Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER CHONG**
(Mailed 3/28/2006)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's own motion for the purpose of considering policies and guidelines regarding the allocation of gains from sales of energy, telecommunications, and water utility assets.	Rulemaking 04-09-003 (Filed September 2, 2004)

OPINION REGARDING ALLOCATION OF GAINS ON SALE OF UTILITY ASSETS

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OPINION REGARDING ALLOCATION OF GAINS ON SALE OF UTILITY ASSETS

I. Summary

This decision adopts a process for allocating gains on sale received by certain electric, gas, telecommunications and water utilities when they sell utility land, assets such as buildings, or other tangible or intangible assets formerly used to serve utility customers. In most cases, utility ratepayers receive 100% of the gain from depreciable property such as buildings. This policy is based on our findings that ratepayers generally bear the risks associated with utility ownership of depreciable property and because this Commission reviews and approves depreciation rates, which in general drive the salvage value and the attendant gain or loss from this type of property. Ratepayers and shareholders, however, will split the gain from non-depreciable property such as land and water rights. This policy is based on our finding that ratepayers and shareholders split the risks associated with owning such property.

These rules of thumb will apply to routine asset sales where the sale price is $50 million or less and the after-tax gain or loss from the sale is $10 million or less. Most ordinary asset sales that come before this Commission for approval should meet these criteria. The rules we develop here will not apply where the asset sale price exceeds $50 million or the after-tax gain or loss exceeds $10 million. The rules also do not apply to utility sales of assets of extraordinary character; to sales of nuclear power plants; where a party alleges the utility engaged in highly risky and non-utility-related ventures; or where a party alleges the utility grossly mismanaged the assets at issue. We cannot predict in advance every exceptional circumstance to which our general rule will not apply. However, most of our decisions allowing asset sales over the last several years

have involved fairly routine utility assets that do not meet the foregoing thresholds.

We have deferred allocation of the gain in many past cases (see Appendix A). Within 60 days of this decision's mailing date, the parties bound by this decision shall file Advice Letters within 60 days of this decision's mailing date indicating how they plan to comply with the rules set forth herein for each of those past sales (if deferred) and any other sales for which the decision was deferred. We add language indicating that, "[a]ny party objecting to the proposed treatment of any deferred gain on sale determination may file an Advice Letter protest within the normal Advice Letter protest period."

Where a utility or other party believes asset values exceed the foregoing dollar thresholds; or are extraordinary in character. or where losses result where there are allegations of highly risky, non-utility-related ventures or gross utility mismanagement, the utility or other party may ask us to exempt the transaction from our general rule. The Commission will determine how to evaluate cases where a utility or party requests an exception. If the Commission so rules, then it may evaluate how to allocate gains or losses without applying the general rule. We do not expect many cases to fall into this "exception" category, and urge parties to be judicious in their invocation of the exception.

Pursuant to Pub. Util. Code § 455.5,[1] this decision also requires electric, gas, and water utilities to report annually to this Commission whenever any portion of an "electric, gas, heat, or water generation or production facility" is out of service, and immediately when a portion of such facility has been out of

[1] All statutory references cite the Pub. Util. Code, unless otherwise noted.

service for nine consecutive months. This reporting requirement applies only to major electric, gas, heat, or water generation or production facilities. We believe the threshold for defining a "major facility" should vary with the size of the utility, but do not have an adequate record to define such facilities across utilities. We prescribe next steps to develop such a record.

This decision does not change the circumstances under which utilities must file applications seeking Commission approval of such asset sales. Those circumstances are governed by § 851, and any procedures the Commission adopts to implement § 851's mandates. Therefore, we do not now act on the proposal in our initial order instituting this proceeding to prohibit any public utility from selling any capital asset for which it has not filed an Advice Letter and to render void any sale not complying with this rule. A determination of the process a utility must file to obtain our permission to sell assets is beyond the scope of our inquiry into how to account for gains on sale. The Commission has recently adopted a pilot program (Resolution ALJ-186) designed to streamline its review of certain § 851 transactions, and has indicated that it will take additional steps to review how it handles § 851 generally. We need not duplicate those efforts here.

Finally, we provide interpretation of the Water Utility Infrastructure Act of 1995, § 789 *et seq*. We find the Legislature intended the Act to give water companies certainty on how to allocate gains on sale, and to limit Commission flexibility in allocating such gains. However, the statute does not limit our ability to impose record keeping requirements on the water companies to ensure they give notice of planned sales and invest proceeds from the sale of formerly used and useful utility property in new infrastructure, and we impose such requirements here. We also discuss the treatment of proceeds attributable to property purchased with funds that did not come from the water company, such as developer funds and contamination litigation proceeds.

II. Dismissal of Certain Telecommunications Carriers and Gas Storage Providers from Proceeding

When we initiated the Order Instituting Rulemaking (OIR), we proposed to cover assets sold by electric and gas utilities, certain telecommunications carriers, and water utilities. Since that time, several parties have asked that the Commission dismiss them from the proceeding. We discuss each request below.

A. SBC/Pacific Bell and Verizon California

Pacific Bell Telephone Company, dba SBC California (SBC) and Verizon California Inc. (Verizon) filed motions seeking their dismissal from this proceeding on the ground that another proceeding, Rulemaking (R.) 01-09-001, would examine how to treat their gains on sale. Both SBC and Verizon are regulated under our New Regulatory Framework (NRF), a form of incentive regulation, although we are currently examining whether a newer form of regulation is appropriate in R.05-04-005, our Uniform Regulatory Framework (URF) proceeding. The URF proceeding lists gains on sale from telecommunications assets as one of the issues for resolution.

The Utility Reform Network (TURN) and the Commission's Office of Ratepayer Advocates (ORA)[2] oppose the carriers' request. They claim Pacific and Verizon seek exemptions to industry-wide rules and regulations and fail to

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[2] ORA is now known as the Division of Ratepayer Advocates, or DRA. To avoid having to change all references to ORA in the draft decision, we continue to use the ORA acronym.

show why it is better to consider telecommunications gains on sale in another proceeding than in a proceeding designed to develop gain on sale rules across industries.

Either way we handle the issue, one might argue there are efficiencies to be gained. However, the URF proceeding seems to be the best forum to resolve gain on sale issues for Pacific and Verizon, because that proceeding is examining all aspects of telecommunications regulation. It may be that regulatory issues other than gains on sale have bearing on how to treat Pacific and Verizon's gains on sale. On balance, we find that it is best to deal with the telecommunications industry – including the gain on sale issues and many others, and perhaps related, regulatory issues – in one forum. Because the Commission will resolve gains on sale applicable to telecommunications carriers in the URF proceeding, we dismiss SBC and Verizon from this proceeding.

B. SureWest Telephone and Frontier Communications

Second, the other two California NRF carriers, SureWest Telephone (SureWest) (formerly known as Roseville Telephone) and Citizens Telecommunications Company (dba Frontier Communications (Frontier)), have also requested dismissal.

SureWest and Frontier alternately ask that they be required to follow whatever rules we generate in R.01-09-001, even though they are not parties, or that we decline to regulate the gains on sale of NRF carriers.

ORA and TURN oppose the motions on the ground that SureWest and Frontier fail to show why it would be more appropriate for the Commission to address gain on sale issues as part of NRF instead of in the gain on sale rulemaking. They also disagree with SureWest and Frontier's assertion that the gain on sale issue is different for rate base regulated utilities than it is for NRF carriers. Finally, they contend this proceeding is the place to consider all utilities' gain on sale issues because it is focused only on that issue.

Again, on balance, we find the argument in favor of examining the gain on sale issue for NRF carriers in a comprehensive telecommunications proceeding more persuasive than the one asserting that we should resolve all gain on sale issues in one place. Therefore, as with SBC and Verizon, we will dismiss SureWest and Frontier on the ground that their gain on sale issues will be handled in the URF proceeding, R.05-04-005. We do not dismiss other regulated telecommunications carriers from this proceeding.

C. Wild Goose Storage and Lodi Gas Storage

Third, two natural gas storage facilities have asked to be dismissed from this proceeding. Wild Goose Storage Inc. (Wild Goose) and Lodi Gas Storage, L.L.C. (Lodi Gas) each filed comments noting that they operate in a competitive market and are largely unregulated by the Commission. No party opposes their requests.

Since the premise of the OIR is that regulated firms operate on different economic principles than unregulated firms, Wild Goose and Lodi Gas Storage contend that the OIR does not apply to them. We agree, and dismiss them from the proceeding.

III. Definition of Gain on Sale

We initiated this rulemaking to develop standardized guidelines for the allocation of the gains (and losses) from sales of utility assets. A utility receives a gain on sale when it sells an asset such as land, buildings or other tangible or intangible assets at a price higher than the acquisition cost of the non-depreciable asset or the depreciated book value of the depreciable asset. Thus, non-depreciable assets (such as land, water rights and goodwill), and depreciable assets and (such as machinery, buildings, equipment, materials or vehicles) are treated differently when determining whether there is a monetary gain from the sale of these assets.

Buildings, machinery, equipment, materials and vehicles may be depreciated on the utility's regulatory financial statements. Depreciation is a cost of owning the asset that appears on the utility's books each year, and ratepayers reimburse the utility for this depreciation cost. When a utility sells the depreciable asset, its gain is the difference between the depreciated value of the assets at the time of sale and the sales price. Taxes figure into the equation, since they reduce the sales proceeds, or gain, allocable to the utility.

Land, water rights and goodwill, on the other hand, are not depreciable because they need not be replaced, unlike buildings, machinery or other depreciable assets. Thus, ratepayers do not pay the utility its depreciation costs. However, ratepayers still bear costs associated with a non-depreciable asset because the entire cost of the asset is put into rate base and the shareholders receive a return on that amount for as long as the asset is in rate base. Ratepayers also pay for carrying costs such as maintenance, taxes, insurance, administrative costs and interest expense for the asset.

IV. Questions Posed in the OIR

In the OIR, we tentatively suggested that several guidelines apply to gain on sale determinations, and asked for the parties' comment on our initial proposals. Primary among our suggestions was that we establish a specific percentage allocation of gain on sale (*e.g.,* 20%) that would give utilities between 5% and 50% of the gain on sale under normal circumstances, with the remainder allocated to ratepayers. In unusual cases, we suggested considering the issue on a case-by-case basis.

In the sections that follow, we set forth our suggested outcomes from the OIR, discuss the parties' input, and come to a conclusion about the rules to apply to utility asset sales.

A. General Gain on Sale Questions

With regard to gains on sale, the OIR proposed the following outcomes and sought comment:

1. The guidelines we develop in this proceeding should apply to the allocation of both gains and losses upon the sale of a capital asset.

2. The allocation should vary directly, holding everything else constant, with the assumption of the financial risk of the investment.

3. While it is important to ensure that ratepayers are not harmed by the sale of the asset, or that they are compensated if they are, it is equally important to recognize who has borne the burden of the financial risk of the investment.

4. For the majority of cases, ratepayers have borne most of the financial risk and have paid for the asset. Thus, it will be typical for most of the gain to be allocated to the ratepayer. The burden of the financial risk should be a primary consideration whenever the gain is allocated between ratepayer and shareholder.

5. There should be no difference in the treatment of depreciable and non-depreciable assets (land) for the purpose of allocating the gain. If land that has been taken out of rate base is sold, an allocation of the gain or loss

should be assessed consistent with the risk that has been shared between the ratepayer and shareholder.

6. The Uniform System of Accounts (USOA) is useful for the accounting and recording of a transaction, but it is not useful in the determination of how the gain is to be allocated.

7. The allocation of the gain on sale standards should provide an incentive to encourage prudent management of utility assets.

8. The allocation should be applied to after-tax gains only.

We also proposed that our decision in this proceeding supersede any prior contrary interpretations of the proper allocation of gains on sale. We address each of these questions in detail below.

B. Water Gains on Sale – Pub. Util. Code § 789

The OIR also asked for input from water companies on how to interpret the Water Utility Infrastructure Improvement Act of 1995, § 789 *et seq.* Section 789 provides that a water corporation shall invest the "net proceeds" of the sale of real property in water system infrastructure that is used and useful for utility service. The OIR stated, "We wish to determine in this proceeding whether § 789 applies to this real property or whether water utility shareholders can enjoy a return only on assets that were the product of shareholder investment."[3]

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[3] *See, e.g., Alisal Water Corp*., D.90-09-044, *mimeo.,* p. 11, *quoted in California Water Service Company*, D.94-02-045, *mimeo.*, p. 14, 53 CPUC 2d 287 (1994), ("[U]tilities should earn a return only on the money they invest, absent extreme circumstances not present [here]. We found this policy superior to one which would allow utilities to earn a return on

Footnote continued on next page

The OIR asked for comment on whether water utility shareholders should receive gains pursuant to § 789 when the utility acquires the property being sold without paying for it. We noted the following examples: (1) facilities paid for by company ratepayers, (2) facilities constructed in the 1980s and 1990s with state-provided low interest loans under the Safe Drinking Water Bond Act (SDWBA) and the State Revolving Fund, (3) water assets that developers or other entities pay for as contributions in aid of construction, and (4) state grant funds from Proposition 50[4] proceeds to construct water utility infrastructure in low-income areas.

We also asked the following questions regarding gains on sale from water utility assets:

1. If according to § 790, the full gain is included as rate base, should there be any safeguards against "churning" of assets by utility management in order to increase rate base? What should these safeguards be?

2. In order to reconcile §§ 790 and 851, at what point do we require the utility to file an application? If the utility files a § 851 application at the time of the sale and the Commission approves the sale, what must the utility file

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someone else's investment, whether it be plant [paid] for by the customers of the mutual water company being acquired, by customer donations, or by any other means.").

[4] Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002 (Water Code, Division 26.5), passed by the California voters in the November 2002 general election, signed into law in August 2003 and immediately effective. We have another rulemaking related to Proposition 50, R.04-09-002, and defer Proposition 50 issues to that proceeding.

at the end of the eight years, if anything, to reconcile the net proceeds?

3. What amount, if any, of the gains from non-shareholder investment (*i.e.*, developer contributions in aid of construction) should be included in rate base?

We address the gain on sale issues particular to water utilities in a separate section of this decision. Unless otherwise stated, we also intend the answers to the generic gain on sale questions to apply to water utilities.

C. Notice of Utility Assets Taken Out of Service – Pub. Util. Code § 455.5

The OIR asked affected utilities to comment on how we should enforce § 455.5. That statute requires that utilities report periodically to this Commission whenever any portion of an "electric, gas, heat, or water generation or production facility" is out of service, and immediately when a portion of such facility has been out of service for nine consecutive months. Section 455.5 states, in pertinent part:

> (a) In establishing rates for any electrical, gas, heat, or water corporation, the commission may eliminate consideration of the value of any portion of any electric, gas, heat, or water generation or production facility which, after having been placed in service, remains out of service for nine or more consecutive months, and may disallow any expenses related to that facility . . . .
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> (b) Every electrical, gas, heat, and water corporation shall periodically, as required by the commission, report to the commission on the status of any portion of any electric, gas, heat, or water generation or production facility which is out of service and shall immediately notify the commission when any portion of the facility has been out of service for nine consecutive months.

> (c) Within 45 days of receiving the notification specified in subdivision (b), the commission shall institute an investigation to determine whether to reduce the rates of the corporation to reflect the portion of the electric, gas, heat, or water generation or production facility which is out of service. . . .

We proposed in the OIR to require utilities with electrical, gas, heat, or water generation or production facilities to inform the Commission about any such facility or portion thereof taken out of service the previous calendar year. We also proposed that these utilities be required to estimate the effect of this action on their revenue requirement and rate base.

Section 455.5(f) notes that an "electric, gas, heat, or water generation or production facility includes only such a facility that the commission determines to be a *major facility*." (Emphasis added.) The OIR suggested a definition of a "major facility" as any asset with an initial acquisition price of $500,000 or more. The OIR also suggested that the Commission require reporting regarding any facility whose entirety meets this dollar threshold, even if the portion out of service cost less.

We address this issue in detail below.

D. Commission Approval of Sales

Finally, we asked parties to comment on whether, pursuant to Pub. Util. Code § 851, we could prohibit a public utility from selling any capital asset for which it had not filed an Advice Letter and to render void any sale not complying with this rule. We find that this question is beyond the scope of this rulemaking, and do not reach a finding on the permission a utility must receive to sell capital assets.

V. Rule Applicable to Both Gains and Losses

A. Comments – Same Rule for Gains/Losses

The OIR suggested that we apply the same rules to gains and losses in most cases. Aglet Consumer Alliance (Aglet) and ORA/TURN support a symmetrical rule, with the exception of large losses related to nuclear power plants or other significant assets.

ORA/TURN claim that, "Sometimes there are unique reasons for the Commission's assigning losses to shareholders [rather than utility ratepayers]. For example, the Commission has assigned losses to shareholders when the utility engaged in highly risky and non-utility-related adventures, or if the utility grossly mismanaged certain projects."[5] ORA/TURN therefore advocates a case-by-case approach to catastrophic losses. Aglet recommends the same approach. The utilities did not address these arguments.

B. Discussion – Same Rule for Gains/Losses

We agree that where a utility incurs unusual or catastrophic losses from sale of a capital asset, any party may request that we analyze the loss on a case-by-case basis. We obviously cannot anticipate in advance all types of losses for which we should conduct this type of analysis, but note that the Commission has had very few applications seeking to allocate losses in the last several years. Most sales of land or buildings used to provide utility service produce capital

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[5] *ORA/TURN Comments* at 4, n.8, citing *Application of SoCalGas for Authority Pursuant to PU Code § 851 to Sell Certain Intellectual Property,* D.00-06-005, 2000 Cal. PUC LEXIS 281, and *In the Matter of Application of SCE for Authority to Encumber Certain Fuel Oil Pipeline and Storage Systems Facilities,* D.94-10-044, 56 CPUC 2d 642 (1994). All parties' comments in this proceeding are cited as "___________'s Comments" or "________'s Reply Comments."

gains. For the small number of situations that produce losses, we propose two triggers for a case-by-case analysis:

> Losses greater than $50 million: If the asset causes a utility an after-tax loss greater than $50 million, the utility shall automatically file an application seeking case-by-case determination of how to allocate the loss.
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> Other unusual losses: In cases involving losses of $50 million or less, the utility may seek allocation of the loss to ratepayers. If any party, including ORA, contends that the Commission should allocate the loss, in whole or part, to utility shareholders, the party should seek case-by-case treatment in a protest to the utility application.

For losses that do not exceed $50 million, or for which no party seeks case-by-case treatment, the general rule for allocation of losses will be the same as for gains. As we discuss below, for depreciable assets, the utility may allocate 50% of the after-tax loss to ratepayers. Ratepayers shall bear 50% of the loss from non-depreciable assets, and shareholders shall bear 50% of the loss.

VI. Allocation Dependent on Risk

A. OIR Proposals – Risk

1. Risk as Primary Determinant of Gain/Loss Allocation

The OIR stated:

> A primary goal of this Rulemaking is to articulate clear principles and standardize Commission practice in gain on sale proceedings, thus providing regulatory stability and predictability to the benefit of both shareholders and ratepayers. Exceptions to the rules that result from this Rulemaking should only occur in unusual cases.

> A return to the prominent use of the incidence of risk should be the primary standard for the efficient allocation of the gain. It is clear to us that the assumption of risk is an integral part of the regulatory compact, and that the incidence of this risk should be a major consideration when allocating any gain realized at the sale of a utility asset. Further, the appropriate measure of risk for this purpose is the possibility of financial loss.[6]

The OIR instituting this decision also proposed tentative allocations of gains on sale and reached tentative conclusions on who bears the risks that arise from the ownership of utility assets.[7]

2. Other Tests

The OIR also suggested that in focusing its gain on sale analysis on risk, we should discard tests on which we have relied in the past, such as "ratepayer harm"[8] or "ratepayer indifference."

a) *Redding II* Ratepayer Harm Test

We developed the "ratepayer harm" standard in our *Redding II* decision.[9] In that decision, we found that where (1) a public utility sells a

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[6] OIR at 35

[7] See OIR at 35-38. The OIR tentatively concluded that the shareholders do not bear most of the risk or investment. We note that this particular conclusion was based only on a preliminary record, while today's determination is based on a more complete evaluation of the filings.

[8] We cited the decision colloquially known as *Redding I*, D.85-11-018, 19 CPUC 2d 161 (1985), and *Democratic Central Committee v. Washington Metropolitan Area Transit Comm.*, 485 F.2d 785 (D.C. Cir. 1973).

[9] D.89-01-016, 32 CPUC 2d 233 (1989).

distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system.

The OIR proposed that the decision issued here supersede all previous decisions, including *Redding II* and its ratepayer harm standard.[10]

b) Southern California Gas Headquarters Sale – Ratepayer Indifference Test

In the OIR, we also cautioned against a test such as the "ratepayer indifference" standard we initially adopted – and soon thereafter rejected – when considering Southern California Gas Company's (SoCalGas) sale of its headquarters.[11] In D.90-04-028, the Commission adopted the ratepayer indifference test in order to "discourage poor sales and maintain ratepayer indifference by allocating to ratepayers that portion of the gain that reflects the remaining value the asset would have had in utility service."[12] The basic

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[10] OIR at 23.

[11] D.90-04-028, 1990 Cal. PUC LEXIS 200, 36 CPUC 2d 235 (1990), 112 PUR 4th 26.

[12] 1990 Cal. PUC LEXIS 200, at *43.

principle the Commission developed was that, "To keep ratepayers indifferent to the transaction, we need to allocate to them enough of the gain on sale to compensate for the difference between what the old building would have cost had it continued in rate base, and what the new asset will actually cost."[13] The difference between replacement value and actual market value would go to "shareholders as a reward and incentive for seeing that its (sic) [asset] was put to the highest and best use in the economy."[14]

On rehearing, the Commission rejected the ratepayer indifference test in favor of a more traditional risk/reward analysis.[15] While the Commission found that shareholders had borne some risks and allocated shareholders approximately half the gain, it took great pains to limit the scope of its decision to the case at hand.

SoCalGas' headquarters posed health and safety risks from asbestos, seismic vulnerability and lack of adequate fire protection. The Commission therefore found it was appropriate to allocate approximately half the gain to shareholders as an incentive to the utility to sell the building: "It is a reasonable incentive, where a utility's principal 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

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13 *Id.* at *44.

14 *Id.* at *45.

15 SDG&E and SoCalGas claim the OIR shows bias against utility shareholders in how it discusses D.90-04-028. We fail to see how citing prior Commission decisions is evidence of bias, and reject the claim.

encourage management to seek a more suitable new headquarters." However, we cautioned against general application of the decision: "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."[16]

B. Comments – Risk as Primary Determinant of Gain/Loss Allocation

1. Differing Views of Who Bears Risk

The parties' comments are divided on the OIR's assumption that risk should drive the outcome of gain on sale decisions, and that we should cease relying on ratepayer harm or indifference to allocate the gain.

The consumer advocates (ORA/TURN and Aglet) agree with the risk premise. ORA/TURN's joint comments conclude that, "Based on the risk allocation theory, the OIR correctly finds that ratepayers should be rewarded most of the gain from sales of utility assets because the regulated utility's financial risk is primarily borne by the ratepayers."[17]

Similarly, "Aglet agrees with the Commission's policy statement on gain on sale, 'A return to the prominent use of the incidence of risk should be the primary standard for the efficient allocation of the gain.'" Aglet notes that "Ratepayer risks are asymmetrical . . . . If things go bad, ratepayers are most

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[16] 1990 Cal. PUC LEXIS 1015, findings of fact 42-43, at *114-15.

[17] *ORA/TURN Comments* at 8.

often left on the hook for losses. The outcome of the utility financial crisis of 2000-2001 is a notorious example of protecting shareholders at ratepayer cost."[18] Aglet therefore supports using risk as the primary test for allocating capital gains.

Aglet cites many instances in which ratepayers have borne extraordinary utility losses:

> Aglet does not suggest that shareholders bear no risk of utility investments, but assignment of ownership risks to ratepayers has a long history. Examples abound: special ratemaking provisions for contamination by hazardous materials; similar protections for catastrophic losses; opportunity to seek replacement cost recovery for assets that are retired prematurely; for example, steam generators at PG&E's Diablo Canyon Power Plant; recovery of uneconomic power plant costs through headroom during the early years of electric industry restructuring; recovery of the costs of undepreciated, abandoned plant that is not used and useful; and balancing accounts that assign to ratepayers the risks of inaccurate sales and fuel cost forecasts. . . . The Commission will not allow California utilities to fail, and ratepayers are the ultimate insurers against the largest investment risks.[19]

In contrast, the electric and water utilities point to risks they contend the OIR did not consider, and disagree with the OIR's conclusions about the risks it did mention. SCE observes that the OIR's risk calculus does not acknowledge anomalies such as the California energy crisis, stating that the crisis "has left

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[18] *Aglet Comments* at 2.

[19] *Aglet Reply Comments* at 2.

doubts in the minds of utility stakeholders as to California regulators' ongoing commitment to the regulatory compact."

SCE states that the OIR understates shareholder risks, alleging that there is no guarantee the utility will receive a rate of return that is compensatory under test-year ratemaking because forecasts of costs are not perfect. SCE notes that regulated utilities receive a cost of capital lower than unregulated businesses; hold assets longer than typical businesses and therefore recover investments more slowly; and have an obligation to serve that unregulated businesses do not bear. SCE claims the OIR ignores these shareholder risks, and reaches conclusions about the level of ratepayer risk in holding property that the facts do not justify. PacifiCorp also claims shareholders bear "less quantifiable risks associated with municipalization[20] and changes in regulatory regimes."[21]

Similarly, the water utilities raise concerns about various risks the OIR does not consider, including possible inaccuracy of forecast estimates,[22] Commission cost disallowances, and the Commission practice of giving utilities a rate of return on the original cost of an asset, rather than on the appreciated worth of the asset as it grows in value over time.[23]

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[20] The risk of municipalization is the risk that a portion of a utility distribution system will be condemned by a municipality's exercise of the power of eminent domain.

[21] *PacifiCorp Comments* at 4.

[22] The small local exchange carriers (LECs) also assert that potential errors in an annual forecast are risks utility shareholders alone face.

[23] *See, e.g., Park Water Comments* at 12-20, *San Gabriel Valley Water Comments* at 2-3.

2. Renter Analogy

SDG&E/SoCal Gas analogizes ratepayers' relationship to utility property to the role of a renter occupying private rental property. For example, SDG&E/SoCalGas assert that renters do not obtain any interest in the building simply because they pay rent. SDG&E/SoCalGas conclude that ratepayers should not recover profits from the sale of utility assets for the same reason that renters do not profit when a landlord sells his building.

In reply to the renter analogy, Aglet acknowledges that ratepayers do not own utility property, but argues that they nonetheless "bear risks associated with the value of the property. Tenants do not pay landlords for vacancies, fire damage or repair of hazardous circumstances . . . ." Aglet concludes that "fairness to shareholders and ratepayers regarding gains on sale depends on assessment of risks and rewards, not legal theories about property ownership."[24]

California Water Service Company suggests that to allow ratepayers to receive a portion of the gain from the sale of utility property effects an unconstitutional taking of property. It cites *Pacific Gas & Electric Co. v. Public Util. Comm'n of California*, 475 U.S. 1 (1986), for the proposition that "utilities own their property and . . . ratepayers do not acquire an interest in such property by virtue of paying rates for utility service."[25]

The small LECs make the same argument, stating that in relying on *Democratic Central Committee Washington Metropolitan Area Transit Commission*,

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[24] *Aglet Reply Comments* at 2-3.

[25] *California Water Service Company Comments* at 5.

485 F.2d 786 (D.C. Cir. 1973) in support of our risk allocation theory, we ignore "the most important historical authority on the subject, *Board of Public Utility Comm'r v. New York Telephone Co.*, 271 U.S. 23, 32 (1926), in which the Supreme Court held that utility customers pay for service, not for a property interest in any of the facilities used to provide service to them." If ratepayers do not own utility property, the small LECs assert, they may not recover any gains from the sale of that property.

SCE asserts that *Democratic Central Committee* is not controlling precedent and must be distinguished on its facts. It states that because the case was decided by the D.C. Circuit Court of Appeals, and not the 9th Circuit, where California is located, it is not controlling precedent.

3. Other Tests

a) *Redding II* Ratepayer Harm Test

The utilities urge us not to abandon the "ratepayer harm" standard we developed in *Redding II*. They note that *Redding II* is one of the few Commission decisions that set generic policy on gain on sale allocation in any context. PG&E notes that the Commission has applied the *Redding II* standard guidelines to at least 16 PG&E operating system sales in the past seven years. PG&E asserts that "there is no valid policy reason for departing from what the Commission has recognized as 'established Commission precedent . . . .'"[26] California Water Association states that the OIR "gives rather short shift to the

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[26] *PG&E Comments* at 13 & 15, citing D.03-04-032, 2003 Cal. PUC LEXIS 234, at *3 ("We allocate PG&E's gain resulting from the sale of its distribution assets to [Turlock Irrigation District] to PG&E shareholders, pursuant to established Commission precedent, *Redding II*."). *See also California Water Association Comments* at 10-11.

one subset of such sales for which the Commission has adopted a clear and concise set of guidelines . . . ."[27] The small LECs ask that we retain the *Redding II* standard for sales of an entire utility.[28]

Further, the utilities assert that the Redding customers (the departing customers) paid in rates their portion of the system sold to Redding. They question why the ratepayers left after sale of the distribution system should receive the gain on sale, since they may not have been responsible for the costs of the assets that are left.

Aglet, in contrast, states that the "logic behind *Redding II* is faulty." It argues that the distribution facility sales to which we have applied *Redding II* always result in a gain: "Aglet is unaware of a single sale that resulted in a loss to the utility. It is no surprise that utilities support the *Redding II* doctrine because it gives shareholders consistent gains without any real risk of loss."[29] Aglet asserts that our *Redding II* analysis "is a matter of policy, not law, and there is good cause for reassessment of prior Commission policies."[30]

The Modesto Irrigation District also criticizes the *Redding II* process: "Despite the fact that the rules established in [the *Redding II*] rulemaking were intended to address gain-on-sale issues arising out of those situations identified in that decision, there has been a sufficient level of

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[27] *Comments of California Water Association* at 10.

[28] *Comments of Small LECs* at 3.

[29] *Aglet Reply Comments* at 6.

[30] *Id.*

dissatisfaction with the *Redding II* principles that, as the instant OIR notes, gain-on-sale issues are often addressed on a case-by-case basis."[31]

b) Ratepayer Indifference Test

The parties do not specifically comment on the continued viability of the ratepayer indifference test.

C. Discussion – Risk Analysis

1. Summary

We conclude that incidence of risk is the best determinant of how to allocate gains and losses on sale. We find that the question before us is based more in economic theory and policy than on strict legal principles. We have discretion to adopt a gain or loss allocation methodology that reflects the regulatory compact into which utilities enter. Because the salvage value and/or gain from the sale of depreciable property is driven mostly by the regulatory-set depreciation rate and because generally ratepayers assume the risks associated with depreciable property, ratepayers should accrue all the gains or loses for this type of property. Because ratepayers and shareholders share risks that are associated with the ownership of non-depreciable utility property, they should split the gains and losses in most routine asset sales. Thus while finding a perfect spot on the continuum involves an exercise of discretion, we hold that in routine sales of utility assets, the allocation should be as follows:

- Depreciable assets: 100% of gain or loss to ratepayers; and
- Non-depreciable assets: 50% of gain or loss to ratepayers and 50% to shareholders.

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[31] *Modesto Irrigation District Comments* at 1.

Our conclusions that in many cases ratepayers and shareholders share the risks of loss associated with utility assets and that gains and losses should follow risks are not new. The D.C. Circuit Court of Appeals so found in the *Democratic Central Committee* case. There, the court concluded after a lengthy analysis of precedent around the country that,

> In sum, the decisions outside the District [of Columbia Circuit] have not viewed capital gains on in-service non-depreciable utility assets as inevitably belonging to investors to the exclusion of consumers. Rather, in each of the cases – although they are few – the allocation has depended upon location of the risk of loss. These holdings, then, may be accepted as applications of the broader principle that the benefit of a capital gain follows the risk of capital loss.[32]

The court further held that "[t]he ratemaking process involves fundamentally 'a balancing of the investor the and the consumer interest.'"[33] The court found that "[t]he proposition that capital gain rightly inures to the benefit of him who bore the risk of capital loss has been accepted in ratemaking law.[34]

2. Risk Analysis Based on Economics of Utility Regulation

The OIR's risk analysis and our finding here are based on the economics of utility regulation. To ensure efficiency, rewards should go to those

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[32] 485 F.2d at 798.

[33] 485 F2d at 806.

[34] 485 F2d at 807-808

who bear the actual costs and burdens of the risks engendered by particular economic actions, such as the purchase of assets.

The utilities in their comments raise many risks that shareholders face from investing money in the utility. A consideration of these risks lead us to alter that tentative conclusion, reached by the OIR, that ratepayers bear the major portion of the risks associated with utility property. Instead, we find that the risks for non-depreciable property are borne by both ratepayers and shareholders.

Although a similar analysis would find depreciable property incurs risks accruing to depreciable property, the market and business risks associated with depreciable property are dwarfed by the regulatory risk associated with setting the depreciation schedules correctly. Thus, for depreciable property, the current allocation of 100% of the gains or losses from depreciable assets to ratepayers serves mainly to correct any errors in the Commission-set depreciation rate. As such, this policy ensures that ratepayers pay the true costs of the assets used to serve them – no more and no less.

3. The Energy Crisis, Natural Disasters and Other Extraordinary Losses

The general, ordinary risks utilities and their ratepayers face and the extraordinary risks should both determine the allocation of gains. Extraordinary risks include the recent California energy crisis and natural disasters, such as Hurricane Katrina, floods and earthquakes.

Whatever the reasons for the energy crisis – an imperfect market structure, market manipulation, regulatory and competitive failures – it is clear that the crisis imposed risks on utility shareholders that severely jeopardized their ability to get a return from money invested in utility assets. Thus, the energy crisis reminds us that risks arise from the very fact of placing assets into the holdings of a utility company, and our decision on how to allocate routine capital gains should incorporate a consideration of these risks. As SCE points out:

> While SCE believes that the California regulatory environment is improving from the nadir of the Electricity Crisis, the traditional notions of the "protection" afforded by regulation are still viewed by the investment community with some degree of skepticism.[35]

In particular, the bankruptcy of one major energy utility and the failure of another to provide dividends make clear that these risks are real and losses to investors can be large.

In joint comments on the alternate proposed decision, TURN and ORA note that the Commission has created a Catastrophic Events Memorandum Account, which enables a utility to book for future recovery many of the costs associated with a catastrophic event. Yet for many catastrophes, some costs cannot be booked into a memorandum account, and not all costs are allowed upon subsequent regulatory review. Thus, the existence of this memorandum account does not dissuade us that a 50%-50% allocation of the gain from the sale of non-depreciable assets is appropriate.

4. Forecasts

Forecasts may understate true costs in a given year. In the long run, forecasts of utility costs and earnings necessary to cover those costs should ensure that utilities are adequately compensated. Nevertheless, we recognize

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[35] SCE, Opening Comments, p. 4.

that the regulatory process itself creates risks arising from forecasts that other businesses do not face. Ratepayers bear a risk that forecasts will overstate needed utility rates of return in a given year. Moreover the Commission often allows utilities to true up their forecasts with their actual costs, thus shifting these forecast risks onto ratepayers.

Forecast risks, however, are only one type of many business risks faced by utility shareholders and ratepayers. While asymmetric, forecast risks do not lead us to revise further our allocation rules. These risks are adequately accounted for in our proposed rules.

5. Renter Analogy

The utilities assert that we should treat ratepayers just as landlords treat renters. Under this reasoning, if property values rise, the utility, as owner, should recover all of the gain. Ratepayers, by analogy to renters, should not be entitled to share in the owners' profits.

There are several problems with this analogy. Key among them is the distinction between operating in a regulated market and an unregulated one. Utilities acquire land, improvements and other assets to serve their utility customers with the understanding that they will place the assets in rate base and be compensated with a reasonable rate of return. Ratepayers will cover the utilities' operational costs (maintenance, repairs, depreciation if applicable, taxes and other carrying costs) and at times rates are subsequently revised to recover the costs of realized risks. Landlords, by contrast, operate in a competitive market. In such markets, customers are not captive to the monopoly and may move away. The market, not the regulator, determines rental prices. The apartment owner is at risk of losing his investment, or at least not covering his full costs, due to loss of customers or falling rental prices, which are both beyond his control. A landlord's property may remain vacant in times of slack demand, so the property owner has no guaranteed stream of revenue. The whims of the market control the value of a landlord's investment.

Thus, the terms under which utilities and private property owners operate are somewhat different. A utility acquires property dedicated to public use, and receives a rate of return and payment for maintenance and repair that it collects independent of market valuations. We are not holding, as the IOUs claim we cannot do, that ratepayers hold legal title to utility property by virtue of bearing the foregoing costs. Rather, we find that ratepayers should receive some capital gains from the property's sale because they bear some of the burden of the financial and business risk of the investment. If ratepayers bear risks, it is reasonable that they be compensated for such risks once the utility sells the property.

Thus, utility shareholders should receive a return on the sale of an asset that compensates them for the general risks that they bear by investing a utility that provides service in markets fraught with business risk, financial risk, and regulatory risk.

6. Other Tests

a) *Redding II* Ratepayer Harm Test

We will continue to apply the *Redding II* principles in the narrow circumstances to which they were designed to apply. Thus, where (1) a public utility sells a distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system. We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope.

b) Ratepayer Indifference Test

We have no basis to return to the ratepayer indifference test we adopted in D.90-04-028 – and promptly rejected within the year in D.90-11-031. No party urges that we adopt the test as a standard. The standard involved overly complicated calculations to derive the capital gain applicable to ratepayers and shareholders in any event. We thus reject the ratepayer indifference test as a means of allocating gains on sale going forward.

VII. Depreciable vs. Non-Depreciable Assets

A. OIR Questions

In introducing the OIR, we asked parties to comment on whether there should be a difference for the purpose of allocating the gain in the treatment of depreciable assets such as buildings, machinery and other assets, and non-depreciable assets such as land. The OIR tentatively concluded that there should be no difference in the treatment of depreciable and non-depreciable assets.

We acknowledged that land is treated differently on a utility's books from other assets in the OIR. We stated: "Because it needn't be replaced, land is not depreciated, as in the case of buildings or machinery." Nonetheless, we noted that ratepayers still bear significant costs in association with utility land:

"the entire acquisition cost of the land is put into rate base and the shareholder receives a return on that amount for as long as the land is in rate base. Ratepayers still pay for carrying costs such as maintenance, taxes, insurance, administrative costs and interest expense for the land." On the other hand, shareholders continue to bear a general risk for tying their cash up in such an asset, and this risks warrants compensation at the time of a sale.

B. Comments on Treatment of Non-Depreciable Assets vs. Depreciable Assets

1. Ratepayer Advocates – Uniform Treatment

ORA and TURN agree that the Commission should have consistent rules for both depreciable and non-depreciable assets on the theory that ratepayers bear the risk of utility assets, regardless of whether the asset is depreciable or non-depreciable. Aglet asks us to come up with a standard outcome, with 50-95% of gains and losses assigned to ratepayers, for the sale of non-depreciable assets (predominantly land) and depreciable assets for which gains or losses do not exceed $10 million. Thus, Aglet too seeks equal treatment of non-depreciable and depreciable property.[36]

[36] As noted elsewhere in this decision, Aglet advocates case-by-case treatment for major facilities (power plants – especially nuclear plants), pipelines, office buildings and assets with a sale price that exceeds $50 million or a gain or loss that exceeds $10 million. We adopt these recommendations with modification.

2. Utilities – Uniform Treatment

Calaveras Telephone Company, Cal-Ore Telephone Company, Ducor Telephone Company, Foresthill Telephone Company, Global Valley Networks, Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, The Siskiyou Telephone Company, Volcano Telephone Company and Winterhaven Telephone Company (the Small LECs) argue that ratepayers have no property right in a utility's property and therefore all gains or losses should accrue to sharehoders.[37] Similarly, CWA argues that the "legal principle of property ownership" should determine the allocation of the gain on sale.[38] Park Water also argues that shareholders "should receive the gain, and bear the loss, from any disposition of their assets."[39]

3. Utilities Favoring Non-Uniform Treatment of Assets

a) Treatment of Depreciable Assets

SCE notes that depreciation rates for such assets fully compensate utility shareholders for the cost of service, "with any gains or losses on individual assets continuing within the utility as the responsibility of ratepayers."[40] SDG&E states that, "any gain loss on sale of depreciable property

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[37] Small LECs, Opening Comments on Draft Decision, p. 3

[38] CWA, Comments on Draft Decision, p. 2.

[39] Park Water, Comments on Draft Decision, p. 18.

[40] *SCE Comments* at 22.

should be allocated 100% to ratepayers."[41] SDG&E further states that although they believed that

> "100% of gain or loss attributable to depreciable property should flow to ratepayers in a gain or loss-on-sale situation, they would not dispute a Commission decision to allocate gain/loss on depreciable property as well as nondepreciable property on a 50/50 basis. However. SDG&E/SoCalGas were clear that any percentage split of gain/loss on depreciable property should apply only in the case of a true "gain on sale" type of situation and not in the case of routine retirement and salvage of depreciable assets."[42]

PG&E contends that, "gains on sale of depreciable property, with certain exceptions, should flow to ratepayers through the depreciation reserve."[43] PG&E explains that depreciation allows utility shareholders to recover the cost of the depreciable property from ratepayers over the depreciable property's useful life.

b) Utilities – Non-Depreciable Assets

The utilities are unanimous in their opposition to a rule that treats land and buildings in the same way for purposes of the gain on sale. IOUs claim that for land (and not buildings or other depreciable assets) the risk analysis we set forth in the OIR is unfair, because utilities earn a rate of return on the land's original cost, rather than on its appreciating value. This "original cost" assertion

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41 *SDG&E Comments* at 11.

42 SDG&E Comments on Draft Decision, p. 10.

43 *PG&E Comments* at 10 (heading).

is the key distinction, they claim, between land and buildings or other depreciable assets.

SDG&E/SoCalGas state that gain or loss on sale of non-depreciable property should be allocated 100% to utility shareholders. They explain that while such assets are in service, "shareholders are allowed to recover in rates a return on their investment in the assets (at their original cost) but recover none of the capital cost of the assets."[44] They ask that if the asset is no longer necessary or useful to provide utility service, shareholders "simply get their asset back and ratepayers stop paying a return on it." If the asset is sold, SDG&E/SoCalGas assert, the value of the asset when sold is the property of shareholders.

SDG&E/SoCalGas' key point is that ratepayers pay the authorized rate of return on the land only at its original cost of acquisition by the utility. They assert that this situation creates the potential that ratepayers will pay a return on an amount far less than the current market value of the land. "[I]f utility shareholders are allowed to retain from sale proceeds on land only their original cost, they will be receiving back only a small fraction of the real value of their original investment."[45]

With regard to non-depreciable property, PG&E claims that shareholders bear the financial risks because "Commission-authorized rates do not include any component to recover the cost of acquiring the land."[46] PG&E notes that shareholders pay the acquisition cost of non-depreciable property.

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[44] *SDG&E/SoCalGas Comments* at 6.

[45] *Id.* at 8.

[46] *PG&E Comments* at 7.

Park Water Company (Park) makes the same argument, noting that shareholders do bear a financial risk with regard to land. "If the value of the land subject to regulation increases, the rates may not rise to reflect that increase given that rates are typically tied to costs not to current estimations of value."[47]

C. Discussion – Treatment of Non-Depreciable Assets vs. Depreciable Assets

As noted above, the consumer advocates, the Small LECs, CWA, and Park Water support a consistent approach to non-depreciable and depreciable assets sales, while the energy utilities support allocating all gains/losses from the sale of depreciable assets to ratepayers and argue that a good case can be made for allocating all gains or losses from non-depreciable assets to shareholders.

The comments of the alternate draft decision and our reexamination of the record persuade us to allocate depreciable and non-depreciable gains differently. As the large energy IOUs acknowledged in their original comments, we have traditionally allocated 100% of most gains (and losses) from the routine retirement and salvage of depreciable property sales to ratepayers. This practice, as we discussed earlier, corrects any errors in the regulatory-set depreciation rate and ensures that ratepayers pay the true costs of the depreciable assets used to provide service – no more and no less. We therefore retain the historic practice of allocating all gains and losses from depreciable property to ratepayers.

With respect to non-depreciable assets, we will adopt a 50%-50% allocation between ratepayers and shareholders in light of the fact that both ratepayers and shareholders incur risks from non-depreciable utility property. Our discussion

[47] *Park Water Company Comments* at 13.

above establishes that the risks to ratepayers are approximately equal to the risks that shareholders bear. Moreover, we believe that further efforts to quantify the level of risks would provide a false precision. The 50-50 allocation is fair in light of the record and in light of the impossibility of determining a precise allocation.

Despite the arguments of CWA, Park Water and the Small LECs, we reject an approach that allocates all of the gains on sale of land and other non-depreciable property to utility shareholders. We are not persuaded by the utilities' argument that any gain on sale should accrue to shareholders because shareholders only receive a rate of return on the original cost of land, which is frequently far below the current fair market value of the asset. Court and Commission precedent do not require us to adopt the utilities' approach. The U.S. Supreme Court does not require that ratemaking bodies give utility shareholders a rate of return based on the "present fair value" of utility property.[48] Moreover, in our *Redding I* decision,[49] we cited both *Democratic Central Committee* and *Hope Natural Gas* in support of the proposition that original cost ratemaking does not dictate that shareholders receive gains on sale from land. The Commission concluded that "the allegation that original cost is the upper bound of the losses ratepayers face does not and should not mean that the gains to which they are entitled should be limited to original cost as well."[50] Similarly, we found in D.90-11-031, our SoCalGas headquarters sale decision,

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48 *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 599-600 (1944).

49 D.85-11-018, 19 CPUC 2d 161 (1985), 1985 Cal. PUC LEXIS 958.

50 1985 Cal. PUC LEXIS 958 at *22. Even though our *Redding II* relied on a test different from that we adopted in *Redding I,* that change did not alter applicable court precedent.

that "[o]ur system of original cost ratemaking represents a careful balancing of interests and is not weighted unfairly toward either ratepayers or shareholders."[51]

Furthermore, while SDG&E and SoCalGas cite our *Suburban Water Company* decision in support of their original cost assertion, that case merely found that original cost ratemaking did not support allocation of the gain to ratepayers in a narrow circumstance.[52] In granting the gain on sale to shareholders, the Commission made clear that the holding was limited to that case only, and should not serve as precedent.[53]

Nor are we persuaded by arguments that utility shareholders are entitled to all of the gain, because they "own their own property. . . ."[54] While it is true that payment of rates does not transfer ownership of property to ratepayers, such ownership is not necessary in order for ratepayers to be entitled to the gain. Thus, cases such as *Pacific Telephone v. Eshleman*, 166 Cal. 640 (1913)[55] are not meaningful in the gain on sale context.

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51 1990 Cal. PUC LEXIS 1015, conclusion of law 4, at *118.

52 In *Suburban Water Company*, rate base property was sold under threat of condemnation.

53 D.94-01-028, 53 CPUC 2d 45 (1994), 1994 Cal. PUC LEXIS 45, conclusion of law 1, at *25.

54 *See California Water Association Comments* at 5, and cases cited there.

55 *See id.* at 5.

In conclusion, we reject the claim that original cost ratemaking dictates that the value of land when sold should be the property of shareholders.[56] Instead we expect most sales to follow the 100% allocation of gains to ratepayers from sales of depreciable property and the 50%-50% allocation of gains from sales of non-depreciable property as rules of thumb, but once again allow for case-by-case analysis in unusual situations. Such unusual situations include asset sales where the sale price is more than $50 million, or where the after-tax gain or loss from the sale is more than $10 million, as Aglet proposes.

VIII. Uniform System of Accounts Not Determinative of Proper Allocation of Gain on Sale

In the OIR, we took the position that the Uniform System of Accounts (USOA), which provides accounting instructions for plant assets, should not determine how to allocate gains on sale:

> The usefulness of the USOA is limited only to the accounting and recordation of a transaction; it lacks clarity as to the appropriate treatment for ratemaking purposes. . . . The USOA only provides the accounting instructions and procedures to record the transaction; it does not provide or mandate any ratemaking guideline to the treatment of the gain or loss from the sales.[57]

We sought comment on this proposal.

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[56] *See SDG&E and SoCalGas Comments* at 6.

[57] OIR at 14.

A. Comments on Applicability of USOA to Gain on Sale Determination

Aglet and ORA/TURN agree with the Commission's finding that the USOA is not useful in determining how gains on sale should be allocated. ORA/TURN cites several cases in which the Commission has declined to apply USOA accounting rules to ratemaking questions.

In contrast, San Gabriel Water Company (San Gabriel) contends that the USOA provides consistent accounting procedures for recording gain or loss from sales of utility property, and should be relied upon to reinforce, not deviate from, ratemaking policies. San Gabriel states that the USOA was developed "so that regulatory agencies could be consistent and rational," and notes that the USOA provides accounting treatment for the sale of utility property. San Gabriel asserts that stock and bondholders purchase investments based on utility financial statements kept in accordance with the USOA. Failure to adopt gain on sale rules consistent with the USOA would, San Gabriel contends, "undermine the integrity of the utility's financial statements with lenders and investors."[58]

While most other parties do not appear to address the USOA question, SCE states that it "understands that it is the Commission's policy that the [USOA] is not necessarily binding with regard to ratemaking practices."

B. Discussion – USOA

The USOA dictates how utilities maintain their accounts for regulatory purposes. It ensures uniform accounting policies across utilities in the same industry. In the case of electric utilities, we adopted the Federal Energy

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[58] *Comments of San Gabriel Water Co.* at 7-8.

Regulatory Commission (FERC) USOA in 1970. At that time, however, we stated 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." We further noted that, "we have consistently maintained that the accounting provisions contained [in the USOA] are not controlling as to the ratemaking policies which this Commission may determine to be reasonable and necessary."[59]

We have long acknowledged that the USOA is not determinative of gain on sale allocation. We have stated that, "the FERC adopted USOA is really a record keeping system, and . . . is not a ratemaking treatise that is controlling on the issue before us [how to allocate the gain on sale]."[60] Similarly, in connection with a water gain on sale issue, we held that,

> [n]otwithstanding the specificity with which the USOA governs the accounting practices of a water company, we stress that the purpose of a system of accounts is to predict the bookkeeping entries but not the ratemaking impact of a sale. The purpose of the USOA is not to provide a methodology for allocating the gain on sale for the purpose of setting rates but to properly track the Commission-imposed allocation. The Commission is not bound by accounting convention; it is free to pursue its legislative duty to balance the interests of shareholders and consumers.[61]

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59 *See* D.03-12-056, 2002 Cal. PUC LEXIS 1069, at *17 (citations omitted).

60 D.90-04-028, 1990 Cal. PUC LEXIS 200, at *27.

61 D.94-09-032, 56 CPUC 2d 4 (1994), 1994 Cal. PUC LEXIS 529, at *25 (citations omitted).

We made the same determination in the telecommunications context in D.94-09-080: "we reject any argument that the USOA alone should direct the Commission's allocation of gain between shareholders and ratepayers. While GTEC's interpretation of the accounting rules is correct, accounting practices do not drive ratemaking nor will we base our decision solely on the principles set forth in the USOA."[62]

San Gabriel provided no evidence supporting its claims that stock and bondholders rely on the USOA for gain on sale allocation, and no other party makes that claim. Consistent rules adopted by a regulator should provide investors with a level of consistency and certainty that is equal to or greater than that provided in the USOA. Given our long line of cases holding that the USOA accounting categories should not determine ratemaking allocations such as gain on sale, it would be unreasonable for investors to assume that the USOA would determine gain on sale allocations. Thus, we reject San Gabriel's position.

We find that USOA accounting categories, while necessary to ensure that utilities maintain their books in a consistent manner, do not control gain on sale allocations.

IX. Allocation as Incentive for Prudent Asset Management

In the OIR, we tentatively concluded that, "[t]he allocation of the gain on sale standards should provide an incentive to encourage prudent management of utility assets." We explained that, "if shareholders receive a portion of the gain on sale that is too large, they have an incentive to add properties that are not

62 D.94-09-080, 1994 Cal. PUC LEXIS 663, at *20.

really needed for service to customers but have the potential to bring them high profit at some later date when sold." On the other hand, we noted, "it may be necessary to provide shareholders with enough of the gain to encourage the utilities to sell properties that are no longer needed."[63]

A. Comments – Incentives

ORA/TURN assert that we should only allocate a small fraction of the gains to shareholders. They reason that, "assigning most of the gains to ratepayers will minimize the likelihood of adverse incentives to the utility management to hedge unnecessarily in the property market." ORA/TURN believes the primary business of utilities should be utility service and not real estate investment or speculation. They conclude by stating that over-allocation of gains to shareholders "may tempt management to sell useful and economic utility assets prematurely based solely on a sudden opportunity from a spasm in the market."[64]

SCE believes that existing regulatory and ratemaking practices already provide appropriate and adequate incentives for prudent management of utility assets. Although SCE does not disagree *per se* that an appropriate allocation mechanism should not create perverse incentives, SCE does not believe that a fixed allocation ratio is necessary or appropriate.

PacifiCorp asserts that sales of utility assets carry elements of risk and require substantial management attention, and urges that shareholders be compensated for these risks. It cites its sale of its Centralia coal-fired generating

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[63] OIR at 3.

[64] *ORA/TURN Comments* at 15.

plant to a Canadian company as an example. Despite the fact, according to PacifiCorp, that several regulatory commissions granted its shareholders the right to a portion of the gain, "in total, more than 100% of the gain was allocated to customers even though each state recognized that shareholders should receive a portion . . . . Pacific is less likely now to seek such opportunities."[65]

Park asserts that it is not credible to assert that the utilities will have an incentive to add properties that are not really needed for service to customers. Park reasons that the inclusion of these properties in rate base must pass muster at the Commission, which would not happen if property lay idle. Park also delivers a warning: "There is no reason to think that any utility would come forward to sell property if 80 percent of the gain or more were to go somewhere else. Better to hold onto the property." Park notes that "the strongest incentive to take care of … property is to allow the shareholders 100 percent of the revenue." [66]

Aglet reacts to several utility assertions with the question "incentives or threats? Aglet is very concerned about the tenor of utility arguments that allocating gains to ratepayers will lead to higher costs and stagnation or decline of service quality." Noting that, "public utilities are in the business of providing safe, reliable service," Aglet concludes: "Bullying the Commission for risk-free rewards is offensive."[67]

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[65] *PacifiCorp Comments* at 5.

[66] *Park Water Comments* at 11.

[67] *Aglet Reply Comments* at 6-7.

B. Discussion – Incentives

We do not believe law or good regulatory policy require that we set the shareholder portion of gain on sale at an extremely high level in order to achieve prudent property management. Nor do we believe utilities are threatening to deliberately manage their property irresponsibly if we do not set shareholder gain at a high level. We believe that the sharing rules adopted here assets provides adequate incentives to the company for prudent asset management.

X. Only After-Tax Gains Considered

The OIR proposed that any rule we develop here apply only to after-tax gains. In this way, if a sale caused a taxable gain, we would only allocate the net proceeds after taxes were paid.

A. Comments – Taxation

The comments do not address the taxation issue, with one exception. ORA/TURN note that SCE includes the entire pre-tax gain in its "Other Operating Revenue" (OOR) account: "The inclusion of the entire gain in other operating revenue generates a reduction to the utility's taxable income that offsets the tax paid at the time of the gain . . . ."[68]

SCE states that it believes ORA, TURN and SCE share a mutual understanding and agreement with regard to the treatment of taxes in the allocation of gains and losses. SCE clarifies that tax treatment of gains/losses

[68] *ORA/TURN Comments* at 12-13.

depends on whether the Commission adopts "flow-through" or "normalized" tax accounting.[69]

The California Supreme Court in *Southern California Gas Company v. Public Utilities Commission,* 23 Cal. 3d 470, 475-76 (1979) noted that the Commission's ordinary policy is to require flow-through, or cash-basis, tax accounting:

> [T]he commission [has] generally taken the position that rates . . . should reflect only actual costs incurred. As taxes are treated as part of a utility's cost of service, any tax savings should not be retained by the utility but should be immediately passed on to the utility's customers. Accordingly, since 1960 the commission has required utilities to charge as operating expenses only the amount of taxes actually paid. Any savings acquired through the use of accelerated depreciation or the investment tax credit is to be immediately flowed through to the ratepayers.

Where flow-through tax accounting is used, SCE states that the Commission's gain on sale policy should "ensure that any tax benefits or detriments . . . passed along in rates to ratepayers are essentially 'recaptured' by ratepayers before allocating the gains or losses to shareholders."[70] SCE

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[69] There are two methods to account for income tax expense for regulatory purposes. Under the flow-through method, the income tax expense recognized for regulatory purposes during a given period is equal to the taxes that are assessed and paid during the period. Under the normalization method, the income tax expense for a given period is based on the net income recognized for regulatory accounting purposes during the period, regardless of when the taxes associated with the accounting income are actually paid. The flow-through method can be viewed as cash-basis accounting, while the normalization method reflects accrual accounting.

[70] *SCE Reply Comments* at 15.

continues: "To accomplish this [recapture], shareholders' allocated gain or loss should be equal to the pre-tax gain or loss, minus the product of the composite income tax rate times the pre-tax gain or loss."

B. Discussion – Taxation

The rules we develop here apply to after tax gains and losses. While ORA/TURN advocate for a rule that allocates pre-tax gains, allocating gains after-tax makes more sense since taxes reduce or alter the actual gains or losses available for allocation to shareholders and ratepayers.

ORA/TURN assert that the draft decision errs in its discussion of the effect of taxation on gains and losses. We add language to clarify that gains and losses should be allocated to ratepayers on a net after-tax basis, grossed up to a revenue requirement. Allocating gains and losses to ratepayers on this basis ensures that any tax benefits or detriments that were previously borne by ratepayers are appropriately reflected into the allocated gain or loss amount. As SCE pointed out in its comments, California ratemaking practices do not utilize full normalization of income taxes. This gives rise to a situation where tax benefits are passed through to ratepayers at a different rate than are charges for depreciation because tax depreciation and book depreciation are not the same. For example, there are certain costs that are not normalized for income tax purposes, such as the cost of removing utility plant. These costs are immediately expensed through depreciation expense for accounting purposes, but are not allowable deductions for income tax purposes. The ratepayers are charged an additional amount to recover the additional income taxes associated with not deducting the removal costs on the utility's income tax return. Once the asset is actually sold, the ratepayer is made whole by receiving the gain on the sale, plus the income taxes that they had paid that were associated with the cost of removal.

The mechanism for the distribution of gains through OOR described by ORA/TURN and SCE derives from D.87-12-066[71] and applies to the sales of land and timber. The distribution of the gain through this mechanism depends, among other things, on the amount of time the property was included in rate base. However, SCE's OOR from the sale of non-tariffed products and services is distributed in an entirely different manner through D.99-09-070.[72]

The distribution of OOR varies widely among the other utilities. It is beyond the scope of this proceeding to specify the precise method for distributing the gains to particular accounts such as OOR; our purpose here is to provide guidelines to help determine the amount of gain to allocate to each of the parties. This decision does not supersede D.87-12-066, nor does it recommend its mechanisms for the distribution of OOR to other utilities. Further, a tax treatment designed for a specific OOR distribution method should not be imposed on all methods. There is nothing in the statements of either SCE or ORA/TURN that would suggest we should apply these rules to anything other than after tax gains.

XI. Notice of Utility Assets Taken Out of Service – Pub. Util. Code § 455.5

The OIR proposed to implement Pub. Util. Code § 455.5(f), which requires that utilities report periodically to this Commission whenever any portion of an

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71 26 CPUC 2d 392, 410 (1987).

72 2 CPUC 2d 579, 605 (1999).

"electric, gas, heat, or water generation or production facility" is out of service, and immediately when a portion of such facility has been out of service for nine consecutive months. Section § 455.5(f) notes that an "electric, gas, heat, or water generation or production facility includes only such a facility that the commission determines to be a *major facility*." (Emphasis added.) The OIR suggested a definition of a "major facility" as any asset with an initial acquisition price of $500,000 or more. The OIR also suggested that the Commission should require reporting regarding any facility whose entirety met this dollar threshold, even if the portion out of service cost less.

A. Comments – Pub. Util. Code § 455.5

With regard to the proposed $500,000 threshold for a reportable "major facility," the utilities generally support a higher threshold, while ORA/TURN support a definition based on the size of the utility.

ORA/TURN "are sensitive to the large utilities' concern regarding the large amount of assets to be reported if the reporting threshold is built too small. . . ."[73] They ask that the Commission allow the parties to collaborate on establishing the proper threshold for the reporting requirements, or carry out a process for determining the threshold separately from our decision on gain on sale rules.

SDG&E/SoCalGas ask for a threshold of $50 million. SCE recommends that we define § 455.5's language relating to a "portion of any electric . . . generation or production facility" as any component of the major generating facility which, when out of service, reduces the output of the facility by

[73] *ORA/TURN Reply Comments* at 6.

50 megawatts (MW) or 20% of nameplate capacity,[74] whichever is lower. PG&E suggests a higher dollar value threshold or a threshold based on the size of the plant: "a major facility would be defined as a facility (1) generating in excess of 50 megawatts; or (2) costing in excess of $50 million." It cites several provisions elsewhere in the Public Utilities Code that use a $50 million, $100 million or 50 MW benchmark.

SDG&E and SoCalGas question whether the OIR recognizes the fact that § 455.5 applies only to "generation" or "production" facilities. It explains that "generation" and "production" are terms of art used in the USOA applicable to electric and gas utilities, and urges us to limit our interpretation of the terms to the definition in the USOA.

SDG&E/SoCalGas also challenge the OIR's tentative conclusion to prohibit a utility from selling an asset for which the utility provides no § 455.5 notice, and to void *ab initio* a sale for which the utility fails to provide notice. SDG&E/SoCalGas state that an asset out of service for nine months probably should be sold, and that it would burden the utility to require it to retain such property.

B. Discussion – Pub. Util. Code § 455.5

None of the comments support our initial determination to define a "major facility" as any asset with an initial acquisition price of $500,000 or more, or any facility whose entirety meets this dollar threshold, even if the portion out of service cost less. We agree with the comments that urge us to define a "major facility" threshold based on the size of the utility, rather than setting a flat dollar

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[74] The nameplate capacity of a power plant is the capacity it was designed to handle.

value. A facility that is major to a medium sized water company may be minor to a large investor owned utility such as PG&E.

By the same token, we believe the $50 million threshold some propose is probably too high, even for the largest electric utilities. Assuming a rate of return in the 10% range, such an asset, if left in rate base without being used for utility service, could lead to significant ratepayer overpayments. The statute's purpose to avoid such overpayment is clear on its face. If nothing else, the statute is designed to ensure that ratepayers do not pay a rate of return on assets in rate base that the utility is not using for utility service. Setting the "major facility" definition too high could cause significant ratepayer harm.

We require a better record on this issue, and ask the parties for further comment. The parties should assume we will define a "major facility" based on the size of the utility. Thus, the large electric, gas and water utilities will have thresholds that are higher than those of small energy providers and small water companies. The parties shall file comments in this regard within 90 days of the effective date of this decision, and may file reply comments within 30 days of receipt of the opening comments. Before filing such comments, all non-telecommunications parties who filed comments shall meet and confer in an attempt to reach agreement on standard definitions of major facilities based on utility size. These parties shall report the results of their meet and confer session to the assigned administrative law judge (ALJ) before filing comments.

At a minimum, parties shall assume that the following rules will govern their negotiations and/or written proposals:

- The statute applies only to electrical, gas, heat or water corporations' generation or production facilities. The parties should try to agree upon a common definition of "generation" and "production" that is based on either the USOA or another rational interpretation of the terms, and

- The statute applies to facilities as well as portions of facilities.

We agree with SDG&E that the statute does not require that sales of major facilities be barred or voided if the utility fails to meet its reporting requirements under § 455.5. Section 851 is the appropriate provision for determining whether a utility may sell its assets, and we hold in this decision that interpretation of § 851 is beyond the scope of this proceeding.[75] The Commission has recently adopted a pilot program (Resolution ALJ-186) designed to streamline its review of certain § 851 transactions, and has indicated that it will take additional steps to review how it handles § 851 generally. We need not duplicate those efforts here.

XII. Other Issues

A. FERC Jurisdictional Property

1. Comments – FERC Jurisdictional Property

PG&E asks us to exclude electric transmission assets from this rulemaking on the ground FERC has exclusive ratemaking authority over such assets. We have found in certain asset sale decisions that the gain on sale policy

[75] We do deal, however, with a special situation confronting water companies later in this decision.

applicable to electric transmission assets is subject to FERC jurisdiction for ratemaking purposes.[76]

However, ORA/TURN correctly note that we recently deferred to this OIR the issue of whether we may apply our gain on sale policy to electric transmission assets. In D.04-02-025, PG&E sought Commission approval to sell land underneath transmission lines while retaining an easement to maintain the lines. PG&E argued that the land was transmission related and subject to FERC jurisdiction. ORA argued that the land was no longer transmission related since what PG&E was selling was only the non-transmission related asset. It was retaining the sole asset related to transmission: an easement for access to the transmission lines.

2. Discussion – FERC Jurisdictional Property

Without commenting on broader issues of FERC jurisdiction over transmission, we find in this context that the utilities should allocate gains on sale of transmission property according to FERC rules. We have considered ORA/TURN's point that once the utility sells property and retains a right-of-way to service the transmission, it has divided the use of the property. Nonetheless, we have rejected attempts in the past to parse the gain on sale analysis in this way. We deem the ORA/TURN approach too procedurally burdensome to adopt.

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[76] *See, e.g.,* D.02-01-058, 2002 Cal. PUC LEXIS 11, at *11 (approving the grant of an easement over electric transmission property and holding that it was "appropriate for revenues from the easement to be credited according to applicable FERC orders and requirements"); D.03-04-032, *mimeo.,* p. 1, 2003 Cal. PUC LEXIS 234, at *1 (ordering that gain on sale of transmission facilities be allocated "according to applicable FERC authority.").

In D.90-11-031, the Southern California Gas headquarters building sale case, the Gas Company asked us to apply one gain on sale test to the sale of the building and another to the sale of the land. ORA's predecessor, the Division of Ratepayer Advocates (DRA) opposed such an allocation, asking instead for us to apply a consistent test to the entire property: "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."[77] We rejected SoCalGas' approach and decided to consider the sales proceeds on a consolidated basis.[78]

We acknowledge that the issue of whether to allocate gains on sale according to CPUC rules or FERC rules is a somewhat different question, since it involves the jurisdictional question as well as application of different gain on sale rules to the same property. We find nonetheless that it would burden the Commission and parties to have to examine the transaction this closely to determine which gain on sale rules to apply. It is far simpler to allocate sales of all transmission property according to FERC's rules, regardless of whether the utility maintains an easement after the sale. We find that this is the appropriate result here, especially since our goal is to develop consistent, easy-to-apply rules applicable to most situations.

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77 1990 Cal. PUC LEXIS 200, at *25.

78 1990 Cal. PUC LEXIS 200, at *30. We did not alter this conclusion on rehearing. *See* D.90-11-031, 1990 Cal. PUC LEXIS 1015, at *47.

As we understand the process, the utilities post all gains/losses from FERC-jurisdictional transmission property to a single account, which FERC addresses in the context of the utilities' periodic transmission cost recovery filings. The utilities should continue to account for FERC jurisdictional transmission in this way.

Nothing in this decision should be construed as an opinion on the FERC's general jurisdiction over transmission lines. This Commission engages in many activities regarding such lines, including siting of new lines. We do not intend to change our current process with this decision.

B. Gains/Losses on Non-Utility Assets

1. Comments – Non-Utility Assets

PG&E and SDG&E/SoCalGas urge us to make clear that the gain on sale rules we develop here apply only to utility assets. According to PG&E, shareholders should receive 100% of the gain from assets that are recorded 100% as non-utility property, 75% of the gain from assets recorded 75% as non-utility property, and so on.[79]

SDG&E/SoCalGas note that in the past they have held real estate outside rate base with the knowledge of the Commission for extended periods without the Commission ever telling them this course was prohibited. SDG&E/SoCalGas oppose any limit on their ability to hold property out of rate base, asserting that Pub. Util. Code § 851 only requires Commission intervention

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79 PG&E cites D.98-02-031 (PG&E shareholders permitted to retain 75% of gain from sale of property recorded 25% as plant in (utility) service, 75% as non-utility property); D.98-02-032 (PG&E shareholders permitted to retain 100% of gain from sale of property recorded 100% as non-utility property) and other cases with consistent holdings.

when a utility proposes action with regard to property that is necessary and useful to serve utility customers.

Aglet generally agrees with utility arguments that gains or losses that accrue during periods when plant is out of rate base should go to shareholders. Aglet notes, however, that such calculations may be difficult because land values do not escalate uniformly over time. Conceding that any calculation that attempts to link gains to asset appreciation at a particular point in time would be difficult and inexact, Aglet proposes that the Commission create a rebuttable presumption that allocation of gains and losses can be determined based of length of time that individual assets are in or out of rate base.

2. Discussion – Non-Utility Assets

We agree that it is appropriate in most cases to allocate gains or losses on property held out of rate base to shareholders. Thus, where property is never in rate base, all gains or losses should accrue to shareholders. This includes property used for speculative or unregulated activities funded entirely by shareholders. Gains or losses from property that is partially in rate base and partially out of rate base should be allocated proportionately to the percentages in and out of rate base as PG&E proposes.

However, if assets move in and out of rate base over time, we agree with Aglet that it is best that we adopt a rebuttable presumption for such property. An applicant (or other party) may assume that the gain allocable to shareholders directly mirrors the time the asset was out of rate base. Thus, for example, if the property is in rate base for 20 years and out of rate base for 20 years, shareholders should receive 50% of the gain/loss, and the remainder should be allocated according to the sharing rules applicable to property in rate base. However, if there is evidence that demonstrates that most of the property's appreciation (or depreciation) occurred while the property was in (or out of) rate base, evidence of such variance may be submitted to rebut the presumption.

In all cases, utilities bear the burden of proving the time property was out of rate base in the case of a gain and in rate base in the case of a loss.

C. Section 851 Issues

1. Comments – Section 851

ORA/TURN recommend a process for the Commission to use in evaluating utility § 851 applications. They ask the Commission to require utilities to include a standard list of consistently-formatted information in all such applications. SCE states that such a process is beyond the scope of this proceeding, noting that § 851 is applied and invoked in numerous transactions wholly unrelated to the sales transactions contemplated in the OIR.

The parties also engage in debate about the meaning of § 851. The utilities, on the one hand, state they need not seek Commission approval to sell property that is no longer used or useful for utility service. ORA/TURN contend to the contrary that the Commission must validate at the threshold a utility's claim that property is no longer used or useful.

2. Discussion – Section 851

Section 851 prohibits public utilities from selling or encumbering utility property that is necessary or useful in the performance of their utility duties to the public without Commission permission. While the parties make several interesting comments and proposals regarding our § 851 process, those matters are beyond the scope of this rulemaking. This OIR is designed primarily to develop rules for allocating monetary gains and losses, rather than refining our process for allowing sales in the first instances.

We have recently asked utilities and other interested parties to weigh in on a proposed pilot program governing our § 851 process[80]; the Commission approved the pilot program in Resolution ALJ-186 dated August 25, 2005, and also described the next steps it would take in its ongoing review of § 851 policies. This Rulemaking is not the place to consider generic § 851 issues, which may have application to parties other than those who commented, and for which we have an inadequate record. We decline to decide in this forum the § 851 issues the parties raise.

By the same token, our discussion of the Water Utility Infrastructure Act of 1995, Pub. Util. Code § 789 *et seq.* (Infrastructure Act) relates peripherally to § 851. In connection with comments on the Infrastructure Act, some of the water companies claim they need not apply to the Commission for approval to sell utility assets that they claim are no longer used and useful in utility service. As we discuss in detail below, we believe notice to the Commission is required. Since the Infrastructure Act may create an incentive on water companies to sell assets that are still used and/or useful, we should impose tracking and application requirements on such utilities so we can ensure only obsolete property is sold. In addition, we will require water utilities to give the Commission notice, as described more fully below, when they wish to sell assets covered by the Infrastructure Act.

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80 *See Chief ALJ Minkin's Management Report Concerning Section 851 Pilot Program,* dated March 17, 2005, available on the Commission's website at http://www.cpuc.ca.gov/Published/Report/44537.htm.

D. Abandoned Plant

1. Comments – Abandoned Plant

Aglet asks that we broaden the scope of the OIR to consider gain on sale treatment for "abandoned plant," which it characterizes as the undepreciated asset value of plant that is retired early. Aglet proposes that any losses on early-retired plant be borne by shareholders, but that gains associated with early retirement go to ratepayers.[81]

Calling Aglet's proposal a "heads-I-win-tails-you-lose" proposal, SCE suggests that the Commission itself may err in setting the rate of depreciation, and that shareholders should not bear the brunt of such error. SCE also notes that it depreciates certain assets (poles, transformers, meters and PCs) *en masse,* and that under this group accounting procedure, the process of setting asset lives and depreciation rates is done on an average basis. Some assets are retired early and some last beyond their expected retirement age. According to SCE, Aglet's proposal would be both unworkable and unfair: all components that retire earlier than the group's average service life would result in a loss to be borne by shareholders.

2. Discussion – Abandoned Plant

We do not believe a special rule for "early-retired plant" (what Aglet refers to as "abandoned plant") is warranted. W e have already provided for case-by-case consideration of extraordinary losses, such as those attributable to nuclear power plants. Thus, we decline to adopt the special rule Aglet advocates.

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[81] Aglet notes that this issue is now reserved for hearing in PG&E's next general rate case.

The parties' apparent confusion over terminology, however, convinces us that the term "abandoned plant" is not universally understood and we therefore take this opportunity to clarify its definition. The term "abandoned plant" refers specifically to investments in preoperational assets that never become used and useful and thus have never entered rate base.

XIII. Water Specific Issues – Water Utility Infrastructure Improvement Act of 1995, Public Utilities Code § 789 et seq.

A. OIR Questions – Water

Water utility regulation is unique because there is a specific statute governing gain on sale allocation, the Water Utility Infrastructure Improvement Act of 1995, Pub. Util. Code § 789 *et seq*. (Infrastructure Act). The statute provides, in pertinent part, that a water corporation shall invest the "net proceeds" of the sale of "real property" in water system infrastructure that is necessary or useful for utility service. The statute gives a utility a period of eight years from the end of the calendar year in which the water corporation receives the net proceeds to invest them in facilities necessary or useful to the performance of duties to the public. Any proceeds the utility does not so invest in the eight-year period shall be allocated solely to ratepayers.

The OIR poses several questions specific to the statute:

> May water utility shareholders enjoy a return on assets that the utility's shareholders did not purchase? Examples:
>
> (1) facilities paid for by company ratepayers,
>
> (2) facilities constructed in the 1980s and 1990s with state-provided low interest loans under the SDWBA and the State Revolving Fund,

(3) water assets developers or other entities pay for as contributions in aid of construction, and

(4) state grant funds from Proposition 50 proceeds to construct water utility infrastructure in low-income areas.

If according to § 790, the full gain is included as rate base, should there be any safeguards against "churning" of assets by utility management in order to increase rate base? What should these safeguards be?

In order to reconcile § 790 and § 851, at what point do we require the utility to file an application? If the utility files a § 851 application at the time of the sale and the Commission approves the sale, what must the utility file at the end of the eight years, if anything, to reconcile the net proceeds?

We address each of these questions below.

B. General Interpretation of Infrastructure Act, Pub. Util. Code § 789 et seq.

1. Comments – General Interpretation of Infrastructure Act

According to the California Water Association (CWA), § 790's requirement that water utilities invest net sales proceeds in utility plant means that all such investment should be included in the utility's rate base with the opportunity to earn a reasonable return. CWA believes the Legislature in passing the statute recognized a pressing and continuing need for substantial investment by water utilities in new infrastructure, plant and facilities, and looked to real property no longer needed for utility service as a source of capital to fund that investment. The statute offers rate base inclusion for the reinvested proceeds "as an inducement to utilities to dispose of such property and to make such needed reinvestments."[82]

2. Discussion – General Interpretation of Infrastructure Act

We interpret the Infrastructure Act to limit Commission discretion in how it allocates gains on sale of real property, provided that water companies shall use the proceeds from sales of formerly used and useful utility real property to invest in new water infrastructure.[83] Such proceeds may not be used to reduce rates or otherwise be returned to ratepayers unless the water companies fail to reinvest the proceeds within the eight-year period contained in § 790(c).[84]

No party cites the legislative history of the Infrastructure Act in its comments. Nonetheless, we have examined the committee reports submitted at the Legislature when it was considering the Act, and find them quite definitive on how to interpret the statute. The California Supreme Court has stated: "To interpret statutory language, the courts must ascertain the intent of the

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82 *CWA Comments* at 20.

83 The § 790 portion of this decision relates only to reinvestment of gains or losses from sales of water utility assets.

84 "This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of 8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers."

legislature so as to effectuate the purpose of the law."[85] While the first (and often last) step in interpreting a statute is always the statutory language itself, the parties' differing interpretations of the Act's language suggest that it is appropriate to examine the legislative analysis to determine what the Legislature intended in enacting the statute.

The April 5, 1995, analysis provided for the California Senate floor when it was considering the legislation[86] explained that the statute was designed to ensure uniform allocation of gains on sale and to limit Commission discretion in allocating such gains:

> The PUC, which is charged with the regulation of the water companies, has issued several decisions in the area of gain on sale (the disposition of the proceeds) from a sale of non used and useful property. In some instances, the PUC has allowed a water company to allow the gains to revert to shareholders. In other instances, the PUC has required the company to flow all or part of the gains to ratepayers often in the form of lower rates.
>
> This bill attempts to create a uniform standard that would accrue all gains on the sale of property back to the owners for the specified use of improvements in

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[85] *California Teachers' Ass'n v. Governing Board of Rialto Unified School Dist.*, 14 Cal. 4th 627, 632 (1997).

[86] The April 5, 1995 Senate Floor Analysis of SB 1025, the legislation that became the Infrastructure Act, is available on the Internet at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_1001-1050/sb_1025_cfa_950405_165744_sen_floor.html.

> infrastructure and then after a period of ten years,[87] the proceeds will be allocated to ratepayers.

All other reports on the legislation say essentially the same thing.[88] These reports evince a legislative intent to give water companies certainty on how to allocate their gains from the sale of real property. Recognizing the need for infrastructure investment, the difficulty for water companies of acquiring capital in the market, and the varying approaches the Commission has taken on the subject, the Legislature created a bright-line rule. Thus, water utilities must invest net proceeds from the sale of formerly used and useful real property in new water infrastructure. They need not refund such proceeds to ratepayers, but they may not pay the funds out to shareholders in the form of dividends or other earnings either.

We discussed the legislative intent behind the Infrastructure Act at length in D.03-09-021. In keeping with the foregoing analysis, we found that,

> In summary, § 790 requires water utilities to sell no longer needed property and to invest the net proceeds in needed infrastructure. These net proceeds are to be the utility's primary source of capital for infrastructure, and

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[87] The term was later amended to eight years.

[88] *See* July 11, 1995 Assembly Committee Analysis of SB 1025, at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_1001-1050/sb_1025_cfa_950711_103355_asm_comm.html; July 6, 1995 Senate Floor Analysis, at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_1001-1050/sb_1025_cfa_950706_122701_sen_floor.html; June 9, 1995 Assembly Committee Analysis, at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_1001-1050/sb_1025_cfa_950609_124807_asm_comm.html, and February 24, 1995 Senate Committee Analysis, at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_1001-1050/sb_1025_cfa_950224_160520_sen_comm.html.

> the utility must track the investment of the proceeds. The utility has eight years to re-invest the funds, and must include the property among its other utility property.

We also voiced a word of caution: "the result of allocating all net proceeds to shareholders creates a powerful financial incentive for water utilities to sell real property . . . . Such a right could encourage water utilities to sell real property without regard to long-term customer service needs, and may even lead to real property speculation by water utilities, relying on rate base treatment to protect shareholders from losses but using § 790 to reap all gains."[89]

We therefore concluded in D.03-09-021 that water companies must carefully track real property sales proceeds, and must be able to link funds received from such sales to their investments in new infrastructure. We also concluded that, "[t]he Commission has exclusive authority to determine the used, useful, or necessary status of any and all infrastructure improvements and investments." Therefore, we adopted several tracking and application requirements under the Act, which we applied to the party to the proceeding and reaffirm below.

Nothing in the Infrastructure Act or its legislative history precludes us from adopting tracking requirements to ensure that water companies actually comply with the statute. We believe tracking is appropriate given the risks we acknowledged in D.03-09-021.

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[89] D.03-09-021, 228 PUR 4th 204 (2003), 2003 Cal. PUC LEXIS 1249, at *104.

C. Shareholder-Purchased Assets vs. Other Assets

As noted above, the OIR asks several questions about how water companies should treat sales proceeds from property not purchased with shareholder funds. We address each type of property in turn.

1. Government Funding

a) Comments – Government Funding

Park believes that any gains from sale of assets funded by non-shareholder investment, if in the form of government-financed funding, should be returned to the funding agency. It states that § 790 should be revised to conform to that position.

With regard to Proposition 50, ORA/TURN assert that water companies should return net proceeds from the sale of Proposition 50-financed property to the granting public agency. "ORA and TURN believe that the Commission should uphold its longstanding policy of forbidding utilities to earn on the investment of others."[90]

b) Discussion – Government Funding

We will take up claims regarding Proposition 50 funds, including how to allocate gains on sale, in our Proposition 50 proceeding, R.04-09-002. Thus, we do not act on the parties' comments on Proposition 50 here.[91]

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[90] *ORA/TURN Comments* at 51.

[91] The Assigned Commissioner in R.04-09-002 recently proposed expanding the scope of that proceeding to cover all government bond funds.

With regard to other water utility investments made with government funds, we lack a record to determine whether the funding agencies are in a position to receive reimbursement for sales proceeds traceable to property purchased with government funding.

2. Developer Contributions in Aid of Construction

a) Comments – Developer Contributions in Aid of Construction

ORA/TURN claim that advances for construction and contributions in aid of construction comprise as much as 30% to 40% of plant investments for some water utilities. They claim that such funds do not belong to the shareholders, who bear none of the financial risks related to the funds, and that the Commission has long prohibited utilities from earning a rate of return on investments that do not belong to the shareholders. They cite D.03-09-021, in which the Commission rejected an interpretation that the Infrastructure Act requires all net proceeds from a § 790 sale to be allocated to the shareholders. Thus, ORA/TURN ask the Commission to declare that the Act requires § 790 net proceeds allocable to advances for construction and contributions in aid of construction be assigned to ratepayers.

Developer contributions in aid of construction are not generally in rate base, according to Park. Thus, ratepayers have no claim to the gain on sale since they have not paid for the property, a rate of return, or maintenance costs. Since, according to Park, ratepayers have not borne risks related to such assets, returns from such assets, once reinvested, should be in rate base.

CWA contends that the Infrastructure Act does not contemplate a "second 'rate base' on which a different (*i.e.*, lesser) rate of return would be allowed."[92] According to CWA, the statute makes no distinction between real property financed by shareholders' equity, by debt, by developers' contributions, or otherwise. The utility should be allowed a return on all such property.

b) Discussion - Developer Contributions in Aid of Construction

Section 790 does not limit the definition of "net proceeds" to proceeds attributable to shareholder investment. The clear intent of the Infrastructure Act, as we discuss above, is to ensure that water companies invest proceeds from sales of no longer used and useful utility real property in water infrastructure. If such property was once used and useful, but not in rate base (as Park Water says is the case with most developer contributions in aid of construction), § 790 nonetheless governs such assets. We find that water companies should re-invest gains from the sale of assets recorded under Contributions in Aid of Construction (CIAC) in new water infrastructure, and that the water companies may earn a reasonable rate of return on that reinvested gain. The gain must result from a sale of formerly used and useful real property, as we discuss above, because the statute only applies to such property.

The Commission leaves open for further consideration the issue of whether a "reasonable rate of return," on reinvested gain from the sale of CIAC property ought to be the same as (or different from) the rate of return the utility earns on other property.

Only if the water company fails to make such investment within the statutory eight-year period should the proceeds revert to ratepayers. At the

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92 *CWA Comments* at 22.

same time, the companies may not pay out the sales proceeds in dividends or other profit to shareholders. Rather, they must place the proceeds in a memorandum account approved by the Commission and meet the other tracking requirements we imposed in D.03-09-021 and reiterate here.

3. Contamination Proceeds

a) Comments – Contamination Proceeds

A related issue on which several parties commented relates to proceeds a water company recovers from a polluter for contaminating water supply. These are essentially litigation proceeds that water companies receive from third parties who contaminate water supplies.

b) Discussion – Contamination Proceeds

We evaluated water utility treatment of contamination proceeds in D.04-07-031.[93] There, the Southern California Water Company had received a monetary settlement for pollution of groundwater from MTBE, a gasoline additive and known carcinogen. We concluded that the settlement proceeds should pass to ratepayers to compensate them for the higher water rates they had paid in the past and would pay in the future due to contaminated groundwater. We rejected the water company's assertion that the proceeds should not be refunded to ratepayers.

Contamination proceeds do not involve sales of real property, so the Infrastructure Act does not apply, nor are such proceeds gains on sale. Thus, such proceeds are outside the scope of this proceeding.

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[93] 2004 Cal. PUC LEXIS 368.

D. Churning

The OIR asked parties to comment on the following question related to "churning" of assets:

> If according to § 790, the full gain is included as rate base, should there be any safeguards against "churning" of assets by utility management in order to increase rate base? What should these safeguards be?

1. Comments – Churning

Park Water Company states that there is little risk that utilities would churn their assets to increase rate base. Any such risk "could be eliminated if the rates at each period were set to compensate the owner for the use value of the asset during the regulated period, whether that be higher or lower than cost."[94]

CWA agrees that it is a "valid concern" that "water utilities will improperly characterize real property with little or no rate base value as no longer necessary or useful for public utility service just in order to sell such property and reinvest the net proceeds in new plant that will qualify for rate base treatment."

However, CWA believes the Commission can address the concern without creating cumbersome new regulatory procedures. It believes water utilities' triennial general rate case reviews and filing of § 851 applications to sell or otherwise dispose of property will safeguard against churning. The requirement that utilities file reports pursuant to Pub. Util. Code § 455.2 will keep the Commission informed on a timely basis of any water utility sales of real

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[94] *Park Water Comments* at 18.

property and subsequent reinvestment of the proceeds. The new water rate case plan in D.04-06-018 will also ensure detailed reporting of all dispositions of real property.[95] That decision provides as follows:

> To the extent not included in a previous GRC [General Rate Case] application, include a detailed, complete description accounting for all real property that, since January 1, 1996, was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public and explain what, if any, disposition or use has been made of said property since it was determined to no longer by used or useful in the performance of utility duties. The disposition of any proceeds shall also be explained.

CWA contends that § 851 does not require utilities to seek Commission permission to sell property that is not necessary or useful for utility service. Thus, CWA contends, there is no justification to require such advance permission as a safeguard against churning. The foregoing reporting requirements should give the Commission adequate opportunity to investigate utility determinations that particular sales of real property need not have been submitted for § 851 authorization, and to evaluate whether the proceeds were in fact reinvested in utility plant that is necessary and useful in providing utility service.

2. Discussion – Churning

D.03-09-021 gives us a good look at how the Infrastructure Act might prompt a water company to sell property without Commission approval

[95] *Re General Rate Case Plan for Class A Water Companies,* D.04-06-018, App. A, at 10, 2004 Cal. PUC LEXIS 018, at *62-63.

in an attempt to enhance shareholder profits rather than improving infrastructure. In that case, a water company had built a new customer service center using proceeds from the sale of its old customer center. We found that the "customer center replacement project [did] not comport with the statutory provisions [in § 790] . . . for regulatory scrutiny and ratemaking treatment . . . . [T]he project is remarkably vague and the need for the project has not been demonstrated. Cal Water has not presented any objective fact, such as customer growth rates, that would justify this project."

Moreover, we rejected the water company's claim that,

> [t]o meet the reinvestment requirement of § 790, . . . reinvestment of the actual sale proceeds is not necessary so long as the utility invests at least that amount in needed facilities during the same year. Under this reasoning, Cal Water conclude[d] that the actual sale proceeds should be available for immediate distribution to shareholders. Cal Water's statutory interpretation allowing this substitution process results in real property sales proceeds, such as the sale of the old Chico customer center, being allocated exclusively and immediately to shareholders.

We therefore required the water company to make a detailed filing demonstrating that it was acting in the ratepayers' interest:

> We, therefore, order Cal Water to submit an application fully explaining in detail its real estate program from its beginning to current plans. All properties included in the program shall be specifically identified and the use and regulatory history of each property set out. Cal Water shall state its rationale for removing any property from rate base and provide supporting documentation. Cal Water shall include the accounting history of each property, including original cost and amount realized, for

> each property as well as the disposition of all proceeds. The Commission staff, after careful review of the proposed transactions for compliance with all applicable statutes and rules, will file and serve a detailed report on its review.[96]

In view of the situation in D.03-09-021, we agree that safeguards against churning are appropriate. The reporting requirements D.03-09-021 imposed on Cal Water are sufficient for that purpose, and we will require regulated water companies to do the following:

1. Track all utility property that was at any time included in rate base and maintain sales records for each property that was at any time in rate base but which was subsequently sold to any party, including a corporate affiliate.

2. Obtain Commission authorization to establish a memorandum account in which to record the net proceeds from all sales of no longer needed utility property.

3. Use the memorandum account fund as the utility's primary source of capital for investment in utility infrastructure.

4. Invest all amounts recorded in the memorandum account within eight years of the calendar year in which the net proceeds were realized.[97]

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[96] The full discussion of this issue appears at 2001 Cal. PUC LEXIS 1249, at *91-109.

[97] We denied rehearing of D.03-09-021's interpretation of § 790 in D.04-01-052, 2004 Cal. PUC LEXIS 1.

E. Reconciliation of § 851 and § 790

The OIR asked, with regard to the interplay between § 851 and § 790, at what point we should require the utility to file an application and how we should track the proceeds of a sale, consistent with those statutes.

1. Comments – § 851 and § 790

ORA/TURN recommend that in order to ensure a water utility complies with both § 851 and the Infrastructure Act, we should require the utility to file a pre-sale § 851 application and keep detailed records matching net sales proceeds with reinvestment.

Park observes that there is nothing to reconcile between § 851 and § 790, since the former deals with sale of necessary or useful utility property and the latter deals with property that was at one time but is no longer necessary or useful in the performance of the water corporation's duties to the public. CWA similarly contends that there is no need to reconcile the two statutes.

Nonetheless, Park acknowledges recent Commission positions that a utility cannot rely on its own determination of whether the plant is necessary or useful, or may be considered so in the future. Park states that it "may behoove utilities to file a § 851 application at the time of the sale." Since § 790(a) requires that the water utility maintain records necessary to document the investment of the net proceeds pursuant to the statute, at the end of the eight years, Park states that the utility should file these records with the Commission. Park suggests that this be done as a compliance filing with the Commission's Water Division.

CWA reiterates its position that utilities need not file for § 851 approval to sell property that is not necessary and useful. Nonetheless, states CWA, the Commission may wish to authorize water utilities to establish memorandum accounts to track the net proceeds of utility sales and "net proceeds" investments. CWA suggests that the Commission review these memorandum accounts when it conducts the water companies' general rate cases. "If memorandum account records eventually reveal that a utility has not reinvested all the net proceeds of a sale of real property and accrued interest within the eight-year period prescribed by the Infrastructure Act, then a timely general rate case decision can ensure that the remaining balance 'shall be allocated solely to ratepayers.'"[98]

2. Discussion – § 851 and § 790

As noted previously, § 851's general requirements are beyond the scope of this proceeding. However, in the context of the Infrastructure Act, we agree with ORA/TURN (and have already decided in D.03-09-021) that we should impose certain reporting and application requirements to ensure that water companies act in compliance with § 790 and invest sales proceeds from formerly used and useful utility property into new infrastructure.

Because § 790 may create incentives for water companies to sell property that is still useful for utility service, water companies must notify the Commission before they propose to sell real property covered by § 790 notwithstanding participation in the pilot program authorized in Resolution ALJ-186. We will require that water companies provide the Director of the Water Division of the Division of Ratepayer Advocates 30 days' advance written notice whenever they plan to sell land, buildings, water rights, or all or part of a water system. This notice requirement applies to water company assets that the company believes are no longer used and useful. The 30 days' advance notice

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[98] *CWA Comments* at 26-27.

will give the Commission an opportunity to assess whether companies are selling off key portions of their asset base. Notice will not preclude later review of such sales in a water company's GRC or a later proceeding.

The notice shall include the following heading in at least 16 point bold type: "Notice under Rulemaking 05-06-040. Commission staff must respond within 30 days." The notice must include the name, address, phone and email address of the potential purchaser(s). If the Commission staff objects to the proposed sale, it may send an objection in any form to the seller and proposed purchaser(s). Mailing of such an objection shall prevent the proposed purchaser from claiming it is a bona fide purchaser of the property at issue until the issues raised in the objection are resolved.

F. Condemnations/Involuntary Conversions

1. Comments – Condemnations/Involuntary Conversions

San Gabriel points to two types of condemnation for which it contends the utility should receive the proceeds. First, utilities routinely sell property as a result of condemnation or under the threat or imminence of condemnation by a city or other governmental agency. The condemnations occur so the government agencies can complete public works projects such as street widening.

Second, water utilities may also receive proceeds from "inverse condemnation" under the "Service Duplication Law," Pub. Util. Code § 1501 *et seq.* Such condemnations occur when the government constructs water facilities that duplicate the facilities of a private water utility. Under § 1503, the private utility is entitled to compensation for the reduction in value of its property even where the government does not physically acquire the utility property.

In both cases, San Gabriel contends the proceeds should be treated as sales proceeds, and the gain or loss passed to utility shareholders. San Gabriel claims such treatment is consistent with the USOA, Generally Accepted Accounting Principles (GAAP) and federal and California income tax rules.

Confusingly, the CWA states that "any rules adopted in this proceeding should apply only to gains from the voluntary sale of utility property," while asserting that its position is consistent with San Gabriel's.[99]

ORA/TURN oppose San Gabriel's recommendations. They state a condemnation is not a "sale" contemplated by § 790, and therefore that monies received in compensation for condemnation do not constitute "net proceeds" under the Infrastructure Act. They note that some condemnations involve non-real property assets, while the Infrastructure Act applies only to real property. They claim the common law definition of the term "sale" requires a willingness to sell, while condemnation involves an involuntary transfer of property rights or value. Thus, the Commission should exclude condemnations from the ambit of § 790.

2. Discussion – Condemnations/Involuntary Conversions

We received a great deal of comment on the condemnation (including sale under threat of condemnation) issue after the draft decision issued. We find the issue requires further consideration and, perhaps, briefing.

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[99] *CWA Reply Comments* at 10.

We therefore defer consideration of this issue to a second, narrowly focused phase of this proceeding. We will decide this issue concurrently with the § 455.5 issue discussed earlier in this decision.

G. Small Water Companies (Class B, C and D)

1. Comments – Small Water Companies

Aglet opposes application of the rules we develop here to Class B, C or D water companies, and suggests we apply the rules only to the Class A companies, the largest type of water utility we regulate. Aglet states that regulatory treatment of small water companies differs significantly from that for large utilities. Many small water utilities have little or no rate base, rarely if ever issue dividends, and do not have the resources to litigate complicated ratemaking issues before the Commission. Aglet suggests that we consider issues pertinent to Class B, C and D utilities in the OIR on water contamination issues we alluded to in the OIR.[100]

2. Discussion – Small Water Companies

We disagree that the rules we develop here should apply only to Class A water companies. The statute applies on its face to all "water corporations" without limitation. Moreover, the smaller water companies may need the infrastructure investment § 790 facilitates as much or more than larger companies, and have less access to the capital markets than their larger brethren. Thus, we see no basis to make the requested distinction among water companies. The rules we apply here shall apply to all water companies we regulate.

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[100] "Due to the complexities of water contamination issues, these issues will be considered in a separate OIR." (OIR at 28.)

XIV. Assignment of Proceeding

Geoffrey F. Brown is the Assigned Commissioner and Sarah R. Thomas is the assigned ALJ in this proceeding.

XV. Comments on Draft Decision

The draft decision of Commissioner Chong in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on April 17, 2006 by Aglet, ORA and TURN (filing jointly), CWA, Park Water, SDG&E, PG&E, SCE and the Small LECs.

Aglet makes the technical point that for some assets, group depreciation rules can lead to circumstance where routine retirement and salvage might not result in the assignment of all gains and losses to ratepayers. SCE responds that this is only a hypothetical, and Aglet has proposed no scenario where our rules are either ambiguous or would result in shareholders receiving the gain or loss from depreciable property. We have amended our discussion to indicate that in allocating 100% of the gain or loss from depreciable assets to ratepayers we are not imposing a requirement to change the current allocation practices for these assets or to adopt some new accounting treatment.

Aglet objects to the allocation rules adopted for CIAC property. ORA/TURN join Aglet in this position. As discussed above, we find, however, that § 790 compels our allocation and the comment do not point out any specific error in our reasoning.

More generally, ORA/TURN argue that ratepayers should receive a higher percentage of all gains and losses from the sale of property. ORA/TURN's argument deserves little weight, because it inappropriately minimizes the risks that utilities face in making this argument. ORA/TURN fail to understand that under "test-year ratemaking" a utility assumes many of the risks of operating the business.

Park Water, the California Water Association, and the Small LECs filed comments reasserting their position that the fact of ownership should be the guiding principle for allocating any gains. This argument adds nothing new to our discussion, but we note their continued objection for the record. Moreover, their argument includes multiple factual errors, as identified by SDG&E (Reply Comments, page 3) and SCE (Reply Comments, pages 4-6 and Appendix A).

SDG&E , PG&E, SCE and ORA/TURN continue to support a 100% allocation of all gains and losses from depreciable property to ratepayers as more consistent with general principles of risk and reward. We find this criticism is well taken, and we changed the policy we have adopted and amended the discussion.

On April 24, 2006, Aglet; ORA and TURN (filing jointly); CWA; Park Water; SDG&E; PG&E and SCE filed reply comments.

We have reviewed all the comments and replies. In addition to the comments explicitly addressed in this section, we have amended the decision as we deemed appropriate.

In addition, comments were filed on January 5, 2006 and reply comments were filed on January 17, 2006 on the draft decision of Commissioner Brown. We a discuss these comments as follows.

1. Time In/Out of Rate Base – Who Bears Burden

All parties agree with our conclusion that the time in and out of rate base should affect who receives the gain on sale. If a utility sells property that was for a time in rate base and for the rest of its life out of rate base, the gain on sale allocation we adopt in this decision should only apply to the time in rate base.

However, ORA/TURN ask that we put the burden on the utility to demonstrate when the property was in and out of rate base. We agree that the utility selling the property should bear this burden, and add an ordering paragraph to this effect. Utilities shall bear the burden of proving time out of rate base where there is a gain on sale, and of proving time in rate base where there is a loss on sale.

2. Taxation

ORA/TURN assert that the draft decision errs in its discussion of the effect of taxation on gains and losses. We add language to clarify that gains and losses should be allocated to ratepayers on a net after-tax basis, grossed up to a revenue requirement. Allocating gains and losses to ratepayers on this basis ensures that any tax benefits or detriments that were previously borne by ratepayers are appropriately reflected into the allocated gain or loss amount.

3. Routine Retirements/Salvage of Depreciable Assets

Several parties urge us not to extend our gain on sale formula to routine retirements of depreciable assets. We agree that the rules should apply principally to high value assets such as land, buildings and water rights. Gains or losses of poles, wires, equipment and other materials that utilities routinely retire from service as they wear out and even major assets such as substations and generation plants are already taken care of through normal depreciation accounting mechanisms. Ratepayers receive all gains for the normal retirement of depreciable property through normal depreciation accounting, and also bear the risk of any loss on the retirement, such as when the cost of removal exceeds the depreciated value of the asset (net book value). (This amount is termed the property's "negative salvage value.") Sales transactions of useful utility assets are distinct from, and should be treated differently than, the retirement of depreciable assets that are no longer useful. We do not intend to alter the existing ratemaking treatment of asset retirements n this decision in this decision.

4. At-Risk Activities by Utilities

Several parties urge us not to extend our gain on sale formula to routine retirements of depreciable assets. We agree that the gain on sale rules should apply principally to high value assets such as land, buildings and water rights. Gains or losses of poles, wires, equipment and other materials that utilities routinely retire from service as they wear out and even some gains or losses of major assets, such as substations and generation plants, are already taken care of through normal depreciation accounting mechanisms. Ratepayers receive all gains for the normal retirement of depreciable property through normal depreciation accounting, and also bear the risk of any loss on the retirement, such as when the cost of removal exceeds the depreciated value of the asset (net book value). (This amount is termed the property's "negative salvage value.") Sales transactions of useful utility assets are distinct from, and should be treated differently than, the retirement of depreciable assets that are no longer useful. We do not intend to alter the existing ratemaking treatment of asset retirements in this decision.

5. Cases in Which Gain on Sale Determination Deferred

To the extent we deferred gain on sale determinations for any case not listed in Appendix A to this decision, or finally determined the gain on sale allocation elsewhere, we provide additional guidance. For any case on which we deferred the gain on sale issue – whether listed in Appendix A or not – the general rule set forth in the draft decision shall apply: "The parties bound by this decision shall file Advice Letters within 60 days of this decision's mailing indicating how they will comply with the rules set forth herein for each of those past sales."

We add language indicating that, "Any party objecting to the proposed treatment of any deferred gain on sale determination may file an Advice Letter protest within the normal Advice Letter protest period."

6. Water Issues

a. Developer Contributions in Aid of Construction

Park Water claims that the draft decision errs with regard to the allocation of gains on property that developers contribute to water utilities as part of construction projects. The draft decision correctly concludes that these developer Contributions in Aid of Construction (CIAC) should be covered by § 790. Thus, water utilities must reinvest gains from the sale of such property in water utility infrastructure. They may not pay such proceeds to shareholders (unless the eight-year period set forth in the statute lapses). Utilities may receive a "reasonable rate of return" on such gains, but we defer for future consideration whether such "reasonable rate of return" should be the same amount as it is for other utility property in rate base.

b. Section 851 Requirements

The water companies oppose the draft decision's requirement that they file § 851 applications seeking Commission approval of their sales of property that is no longer used and useful. The draft decision reasons that it should be up to the Commission to verify water companies' claims that the property they are selling is truly no longer useful. It expresses concern that leaving this determination entirely to water companies may allow them to sell property (including water rights) necessary to service without any Commission intervention.

As the draft decision points out, the Commission is currently trialing a program that allows parties seeking to sell property governed by § 851 (used and useful property) to do so by advice letter rather than application. The water companies seek either to be covered by this program, or to be exempted from any review requirement at all.

We are not prepared to exempt water utilities from any filing requirement. It is reasonable to require an entity other than the utility itself – which stands to gain from property sales – to verify that property proposed for sale is no longer used and useful. Section 851 gives us discretion to review such applications. By the same token, we are persuaded that requiring a § 851 application for every sale would be cumbersome.

We modify the decision to require that water companies regulated by this Commission provide 30 days' advance written notice to the Director of the Commission's Water Division, as well as to the Director of ORA (now DRA) when they propose to sell land, water rights, buildings, or all or a portion of a water system that they determine are no longer used or useful. This notice will give the Commission the opportunity to respond to the proposed sale and prevent sales of property that is obviously used and useful.

However, Commission silence in response to the notice should not be interpreted as consent to the sale. At a later time, such as the water company's general rate case, the Commission may nonetheless inquire into the propriety of water company asset sales.

We acknowledge that we are requiring that water companies to provide notice that we do not require of other utilities. We believe that the different treatment of water utility gains on sale under § 790 justifies this result. Because all proceeds under § 790 go to the utility – rather than its ratepayers – water companies may be more eager to sell property than they otherwise should. A notice requirement at least gives the Commission the opportunity to review such sales in advance.

c. Condemnation

The water companies challenge our assertion that condemnations are not covered by § 790. We defer this issue for further input.

Findings of Fact

1. Certain parties described herein should be dismissed from the proceeding: SBC/Pacific Bell, Verizon California, SureWest, Frontier, Wild Goose Storage and Lodi Gas Storage.

2. Depreciable assets for purposes of this decision include, but are not limited to, buildings, equipment, machinery, materials and vehicles.

3. Non-depreciable assets for purposes of this decision include, but are not limited to, land, water rights and goodwill.

4. A utility receives a gain on sale when it sells an asset such as land, buildings or other tangible or intangible assets at a price higher than the acquisition cost of the non-depreciable asset or the depreciated book value of the depreciable asset.

5. Depreciable and non-depreciable assets are treated differently when determining whether there is a monetary gain from the sale of these assets.

6. It is reasonable to distinguish routine depreciable property used in the provision of utility service, such as transmission poles, which are subject to routine retirement and salvage from other depreciable assets, such as office buildings. Most commonly, the gain or loss from the disposal of depreciable property used in the provision of utility service is accrued into USOA Account 108

7. Land, water rights and goodwill are not depreciable because they do not wear out and need not be replaced, unlike buildings, machinery or other depreciable assets. Ratepayers bear costs associated with a non-depreciable asset because the entire cost of the asset is put into rate base and the shareholder receives a return on that amount for as long as the asset is in rate base. Ratepayers also pay for carrying costs such as maintenance, taxes, insurance, administrative costs and interest expense for the asset.

8. We cannot anticipate in advance all types of losses for which we should conduct a case-by-case analysis.

9. Ratepayers compensate utilities for costs related to assets dedicated to utility use.

10. The percentage allocations we adopt here for depreciable and non-depreciable property ensure mitigation of the risks we acknowledge shareholders face in holding property.

11. Rewards should go to those who bear the actual costs and burdens of the risks engendered by particular economic actions.

12. Many of the risks the utilities raise in their comments relate generally to the risks of being in the utility business and holding utility-related assets such as land, buildings and other utility assets. Specific utility assets share in these risks.

13. The gain on sale calculus should take into account extraordinary risks such as the recent California energy crisis. The crisis demonstrates that the capital provided by shareholders to finance electric utilities' ownership of land, buildings or other assets incurs significant market, regulatory, and financial risks.

14. The risks utilities and their ratepayers face should determine the gains allocation outcome.

15. Generalized risks affect the market value of the utility's stock and the allowable rate of return assigned by the Commission in the utilities' cost of capital proceedings. On average, this compensates utility owners for most routine risks arising from the ownership of a utility.

16. Forecasts of costs may understate true costs in a given year, and forecasts of revenues may overstate actual revenues in a given year. These risks are part of the routine risks that accrue to the owners of a utility.

17. Ratepayers bear the risk that forecasts will overstate needed utility rates of return in a given year.

18. The Commission often allows utilities to true up their forecasts with their actual costs.

19. Utilities acquire depreciable and non-depreciable assets to serve their utility customers with the understanding that they will place the assets in rate base and be compensated with a reasonable rate of return. Ratepayers will cover the utilities' operational costs (maintenance, repairs, depreciation where applicable, taxes and other carrying costs). Utilities are guaranteed customers and a revenue stream in the form of rates.

20. Landlords operate in a competitive market. In such markets, customers are not captive to the monopoly and may move away. The market, not the

regulator, determines rental prices. The apartment owner is at risk of losing his investment, or at least not covering his full costs, due to loss of customers or falling rental prices, which are both beyond his control. A landlord's property may remain vacant in times of slack demand, so the property owner has no guaranteed stream of revenue. The whims of the market control the value of a landlord's investment.

21. The terms under which utilities and private property owners operate are different. A utility acquires property dedicated to public use, and receives a rate of return and payment for maintenance and repair.

22. Ratepayers do not hold legal title to utility property by virtue of bearing costs related to the property.

23. The large IOUs agree that 100% of gains/losses from depreciable property sales should be allocated to ratepayers.

24. The allegation that original cost is the upper bound of the losses ratepayers face does not and should not mean that the gains to which they are entitled should be limited to original cost as well.

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

26. Ratepayer ownership of property is not necessary in order for ratepayers to be entitled to some of the gains on sale.

27. In general, the USOA is not determinative of the proper allocation of gains on sale.

28. The USOA dictates how utilities maintain their accounts for regulatory purposes. It ensures uniform accounting policies across utilities.

29. The Commission has consistently maintained that the accounting provisions contained in the USOA are not controlling as to the ratemaking policies which this Commission may determine to be reasonable and necessary.

30. The FERC adopted USOA is really a record keeping system, and is not a ratemaking treatise that is controlling on how to allocate the gain on sale.

31. We have held in connection with energy, water and telecommunications asset sales that the USOA is not determinative of how to allocate gains on sale.

32. We have no evidence that stock and bondholders rely on the USOA for gain on sale allocation.

33. Given our long line of cases holding that the USOA accounting categories should not determine ratemaking allocations such as gain on sale, it would be unreasonable for investors to assume that the USOA would determine gain on sale allocations.

34. Taxes reduce or alter the amount of gains and losses available for allocation to shareholders and ratepayers.

35. Setting the "major facility" definition too high for purposes of Pub. Util. Code § 455.5 could cause significant ratepayer harm.

36. We do not have an adequate record on how to define a "major facility" in § 455.5, but we believe the term should be defined based on the size of the utility.

37. We also do not have an adequate record on how to define "portion" of a major facility.

38. Issues regarding interpretation of Pub. Util. Code § 851 are by and large outside the scope of this proceeding.

39. The parties do not offer a consistent definition of term "abandoned plant."

40. Water utility regulation is unique because there is a specific statute governing gain on sale allocation, the Infrastructure Act.

41. The April 5, 1995, analysis provided for the California Senate floor when it was considering passage of the Infrastructure Act explained that the statute was designed to ensure uniform allocation of gains on sale and to limit Commission discretion in allocating such gains.

42. In enacting the Infrastructure Act, the Legislature was attempting to create a uniform standard that would flow all gains on the sale of no longer used and useful water utility real property back to the owners for the specified use of improvements in infrastructure and then after a period of years, the proceeds would be allocated to ratepayers.

43. Settlement proceeds paid to water utilities in connection with contamination of water supplies do not involve sales of real property, so the Infrastructure Act does not apply. Nor are such proceeds gains on sale. Thus, such proceeds are outside the scope of this proceeding.

Conclusions of Law

1. Where a utility incurs unusual or catastrophic losses from sale of a depreciable or non-depreciable asset, any party should be able to request that we analyze the loss on a case-by-case basis.

2. Incidence of risk is a reasonable determinant of how to allocate gains and losses on sale.

3. The Commission has discretion to adopt a gain or loss allocation methodology consistent with statutory authority and judicial precedent.

4. In routine sales of depreciable assets, ratepayers should receive 100% of the gain or loss.

5. In routine sales of non-depreciable assets, ratepayers should receive 50% of the gain or loss and shareholders should receive 50% of the gain or loss.

6. For utility depreciable property subject to routine retirement and salvage and for which gains or losses are typically accrued into USOA Account 108, 100% of the gain or loss should accrue to ratepayers.

7. Gain on sale rules should consider the possibility of extraordinary losses to fully assess the risks related to holding utility assets. Failure to do so is unreasonable.

8. The risk-based calculus should consider forecast risk.

9. We should continue to apply the principles of our *Redding II* decision in the narrow circumstances to which they were designed to apply. Thus, where (1) a public utility sells a distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system.

10. We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope.

11. We have no basis to return to the ratepayer indifference test we adopted in D.90-04-028 – and promptly rejected within the year in D.90-11-031.

12. Ratemaking bodies are not legally required to give utility shareholders a rate of return based on the "present fair value" of utility property. The utility is not entitled of right to have its rate base established at the value that the assets would command on the current market, although that market value exceeds original cost.

13. Our *Suburban Water Company* decision found that original cost ratemaking did not support allocation of the gain to ratepayers in a narrow circumstance. In granting the gain on sale to shareholders, the Commission made clear that the holding was limited to that case only, and should not serve as precedent.

14. Good regulatory policy suggests that we set the shareholder portion of gain on sale at a level sufficient to achieve prudent property management.

15. Gains or losses from property that is partially in rate base and partially out of rate base should be allocated proportionately to the percentages in and out of rate base. Utilities should bear the burden of proving the time an asset was out of rate base if there is a gain on sale, and the time the asset was in rate base if there is a loss.

16. Pub. Util. Code § 455.5 does not require that sales of major facilities be barred or voided if the utility fails to meet its reporting requirements under that provision.

17. Electric utilities should allocate gains on sale of transmission property according to the FERC rules, rather than the rules we develop here.

18. It is appropriate in most cases to allocate gains or losses on property held out of rate base to shareholders. Where property is never in rate base, all gains or losses should accrue to shareholders.

19. The Infrastructure Act limits Commission discretion in how it allocates gains on sale for water utilities.

20. The term "abandoned plant" refers specifically to investments in preoperational assets the never become used and useful and thus have never entered rate base.

21. To interpret statutory language, courts can consider the intent of the legislature when determining the purpose of a law. Thus, it may be appropriate to examine the legislative analysis to determine what the Legislature intended in enacting the Infrastructure Act.

22. Water utilities must invest net proceeds from the sale of formerly used and useful water utility real property in new water infrastructure. They need not refund such proceeds to ratepayers, but they may not pay the funds out to shareholders in the form of dividends or other earnings either.

23. The Commission has exclusive authority to determine the used, useful, or necessary status of any and all water utility infrastructure improvements and investments.

24. Any water utility property that a utility disposes of that does not meet the Infrastructure Act's three criteria: (1) that an asset be sold; (2) that it no longer be used and useful; and (3) that it be real property - shall be accounted for in accordance with our general percentage allocations.

25. Regarding developer contributions of water infrastructure in aid of construction, absent special agreements between the developers that might bind water companies to a different result, water companies should invest such proceeds in new water infrastructure. The proceeds must result from a sale of formerly used and useful real property, because the statute only applies to such property. Water companies may earn a reasonable rate of return on the infrastructure the gains purchase, but we defer to a future proceeding the

question of whether a reasonable rate of return should be the same for CIAC property as for other water utility property.

26. Only if the water company fails to make such investment within the statutory eight-year period should the proceeds revert to ratepayers.

27. Water utilities may not pay out sales proceeds in dividends or other profit to shareholders. Rather, they must place the proceeds in a memorandum account approved by the Commission and meet the other tracking requirements we imposed in D.03-09-021 and reiterate here.

28. We should impose certain reporting and application requirements to ensure that water companies act in compliance with § 790 and invest sales proceeds from formerly used and useful utility property into new infrastructure.

29. Because the Infrastructure Act may incent water companies to sell used and useful property prematurely, safeguards against "churning" are appropriate.

30. We will require that water companies provide the Director of the Water Division of the Division of Ratepayer Advocates 30 days' advance written notice whenever they plan to sell land, buildings, water rights, or all or part of a water system. This notice requirement applies to water company assets that are used and useful and assets the company believes are no longer used and useful. The 30 days' advance notice will give the Commission an opportunity to assess whether companies are selling off key portions of their asset base. Notice will not preclude later review of such sales in a water company's GRC or a later proceeding. The notice shall include the following heading in at least 16 point bold type: "Notice under Rulemaking 05-06-040. Commission staff must respond within 30 days." The notice must include the name, address, phone and email address of the potential purchaser(s). If the Commission staff objects to the proposed sale, it may send an objection in any form to the seller and proposed

purchaser(s). Mailing of such an objection shall prevent the proposed purchaser from claiming it is a bona fide purchaser of the property at issue until the issues raised in the objection are resolved.

31. Our default rule relating to gains on sale shall apply to water utility sale assets, except where the asset sold is real property that is no longer used and useful. In the latter instance, the proceeds shall be reinvested in accordance with the Infrastructure Act.

32. The rules we develop here should apply to after-tax gains and losses.

O R D E R

IT IS ORDERED that:

1. Except as noted below, utility ratepayers shall receive 100% of gains or losses on sale of depreciable utility assets Ratepayers shall receive 50% of the gains or losses on the sale of non-depreciable utility assets. The utilities' shareholders shall receive the remaining 50% of gains or losses on the sale of non-depreciable assets. We will call the allocations in this ordering paragraph the "percentage allocation rule."

2. Non-depreciable assets for purposes of this decision include, but are not limited to, land, water rights and goodwill.

3. The percentage allocation rule applies to routine asset sales where the sale price is $50 million or less and the after-tax gain or loss from the sale is $10 million or less.

4. The percentage allocation rule does not apply where the asset sale price exceeds $50 million or the after-tax gain or loss exceeds $10 million.

5. The percentage allocation rule does not automatically apply to the following situations: sales of assets that are extraordinary in character; sales of

nuclear power plants; where a party alleges the utility engaged in highly risky and non-utility-related ventures; or where a party alleges the utility grossly mismanaged the assets at issue.

6. Where a utility or other party believes assets are extraordinary in character, or where losses result where there are allegations of highly risky, non-utility-related ventures or gross utility mismanagement, the utility or party may ask us to except the transaction from our general rule. The Commission will determine how to evaluate cases where a utility or party requests an exception.

7. We do not expect many cases to fall into the "exception" categories noted in the previous two paragraphs.

8. If an asset causes a utility an after-tax loss greater than $50 million, the utility shall automatically seek case-by-case determination of how to allocate the loss. In cases involving losses of $50 million or less, the utility may seek allocation of the loss according to the allocation percentage rules we adopted here. If any party, including ORA, contends that the Commission should allocate the loss, in whole or part, to utility shareholders, the party should seek case-by-case treatment in a protest to the utility application.

9. We will continue to apply the principles of our *Redding II* decision, Decision 89-01-016, 32 CPUC 2d 233 (1989), in the narrow circumstances to which they were designed to apply. Thus, where (1) a public utility sells a distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the

sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system.

10. We do not have an adequate record on which to define "major facility" under § 455.5. We also do not have an adequate record on how to define "portion" of a major facility. The parties shall file comments in this regard within 90 days of the effective date of this decision, and may file reply comments within 30 days of receipt of the opening comments. Before filing such comments, all non-telecommunications parties who filed comments shall meet and confer in an attempt to reach agreement on standard definitions of major facilities based on utility size. The parties shall report the results of their meet and confer session to the assigned administrative law judge before filing comments. At a minimum, parties shall assume that the following rules will govern their negotiations and/or written proposals: (1) The statute applies only to electrical, gas, heat or water corporations' generation or production facilities. The parties should try to agree upon a common definition of "generation" and "production" that is based on either the USOA or another rational interpretation of the terms. (2) The statute applies to facilities as well as portions of facilities.

11. Interpretation of Pub. Util. Code § 851 is by and large beyond the scope of this proceeding.

12. Electric utilities shall allocate gains on sale of transmission property according to the rules of the Federal Energy Regulatory Commission rules, rather than the rules we develop here. This conclusion is not intended to be a general one with respect to this Commission's jurisdiction over transmission issues.

13. We adopt a rebuttable presumption regarding allocation of gains on sale for property that has moved in and out of rate base over time. An applicant (or

other party) may assume that the gain allocable to shareholders directly mirrors the time the property was out of rate base. Thus, for example, if the property is in rate base for 20 years and out of rate base for 20 years, shareholders should receive 50% of the gain/loss, and the remainder should be allocated according to the percentage allocation rule applicable to property in rate base. However, if there is evidence that demonstrates that most of the property's appreciation (or depreciation) occurred while the property was in (or out of) rate base, evidence of such variance may be submitted to rebut the presumption. In all cases, the utility bears the burden of proving the assets time in and out of rate base. Where there is a gain on sale, the utility bears the burden of proving time out of rate base, and when there is a loss, the utility bears the burden of proving time in rate base.

14. A special rule allocating gains on sale from "abandoned plant" is not warranted.

15. Water companies shall use the gains on sale from sales of formerly used and useful utility real property to invest in new water infrastructure. These proceeds may not be used to reduce rates or otherwise be returned to ratepayers unless the water companies fail to reinvest the proceeds within the eight-year period contained in the Water Utility Infrastructure Act of 1995, Pub. Util. Code § 789 *et seq.* (Infrastructure Act).

16. Because the Infrastructure Act may give water companies incentives to sell used and useful real property prematurely, safeguards against "churning" are appropriate. All water utilities we regulate shall comply with the following requirements in accordance with the Infrastructure Act:

> Track all utility property that was at any time included in rate base and maintain sales records for each property that was at

any time in rate base but which was subsequently sold to any party, including a corporate affiliate.

Obtain Commission authorization to establish a memorandum account in which to record the net proceeds from all sales of no longer needed utility property.

Use the memorandum account fund as the utility's primary source of capital for investment in utility infrastructure.

Invest all amounts recorded in the memorandum account within eight years of the calendar year in which the net proceeds were realized.

17. We will take up claims regarding Proposition 50 funds and other government bond funds, including how to allocate gains on sale, in our Proposition 50 proceeding, Rulemaking (R.) 04-09-002, or in such proceedings as the Commission designates for consideration of such funds.

18. Water companies shall provide the Director of the Water Division and the Director of the Division of Ratepayer Advocates 30 days' advance written notice whenever they plan to sell land, buildings, water rights, or all or part of a water system. This notice requirement applies to water company assets the company believes are no longer used and useful. The 30 days' advance notice will give the Commission an opportunity to assess whether companies are selling off key portions of their asset base. Notice will not preclude later review of such sales in a water company's GRC or a later proceeding. The notice shall include the following heading in at least 16 point bold type: "Notice under Rulemaking 05-06-040. Commission staff must respond within 30 days." The notice must include the name, address, phone and email address of the potential purchaser(s). If the Commission staff objects to the proposed sale, it may send an

objection in any form to the seller and proposed purchaser(s). Mailing of such an objection shall prevent the proposed purchaser from claiming it is a bona fide purchaser of the property at issue until the issues raised in the objection are resolved.

19. Our percentage allocation default rule relating to gains on sale shall apply to water utility sale assets, except where the asset sold is real property that is no longer used and useful. In the latter instance, the proceeds shall be reinvested in accordance with the Infrastructure Act.

20. Water companies may earn a reasonable rate of return on real property purchased with gains on sale from sales of developer contributions in aid of construction (CIAC). We defer for future consideration the question whether "reasonable rate of return" on reinvested gain from the sale of CIAC property should be the same as (or different from) the rate of return the water utility earns on other property.

21. The parties bound by this decision shall file Advice Letters within 60 days of this decision's mailing indicating how they plan to comply with the rules set forth herein for each of the past asset sales (if deferred to this proceeding and listed in Appendix A to this decision), and any other asset sales on which the Commission deferred a decision regarding allocation of gains or losses on sale. Any party objecting to the proposed treatment of any deferred gain on sale determination may file an Advice Letter protest within the normal Advice Letter protest period.

22. We dismiss Pacific Bell Telephone Company, dba SBC California, Verizon California Inc., SureWest Telephone, and Citizens Telecommunications Company from this proceeding so that the Commission may address their gain

on sale issues in R.05-04-005. All other telecommunications carriers the Commission regulates are bound by this decision.

23. We dismiss Wild Goose Storage Inc. and Lodi Gas Storage, L.L.C. from this proceeding because they are largely unregulated by this Commission.

24. The rules we develop here shall apply to after-tax gains and losses.

25. This decision does not apply to routine retirements of minor utility assets that are no longer used and useful such as utility poles, transformers, and vehicles, which are governed by other Commission depreciation rules and schedules.

This order is effective today.

Dated ____________________________, at San Francisco, California.