooling, and mechanical systems. The utility made a year-by-year projection of the potential capital and operating and maintenance (O&M) costs for remaining in its Flower Street headquarters. These projections were based on recent experience, and assumed only moderate, on-going space renovations and certain necessary work which would be required were it to continue occupancy. For examples, within 5 to 10 years the elevator systems would require major renovations or replacements, and employee safety would require costly removal of asbestos originally installed as fire protection and insulation. These projections did not provide for the costs associated with more major building renovations and reconstructions which would be required if SoCalGas were to remain for any substantial length of time. These included new roofs, plumbing, and structural and other work needed to bring the structures up to current building, fire and safety, and earthquake codes, and handicapped access requirements. Such substantial work would involve temporary relocations of the employees during renovation. The utility concluded that not only would the costs involved in updating the existing structures be quite significant, but that even after this 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.

As early as 1979, concerns about the condition of the buildings, inflexibility of the space available, and the desire to be able to consolidate all headquarters staff and functions led to consideration of possible alternative headquarters options. Consultants were retained to review alternatives. To support its position that the sale of its Flower Street complex was reasonable, SoCalGas submitted four such studies.

2. <u>The Landauer Appraisal</u>

In 1984 Landauer Associates, real estate counselors, was engaged to evaluate the existing headquarters facility, and to do a market value appraisal of SoCalGas's 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 had resulted in inefficiencies and a good deal of 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.

3. 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%.

4. 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 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 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 while various of these options could be viable, they involved risks related to uncertainties of market demand when completed, variable rental rates, and the timing of other competitive developments. Cushman pointed out the location of the Flower Street block on the edge of the downtown business core, and noted that any large scale development at that location could encounter difficulties competing with better located properties in obtaining tenants. Cushman observed that other competitive projects had recently experienced difficulties in meeting their renting objectives in the currently "soft" downtown office space market.

Cushman 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.

5. <u>The Stegeman and Kastner, Inc. Study</u>

SoCalGas engaged Stegeman and Kastner, Inc. (Stegeman), project management consultants to make a final evaluation to determine 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.

6. <u>SoCalGas's Decision to Relocate its Headquarters</u>

By late 1986, SoCalGas reached a final conclusion that continuing at Flower Street was no longer economically justifiable, and that it was time to obtain an alternative headquarters. Its own studies coupled with expert outside professional opinion convinced it that the structural limitations and inherent inefficiencies, as well as functional obsolescence, made rehabilitation impractical. Relocation to a single modern and efficient building specifically designed to meet its needs would solve these problems, permit consolidation of all headquarters staff and functions, and provide room for growth. Redevelopment of the site would be risky and would also require several expensive interim moves.

The company determined that its future requirements would best be met by a move to new modern and safe facilities to be constructed downtown. 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, with a letter of intent signed and negotiations on a lease of Grand Place progressing, with firm offers including the favorable one from Shuwa under consideration, 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.[3]

Under the sale agreements the gas company is responsible to demolish and remove all improvements, up to a total of $2,200,000, at the end of the leasebacks. (Since Pacific has

3 The Pacific property across Hope Street was, however, not included in the closing.

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 cancelable 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.

7. DRA's Position Regarding SoCalGas's Decision to Move from 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 inutility 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.

8. Discussion

There can be no doubt that the Flower Street headquarters buildings were useful and had value at the time they were sold. This was demonstrated when Pacific vacated space it had leased in them, and then SoCalGas spent $300,000 to bring back several hundred headquarters employees from other leased space pending the 1991 move. The fact that SoCalGas has been able to occupy the leased-back buildings, "as is," and intends to continue such occupancy until it moves shows that the buildings had value and were not hopelessly obsolete. And the utility's 1985 depreciation schedule adopted by the Commission for the last rate proceeding recognized that, as a result of capitalized improvements and upgradings over the past years, an average service life for the buildings of 15.1 years remained.

But the buildings had reached the point in 1986 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 current 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.[4] Because of old and piecemeal construction the buildings have inefficient design requiring about 25% more floor space per employee than a modern building. Mechanical systems, plumbing, electrical, and elevators are 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. Had the utility remained, SoCalGas would have had very substantial capital expenditures as well as escalating O&M costs, still leaving the gas company with an old building inadequate for its long term needs. In short, the evidence suggests that renovation of the existing buildings would not have been a prudent business decision for the gas company. On the other hand, complete redevelopment to a large scale, mixed use project in a speculative market characterized by uncertainty of demand and abundance of competitive developments involved far greater investment and risks than the gas company wanted to undertake.

A move may not be absolutely compelled for a specific date, but good business practice dictates that at some point no more capital should be put into inadequate buildings. SoCalGas concluded that it had reached this point in 1986. The company cautiously examined alternatives and determined that an alternative headquarters was required.

The Commission accepts that the gas company, in arriving at its decision to move its headquarters office functions from Flower Street, took into consideration the possibility of realizing the theretofore locked in appreciation in value of the Flower Street property. Given the physical problems associated with the

4 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 running into the new code restrictions.

old headquarters, however, we do not believe that the desire to realize this appreciation was the primary motivation for SoCalGas's decision to 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).

SoCalGas and Pacific divided the proceeds, based on their respective square footage of the site, giving SoCalGas a $63,816,566 share of the gross proceeds. No party objected to this division of the proceeds. Although this formula ignores the value of the buildings, as we discuss below, there is no way at this time to precisely apportion the 1987 market value between buildings and land. Accordingly, in the absence of protest from any of the parties, we will approve this allocation of the proceeds between SoCalGas and Pacific.

The gas company's decision to lease back Flower Street for the anticipated four years until Grand Place would be ready 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. For the reasons stated above, we conclude that we should approve the apportionment of the proceeds between Paoific and SoCalGas.

We also conclude that the leaseback is a reasonable and cost-effective resolution to meet the interim requirements of the utility. Not only are the leaseback costs less than the revenue requirement associated with SoCalGas's own continued ownership of the buildings, at least for the first five years, 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.

B. Was There an Over or Undercollection of Headquarters <u>Expenses During the Leaseback Period?</u>

Before moving on to discuss gain on sale, we will address the adjustments that need to be made as a result of our comparison of: (1) the expenses SoCalGas incurred during 1987, 1988, and 1989 as a result of its actual leaseback arrangements; with (2) the headquarters expenses SoCalGas recovered through its authorized revenue requirement.

Table I 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. After adjustments for actual figures in the A.88-12-047 rate proceeding, refund adjustments should be made offsetting future rates to recover this overcollection for ratepayers. Similarly, it would appear that there was an overcollection for 1989, which should be addressed in the A.88-12-047 rate proceeding. There is no need to continue this memorandum account after 1989. D.90-01-016 (SoCalGas's 1990 test year rate case decision) calculated

SoCalGas's revenue requirement for 1990 onwards using the leaseback costs for the Flower Street headquarters, rather than ownership costs.

TABLE I

Memorandum Account
(Adopted Subject to Adjustment
for Last 3 months of 1988)
($ 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.

C. 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. As previously discussed, SoCalGas's share of the gross proceeds was $63,816,516.

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.

1. Demolition Costs

SoCalGas has 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.[5]

2. Treatment of the Undepreciated Building Costs

SoCalGas believes the gain on sale of its Flower Street headquarters should be allocated entirely to the land, and contends

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5 If SoCalGas does not have to pay the full $2,200,000 committed for future demolition of the buildings, the amount of SoCalGas's gain on sale will increase. Accordingly, we will require SoCalGas to file a report with the Commission concerning all demolition-related costs, so that the Commission can provide a ratemaking treatment for any unexpended amount that is consistent with the ratemaking treatment of the gain on sale provided by this decision.

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 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 would be charged as a retirement to the depreciation reserve account. However, the depreciation reserve for these buildings is not sufficient to cover the retirement. Ratepayers would have to absorb the undepreciated building costs after the date of sale as part of the utility's revenue requirement, even though the utility will continue to occupy the same buildings 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 costs to ratepayers.

We agree with DRA that the headquarters sale was a consolidated sale of both land and buildings and that the undepreciated cost 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. DRA's briefs and comments on the ALJ's proposed decision cite a long line of Commission precedent on this issue. See, e.g., D.42068, 48 Cal. P.U.C. 253, 257 (1948).

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 a bad four year 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 costs often incurred by lessors of 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.

As previously noted, the buildings have value to SoCalGas since they provide a home for SoCalGas until the new headquarters building is ready for occupancy 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. Both seller and buyer regarded the sale of the Flower Street buildings and land as a unified transaction. Thus, 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 how to treat the undepreciated building costs. If we had 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 original cost of the land and 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 the sale date of 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. In this way, the Flower Street headquarters is removed from rate base as of October 7, 1987. Accordingly, there shall be no recovery of the amounts recorded in the memorandum account established by D.90-01-016 to track the costs associated with retaining the Flower Street headquarters in rate base after its sale.

3. 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 for plant put into service before normalization was required.

However, SoCalGas presented no evidence regarding how this figure should be adjusted.[6]

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

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6 SoCalGas has presented some figures concerning this issue in its application for rehearing, but does not calculate the amount of increase in the capital gains tax it contends is justified. In any event, an application for rehearing is not appropriate for introducing new evidence that is not on the record.

TABLE II

Calculation of Gain on Sale

(Dollars in Thousands)

Gross Sales		$76,680
SoCalGas's Allocated Share		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

D. <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.

1. <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, therefore 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 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.

2. 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 investors are not legally or equitably entitled to any increase in the value of a utility asset when that land is ultimately sold, since the total they 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 also cites a 1987 tax assessment of the buildings showing a tax base considerably greater than their remaining book value, which supports DRA's contention that some of the sales gain is attributable to the buildings.

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.

3. Discussion

After a careful review of the record and the arguments on both sides of the gain on sale issue, we conclude that there should be a sharing of the net benefits derived from the gain between both ratepayers and shareholders. A share of the benefits realized from the gain on the sale of these assets should be applied to reduce future revenue requirements because ratepayers provided the operating and maintenance expenses, depreciation, taxes, and a return on the investments in the Flower Street headquarters. The shareholders should also receive a share of the benefits, as an incentive to management to maximize the proceeds from selling the utility's principal headquarters, thus benefiting both ratepayers and shareholders, and to seek a more suitable new headquarters, where the old headquarters poses health and safety risks and is no longer suitable for long-term use. By allocating a portion of the benefits from the gain on sale to SoCalGas's shareholders, we also compensate them for the risks they bore in connection with the old headquarters property, in the event that our present ratemaking system has not already fully compensated them for those risks, including the risk that the land component of the headquarters would decline in value between the date it was placed in rate base and the date it was sold.

The three arguments that SoCalGas 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 a utility's ownership of its facilities forms the foundation for its receipt of the gains on the sale of such facilities, then gains from the sale of depreciable and non-depreciable property should be treated the same, since the utility's ownership interest in depreciable property is no less than its ownership interest in nondepreciable property. Similarly, if utilities are entitled to gains on sale because they were limited to 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 all rate base property, whether or not it is depreciable. We 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 in plant held for future use accounts and land held in other rate base accounts. 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 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 because the present sale is assertedly of land only, utility investors are entitled to the gain.

a) Constitutional Property Rights

We believe that the issue of who owns the utility property providing utility service has become a red herring in this case, and that ownership alone does not determine who is entitled to the gain on the sale of the property providing utility service when it is removed from rate base and sold. No one seriously argues that ratepayers acquire title to the physical property assets used to provide utility service; DRA argues that the gain on sale should reduce future revenue requirements not because ratepayers 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.[7]

We 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 operation, they do not purchase specific rate base assets. Capital provided by shareholders and bondholders cannot be traced to specific rate base assets, nor can their relative legal interests in such property be pinpointed precisely. DRA points out that although shareholders own a security of the corporation, they have no legal or equitable title to the corporate assets in their

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7 Utilities frequently cite Board of Public Utilities Commissioners v. New York Telephone Company (1926) 271 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.

individual capacities. As the California Supreme Court noted in Miller v. McColgan (1941) 17 Cal. 2d 432, 436:

> It is fundamental, of course, that the corporation has a personality distinct from that of its shareholders, and that the latter neither own the corporate property nor the corporate earnings. The shareholder simply has an expectancy in each, and becomes the owner of a portion of each only when the corporation is liquidated ...or when a portion of the corporation's earnings is segregated and set aside for dividend payments...

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 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, Duquesne Light Company v. Barasch (1989) 488 U.S. 299, the Supreme Court cited with approval Justice Brandeis' concurring opinion in Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission (1923) 262 U.S. 276. In that decision, Justice Brandeis said:

> 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. (262 U.S. at 290.)

The Court in Duquesne reaffirmed the principles set forth in Federal Power Commission v. Hope Natural Gas (1944) 320 U.S. 591, 605 that "[r]ates 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 "[t]he economic judgements required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties." (Duquesne, 488 U.S. at 314.) Duquesne 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'". (488 U.S. at 307-08, quoting Covington & Lexington Turnpike Road Co. v. Sandford (1896) 164 U.S. 578, 597.) The court then held that a state law prohibiting utilities from recovering in rates the cost of two preoperationally abandoned nuclear plants was constitutional, since the .5% revenue requirement decline associated with the disallowance of the nuclear plant costs did not affect the utilities' overall returns so substantially as to render them unjust or confiscatory.

The point is simply that a wide variety of ratemaking approaches are constitutionally permissible, so long as they provide the utility and its shareholders with a fair return on the utility's overall investment and do not jeopardize the financial integrity of the utility. Moreover, it is constitutionally permissible to compute the fair return due the utility based on the historical cost of the utility's investments (investors have no constitutional right to a return based on the current "fair value" of the utility's property). The Constitution does not require that the appreciation in value of rate base property be given to shareholders.

Of course, the ability to retain the gain on the sale of property is one benefit of the ownership of property in the unregulated marketplace. However, it does not necessarily follow that those who choose to invest in regulated monopoly enterprises have the right to retain the gains on the sale of individual utility assets. The economic tradeoffs involved in the regulation of utilities justify a different allocation of the gain when rate base property is sold while the operating system of which it was a part continues to provide public utility service. [8]

Thus, here we conclude that a share of the benefits realized from the gain on the sale of this property should be used to offset future costs of headquarters facilities, because ratepayers paid operation, maintenance, and depreciation expenses, taxes, and other carrying costs while the property was in rate base, and because ratepayers insulate utility investors from most other expenses and risks associated with property ownership. We do not believe that this allocation of the gain will result in a regulatory system which deprives utility investors of a fair return on their overall investment or will damage the financial integrity of our utilities and prevent them from attracting new investors, nor has any evidence to that effect been introduced into the record of this case.

Nor do we believe that using a portion of these benefits to reduce future revenue requirements will discourage investment in California utilities and thus raise the cost of utility capital. SoCalGas presented no substantial evidence that investors were aware of either our gain on sales decisions or the Uniform System of Accounts, or that our past decisions allocating gains to offset

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8 Compare Re: Rate-making Treatment of Capital Gains Derived from the Sale of a Public Utility Distribution System Serving an Area Annexed by a Municipality or Public Entity, D.89-07-016, 32 Cal. P.U.C. 2d 233 (1989)(Redding II). That decision deals with public utility sales of distribution systems to public or governmental agencies where the agency assumes, and the utility is relieved of, its public utility obligations to customers within the area served by the system. If the requirements set out in that decision are met, the gain on such a sale of a distribution system goes to the utility and its shareholders.

costs of service had any adverse impact on SoCalGas's present or prospective investors. Moreover, investors do not reasonably expect a corporation to be able to liquidate any asset whose market value exceeds book value and retain the proceeds, especially when the corporation has an ongoing need to replace the services provided by the asset. We agree with DRA that the financial community views California regulation favorably, and that the application of the benefits of the headquarters transaction to minimize the utility's cost of service is unlikely to cause this to change in a noticeable fashion.

As the Supreme Court noted in Duquesne, the constitutionality of particular ratemaking decisions can only be evaluated in the context of their impact on the utility's overall authorized revenues and rate of return. (488 U.S. at 311-12.) In the present case, as further explained below, we will use the principal amount of the gain, $24,190,000, to offset costs of service over an 11-year 11-month amortization period. (Shareholders will retain the benefit of all opportunity income earned on this principal amount prior to the beginning of amortization as well as the opportunity income on the unamortized balance during amortization.) The amount amortized each year will be multiplied by the then-current net-to-gross multiplier to determine the amount of revenue-requirement reduction. We have estimated the impact of this revenue-requirement reduction on SoCalGas during the course of the amortization period. (For purposes of making these estimates we have used the test year 1990 figures adopted in SoCalGas's last general rate case (D.90-01-016).) On this basis, we estimate that our allocation of the gain on sale will reduce SoCalGas's revenues by approximately 1/4 of 1 per cent each year during the amortization period. Any impact on SoCalGas's rate of return is also small. If, instead of amortizing the principal amount of the gain to offset costs of service, the gain were amortized to benefit shareholders, SoCalGas's rate of return would increase by approximately 8 basis points each year during the amortization period. In short, using the principal amount of the gain to offset costs of service over an 11-year 11-month amortization period, while allowing shareholders to keep the opportunity income until amortization is complete, will not "destroy the value of the property for all the purposes for which it was acquired" and thus does not deprive the owners of property without due process of law.

To sum up, the constitutional question before us is whether, in the overall system of California ratemaking, a decision to apply all or a portion of the net benefits derived on the sale of rate base assets to reduce the utility's cost of service would so lower the return received by SoCalGas's investors as to yield only a confiscatory return on their investment or would damage the financial integrity of the utility and prevent it from attracting new investors and maintaining its operations in a satisfactory way.[9]

Since our approach to ratemaking compensates utility investors for the operations, maintenance, taxes, and depreciation associated with rate base property, insulates the investors from almost all risks associated with non-regulated property ownership, gives the utility a fair return while its plant is in service, returns the original cost of rate base assets to the utility either through depreciation or when the assets are sold, and in certain circumstances allows utilities to retain the gain on the sale of entire operating systems, we believe that our ratemaking is constitutional.

Our finding that gains on the sale of utility property can be used to offset the cost of ongoing utility service does not conflict with investor property rights.

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9 <u>Duquesne</u> noted that the impact of certain rates can only be evaluated in the context of the system under which they are imposed. (488 U.S. at 314.)

b) <u>The Regulatory Compact</u>

Nor are we convinced that any implicit regulatory compact requires 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, as regulated monopolies which serve the public trust, they are entitled to the opportunity to earn a fair return on the original cost of their investment while it provides utility service, 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.

Original cost ratemaking insulates both ratepayers and shareholders from any risk associated with fluctuations in the market value of utility assets as long as prudently acquired assets remain necessary or useful in providing utility service. Original cost ratemaking also insulates utility investors from the maintenance, operations, tax, and depreciation expenses normally associated with property ownership. In addition, such ratemaking insulates investors from the risk that property might be prematurely retired or written off before it is fully depreciated. In the non-utility private sector, investors are not guaranteed to earn a fair return on such sunk investment. Although shareholders and bondholders provide the initial capital investment, the ratepayers pay the taxes, maintenance, and other costs of carrying utility property in rate base over the years, and thus insulate utility investors from the risk of having to pay those costs. Ratepayers also pay the utility a fair return on property (including land) while it is in rate base, compensate the utility for the diminishment of the value of its depreciable property over time through depreciation accounting, and bear the risk that they must pay depreciation and a return on prematurely retired rate base property. On the other hand, ratepayers benefit because the utility's return is limited to a fair return on an investment with a similar degree of risk. In short, our system of original cost ratemaking represents a careful balancing of interests, and is not weighted unfairly toward either ratepayers or shareholders.

If we allowed utilities to receive the gain as if the rate based land sold had been a speculative investment, while allowing them to burden ratepayers with the costs they would otherwise have borne as speculative investors (i.e., taxes and cost of ownership), we would be giving them the best of two investment decisions. They would get the reward of speculative investing without the attendant risk that the costs over the years 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. Such a double reward, without any real risk, would not represent balanced regulation.[10]

Furthermore, such ratemaking treatment would give utilities an opportunity to update their rate base with higher cost replacement property and thus gain through the back door benefits available under "fair value" ratemaking. (Under fair value ratemaking, utilities earn a return based on the current "fair value" of the property used to provide utility service.) We believe that it would not be good ratemaking policy to give utilities an incentive to replace partly depreciated, or low historical-cost, utility assets with new assets even though the assets they seek to replace are neither worn out nor unserviceable,

10 The court in Duquesne noted that "[t]he risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks." (488 U.S. at 454.)

just because of an opportunity for shareholder gain. Rather, we believe that the economic tradeoffs of regulation justify using gain accruing during the time property was in rate base to offset the costs of replacement property.

The utilities' complaint that they earned over time a lower return on the original cost of a particular rate base asset than they would have earned on the current market value of that asset, and that therefore they are entitled to the gain upon the sale of that asset, is not well taken. One of the tradeoffs of original cost ratemaking is that 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. As Duquesne reaffirmed, there is no necessary connection between rate regulation and the current value of a utility's property.

While the utilities are entitled to their hindsight opinion that they would have been better off not having made such a bargain in this instance, we do not find that utilities have suffered on account of California's original cost ratemaking system.

c) Depreciable vs. Nondepreciable Property; Plant Held for Future Use vs. Plant in Service

Finally, we address the utilities third 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.

i) Do the Uniform Systems of Accounts, Judicial Decisions in Other Jurisdictions, or Our Own Past Decisions Require that the Gains on the Sale of Depreciable Property be Treated Differently than the Gains on the Sale of Nondepreciable Property?

First, we note that we 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, it is important to remember that ratemaking drives accounting, and not vice versa. We view the FERC USOA as simply an accounting tool, and not a philosophical or regulatory mandate. As we stated in PG&E's most recent general rate case decision, 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 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 Cal. P.U.C. 253, 257 (1948).)

We have gone, and will continue to go, beyond the USOA whenever we feel it is necessary to do so in order to strike the proper balance between the interests of ratepayers and shareholders.

Nor do we find utility arguments based on the difference between the FERC USOA (which gives gain on the sale of land, other than land held for future use, to shareholders) and the FCC USOA (which applies such gain to reduce the cost of service) convincing. We are not persuaded by SoCalGas's argument that the FCC would not have resolved the gain on sale issue the way it did if it had not been operating against a backdrop of tax normalization. We believe that any difference in tax accounting whereby FCC-regulated utilities receive additional benefits of tax normalization is irrelevant. We do not believe that FERC allocates gain on sale of energy utility rate-base land to investors in order to provide energy utilities 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 we 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, we find references to the weight of judicial opinions in other jurisdictions unpersuasive. Both DRA and the utilities presented a number of citations to cases supporting their respective positions. While these decisions may be informative they are not dispositive of the allocation question. We prefer to base our decisions on logic from our own jurisdiction.

Third, while we 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 for the sale of property that is not necessary or useful. Section

851 does not contain a requirement that utilities notify the Commission when they determine that a particular rate base asset is no longer useful in providing utility service, and this Commission has generally relied on these issues, if significant enough, being aired in periodic rate proceedings. Some utilities may use this perceived "gap" in regulation to transfer plant from rate base accounts to non-rate base, or "below the line", accounts, to sell the plant without seeking our approval, and then to retain any gain for their shareholders' benefit. The resulting accounting entries may therefore 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, we note that the Commission in D.83160 expressed its concern over such transfers by requiring SoCalGas to notify us of any transfer of rate base plant with a value of $100,000 or more. While it is true that the record shows that occasionally the Commission appears to have responded to such notifications by acquiescing in the utilities' recommended accounting for particular rate base items, we do not find the consistent approval cited by the utilities.

Fourth, our review of past Commission decisions does not convince us that we have traditionally maintained a bright line distinction between depreciable and nondepreciable property.

In D.82-05-038 (<u>Citizens Utilities Felton District</u>), we cited <u>Democratic Central Committee vs Washington Metropolitan Area Transit Commission</u> 485 F.2d 786, 821 (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</u>

nondepreciable assets." (9 Cal. P.U.C. 2d 197, at 206, emphasis added.)

Previously, in D.89517, SoCalGas Blythe-Moreno pipeline withdrawal, 84 Cal. P.U.C. 405, 420 (1978), we quoted Democratic Central Committee, which says:

> The allocation between investors and consumers of capital gains on in-service utility assets ... rests essentially on equitable considerations. The allocative process ... necessitates a delicate balancing of the interests of investors and consumers in light of governing equitable principles. (Democratic Central Committee, 485 F.2d at 821.)

We then noted that:

> In undertaking this delicate balancing of considerations, we recognize, as the court stated, that 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. Further, it is understood that the amount of eventual investor recovery may permissibly be limited to the amount of the original outlay; this is but another way of saying that the investors do not possess a vested right in value-appreciations accruing to in-service utility assets. (84 Cal. P.U.C. at 420.)

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 in situations 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 they have not received their just due. (84 Cal. P.U.C. at 421.)

There, the Commission addressed a pipeline (presumably primarily depreciable property except for the land underlying the pipeline), but did not in its discussion draw a line between depreciable and nondepreciable property.

In D.82-12-121 (10 Cal. P.U.C. 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 Cal. P.U.C.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, 20 Cal. P.U.C. 2d 237, which compared the gains on the sale of depreciable property to those on the sale of nondepreciable property, was in harmony with the FCC's assessment of the issue, and found no good reason to treat the gains differently:

> [T]he 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. (20 Cal. P.U.C. 2d at 264.)

We find that past Commission decisions over many, many years simply do not support a ratemaking distinction between the gain on the sale of depreciable property and the gain on the sale of nondepreciable property.

ii) Should the Commission Allocate the Gain on the Sale of Nondepreciable Property Differently than it Allocates the Gain on the Sale of Depreciable Property or Land Held for Future Use?

Having disposed of the arguments that we are constrained by the past to treat depreciable property differently than nondepreciable property, we move on.

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.

We do not believe that the fact that ratepayers return to investors the capital invested in depreciable rate base assets through depreciation accounting provides a meaningful basis for distinguishing depreciable assets from non-depreciable assets insofar as the proper analysis of investment risk and the proper disposition of gain on sale is concerned. When a depreciable rate base 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 such a proportional allocation of gain; instead, the "gain on sale" of a depreciable rate base asset is allocated entirely to ratepayers.

In the more usual case, depreciable rate base assets are sold at a loss, with the loss being offset by whatever salvage value is obtained upon sale. Commission practices and the USOA provide that 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.

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 of loss 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.

We see little reason why land sales should be treated differently. 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. In practical terms, the investors get their investment returned either over time through standard depreciation accounting, or at the time of asset sale, as a reduction of the "gross proceeds" before the amount of gain is determined. It matters little, in terms of investment risk analysis, whether an investor is repaid by ratepayers over time 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.

In short, 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.[11]

Losses on the sale of non-depreciable rate base assets are rare, since land in California virtually always increases in value over time. In the rare situation in which rate base land sells at a loss, the shareholders might bear the loss, since there is no set adjustment established to reimburse shareholders when land is retired at a loss. We have never faced this issue in ratemaking, but it is fair to assume that if a utility that faced this situation could advance compelling facts and rationale, we could make an adjustment to make shareholders whole. We also note that 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 one view could be that 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

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11 Nor do we see any significant distinction, for purposes of allocating gain on sale, between land carried as plant held for future use and other rate base land. The utility, its shareholders, and ratepayers face the same risks of poor management decisions concerning the acquisition, disposition, or use of both kinds of land. Thus, in D.85-06-023, San Jose Water Co. (June 5, 1985) (Finding of Fact No. 6, Ordering Paragraph No. 3) we ordered San Jose Water to flow through to its ratepayers any gain in appreciation on parcels of land transferred to an affiliated corporation, whether the land was "included in its rate base or in plant held for future use".

with rate base land just as there is with regard to depreciable rate base property.

Moreover, an 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.[12] Not every single risk of loss is offset by a directly connected opportunity for gain, but taken as a whole we

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12 In the late 1970's and early 1980's the Commission was faced with a number of utility projects which 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 ratepayers are generally only charged for property 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 found it unfair to burden shareholders with all costs associated with such preoperationally abandoned plant. It also found it unfair to require ratepayers to pay, as the utilities requested, the usual return on such abandoned plant.

The Commission developed through a series of decisions a risk sharing policy whereby the direct costs of such projects were generally amortized at ratepayers' expense over a number of years but whereby ratepayers were not required to pay an allowance for funds used during construction of such abandoned projects. Any gain resulting from the sale of such abandoned plant was allocated to ratepayers to offset their payments for the nonfunctional plant. See e.g. D.92497 (4 Cal. P.U.C. 2d 725, at 772-783) (SoCalGas WESCO coal venture); D.90405 (1 Cal. P.U.C. 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). These decisions 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.

believe our ratemaking system amply rewards and protects utility investors.

In the present proceeding, DRA fears that if we give utilities the gain on the sale of rate base land we will encourage utilities to sell highly appreciated land and then request full rate base treatment of the replacement land used to fill the function served by the property that was sold. We believe that automatically granting utilities the gain on sale of rate base land, as they request, would establish a perverse incentive to replace assets with a low historical cost with more expensive, newly-purchased assets, which would impose higher costs on ratepayers without accompanying benefits.

Nevertheless, in this case, for reasons more fully explained below, we find it appropriate to allocate a portion of the benefits from the gain on sale to shareholders, by allowing shareholders to retain the benefit of all opportunity income earned on the principal amount of the gain until the principal is fully amortized. This allocation will also compensate shareholders for any risk they bore that the land component of the Flower Street headquarters might have declined in value between the date it was placed in rate base and the date it was sold.

In any event, the transaction before us today includes both depreciable and nondepreciable property, and thus we do not need to address the issue of the gain on sale of nondepreciable property any further at this time.

iii) <u>History of Consolidated Sales of Both Depreciable and Nondepreciable Property</u>

As explained above, in our discussion of the treatment of the undepreciated building costs, we find that the sale of SoCalGas's Flower Street headquarters represents a consolidated sale of both land and buildings, and that the gross proceeds must be attributed to both land and buildings. Therefore, we need look no further than our previous decisions concerning headquarters transactions to determine the proper allocation of the gain on sale here.

We have in the past treated gain on the sale of utility headquarters in a variety of ways. Frequently we have found it appropriate to use the gain on sale to offset the cost of replacement facilities. Ratepayers benefit from the reduction in rate base associated with the new facilities. Shareholders benefit when they can obtain 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.[13]

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

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13 The Commission has at times made certain ratemaking adjustments designed to allow shareholders to benefit from sale and leaseback transactions. In its decisions concerning SDG&E's sale and leaseback of its headquarters and of its Encina 5 generating plant, the Commission allowed the utility certain rate base and rate of return adjustments designed to compensate the utility for the removal of these substantial assets from rate base. The Commission wished to avoid punishing SDG&E through revenue requirement reductions for what it saw as an innovative financing approach with benefits for both ratepayers and shareholders, especially since the sale and leaseback was a response to the then poorly managed utility's inability to raise needed capital through normal means.

be recorded in a memorandum account and used to reduce rate base. The Commission stated that:

> ...this adjustment resembles as closely as possible a requirement that AT&T-C fold back into its operations a gain on sale of an old building that was largely paid for over time by its customers. (28 Cal. P.U.C. 2d 243, 288 (1988).)

Again, in D.86-12-063 the Commission accepted SoCalGas's proposal that the after tax 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 (16 Cal. P.U.C. 2d 926, 978 (1984)) 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.

In the present proceeding, SoCalGas characterizes the San Fernando Valley Headquarters transaction as one that merely deferred the gain its investors would receive when the new property was eventually sold. This characterization is curious in light of the utility's current contention that the gain on the sale of depreciable property should be treated differently than gain on the sale of land. 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 were to receive all the gain from the new rate base land, its shareholders would capture the deferred gain on the sale of the old depreciable property -- gain that clearly does not belong to the shareholders, even under the utility's own theory. On the other hand, if upon sale of the new headquarters only a portion of the gain on the land were to be used to offset the cost of service -- namely the portion allocable to the deferred gain on the old headquarters buildings -- a great deal of complicated accounting would be required. It seems clear that 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. We do not believe it was our intent in D.86-12-063 to require a "gain deferral" analysis based on a system of allocating non-depreciable gains to investors and depreciable gains to offset the cost of service.

General Telephone's 1985 headquarters relocation provides a good analogy to the current situation. General had a headquarters building configuration consisting of multiple separate sites, most of which were deteriorating due to age. Three of the major sites required extensive overhaul. General wished to move to a single location in order to avoid the need to overhaul the existing sites, and to avoid the extensive travel time and facilities duplication associated with its fragmented headquarters operation. Here, SoCalGas also has deteriorating headquarters buildings and employees located at several sites.

The Commission followed for General the approach it took for Pacific Bell in D.86-01-026 (20 Cal. P.U.C. 2d 237, 289 (1986)) and flowed the gain from the sales transactions to offset the cost of utility service. (D.88-08-061, General Telephone, 29 Cal. P.U.C. 2d 63, 107-10 (1988).) Given the unified nature of General's headquarters sale and its move to its new Thousand Oaks headquarters, the Commission decided to offset the after tax gain with the expenses incurred in the move. The Commission then translated the net after tax gain to before tax gain and amortized the result, plus the before tax gain on two additional properties, to reduce other costs over a three year period.

The conversion, or "gross up," of the after tax gain to pre-tax gain allowed ratepayers to capture the tax benefits of the reduction in General Telephone's income which resulted from the flow through of the gain to reduce the cost of service. (Since the utility's income decreased, its tax liability also decreased.)

The primary differences between the General Telephone situation and the situation faced by SoCalGas are 1) SoCalGas is leasing its new headquarters, not purchasing it as did General; and 2) SoCalGas has not yet moved to its new headquarters and thus has not yet incurred moving expenses that might be used to offset the gain on sale - thus, the net gain on sale here appears a great deal larger than the final net gain amortized in D.88-08-061.

We are not persuaded that it makes a great deal of difference whether a property sold by a utility is replaced by purchased property or leased property. In either situation, there is a capital gain or loss to be allocated upon the sale of the old property and a revenue requirement to be paid for the replacement facilities. From a ratemaking perspective, capital gains could offset the costs of leased or purchased facilities equally well.

We note that General Telephone's pre-offset gain was almost identical to the $24,190,000 in gain we face here. If this proceeding allowed the opportunity to offset reasonable moving costs in the manner they were offset in General Telephone, the final net gain would be significantly less than the current $24,190,000.

d) Benefit Sharing

Most of the discussion above is an assessment of the generic gain-on-sale principle, how it has been applied, and how we have frequently applied gains on sale of utility assets to offset the costs of continuing utility service. But now we turn to the heart of the specific -- and truly unique -- case before us today.

Turning to the case at hand, the sale of the corporate headquarters of the nation's largest gas distribution utility, we must look to the relatively unique circumstances of this sale. This is not a run of the mill transaction. We have found that the Flower Street headquarters buildings had reached the point in 1986 where they were no longer suitable for long-term use by SoCalGas. The buildings had numerous disadvantages, including problems with asbestos and with seismic and fire safety. As we noted above, a move may not have been compelled for a specific date, but at some point SoCalGas needed to move. As part of its plan to move into a new headquarters, SoCalGas decided to sell its Flower Street land and buildings; and we have concluded that its decision to sell the Flower Street property was reasonable. Real estate, unlike most other utility assets, can readily be put to use by non-utility buyers. Thus when a utility, for reasons of sound utility planning, seeks to dispose of real estate that it will no longer need for utility purposes, there are a relatively large number of potential buyers for such property, especially where, as here, the property is located near the center of a major city. This presented SoCalGas with opportunities for maximizing the sales price. At the same time, the volatility of the Los Angeles real estate market (which we noted in D.87-09-076, Finding of Fact No. 8) meant that the timing of the sale was important in maximizing the price. Under these circumstances, we believe that it is reasonable to apportion a degree of incentive to the utility to maximize the sales price of its old corporate headquarters. Such an incentive allows both ratepayers and shareholders to benefit from the utility's efforts to obtain the highest possible price. Similarly, we believe that under the circumstances present here, including the health and safety risks posed by the old headquarters, it is also an appropriate policy to apply a ratemaking approach which apportions a reasonable degree of incentive to the utility for seeking a new headquarters more suited for its long-term needs.[14]

These considerations lead us, under these circumstances, to fashion a sharing of benefits ratemaking treatment which is consistent with the very long line of Commission precedents on the gain-on-sale issue which are discussed at length herein, but which recognizes the equities and policy issues attendant with this once in a century corporate headquarters move. Our holding today must not be misconstrued by any of the fixed utilities which we regulate. We are not reversing any of our prior precedents, which have frequently applied gains on sale of utility assets to offset the costs of continuing utility service. Our holding today is a one case result, premised on refining our ratemaking policy so the outcome more fairly fits the circumstances.

We believe that a portion of the benefits realized from this sale of SoCalGas's Flower Street property should be allocated to reduce the cost of utility service. SoCalGas's old headquarters represented a combination of depreciable and nondepreciable property. Although the shareholders and bondholders provided the initial capital investment, the ratepayers paid the taxes, maintenance, and other costs of carrying the land and buildings in rate base over the years, and paid the utility a fair return on its unamortized investment in the land and buildings while they were in rate base. Furthermore, the ratepayers "compensated" SoCalGas for the diminishment of the value of its depreciable buildings - the lion's share of SoCalGas's investment in the consolidated headquarters - over time through depreciation accounting and the recovery of annual depreciation in utility rates. Although

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14 In saying this, we do not prejudge whether the new headquarters it has selected was the best or most cost effective choice. Those questions are yet to be decided in A.88-12-047.

SoCalGas's old headquarters will soon no longer be necessary or useful in the performance of utility duties, SoCalGas will need a replacement headquarters, and we will use a portion of the benefits realized from the gain on sale to offset its headquarters costs.

However, we also believe that a portion of the benefits realized from the sale should be allocated to SoCalGas. As more fully explained above, we believe that under the circumstances present here it is reasonable to provide incentives for a utility to maximize the proceeds from selling its principal headquarters, and to seek a more suitable headquarters, where its old headquarters poses health and safety risks and is no longer suitable for long-term use. We believe that such incentives should benefit both ratepayers and shareholders.[15] We emphasize that such incentives are not appropriate unless the principal headquarters should be disposed of for reasons of sound utility planning. Otherwise, there would be a perverse incentive to replace depreciated assets, or assets with a low historical cost, with more expensive, newly-purchased assets, imposing higher costs on ratepayers without corresponding accompanying benefits.

By allocating a portion of the benefits from the gain on sale to SoCalGas's shareholders, we also compensate them for the risks they bore in connection with the old headquarters property, in the event that our present ratemaking system has not already fully compensated them for those risks.[16] One of those risks was

15 Here, employees also stand to benefit from the move.

16 See the discussion above concerning the Regulatory Compact and whether the Commission should allocate the gain on sale of nondepreciable property differently than for depreciable property. There we describe how our current ratemaking system already properly balances risks and benefits to shareholders. We also note that the utility's authorized rate of return includes compensation for the risks of investing in the utility's operations.

the risk that the Flower Street land might have declined in value between the time when SoCalGas placed the parcels in rate base and the time when it sold them. SoCalGas also was exposed to additional risks because it asked for, and the Commission granted it, authority to sell and lease back the Flower Street property before any sales and leaseback terms had been agreed to, so that SoCalGas could move expeditiously on a purchase offer in a volatile real estate market. Thus, pursuant to D.87-09-076, SoCalGas was at risk that, after the sale, the Commission might find the terms of the sales agreement unreasonable. Decision 87-09-076 also left SoCalGas at risk if its existing revenue requirement did not fully cover its leaseback costs. If the costs of leasing back Flower Street were less than the ownership costs included in its revenue requirement, on the other hand, SoCalGas also bore the risk of having to refund the overcollection.

In this decision we provide a reasonable allocation between shareholders and ratepayers of the benefits of the gain on sale of the Flower Street land and buildings. Ratepayers will benefit because, consistent with our prior decisions, we will require SoCalGas to use the principal amount of the gain, $24,190,000, to offset its headquarters costs. However, rather than applying the full amount to a single year, we will apply it over the course of an 11-year 11-month amortization period, beginning in December of this year. This amortization period, which runs until November 2002, is based on the remaining book life of the Flower Street buildings.[17] Use of this $24,190,000 to offset

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17 When SoCalGas sold its Flower Street headquarters and set up the memorandum account to track the difference between the ownership and leaseback costs for Flower Street, it effectively stopped earning depreciation on the Flower Street buildings. (Although SoCalGas continued to collect revenues based on ownership

(Footnote continues on next page)

SoCalGas's cost of service will reduce SoCalGas's taxable income and therefore its tax liability, as recognized by SoCalGas's witness Ballew, and will also impact SoCalGas's franchise fee expense and uncollectibles. Consistent with our standard practice we will pass these benefits through to ratepayers, by multiplying the principal amount to be amortized each year by SoCalGas's then current net-to-gross multiplier to determine the amount by which to reduce its annual revenue requirement.[18]

At the same time, shareholders will benefit because we will allow SoCalGas to: (1) retain the investment income it has been able to earn on the sales proceeds from the date of the sale (October 7, 1987) to date; and (2) retain the income it is able to earn on the unamortized balance of the $24,190,000 from now until the end of the 11-year 11-month amortization period. There is no question that the utility has had the use of the proceeds since the date of sale and therefore the opportunity to earn income from the investment of those proceeds. Our decision to apply the $24,190,000 gain to offset headquarters costs over an 11-year 11-month year amortization period will also give the company an opportunity to invest the unamortized portion of the gain. We have

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(Footnote continued from previous page)

costs, including depreciation, until its 1990 general rate case decision, today we order SoCalGas to refund the amounts it collected to the extent that they exceeded the leaseback costs incurred.) SoCalGas's 1987 depreciation study had recognized an average remaining service life of 15.1 years for the account covering the Flower Street buildings. Fifteen and 1/10th years after their sale in early October 1987 brings us to November 2002.

18 If the 1990 adopted SoCalGas net-to-gross multiplier were to remain unchanged for the duration of the amortization period, the gross-up on the $24,190,000 would total $17,116,191 over the years.

estimated the value of these investment opportunities to SoCalGas, based on the assumption that SoCalGas could earn its currently authorized rate of return on the money available for investment. In making this estimate we have also used SoCalGas's currently authorized rate of return, net of tax, to discount the value of future income to a date in early December 1990. (This discounting reflects the fact that it is more valuable to receive a dollar today than a year from now; this would be true even if there were no inflation.) On this basis, we have estimated that the net of tax value to SoCalGas, as of early December 1990, of the above investment opportunities totals approximately $20.5 million.[19]

E. 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

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19 Using the same discount factor, and SoCalGas's currently authorized net-to-gross multiplier, we have also estimated the present value of applying the principal amount of the gain to offset SoCalGas's cost of service. On this basis, the value, as of early December 1990, of using the principal amount of the gain, together with the gross-up on that sum, to offset headquarters revenue requirements over the course of the amortization period totals approximately $23 million. In addition, ratepayers will directly benefit from today's order refunding the amount in the memorandum account established by D.87-09-075.

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.

F. 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 SoCalGas land parcels totaled $1,895,000. The undepreciated cost of the headquarters buildings is $15,025,000. Over the years, though the end of 1987, SoCal has realized, after-taxes, about $32,000,000 from its investment in the Flower Street headquarters.

3. Although constructed in compliance with building codes applicable at the time of construction, the buildings when sold in 1987 could not meet disabled access, fire and safety (including asbestos removal), and earthquake resistance requirements then applicable to new construction.

4. By the 1980s, 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. 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.

6. 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; fireproofing; renovation and replacement of elevators; and replacement of present toilet and plumbing facilities, mechanical cooling and heating systems, roofing, and all secondary electrical distribution. Such major renovation would have involved interim relocation of operations.

7. Even if these renovations were made, the utility would still end up with modernized old buildings with poor column spacing, excessive stairways and corridors, inadequate ceiling heights, and not enough room for all of SoCalGas's headquarters functions.

8. SoCalGas retained outside real estate consultants who 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. SoCalGas's outside consultants compared renovation of the existing buildings with complete redevelopment of the site, as contrasted with moving to either utility-owned or leased facilities elsewhere. SoCalGas's consultants concluded that relocation to a newly constructed modern downtown office structure, where presently required and expansion space could be leased at relatively favorable terms, would be SoCalGas's best option, with SoCalGas and Pacific going separate paths.

9. Late in 1986 SoCalGas management reached the decision that SoCalGas and Pacific should no longer share headquarters offices; that remaining for the future in the Flower Street facilities, or at that site, would no longer be economically justifiable either through renovation or redevelopment of that property; that the utility should remain downtown; and that it was timely and would be economically beneficial for it to move to new, modern, and efficient downtown office space to be especially designed to meet the utility's needs.

10. In December 1986 SoCalGas signed a letter of intent to lease space at Grand Place with occupancy expected to begin about mid-1990.

11. SoCalGas's decision to move from Flower Street was reasonable because of the physical, functional, and technological obsolescence of the aging buildings and the unsatisfactory alternatives involved in remaining there. By 1986 the buildings were no longer suitable for long term-use by SoCalGas.

12. 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. It was reasonable for SoCalGas to sell its property packaged in association with the Pacific property.

13. SoCalGas and Pacific decided to sell Flower Street immediately because of the strong Los Angeles market then available, 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.

14. 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. Such a leaseback avoids costly disruptions of interim, short term moves during the period between SoCalGas's

favorable sales opportunity and its projected occupancy of its new Grand Place headquarters.

15. SoCalGas's offer to sell the Flower Street property was conditioned on the availability of a leaseback. Thus the Flower Street property would continue to be useful in utility service during the leaseback period.

16. By A.87-07-041 SoCalGas sought prior Commission authorization for a sale.

17. Aware that delay could affect the sales price or hamper a sale in the fast-paced Los Angeles real estate market, the Commission, in interim D.87-09-076, authorized SoCalGas to sell the Flower Street property. The utility would be required in a Phase II proceeding to demonstrate the reasonableness and 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. SoCalGas was ordered to maintain memorandum accounts to track the headquarters ownership-cost revenues collected and the actual costs incurred, with excesses subject to refunding, or SoCalGas at risk for undercollections.

18. SoCalGas and Pacific accepted Shuwa's offer of $76,680,000 for the Flower Street property, which also included a leaseback provision which allows SoCalGas to use the property for up to five years at a monthly cost of $319,083, with holdover provisions, and makes the sellers responsible for demolishing and removing the buildings at end of the leaseback. The leaseback also requires SoCalGas to pay operation and maintenance expenses and taxes associated with the Flower Street property. Shuwa's offer provided the best cash price for the property, the lowest cost for a four-year leaseback, the most flexible holdover terms, and reasonable provisions for removal of the buildings at end of the leaseback. Escrow was closed on October 7, 1987.

19. 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 those years.

20. 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 SoCalGas's actions in eventually vacating Flower Street are not prejudged.

21. 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, 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.

22. It was reasonable for SoCalGas to sell its Flower Street headquarters in 1987. The terms of the sale, including the sales price of $76,680,000, were reasonable.

23. SoCalGas and Pacific divided the sales price, based on their respective square footage of the site, giving SoCalGas a $63,816,566 share of the gross proceeds. Because no party objected to this division of the proceeds and because there is no way at this time to precisely apportion the 1987 market value between buildings and land, we will approve this allocation of the proceeds between SoCalGas and Pacific.

24. Ratepayers should not be required to pay leaseback costs and a return and depreciation at the same time.

25. For the period of the leaseback, SoCalGas should be allowed to recover in rates its actual, reasonable leaseback costs, including lease payments, operation and maintenance expense, and ad valorem taxes, but less any rental income derived. The rates authorized by D.90-01-016 (SoCalGas's 1990 test year rate

case decision) calculated SoCalGas's revenue requirement for 1990 and thereafter using the leaseback costs for the Flower Street headquarters, rather than ownership costs. To the extent that rates authorized previously provide revenue in excess of actual, reasonable leaseback costs, the excess should be refunded as provided in this opinion.

26. For 1987 and 1988, subject to adjustment for actual figures for the last three months of 1988, SoCalGas overcollected $640,000 in revenues for headquarters expenses. It appears that there was also an overcollection for 1989.

27. 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) $2,200,000 maximum commitment for future demolition of buildings. These costs total $6,486,000.

28. The costs to demolish and remove the old buildings are a cost of the sale, and should be offset against the sale proceeds to SoCalGas, if actually incurred.

29. Both SoCalGas and Shuwa treated the sale of the Flower Street property and its buildings as a unified transaction. Because the partially depreciated buildings on the property had, and continue to have, value to both SoCalGas and Shuwa, the value of the Flower Street property at the time of the sale was not entirely in the land.

30. Since all bids received by SoCalGas reflected 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.

31. The sale of the Flower Street headquarters was a consolidated sale of both land and buildings. There is no basis or compelling rationale for allocating the gain between land and buildings. The undepreciated cost of the buildings should be

subtracted from the gross proceeds of the consolidated sale in determining the gain on sale.

32. We adopt DRA's tax calculation for the gain on sale of the Flower Street headquarters as reasonable.

33. In order to determine the extent of the gain SoCalGas received on the sale of its Flower Street headquarters, it is necessary to subtract from SoCalGas's $63,817,000 share of the gross proceeds the $1,895,000 original cost of the headquarters land and the $15,025,000 undepreciated cost of the headquarters buildings. SoCalGas's $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%) on this $40,411,000 must be subtracted from these remaining proceeds to arrive at a net gain on sale after taxes of $24,190,000.

34. Following a petition by SoCalGas for modification, Ordering Paragraph 4 of D.87-09-076 was modified by Interim D.88-03-075 issued March 23, 1988 to provide:

> 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.

35. Left undisturbed was the provision in Interim D.87-09-075's Ordering Paragraph 2 that the gain on sale issue be considered in these Phase II proceedings of A.87-07-041.

36. In accord with the requirements set forth in Interim D.87-09-076 and Interim D.88-03-075, SoCalGas on April 7, 1988 filed its timely amendment to A.87-07-041 addressing its proposed ratemaking and capital gain treatment resulting from the sale of its Flower Street property and leaseback.

37. The source of capital for a utility's investment in land necessary or useful in providing utility service might be a

significant factor in determining eventual disposition of gain or loss on sale of that land when no longer necessary or useful, if the contributors of that capital had assumed the general financial risks associated with such investment in land. This is not the case here, where our regulatory environment insulates utilities from most market risks.

38. While the Flower Street headquarters was in rate base, ratepayers paid all operation and maintenance expenses, depreciation, and taxes associated with the headquarters property. They also provided SoCalGas with a fair return on the capital it invested in the headquarters. In addition, ratepayers bore the risk that the headquarters buildings would be prematurely retired and that they would nonetheless be required to pay depreciation and a return on the buildings until they were fully depreciated.

39. With respect to this property, SoCalGas bore only the minimal risk that the value of the land component of the headquarters property would decrease in value between the date it was placed in rate base and the date it was sold; and if the land had indeed "depreciated" in value, SoCalGas could have requested the Commission to fashion a make-whole adjustment to benefit SoCalGas's shareholders.

40. Since ratepayers bore most of the risk associated with the Flower Street headquarters it is appropriate to use a portion of the benefits, resulting from the appreciation in the market value of the headquarters that occurred between the date it was placed in rate base and the date it was sold, to offset continuing headquarters costs.

41. It is a reasonable incentive, where a utility's principal headquarters should be sold for reasons of sound utility planning and where the real estate market is volatile, to provide shareholders with a share of the benefits realized from the sale to encourage management to maximize the sales price for the benefit of ratepayers and shareholders.

42. It is a reasonable incentive, where a utility's prinoipal headquarters poses health and safety risks and is no longer suitable for long-term use and should be sold, to provide shareholders with a share of the benefits realized from the sale to encourage management to seek a more suitable new headquarters.

43. Such incentives are not appropriate unless the principal headquarters should be disposed of for reasons of sound utility planning. Otherwise, there would be a perverse incentive to replace depreciated assets, or assets with a low historical cost, with more expensive, newly-purchased assets, imposing higher costs on ratepayers without corresponding accompanying benefits.

44. By allocating a portion of the benefits from the gain on sale to SoCalGas's shareholders, we also compensate them for the risks they bore in connection with the old headquarters property, in the event that our present ratemaking system has not already fully compensated them for those risks, including the risk that the land component of the headquarters would decline in value between the date it was placed in rate base and the date it was sold.

45. The $24,190,000 principal amount of the gain realized on the utility's sale of the Flower Street headquarters should be applied to offset SoCalGas's headquarters costs over an 11-year 11-month amortization period, beginning in December 1990 and running until November 2002.

46. This amortization period is based on the remaining book life of the Flower Street buildings. When SoCalGas sold its Flower Street headquarters and set up the memorandum account to track the difference between the ownership and leaseback costs for Flower Street, it effectively stopped earning depreciation on the Flower Street buildings. SoCalGas's 1987 depreciation study had recognized an average remaining service life of 15.1 years for the account covering the Flower Street buildings. November 2002 is approximately 15.1 years after the date of sale.

47. The $24,190,000 used to offset SoCalGas's cost of service will reduce SoCalGas's taxable income and therefore its ratemaking tax liability and will also impact SoCalGas's franchise fee expense and uncollectibles. The tax and other impacts can be passed through to ratepayers by multiplying the principal amount to be offset each year by SoCalGas's then current net-to-gross multiplier to determine the amount by which to reduce the utility's annual revenue requirement.

48. Requiring SoCalGas to use the principal amount of the gain on sale (and accompanying gross-up) to offset its headquarters revenue requirement over an 11-year 11-month amortization period will reduce SoCalGas's revenues by approximately 1/4 of 1 per cent of its current annual revenue requirement each year during the amortization period. If the principal amount of the gain were instead amortized to benefit shareholders, SoCalGas's rate of return would increase by approximately 8 basis points each year during the amortization period.

49. Shareholders should be allowed to retain the benefit of all opportunity income earned on the principal amount of the gain from the date of sale until the the beginning of the amortization period, and on the unamortized balance until the principal is fully amortized.

<u>Conclusions of Law</u>

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 the utility and its shareholders with a fair return on the utility's overall capital investment and do not jeopardize the financial integrity of the utility. Rates which enable a utility to operate successfully,

to attract capital, and to compensate its investors for the risks assumed cannot be condemned as a constitutionally invalid taking of property.

3. Constitutionally required compensation for the public's use of utility property may be based on original investment cost rather than on changing current market values. The Constitution does not require that the appreciation in value of rate base property be given to shareholders; it can be used to offset the cost of ongoing utility service.

4. Our system of original cost ratemaking represents a careful balancing of interests and is not weighted unfairly toward either ratepayers or shareholders.

5. The Uniform System of Accounts is a bookkeeping system, and is not binding on the Commission for ratemaking purposes.

6. The Commission's decisions over many years do not support a ratemaking distinction between gains on sale of depreciable and nondepreciable property. The basic relationship between the utility and its ratepayers is the same for depreciable and nondepreciable assets. It matters little that in one case investors are repaid over time through depreciation and in the other out of the gross proceeds of sale. Nor is there any significant distinction, for purposes of allocating gain, between land carried as plant held for future use and other rate-base land.

7. The Commission's decisions have frequently used the gain on sale of headquarters facilities to offset the cost of replacement facilities.

8. Consistent with prior Commission precedent, the $24,190,000 principal amount of the gain realized on the utility's sale of the Flower Street headquarters should be applied to offset SoCalGas's headquarters costs over an 11-year 11-month amortization period. Allocation of this sum to offset utility costs is equitable because 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 the risk that the headquarters buildings would be prematurely retired and that they would nonetheless be required to pay depreciation and a return on the buildings until they were fully depreciated.

9. The tax benefits that result from using the $24,190,000 principal amount of the gain to offset costs of service, and the franchise fee expense reductions and uncollectibles adjustments that will also result, should be passed through to ratepayers, consistent with our standard practice.

10. SoCalGas should retain the income it has earned on the Flower Street headquarters sales proceeds so far and any future income it earns on the unamortized portion of the $24,190,000 gain during the amortization period. Allocation of these benefits to SoCalGas will serve as a reasonable incentive for the utility to maximize the proceeds from selling its principal headquarters, thus benefiting both ratepayers and shareholders, and to seek a more suitable headquarters, where its old headquarters poses health and safety risks and is no longer suitable for long-term use. Allocation of these benefits to SoCalGas's shareholders will also compensate them for the risks they bore in connection with the old headquarters property, in the event that our present ratemaking system has not already fully compensated them for those risks, including the risk that the land component of the headquarters would decline in value between the date it was placed in rate base and the date it was sold.

11. Our prior precedents have frequently applied gains on sale of utility assets to offset the costs of continuing utility service. Case-specific circumstances present here make it reasonable to share the benefits of the gain on sale of the Flower Street headquarters as provided in this decision.

12. The benefit sharing policies enunciated herein are intended to apply only to the sale of a utility's principal, corporate headquarters.

13. The issue of how to allocate the benefits of the gain-on-sale of a utility headquarters is best approached on a case by case basis, consistent with prior rulings of the Commission when similar factual circumstances exist, so that the Commission can consider the specific facts and circumstances of each case.

14. In the future, the Commission should consolidate its review of the reasonableness of the sale of a utility asset, such as a utility's headquarters, with its determination of the reasonable level of expenses for its replacement. In this instance, issues associated with SoCalGas's replacement headquarters should be addressed in A.88-12-047.

15. Requiring SoCalGas to use the principal amount of the gain on sale (and accompanying gross-up) to offset its headquarters revenue requirement over an 11-year 11-month amortization period will reduce SoCalGas's revenues by approximately 1/4 of 1 per cent of its current annual revenue requirement each year during the amortization period. If the principal amount of the gain were instead amortized to benefit shareholders, SoCalGas's rate of return would increase by approximately 8 basis points each year during the amortization period. The allocation of this amount of gain to offset headquarters costs over the course of the amortization period, while allowing shareholders to keep the opportunity income until amortization is complete, will not cause SoCalGas's rates to be so unjust as to be confiscatory, and 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 does not deprive the owners of property without due process of law.

16. SoCalGas is holding over temporarily on a leaseback after its sale of the property. It would be inequitable for the utility during this leaseback period to receive from ratepayers depreciation, a return on the undepreciated cost of these

improvements, or allowances for income taxes related to them. SoCalGas is entitled to actual leaseback costs.

17. SoCalGas's reasonable and appropriate costs associated with the leaseback were less for 1987 and 1988 than the headquarters revenue previously authorized, so pursuant to provisions of D.87-09-076 SoCalGas should refund the overcollection for those two years, and any overcollection for 1989 as well.

18. SoCalGas should promptly file a report with the Commission concerning all demolition-related costs. If SoCalGas does not have to pay the full $2,200,000 committed for future demolition of the buildings, the Commission should provide a ratemaking treatment for the unexpended amount that is consistent with the ratemaking treatment of the gain on sale in this decision.

O R D E R

IT IS ORDERED that:

1. SoCalGas shall recover from its share of the gross proceeds of the headquarters sale its costs of 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 (but only if those demolition costs are actually incurred). 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 its share of the gross proceeds.

2. Within fifteen months of the termination of the Flower Street headquarters leaseback, SoCalGas shall report to the Commission all demolition costs, any salvage value, and any offsetting reimbursements, under its demolition agreement with

Shuwa. If the net of cash outlays by SoCalGas, any salvage benefits to SoCalGas, and any other offsetting reimbursements to SoCalGas are less than the $2,200,000 assumed in calculating the gain on sale of the headquarters building, the Commission will provide a ratemaking treatment for the difference consistent with this decision.

3. The memorandum account established by D.90-01-016 to track the costs associated with retaining the Flower Street headquarters in rate base after its sale shall be discontinued.

4. SoCalGas shall amortize, as an offset against its cost of service, the $24,190,000 capital gain realized from the Flower Street headquarters sale over a period of eleven years and eleven months from December 1, 1990. The amortization amounts shall be grossed up in calculating the revenue requirement. SoCalGas shall reduce its annual revenue requirement by $3,466,254 starting December 1, 1990, and this reduction shall stay in effect for 11 years and 11 months. Any impact due to changes in the gross-up factor during this period shall be reflected in General Rate Case proceedings.

5. SoCalGas shall retain the income it has earned and will earn on the net sale proceeds from the date of sale until the beginning of the amortization period and on the unamortized balance until the end of the amortization period.

6. SoCalGas shall continue to recover through rates its reasonable lease costs and reasonable and appropriate maintenance costs incurred by the utility during the actual leaseback period at Flower Street, as authorized by D.90-01-016.

7. SoCalGas shall refund the overcollection in the memorandum account required by D.87-09-076, consistent with the discussion, accompanying Table 1, Findings of Fact, and Conclusions of Law in this decision. The precise amount and method of

refunding this sum to ratepayers shall be determined in the next phase of A.88-12-047. Interest shall accrue at the three-month commercial paper rate.

8. 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 is effective today.

Dated November 9, 1990, at San Francisco, California.

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

Commissioner Stanley W. Hulett, being necessarily absent, did not participate.

END OF ATTACHMENT 1

1164-1

A.87-07-041
D.90-11-031

COMMISSIONER FREDERICK R. DUDA, Concurring:

I am very pleased with today's decision regarding the disposition of the gain on the sale of SoCalGas' Flower Street headquarters.

The decision appropriately balances the interests of both ratepayers and shareholders.

Ratepayers rightfully benefit because they bore most of the risk associated with the Flower Street headquarters. As the decision notes, ratepayers paid all operations and maintenance expenses, depreciation, and taxes associated with the headquarters property while it was in rate base, provided a fair return on the capital invested in the headquarters, and bore the risk the headquarters would be prematurely retired and that they would nonetheless have to pay depreciation and a return on the buildings until they were fully depreciated.

And while shareholders bore only the minimal risk that that value of the land component of the headquarters property would decrease in value between the date it was purchased and the date it was sold. It is appropriate to provide the utility with an incentive to find a suitable replacement for its principal headquarters which pose a health and safety risk for utility employees and to maximize the sales price of that headquarters in a time of real estate market uncertainty.

I believe that, in addition to resolving the specific issues arising from SoCalGas' headquarters sale, this decision, provides guidance for the disposition of future gains on the sale of utility property.

Once again, I am very happy to concur in today's decision.

Frederick R Duda

Frederick R. Duda, Commissioner

November 9, 1990
San Francisco, California

A.87-07-041
D.90-11-031

Commissioner John B. Ohanian, Concurring

I strongly concur with this decision's emphasis on our traditional concept of risk and reward as a starting point for the allocation of the gains associated with the sale of SoCalGas' headquarters building.

The traditional concept for equitably sharing risk and reward is the cornerstone upon which our system of utility regulation is founded. Our approach has been to ensure that utility decisions to build or sell assets are based on public need -- not on the maximization of profits for the utility. In return, the utility is assured recovery of reasonable operating expenses, recovery of capital prudently invested to provide public service, and a fair opportunity to earn a reasonable return. Ratepayers thus have an equitable interest in the gain from the sale of rate base property because of their bearing the associated costs and risks; and because in so doing they insulate utility investors from most of the risks and expenses associated with property ownership.

This traditional system of equitably sharing risk and reward has served us well for many years. It has resulted in rates that are just and reasonable, for shareholders and ratepayers alike. It has brought a level of utility service that is perhaps unequalled anywhere in the world. I see no reason to deviate in the case before us from this sound state of regulation.

Today's decision makes it abundantly clear that there is ample precedent for this risk/reward analysis and the resultant allocation of gain or loss from the sale of rate base property.

I will not repeat here the precedent cited in the decision. I do wish to make clear, however, that as a matter of policy I believe that the Commission should adhere to a pattern of stable and predictable ratemaking.

Tampering with our traditional pattern of ratemaking could have undesirable consequences. Re-allocation of risk and reward could create uncertainty in the minds of investors that would raise the cost of capital, and ultimately the cost of utility service. Moreover, absent a stable regulatory environment, utilities could be reluctant to engage in serious long-term planning, or to commit the large amounts of capital necessary to ensure the continuation of high-quality utility services.

Furthermore, were we to switch back and forth among methodologies for allocating risk and reward, we would not only jeopardize continued high-quality utility service, but confront serious legal questions. We must be mindful of our legal duty to shareholders to provide a return sufficient to maintain the financial integrity of the company, which includes the ability to service debt and to pay common dividends. By relying on our well-established framework for sharing risk and reward, today's decision fulfills our obligation to shareholders.

I also support today's decision because it provides the correct signals for the parties involved to take action that is most economically efficient and beneficial to the continued provision of safe, reliable, and universally available utility service. Included among the signals we send through this decision is the incentive for utilities to maximize the value of ratebase assets for the benefit of high-quality utility service. SoCalGas clearly maximized the value of its Flower Street headquarters for the benefit of its ratepayers, first by staying in its headquarters for as long as it did, thereby helping to keep rates low; and when the building was worn and obsolete, by selling the headquarters at terms that were clearly favorable. Such exemplary behavior should be rewarded if we are to expect more of the same in the future.

In sum, by this decision we reaffirm our commitment to the "benefit following burden" test of allocating gains from the sale of ratebase property. That is why I support today's decision. I am not against the Commission reconsidering the framework by which it allocates risk and reward, as long as we maintain an appropriate and fair balance between the two. We did this in our recent decision establishing a new regulatory framework for Pacific Bell and General Telephone Company of California; and we will be closely examining the appropriate allocation of risk and reward in our gas industry OII and the upcoming OII for the electric utilities. But until the results of our investigations are complete, I prefer to stick with our current tried and true system of sharing risk and reward for California's energy utilities.

John B. Ohanian, Commissioner

November 7, 1990
San Francisco, California