

DRAFT

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA
ENERGY DIVISION

I.D.# 6784
RESOLUTION G-3399
July 26, 2007

R E S O L U T I O N

Resolution G-3399. Southern California Gas Company and San Diego Gas and Electric Company file for approval of their methods to allocate the gains from the sale of assets pursuant to Decision (D.) 06-05-041. The utilities use an incorrect formula in these methods. These advice letters are approved except for the incorrect formula. The utilities are instructed to supplement the advice letters using the correct formula as specified herein.

**By SoCal Gas Advice No. 3642 and SDG&E Advice Letter 1804-E/
1623-G filed on June 30, 2006**

SUMMARY

D.06-05-041 (the Decision), as modified by D.06-12-043, established guidelines for the allocation of gains and losses whenever certain electric, gas, telecommunications and water utilities sell an asset. The Decision required the parties bound by it to file with this Commission within 60 days to show how they plan to comply with the rules set forth by the Decision. Southern California Gas Company (SoCal Gas) and San Diego Gas and Electric Company (SDG&E) filed advice letters describing the methodologies they plan to apply to the allocation of these gains. We find that these methodologies are flawed; specifically, their method for grossing-up the ratepayer share of the allocation for taxes is incorrect. We approve the advice letters except for this incorrect formula. The utilities are instructed to supplement the advice letters using the correct formula as specified herein.

These advice letters were protested by the Commission's Division of Ratepayer Advocates (DRA). The protests each made two identical points; the protests are granted on one point, and are held moot on the other.

BACKGROUND

SoCal Gas and SDG&E filed advice letters pursuant to D.06-05-041 proposing a methodology to allocate the after tax gain or loss on the sale of assets between ratepayers and shareholders. They use an incorrect formula to adjust these allocations for the effect of taxes.

Rulemaking (R.)04-09-003, filed September 2, 2004, reviewed and considered policies and guidelines regarding the allocation of gain from sales of certain energy, telecommunications, and water utility assets. D.06-05-041 established those policies and guidelines, providing that, in most cases, utility ratepayers should receive 100% of the gain from the sale of depreciable property such as buildings. The gain from non-depreciable property, such as land and water rights, should be split between ratepayers and shareholders on a 50-50 basis. In response to an Application for Rehearing filed by DRA and The Utility Reform Network (TURN), the Commission issued D.06-12-043 which modified this percentage allocation rule for non-depreciable assets to 67% of gains or losses to ratepayers and 33% to shareholders.

The Commission has approved several sales of assets by the utilities, but on some of these the Commission has deferred a decision regarding the disposition of the gains or losses. Ordering Paragraph (OP) 22 of D.06-05-041 required the “parties bound by this decision” to file within 60 days their plans to comply with the rules and policies established by the Decision for such sales. SoCal Gas filed Advice No. 3642 (AL 3642) on June 30, 2006, which submitted a plan for the allocation of after tax gains or losses associated with the sale of 36 lots at Playa del Rey and Marina del Rey. SoCal Gas also proposed to modify its Preliminary Statement, introducing Part XII, its Gain/Loss on Sale Mechanism (GLOSM) which replaces its Gain on Sale Memorandum Account (GOSMA).

SDG&E filed Advice Letter (AL) 1804-E/1632-G, also on June 30, 2006, which proposed to discontinue its Harbor/Harborside Gain on Sale Memorandum Account (HGOSMA) and create the Gain/Loss on Sale Memorandum Account (GLOSMA) to record the ratepayer’s allocation of any after tax gains or losses derived from future sales of its assets.

NOTICE

SoCal Gas states that AL 3642 was served on parties in R.04-09-003 and Application (A.)99-05-029. SDG&E states that AL 1804-E/1632-G was served on parties in R.04-09-003, and parties on its service list developed in accordance with Section III of General Order 96-A.

PROTESTS

DRA protested SoCal Gas's and SDG&E's advice letters on the grounds that they are premature and that the methods proposed by the utilities to allocate the gain or loss are incorrect.

These advice letters were protested by DRA on July 20, 2006. DRA made two arguments in its protests:

1. The advice letters were premature as there was an outstanding Application for Rehearing, filed by DRA and The Utility Reform Network (TURN), regarding D.06-05-041.
2. The mechanism proposed by the utilities to allocate the gain or loss is incorrect. Specifically, the formula used to "gross-up" the ratepayer portion of the gain to account for the effect of taxes was argued to be incorrect. The utility proposed to use a gross-up factor of

$$\frac{1}{1-rt}$$

where r is the ratepayer percentage share of the monies to be allocated, and t is the composite income tax rate. This is in contrast to the formula used by other utilities¹ for this purpose:

$$\frac{1}{1-t}$$

¹ For example, see PG&E Advice 2746-G-B/2866-E-B, Attachment 2.

DRA argued that there is nothing in the decision that supports the formula proposed by SoCal Gas and SDG&E.

No other parties protested these advice letters.

SoCal Gas and SDG&E replied to DRA's protest and assert that their filings were not premature, and that their proposed methods for allocating gains and losses is proper. The joint response was filed on July 27, 2006, making the following points:

1. According to SoCal Gas and SDG&E, an application for rehearing "should not prevent or delay implementation of" the advice letters, and point to Rule 86 of the Commission's Rules of Practice and Procedure, which says the "[m]ere filing of an application for rehearing shall not excuse compliance with an order or decision."² The utilities also point to Sec. 1735 of the Public Utilities Code which states "[a]n application for rehearing shall not excuse any corporation or person from complying with and obeying any order or decision..."

We note that the Rule and PU Code Section cited by SoCal Gas and SDG&E in their reply to DRA's protest refer to compliance by the utility and not to actions by other parties wishing to delay such compliance. Also, the application for rehearing did not stay the compliance filings, nor did the Commission otherwise stay the filings, further suggesting that the compliance filings were not premature. Nevertheless, we do not decide this issue here, as the Commission acted on the application on December 14, 2006, in D.06-12-043, making this portion of DRA's protest moot.

2. The utilities assert that the formula proposed by SoCal Gas and SDG&E "is proper, and consistent with the similar methods previously adopted by the Commission." SoCal Gas and SDG&E point to the gross-up formula they have used since the adoption of Performance Based Ratemaking (PBR) by the Commission (A.92-10-017 for SDG&E and A.95-06-002 for SoCal Gas).

² Note that Rule 86 was replaced with Rule 16.1 when the Commission revised its Rules in September 2006.

It is the second issue, i.e. the appropriate gross-up formula to apply to the ratepayer portion of the allocation, that we decide in this Resolution.

DISCUSSION

Gains and losses shall be allocated to ratepayers on a net after-tax basis, grossed up to a revenue requirement. SoCal Gas and SDG&E shall file supplements to their advice letters reflecting the formula required by this Resolution.

D.06-05-041 states that “gains and losses should be allocated to ratepayers on a net after-tax basis, grossed up to a revenue requirement.” (p. 83, mimeo) The formula that is needed to gross-up the after tax gain to a revenue requirement can be derived as follows:

1. Let π represent the gain from sale of an asset, after all appropriate costs of the sale have been deducted. Note that π can be a negative number (loss).
2. Let t represent the appropriate income tax rate, usually combining both the federal and state income taxes.³
3. Let r represent the ratepayers’ share of the gain (e.g., 67% per D.06-12-043).
4. It is then true that the after tax gain is $(1-t)\pi$.
5. The ratepayers’ share of the after tax gain, before gross-up, is $r(1-t)\pi$.
6. The shareholders’ share of the after tax gain, before gross-up, is $(1-r)(1-t)\pi$.

³This is a simplification of the tax component of this factor. Often the tax rate includes not only income taxes, but also a rate for uncollectibles, franchise fees, and sometimes a superfund tax.

Derivation of the formula using the ratepayer share of the gain.

Ratepayers receive their portion of the gain through a subsequent decrease in the utility's revenue requirement, and therefore through lower rates. Lower rates decrease the income to the utility, lowering the tax burden. This lower tax burden is the reason for the gross-up calculation. Let g be the factor by which the ratepayer share is multiplied to determine the grossed-up amount (which we will call GU). Then:

$$7. \quad gr(1-t)\pi \equiv GU$$

GU is the amount that the revenue requirement is decreased due to the gross-up. This decrease is then reflected in rates. Multiplying GU by the tax rate gives the tax benefit (the amount by which income tax liability decreases when the revenue requirement, and thus income, is decreased by GU):

$$8. \quad tgr(1-t)\pi \equiv \text{tax benefit}$$

The difference between the grossed-up amount, which goes to ratepayers, and the tax benefit, which goes to shareholders, should be the original ratepayer share (from #5, above):

$$9. \quad GU - \text{tax benefit} = \text{ratepayer share}$$

Said another way, the sum of the original ratepayer share and the tax benefit should be the entire grossed-up amount.

Substituting from #5, #7 and #8 into #9, we get:

$$10. \quad gr(1-t)\pi - tgr(1-t)\pi = r(1-t)\pi$$

Solving this equation for g , the gross-up factor, yields

$$11. \quad g = \frac{1}{1-t}$$

This is the appropriate gross-up factor to be used when allocating the gain or loss from the sale of an asset.

Derivation using the shareholder portion of the gain.

This formula can also be derived using the shareholder portion of the gain. It is true that shareholders keep the tax benefit as well as the entire after tax gain, but they give the grossed-up amount to the ratepayers. Algebraically, using #8, #4, #7, and #6, above, we have:

$$12. \quad tgr(1-t)\pi + (1-t)\pi - gr(1-t)\pi = (1-r)(1-t)\pi$$

In other words, the sum of the tax benefit and the total after tax gain, less the grossed-up amount given to ratepayers, should equal the shareholder portion of the gain. Rearranging these terms gives:

$$13. \quad tgr(1-t)\pi - gr(1-t)\pi = (1-r)(1-t)\pi - (1-t)\pi$$

Solving for g , the gross-up factor, gives us the same formula we derived above in 11:

$$14. \quad g = \frac{1}{1-t}$$

SoCal Gas's proposal

SoCal Gas proposes to use a variant of this gross-up factor, call it g' , so that

$$15. \quad g' = \frac{1}{1-rt}$$

where, from #3, r is the ratepayer allocation share.

A simple numerical example might clarify the difference in the effect on the allocation of the gain when using these two factors. Assume that the monies to be shared is \$50 million before tax, the tax rate is 40%, and that the Commission has determined that these monies are to be shared 50-50 between shareholders and ratepayers. Using our notation from #1-6 on page 5, above, we have:

$$\text{Tax rate} = t = .4$$

$$\text{After tax monies to be shared} = (1 - t)(\$50\text{million}) = .6(\$50\text{million}) = \$30\text{million}$$

$$\text{Ratepayer share before gross-up} = (.5)(\$30\text{million}) = \$15\text{million}$$

$$\text{Gross-up factor} = g = \frac{1}{1-t} = \frac{1}{.6} \approx 1.667$$

$$\text{Total gross-up} = 1.667(\$15\text{million}) = \$25\text{million}$$

If we instead use SoCal Gas's proposed gross-up factor, we get:

$$\text{Gross-up factor} = g' = \frac{1}{1-rt} = \frac{1}{1-.5(.4)} = \frac{1}{.8} = 1.25$$

$$\text{Total gross-up} = 1.25(\$15\text{million}) = \$18.75\text{million}$$

In this example, the gross-up is reduced by \$6.25 million, or 25%, by using SoCal Gas's proposed factor.

SoCal Gas claims that its proposed gross-up factor is derived from the Commission's PBR decision D.94-08-023. We find no such formula derived in this decision. However, whether or not this is a correct interpretation of the decision is not determined here. We note that D.94-08-023 imposes constraints upon the allocation of sharable monies not found in D.06-05-041. For instance, D.94-08-023 requires the tax benefit be shared between ratepayer and shareholder in proportion to the appropriate allocation percentages, and that the total monies received by ratepayer and shareholder be in that proportion after the gross-up. We did not put these additional conditions in D.06-05-041.

SoCal Gas shall supplement Advice No. 3642 and SDG&E shall supplement Advice Letter 1804-E/1632-G to replace these advice letters and reflect the correct gross-up mechanisms, as specified above.

COMMENTS

Public Utilities Code section 311(g)(1) provides that draft Resolutions generally must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this

30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this Resolution was neither waived nor reduced. Accordingly, this draft Resolution was mailed to parties for comments, and will be placed on the Commission's agenda no earlier than 30 days from the date it was mailed.

FINDINGS

1. Rulemaking (R.)04-09-003, filed September 2, 2004, reviewed and considered policies and guidelines regarding the allocation of gain from sales of certain energy, telecommunications, and water utility assets.
2. D.06-05-041 (the Decision), as modified by D.06-12-043, established those policies and guidelines, providing that, in most cases, utility ratepayers should receive 100% of the gain from the sale of depreciable property such as buildings. The gain from non-depreciable property, such as land and water rights, should be split between ratepayers and shareholders on a 67-33 basis.
3. Ordering Paragraph (OP) 22 of D.06-05-041 required the "parties bound by this decision" to file within 60 days their plans to comply with the rules and policies established by the Decision for sales for which the Commission has deferred a decision regarding the allocation of gains.
4. SoCal Gas filed Advice No. 3642 on June 30, 2006, which submitted a plan for the allocation of after tax gains or losses associated with the sale of 36 lots at Playa del Rey and Marina del Rey. SoCal Gas also proposed to modify its Preliminary Statement, introducing Part XII, its Gain/Loss on Sale Mechanism (GLOSM) which replaces its Gain on Sale Memorandum Account (GOSMA).
5. SDG&E filed Advice Letter 1804-E/1632-G, also on June 30, 2006, which proposed to discontinue its Harbor/Harborside Gain on Sale Memorandum Account (HGOSMA) and create the Gain/Loss on Sale

Memorandum Account (GLOSMA) to record the ratepayer's allocation of any after tax gains or losses derived from future sales of its assets.

6. On July 20, 2006, the Commission's Division of Ratepayer Advocates (DRA) protested SoCal Gas's and SDG&E's advice letters, stating that the advice letters are premature, and the proposed gross-up mechanism is incorrect.
7. SoCal Gas and SDG&E filed a joint reply to DRA's protest on July 27, 2006.
8. As we have acted on the Petition to Modify D.06-05-041 with D.06-12-043, the argument that the advice letters are premature is now moot.
9. SoCal Gas and SDG&E argued in their reply to DRA's protest that the formula proposed by the utilities "is proper, and consistent with the similar methods previously adopted by the Commission." The utilities point to the gross-up formula they have used since the adoption of Performance Based Ratemaking (PBR) by the Commission (A.92-10-017 for SDG&E and A.95-06-002 for SoCal Gas).
10. D.06-05-041 states that "gains and losses should be allocated to ratepayers on a net after-tax basis, grossed up to a revenue requirement." (p. 83, mimeo)
11. Ratepayers receive their portion of the gain through a decrease in the utility's revenue requirement, and therefore through lower rates. Lower rates decrease the income to the utility, lowering the tax burden. This lower tax burden is the reason for the gross-up calculation.
12. The correct formula to use to gross-up the ratepayer share of the gain is:
$$g = \frac{1}{1-t}$$
 where t is the combined income tax rate.
13. SoCal Gas and SDG&E propose to use a variant of this gross-up factor, call it g' , so that

$$g' = \frac{1}{1-rt}$$
 where r is the ratepayer allocation share.

14. SoCal Gas and SDG&E claim that their proposed gross-up factor is derived from the Commission's PBR decision D.94-08-023. We find no such formula derived in this decision.
15. Whether or not SoCal Gas's and SDG&E's interpretation of D.94-08-023 is correct is not determined here.
16. SoCal Gas should supplement Advice No. 3642 and SDG&E should supplement Advice Letter 1804-E/1632-G to reflect the correct gross-up mechanisms, as specified above.
17. This Resolution should be effective today.

THEREFORE IT IS ORDERED THAT:

1. SoCal Gas shall supplement Advice No. 3642 and SDG&E shall supplement Advice Letter 1804-E/1632-G to reflect the correct gross-up mechanisms, as specified above. Both supplements shall be submitted to the Commission's Energy Division within 10 days of the effective date of this Order. The advice letters, supplemented as required by this order, shall be effective on today's date subject to the Energy Division determining that it is in compliance with this Resolution.
2. This Resolution is effective today.

Resolution G-3399
SoCal Gas Advice No. 3642
SDG&E AL 1804-E/1623-G/JEF

DRAFT

July 26, 2007

I certify that the foregoing Resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on July 26, 2007; the following Commissioners voting favorably thereon:

Paul Clanon
Executive Director

June 26, 2007 Commission Meeting Date: July 26, 2007
I.D.# 6784

TO: Parties to SoCal Gas Advice No. 3642 and SDG&E Advice
Letter 1804-E/1623-G

Enclosed is draft Resolution G-3399 of the Energy Division. It addresses the filings of SoCal Gas and SDG&E in compliance with D.06-05-041, as modified by D.06-12-043, which established guidelines for the allocation of gains and losses whenever certain electric, gas, telecommunications and water utilities sell an asset. These filings proposed methodologies which we find to be flawed; specifically, their method for grossing up the ratepayer share for taxes is incorrect. The draft Resolution will be on the agenda at the July 26, 2007 Commission meeting. The Commission may then vote on this draft Resolution, or it may postpone a vote until later.

When the Commission votes on a draft Resolution, it may adopt all or part of it as written, amend, modify or set it aside and prepare a different Resolution. Only when the Commission acts does the Resolution become binding on the parties.

Parties may submit comments on the draft Resolution.

An original and two copies of the comments, with a certificate of service, should be submitted to:

Honesto Gatchalian
Energy Division
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Fax: 415-703-2200; JNJ@CPUC.CA.GOV

A copy of the comments should be submitted on the same day by electronic mail in Microsoft Word to Jack Fulcher in the Energy Division at: jef@cpuc.ca.gov

Any comments on the draft Resolution must be received by the Energy Division by July 16, 2007. Those submitting comments must serve a copy of their comments on 1) the entire service list attached to this letter, 2) all Commissioners, 3) the Chief Administrative Law Judge, and the General Counsel on the same date that the comments are submitted to the Energy Division. Comments may be submitted electronically.

*Draft Resolution G-3399
SoCal Gas Advice No. 3642
and SDG&E Advice Letter 1804-E/1623-G*

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Comments shall be limited to fifteen pages in length, and shall list the recommended changes to the draft Resolution. Comments shall focus on factual, legal or technical errors in the proposed draft Resolution. Comments that merely reargue positions taken in the advice letter or protests will be accorded no weight and are not to be submitted.

Replies to comments on the draft Resolution may be submitted (i.e. received by the Energy Division) on July 23, 2007, and shall be limited to identifying misrepresentations of law or fact contained in the comments of other parties. Replies shall not exceed fifteen pages in length and shall be served as set forth above for comments.

Late submitted comments or replies will not be considered.

Gurbux Kahlon
Program Manager
Energy Division

Enclosures:

Certificate of Service
Service List

CERTIFICATE OF SERVICE

I certify that I have by mail this day served a true copy of Draft Resolution G-3399 on all parties in these filings or their attorneys as shown on the attached list.

Dated June 26, 2007 at San Francisco, California.

Honesto Gatchalian

NOTICE

Parties should notify the Energy Division, Public Utilities Commission, 505 Van Ness Avenue, Room 4002 San Francisco, CA 94102, of any change of address to ensure that they continue to receive documents. You must indicate the Resolution number on the service list on which your name appears.

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Resolution G-3399
SoCal Gas Advice No. 3642
SDG&E AL 1804-E/1623-G/JEF

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July 26, 2007