

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 04-08-XXX

**ORDER INSTITUTING RULEMAKING REGARDING ALLOCATION OF GAINS
ON SALE BY ENERGY UTILITIES, INCUMBENT LOCAL
TELECOMMUNICATIONS CARRIERS AND WATER COMPANIES**

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I. Summary

By this order, we initiate an Order Instituting Rulemaking on our own motion to consider policies and guidelines regarding the allocation of the gains from sales of utility assets. The primary purpose of this proceeding is to set forth clear guidelines regarding the disposition of the capital gains realized upon the sale of utility property. We will consider in this Rulemaking assets sold by electric and gas utilities, certain telecommunications carriers, and water utilities.¹

The goal of this Rulemaking is to ensure that our guidelines related to gain on sale of public utility property are easy to follow, properly allocate gains and losses based on financial risks, provide incentives for prudent investment in and continued ownership of property necessary for service to utility customers, and do not provide utilities any unreasonable incentives for unnecessary and speculative investment to profit from gains on sale. We also seek to ensure that the guidelines provide the utilities with necessary incentives to dispose of properties that have been rendered unnecessary by change of circumstances. We tentatively conclude that utilities be allocated no more than 50% and no less than 5% of the gain on sale of land or non-land assets. We intend to 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 and with the remainder allocated to ratepayers. In unusual circumstances, we would consider the issue on a case-by-case basis.

¹ Pub. Util. Code §§ 789 *et seq.* gives guidance regarding the disposition of the gains from the sale of real property by water utilities. Upon review of this statute, it appears that, as explained more thoroughly below, the Commission will need to interpret that statute to reconcile its impact with the requirements of Pub. Util. Code § 451 and 454 that water utilities' rates be just and reasonable.

We invite comment from utility respondents and other interest parties on the proposed guidelines, the proposed allocation of gains and losses and other related topics discussed herein.

In general, the utilities should invest in real estate and plant only to the extent that it is needed to serve their customers. Such investments should be included in ratebase. When these assets are no longer needed to provide utility service, the utilities should so notify the Commission, the assets should be removed from ratebase and disposed of pursuant to Pub. Util. Code § 851, and their costs should no longer be paid by ratepayers. Our rules should provide incentives to promote these goals.

If shareholders receive a portion of the gain on sale that is too large, they may have an incentive to add properties that are not 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, it may be necessary to provide shareholders with enough of the gain to encourage the utilities to sell properties that are no longer needed. Proper gain on sale guidelines should result in the right kind and level of investment and divestiture, as well as reflect the relative risks borne by shareholders and ratepayers.

Our preference is to create guidelines and a specific rule on allocation of the gain on sale between shareholders and ratepayers, so that the determination of the proper gain on sale for a specific sale is easy and clear-cut. Only where the sale is unusual or especially complex should the guidelines be more open-ended. To date, most of our determinations of how to allocate gains on sale have been conducted on a case-by-case basis. This case-by-case analysis is cumbersome for the Commission and for parties, and often does not provide clear guidance for

future cases on how to allocate gains. This lack of clarity promotes inefficiency and inconsistency.

We deferred such determination in several recent cases because the guidelines for determining how to allocate the gain were difficult to follow. The guidelines we develop in this proceeding will also provide direction for how to allocate the gains – currently held by the utilities in memorandum accounts or otherwise in suspense – in those cases. We identify the cases in which we deferred the gain on sale allocation determination in Appendix B to this decision. We will also require the utilities named as Respondents to supplement the list in Appendix B if they are aware of other cases – whether or not they affect that Respondent – in which we deferred the question.

In summary, the guidelines proposed in this Order are as follows:

1. These guidelines 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 nondepreciable assets (land) for the

purpose of allocating the gain. If land that has been taken out of ratebase 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 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.

II. Recent Commission Treatment of Gain on Sale

The Commission currently allocates gain on the sale of a utility asset on a case-by-case basis. We rely on such factors as how long the asset was in ratebase, who bore the actual financial risk of the investment, how different allocations might affect various management and investor incentives, whether the asset is depreciable or nondepreciable, the type of asset sold, the circumstances leading to its sale, constraints embedded in the Uniform System of Accounts (USOA),² and judicial or Commission precedent. We have made it clear in each decision, however, that the result is not meant to be generally applicable to future asset sales and that the present case is judged on its own merits.

The Commission has issued only a few decisions that discuss in detail the appropriate principles to be used in allocating gains and losses, and even these

² The Commission's USOA provides accounting instructions for plant assets including depreciation allowance and retirement.

cases have limited application. We will discuss these decisions below, but briefly outline them here. A 1985 decision gave the entire gain from the sale of an electric distribution system to ratepayers, using a “risk theory of allocations.” We pointed out that, unlike in the private sector, the risk of the investment was borne by ratepayers and that any gains should therefore accrue to them. However, we reversed this conclusion in 1989, saying that the important criteria were whether the ratepayers were harmed by the transaction, and whether they had contributed capital to the acquisition of the distribution system. If ratepayers were not harmed and they had not contributed capital, we decided that the gain should go to shareholders.

In 1990, we decided that the gain realized on the sale of a utility’s headquarters building should be shared between ratepayers and shareholders. We applied a “ratepayer indifference” analysis and determined that (1) ratepayers should receive enough of the gain to compensate for the difference between what the old building would have cost had it continued in ratebase and what the new asset will actually cost, and (2) shareholders should receive the rest “as a reward and incentive” for putting the property to its best economic use. In a subsequent decision we decided to replace this “ratepayer indifference” principle with the “traditional risk and incentive analysis” approach, and said that to give too much of the gain to shareholders would provide a perverse incentive to utility management. In all of these cases we emphasized that our conclusions were limited to the specific asset sale and were not to be broadly applied.

For large telecommunications carriers, prior to our adoption of the New Regulatory Framework (NRF) price cap regulation in 1994, we generally allocated all of the gain on the sale of land to ratepayers. Under NRF, we

decided to allocate the gain on land between shareholders and ratepayers based on the time that the property had been in utility ratebase. For sales after 1997, we have allocated 50% of the gain to ratepayers and 50% to shareholders.

For buildings and other depreciable assets, we have generally had the telecommunications carriers allocate the gain to ratepayers through a credit to the asset's salvage value. However, in 1997 we allocated the gain from the sale of a line of business equally between ratepayers and shareholders. Again, we stressed that the conclusions we reached should be limited to the specific circumstances of that case and should not be applied broadly.

For water companies, we argued prior to 1995 that ratepayers had borne most of the risk and costs of the utility investments, and thus deserved a portion of the gain. To encourage further investment in infrastructure we also found we should allocate some gain to shareholders. We therefore allocated gains on the sale of these assets equally between ratepayers and shareholders. In 1995, Pub. Util. Code §§ 789 *et seq.* was enacted, which provides 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. This rule effectively allocates the entire gain from the sale of an asset to shareholders if it is reinvested toward a public purpose. The gain is added to the utility's ratebase on which the shareholders earn a rate of return through rates paid by the ratepayers.³

We believe further effort to interpret the water statute is merited. This Commission has not previously considered how to reconcile the Water Utility

³ As a further complication, water utilities commonly receive assets from sources other than the shareholders, such as contributed capital from real estate developers. There is also reason to believe that the number of non-shareholder provided assets will escalate in the future.

Infrastructure Act with the requirement that rates be just and reasonable pursuant to Public Utilities Code § 451.

III. Fundamental Concepts

Economic theory of competition: It is important to understand the fundamental concepts that underlie the reasoning used by the Commission to determine the correct allocation of the gain from the sale of a utility asset. Our policies should be based on a clear understanding of how markets work. Economic theory provides this understanding. Under the economic theory of the firm in a competitive, unregulated⁴ market, the owners of the firm will recoup their costs if the prices they are able to charge for their products are high enough. There is no guarantee that prices will be high enough for the owners to make a profit, or even recoup their investment costs. Firms have no control over this price, and this is a financial risk borne by firms in competitive markets.

If the market price is high enough, the firm will make a positive profit in addition to having all its costs, including depreciation, covered. The profits will accrue to the owners of the firm as a reward for providing the product and bearing the risk of the investment. Similarly, if the firm sells an asset, the sale price may provide a gain over the asset's book value. This gain accrues to the owners as well to encourage investors to bear financial risks.

One indispensable aspect of competition is ease of entry and exit by suppliers. Entry drives the price of output down, keeping it close to production

⁴ A competitive market allows ease of entry and exit by competitors, and is supplied by many firms. Customers have many alternative suppliers from which to choose, and prices are close to the costs of production. However, not all unregulated markets are competitive. Some unregulated markets are dominated by a few firms, prices are much higher than costs, and entry is difficult.

costs. Entry also keeps profits low, so this is another risk borne by the competitive firm.

Monopoly regulation: In the case of the regulated monopoly, the firm does not face a competitive market and is sheltered from many of the risks borne by competitive firms by the regulator. The monopoly's prices are limited, often within a particular range. This range includes all costs associated with the output, plus a return on the shareholders' investment that is considered reasonable by the regulator. The customer has few if any alternative suppliers to which they might take their business, and the product has few if any viable substitutes. Under monopoly regulation, structural limitations and the regulatory compact restrict entry by competitors into the utility's market.

Under the implicit compact enforced by this Commission, regulated utilities face few financial risks, and ratepayers cover almost all costs associated with the assets acquired by the utility. The corollary of limited shareholder risk is limited shareholder profit. The Public Utilities Code entitles a utility to charge its customers rates that cover its costs and are otherwise considered just and reasonable. Once the company prudently purchases an asset that is deemed needed for provision of the service, the shareholders' outlay is added to the utility's ratebase, and shareholders have the opportunity to earn a reasonable rate of return on that asset. All reasonable costs the utility bears are covered by the ratepayers, including a return of the investment through depreciation, maintenance, insurance, taxes, fees, administrative costs, and interest expense, and all other costs associated with that asset (often collectively called "carrying costs").

If the asset is taken out of service before it is fully depreciated, the undepreciated amount, if not covered by the asset sale price, is usually paid for

by the ratepayers. Once again, there is essentially no risk borne by the shareholders from the sale of the asset when it is paid for by ratepayers.

The special case of land: Because it needn't be replaced, land is not depreciated, as in the case of buildings or machinery. However, the entire acquisition cost of the land is put into ratebase and the shareholder receives a return on that amount for as long as the land is in ratebase. Ratepayers still pay for carrying costs such as maintenance, taxes, insurance, administrative costs, and interest expense for the land. Further, in the unlikely event that the land is sold at a loss, ratepayers usually cover the loss in rates. Once again, the shareholders bear no financial risk.

The impact on investment of the allocation of the gain: It is sometimes argued that if some or all of the gain from the sale of an asset is not given to the shareholder, this will suppress future investment. This conclusion is not supported by economic theory. Owners invest their capital in response to what profits are available in the various sectors of the economy. High profits act as a signal to investors that they should move their capital to that sector, because the society has decided that they want more of that good produced. Such flows improve economic efficiency.

However, profits are earned on an ongoing basis by the firm, not on a one-time basis. One well-known conclusion of economic theory is that fixed costs do not affect how much profit-maximizing entrepreneurs invest. Similarly, fixed benefits are equally irrelevant to the investment decision of the firm.⁵

⁵ The profit-maximizing firm will choose its output where its marginal revenues are just equal to its marginal costs. That is, the firm will expand its output until the additional revenue received for selling one additional unit of output (i.e., the market price in the case of the competitive firm) is equal to the additional cost of producing one

Footnote continued on next page

Another way to look at this process is to consider why the regulated utility purchases an asset for its production process. The profit-maximizing management is not considering the potential gain in value of the asset twenty years hence, but is looking at the increase in output and/or decrease in average cost represented by the introduction of this new asset, in line with the utility's underlying requirement to provide service. Management is attempting to increase the yearly return to the shareholders, not the boon that might materialize at the end of the asset's useful life. As the shareholders have not shouldered any of the risk of the investment, it would be lagniappe to allow them to use this rationale to retain the gain when the asset is sold.

Example. The following simplified example shows how, for a regulated utility, shareholders typically bear no risk when they acquire an asset for utility service. For this example, we assume that the acquisition price of a building is \$1,000 and that it is expected to last five years. The method used to calculate depreciation is straight-line, so that every year \$200 is depreciated from the book value of the building. Also, \$200 each year is added to the costs paid by ratepayers in their rates.

Also, for this example we assume that the rate of return deemed reasonable by the Commission is 11% for each of the five years the asset is in use. Finally, we assume that maintenance, taxes, insurance, administrative costs, and

more unit. As a result, the fixed costs of the firm are not considered in this decision process, as fixed costs do not change when one more unit of output is produced. Similarly, fixed benefits such as the gain from the sale of an asset are also not part of this decision process. The magnitude of the gain is determined exogenously, by the dynamics of the asset market governing the sale.

interest expense for the building totals \$100 per year. The following table summarizes these various costs and payments over the five-year life of the asset:

Year	Book Value	Depreciation	Return @ 11%	Maintenance and other charges
1	\$1000	\$200	\$110	\$100
2	800	200	88	100
3	600	200	66	100
4	400	200	44	100
5	200	200	22	100
Total		1000	330	500

Thus, under the assumptions of this example, ratepayers have paid a total of \$1830 to shareholders (\$1000 + \$330 + \$500) for the use of this asset.

Ratepayers have paid for the asset, paid the opportunity cost of the initial investment, and have covered other costs associated with the asset. Ratepayers have paid \$1850 over 5 years for the use of a \$1000 asset that is now ostensibly useless. If, in fact, it has salvage value, a determination of whether shareholders bore risk, and how much, must precede an allocation. While it is possible that a similar investment in a competitive, unregulated market would provide similar or even greater returns to the owners, it is also entirely possible that market conditions would not support prices high enough to cover even the initial investment, let alone the associated costs or rate of return. This is the differential nature of risk faced by regulated utilities and unregulated firms, and forms the basis upon which we reach our conclusion that the gain should go to the party that bears the financial risk of the investment.

IV. The Treatment of Gains by other States

The majority of public service commissions in other states treat gains on the sale of utility assets on a case-by-case basis. Others have specified policies, such as giving all gains to ratepayers, giving all to shareholders, or dividing the gains in some proportion. In 1994, the National Regulatory Research Institute (NRRI) surveyed the states to determine what patterns exist in the treatment of gains.⁶ These are the major findings of this study:

9. Out of 49 responses, 37 state commissions stated that they have no generic policy and treat the disposition of the gain on a case-by-case basis, while 10 specified policies.
10. Five of the 10 state commissions with specific policies allocate the gain to ratepayers, one allocates the gain to shareholders, and two always split the gain between the two. Two states give the gain to ratepayers under specified circumstances, and give the gain to shareholders under other specified circumstances.
11. Overall, the majority of the gain is allocated to ratepayers, although in about half the cases the shareholders are given some of the gain.
12. The gain given to ratepayers is usually provided as an offset to the revenue requirement, although sometimes it is given as a reduction to the ratebase.
5. The most common rationale cited for allocating the gain is whether the asset was in ratebase during its use. Other reasons cited were:
 - Judicial, statute, or commission precedent. The P.U. Code does not guide the Commission regarding the allocation of the gain, except for water companies as

⁶ *State Public Service Commission Disposition of the Gain on Sale of Utility Assets*, NRRI 94-17, David Wirick, NRRI, 1994.

specified in P.U. Code Sections 789, *et seq.* See below for a discussion of these Code sections. Also see below for a discussion of some major Commission decisions covering the appropriate allocation of the gains.

- Who bore the risk? The risk of financial loss from the investment is borne by either the shareholder, ratepayer, or both. As a reward for bearing this risk, that party is given the gain. Sometimes the definition of risk is broadened to include the possibility of lowered levels of service to ratepayers, or the possibility of entry into the market by competitors.
- Is the asset depreciable? Land is not depreciable, whereas capital wears out and is thus depreciable. If the asset in question is land, shareholders do not receive depreciation payments in rates. However, ratepayers provide a return on the original cost of the land for as long as it is in ratebase, and continue to pay for carrying costs.
- The Uniform System of Accounts (USOA). The Commission's USOA provides accounting instructions for plant assets including depreciation allowance and retirement. The Commission adopts the straight line remaining life depreciation method for the cost recovery of plant investment. If the utility plant serves out its useful life as anticipated, ratepayers will pay the investors their cost of investment through depreciation and a return on the undepreciated balance during the remaining life of the plant.
- 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. When an asset is retired at the end of its useful life, the book cost of the asset and the cost of removal are charged to the Accumulated Depreciation account, and the salvage value (e.g., proceeds from plant sales) is also credited to the Accumulated Depreciation account to offset the cost of plant and the

cost of removal. Under normal retirement, the USOA prescribes the same treatment as if the plant serves out its full useful life. It makes ratepayers responsible for paying back the cost of plant investment and a return on the investment to the shareholders, together with any loss or gain from the retirement.

- In the case of abnormal retirement, e.g., the retirement of a building due to fire damage, the USOA will isolate the gain or loss resulting from the occurrence and will record it either in a Miscellaneous Credit or Debit account awaiting the Commission's decision 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.
- Ownership interest by ratepayers in the property. Some commissions find that ratepayers pay only for the service while the shareholders maintain ownership interest in the capital. While shareholder ownership of the capital is not at question here, this begs the question of how the gain from sale of the capital should be allocated. Allocation of all or part of the gain to ratepayers does not interfere with the shareholders' claim to the capital itself.
- Intergenerational equity. A lack of intergenerational equity arises, for example, when benefits that accrue to current customers are paid by future customers. The theory is that the group of customers that realize the benefit should pay the cost associated with the benefit.
- This Commission has not found that intergenerational inequity is an appropriate criterion to consider in determining who should receive the gain on sale of a utility asset.

- Need for investment in infrastructure improvements.
Some jurisdictions consider the gain as something to save for future investment in utility plant. Capital planning at this Commission is incorporated in general rate case reviews that scrutinize the utility's construction budget to ensure that sufficient investment is made to maintain quality service, meet anticipated demand increases, and to offer new services.
- Incentives for management to sell wisely and timely.
The utility management has the obligation to use assets efficiently and to buy and sell assets prudently. This is to keep the prices for utility services as low as possible, while providing customers with good utility service.
- However, if the Commission provides "incentives" to a utility to manage assets efficiently that are higher than necessary, prices for service may also be unnecessarily high because the revenue requirement paid by customers does not reflect additional revenues that could be used to offset the cost of service. For instance, it is a goal of this Commission to encourage prudent investment in and continued ownership of property that is necessary for utility service, and to ensure that management disposes of properties that have been rendered unnecessary by change of circumstance, and to encourage utility management to negotiate a reasonably high sale price. This may require that shareholders be given an incentive of a small percentage of the gain even though other factors, such as the burden of the financial risk of the investment, suggest that ratepayers should receive the entire gain. Such an incentive would promote efficiency as it encourages utility management to stress the above goals. However, an increase in this percentage would lower efficiency, as a higher incentive would not be necessary to achieve these goals, it will transfer money needlessly from those who bore the risk burden of the investment, and it will encourage speculation by utility management.

- It is reasonable to provide shareholders with a guarantee of a small percentage of the gain upon sale of utility assets, a share that is great enough to provide an incentive for management to promote the above goals, but not so great as to interfere with the efficiency goals of the Commission or promote speculation by utility management.
- Utility management also has the requirement under PU Code 455.5 to advise the Commission whenever an asset has become no longer used and useful for utility service. This requirement will be discussed below.

- Obligation of utility to provide ongoing service. The first objective of the utility is to provide service to the ratepayers. It is responsible for maintaining the capital in such a way that it will continue to provide adequate service. Firms do not make capital utility investments to make a profit by realizing gain on the appreciation of the capital assets. Rather they are made with an objective to earn a return on the investment on an on going basis.
- The specific nature of the sale. This category is self-explanatory. Many of the state commissions' determinations of the allocation of the gain from sale were governed by the specific nature and circumstances of the sale.
- Opportunity cost for the utility. Some states have factored in opportunity cost for the allocation of gain on sale of asset. Opportunity cost is how much the utility would have earned had it invested the same capital elsewhere. Under the Commission's ratemaking practices, the rate of return allowed the utility is calculated by considering the opportunity cost of the capital invested in the company.

Some states will allocate the gain based on the proportion of time the asset has been in ratebase, while others will allocate the gain entirely to ratepayers if the asset has at any time been in ratebase. These states argue that if ratepayers have contributed to the cost of the asset, they should share in the gain.

More than half the states cited legal or commission precedent as having influenced commission policy on this issue.

Risk was the third most cited rationale, citing the CPUC's action regarding SoCal Gas' sale of its headquarters in A.87-04-041, D.90-11-031.

Delaware has taken guidance from a Federal Communications Commission (FCC) order (Docket No. 20188, 11-6-1980):

...Thus, the ratepayers bear the risk both in terms of the return they pay the investors for the use of their capital and in the reimbursement of the investors for the decline in value (depreciation) of the assets used to provide service.... Thus when such a piece of property is retired and disposed of and a gain results, the equities of the situation would suggest that the ratepayer should receive the benefit of that gain.

The Tennessee commission in #93-06946 said:

It is a well established principle, adopted by the Courts and this Commission, that gains as the result of the removal of utility assets from regulated service go to the interest of those who bore the risk over the regulated life of the assets.

Nineteen states said that ownership considerations are important, and several supported the doctrine that ratepayers pay for the use of the assets, but not the assets themselves.

Several cited the USOA, and used those accounting rules for the disposition of gains. However, these rules themselves do not give precise guidance regarding the ultimate disposition of the gains. There is a difference in how the FERC and FCC apply this system. Generally, the FERC policy is to allocate the gain to shareholders. The FCC policy allocates gains on the sale of land to ratepayers if the land was in ratebase.

Thirteen commissions cited whether the assets were depreciable as a rationale. The Missouri commission said in EO-85-185 and EO-85-224:

The argument for passing through the profit to the ratepayer is less persuasive in the case of nondepreciable property, since the shareholder has not received a multiple recovery of the investment through depreciation and again through a sale of the property.

Once again, most of the states do not have a rule that governs all situations, but decide the disposition of the gain on a case-by-case basis.

Parties may comment on whether gain-on-sale policies adopted by other states should form the basis of CPUC policy.

V. Important Prior Commission Decisions

Energy: In D.85-11-018⁷, we approved the sale of a portion of PG&E's electric distribution system to the City of Redding. The sale of these assets resulted in a gain which we allocated to ratepayers. The Commission relied upon a "risk theory of allocations" for its decision, saying that whoever bears the financial risk of investment should receive the gain upon sale of the asset. The "risk of investment" was defined as the financial responsibility "for the write-off of a capital asset." (p. 168) We pointed to *Democratic Central Committee etc. v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786 (D.C. Cir., 1973) as a leading case using the risk theory of allocations. We allocated the gain to ratepayers through a decrease in the revenue requirement.

We recognized that the use of risk analysis to determine the allocation of the gain "requires a case-by-case assessment" of who bore the risk and whether the risk was shared. (p. 172) The decision also recognized that the protean nature of the industries it regulated required flexibility in its ratemaking. Specifically, it said that these industries were "undergoing rapid and fundamental structural changes" which resulted in "a substantial shifting of costs," requiring that policymakers balance the interests of the parties involved. We said that our

⁷ 19 CPUC 2d, pp. 161-178. This decision has become known colloquially as "Redding I." Its successor, D.89-07-016, has been dubbed "Redding II."

approach was not an “inflexible framework... especially where the equities of the situation require specific ratemaking innovations.” (p. 172) We were convinced that an analysis of the differential burden of financial risk on ratepayers and shareholders should strongly influence our future decisions regarding the allocation of gains, while at the same time we recognized that the individual circumstances of each situation must be reviewed to ensure a reasonable outcome.

The result obtained in D.85-11-018 was essentially reversed in D.89-07-016.⁸ We used two standards to allocate the gain: 1) whether the ratepayers were harmed by the transaction leading to the gain, and 2) whether ratepayers had contributed capital to the acquisition of the asset. We stressed that these standards applied to the particular circumstances of this sale only.⁹ We concluded that, under these standards, the gain should be allocated to the shareholders. If either of these standards had not been met, the gain could have been used to mitigate the harm to ratepayers or repay their contributed capital. We did not reject risk as an important factor in the determination of the allocation of gain, and stated that the regulatory compact includes “assignment of investment rewards or losses to the party that takes the investment risk,” (p. 239) However, we expanded our definition of risk and listed the following categories:

⁸ 32 CPUC 2d, pp. 233-245.

⁹ “sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system.” (p. 235)

- The risk of *poor service* which is borne by ratepayers.
- *Business risk* which includes weak management, unmanageable business conditions, or inaccurate ratemaking forecasts. Both ratepayers and shareholders bear this risk.
- *Financial risk* is the short run variability in the price of the utility's stock. While in the long run the authorized rate of return should mitigate such variability, in the short run this risk is borne by shareholders
- The risk of *specific investments* "attaches to individual investments." The decision does not state how this particular risk is borne.
- *Regulatory Risk* includes decisions by the Commission and other regulatory bodies, such as the current decision regarding the allocation of gain.

Applying these risks to the case addressed in D.85-11-018, viz. the liquidation of a distribution system, we said that the major risks that applied were the risks of poor service, and "general financial risks that attach to any investment, which are assigned to shareholders, to the extent that they have contributed capital to the distribution system." (p. 239) We also said that the risk of an increased burden on the remaining ratepayers should also be considered. However, we did not specify how the relative assumption of these various risks by ratepayers and shareholders should affect our allocation decision, and reiterated that gain should be allocated solely on the basis of 1) whether ratepayers are harmed by the sale, and 2) if ratepayers have contributed capital to the investment.

In D.90-04-028 we approved the sale of SoCalGas's Los Angeles headquarters building, and split the gain on this sale between the ratepayers and shareholders. The major consideration in our allocation of the gain was a

“ratepayer indifference” methodology, wherein ratepayers were compensated for the difference between what the headquarters would have cost had it remained in ratebase, and what a new headquarters would cost. This difference between book value and replacement cost would be given to ratepayers as it represented the implicit financial stake the ratepayers had in the continued use of that asset. The difference between replacement value and actual market value would go to “shareholders as a reward and incentive for seeing that its headquarters was put to the highest and best use in the economy.” (p. 253)

This “ratepayer indifference” methodology was similar to the standard used in D.89-07-016, described above, wherein ratepayers were to be given a portion of the gain only to make them whole if they were harmed by the transaction, and to the extent that they contributed capital to the original purchase of the asset.¹⁰

We reconsidered our decision in D.90-11-031 (38 CPUC 2d, pp. 166-209) and replaced the “ratepayer indifference” principle with the previous “traditional risk and incentive analysis” approach. We found that to give all gain to shareholders would establish a perverse incentive that would result in utility management purchasing new assets too often. However, we decided that shareholders should get some of the gain “as an incentive to management to maximize the proceeds” from the sale. (p. 187) The gain given to ratepayers was

¹⁰ Commissioner Frederick Duda dissented from this decision, saying that all the gains should go to ratepayers as they have borne all risks of the investment. He argued that utilities buy assets not as investments, but to fulfill their requirement to serve as a utility

allocated over time to offset continuing headquarters costs. We rejected SoCalGas's claim that it is constitutionally entitled to retain all of the gain.

We pointed out that it is inconsistent for utility management to argue that there is a difference in the treatment of depreciable and nondepreciable property (i.e., land), and that their arguments regarding the allocation of gain for depreciable property apply equally to nondepreciable property. This is still a valid assessment. The purchase of land is not repaid to the shareholders through depreciation payments, as is the case for capital assets, but the ratepayers pay a reasonable rate of return on the original purchase price as long as the land is in ratebase, and the risk of the investment, if any, is borne by the ratepayers.

For the energy industry, we propose that decision(s) issued in this Rulemaking specifically supersede all previous Commission decisions relating to gain-on-sale, including D.85-11-018, D.89-07-016, D.90-04-028, and D.90-11-031.

Telecommunications: Before we adopted our New Regulatory Framework (NRF) price cap regulation for large telecommunications carriers, our policy for the treatment of gain on sale of land (non-depreciable property) under rate of return regulation had been to allocate the gain 100% to ratepayers, because they bear the risks of property acquisition and maintenance and fund the costs of ownership while the land's value appreciates. (D.86-01-026, 20 CPUC 2d 237 (1986), *mimeo* at 82-83; D.94-06-011, *mimeo* at 90.) The sale of utility property and any resulting gains were then reviewed in each carrier's general rate case.

Under NRF, the Commission adopted a new policy for treatment of the gain on sale of land that is reflected in two decisions: D.93-09-038 (GTEC/Verizon), and D.94-06-011 (Pacific Bell/SBC). The overall policy for each of the companies is similar, and is based on settlements reached between DRA and GTEC and DRA and Pacific Bell whereby the gain on sale of land was

allocated between shareholders and ratepayers based on the time that the property was in utility ratebase pre-NRF (before 1990) and post-NRF (1990 and thereafter).

There were certain terms in the GTEC settlement that required specific treatment for the sale of land in specified periods. However, the basic principle for determining the gain on sale allocation was time in ratebase pre- and post-NRF. The Pacific Bell settlement provides a less complex illustration of the allocation principle. For sales of land that dated prior to the adoption of NRF in 1989, and the years 1990-1993, the Commission allocated 100 percent of the gain to ratepayers. For sales in the years 1994-1996, the gain allocated to ratepayers was based on a ratio of the time that the parcel was held in ratebase prior to NRF to the total operating service life. For sales in the years 1997 and beyond, the gain was split 50% to ratepayers and 50% to shareholders.

Regarding the sale of depreciable property (*e.g.*, buildings), our policy has been to allow ratepayers to realize the gain by crediting the gain to salvage value that will then be reflected as an increase to the depreciation reserve. (*See* D.86-01-026, Section VII.F. *mimeo.*, at 82.) This accounting policy has not changed under NRF. However, since the sharing mechanism was suspended in D.98-10-026 for SBC and Verizon, there is no mechanism in place for those two companies that provides ratepayers with any benefit resulting from the gain on the sale of depreciable property.

Another type of sale relates to lines-of-business. In 1996, Pacific Bell and the other six Regional Bell Operating Companies sold Bellcore, a commonly owned research and development company. In D.97-06-086, we approved Pacific Bell's and the Office of Ratepayer Advocate's agreement to allocate 50 percent of the after-tax intrastate portion of the gain to ratepayers. The

decision was tailored to the specific circumstances of the case and we did not consider it to be a precedent.

For the telecommunications industry, we propose that decision(s) issued in this Rulemaking specifically supersede previous Commission decisions relating to gain-on-sale, including D.86-01-026, D.93-09-038 and D.94-06-011, but not D.97-06-086.

Water: Prior to 1995, we decided in D. 94-09-032 that it was inappropriate to allocate all of the gain on sale to shareholders. Rather, we allocated the gain 50% to shareholders and 50% to ratepayers. We reasoned that there should be some allocation to shareholders in order to meet the utilities' need to invest in new infrastructure. By the same token, we found ratepayers had borne costs associated with the property until its sale, and therefore should share in the gain on sale.¹¹

In 1995, the Legislature enacted the Water Utility Infrastructure Improvement Act of 1995, Public Utilities Code §§ 789 *et seq.* stating:

- (d) Water corporations may, from time to time, own real property that once was, but is no longer, necessary or useful in the provision of water utility service and that now may be sold. It is the policy of the state that water corporations be encouraged to dispose of real property that once was, but is no longer, necessary or useful in the provision of water utility service and to invest the net proceeds therefrom in utility infrastructure, plant, facilities, and properties that are necessary or useful in the provision of water service to the public.

¹¹ See D.94-09-032 (56 CPUC 2d 4-20).

- (e) It is the policy of the state that any net proceeds from the sale by a water corporation of real property that was at any time, but is no longer, necessary or useful in the provision of public utility service, shall be invested by a water corporation in infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public and that all of that investment in infrastructure, plant, facilities, and properties shall be included among the other utility property of the water corporation that is used and useful in providing water service and upon which the commission authorizes the water corporation the opportunity to earn a reasonable return.

Additionally, Public Utilities Code § 790 states:

- (a) Whenever a water corporation sells any real property that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds, if any, including interest at the rate that the commission prescribes for memorandum accounts, from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public. For purposes of tracking the net proceeds and their investment, the water corporation shall maintain records necessary to document the investment of the net proceeds pursuant to this article. The amount of the net proceeds shall be a water corporation's primary source of capital for investment in utility infrastructure, plant, facilities, and properties that are necessary or useful in the performance of the water corporation's duties in providing water utility service to the public.
- (b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision (a) shall be included among the water corporation's other utility property upon which the commission authorizes the water corporation the opportunity to earn a reasonable return.
- (c) 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.

- (d) Upon application by a water corporation with 10,000 or fewer service connections, the commission may, after a hearing, by rule or order, exempt the water corporation from the requirements of this article.
- (e) The commission retains continuing authority to determine the used, useful, or necessary status of any and all infrastructure improvements and investments.

In summary, § 790 enables water utilities that sell no longer needed property and invest the net proceeds in needed infrastructure to earn on these proceeds. These net proceeds are to be the utility's primary source of capital for infrastructure, and 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 have not previously had occasion to review the Water Utility Infrastructure Improvement Act with our statutory obligations pursuant to Public Utilities Code § 451 and 851.

We noted in D.03-09-021 that the result of allocating all net proceeds to shareholders creates a powerful financial incentive for water utilities to sell real property. Such an incentive 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 gains.

This is particularly troubling when a water utility decides to sell water rights which typically for accounting purposes have no monetary value, and then include these proceeds in rate base on which the utility may earn a return. We determined in D.04-07-031 that water in its natural state is a part of land and

therefore constitutes real property.¹² As decided in D.04-03-039 pursuant to § 851, the Commission affirmed that water rights may not be leased or sold without Commission approval.

We also believe the statute may require further interpretation regarding water utility assets originally obtained from sources other than the utility shareholders. Water utilities commonly receive assets from sources other than the utility shareholders. Some water utilities acquire facilities that were paid 100% by company ratepayers. They may be facilities such as the one million dollar treatment plant that Nacimiento Water Company customers paid for rather than incur the cost of interest on a loan or the rate of return on a shareholder investment. Other such assets may include facilities constructed in the 1980s and 1990s with state-provided low interest loans under the Safe Drinking Water Bond Act (SDWB loans) and the State Revolving Fund (SRF loans). Unlike conventional loans for which ratepayer payments may be confined to loan interest, ratepayers bear responsibility to repay, through surcharges, principal and interest for loans. Other water utility assets are completely funded by forgivable loans, which, upon repayment-forgiveness, closely resemble grants. Such loans/grants include funding for infrastructure to replace or correct facilities damaged by MTBE contamination distributed by the State Department of Health Services (DHS) to utilities. DHS forgives the loans if the utility makes a good faith, even though unsuccessful, effort to find and sue the contaminator for damages. Though on some occasions, contamination

¹² See *Stanislaus Water co. v. Bachman* (1908) 152 Cal. 716, 725 and *Smith v. Municipal Court* (1988) 202 Cal. App. 3d 685,689.

litigations result in a monetary gain. Due to the complexities of water contamination issues, these issues will be considered in a separate OIR.

Finally, developers or other entities commonly pay for and provide water utility assets as contributions in aid of construction. There is reason to believe that the number of non-shareholder provided assets will escalate in the future.¹³

When these assets are no longer necessary or useful to the water utility, the utility sells them and uses the proceeds to purchase new infrastructure pursuant to §§ 789 *et seq.* As a result, this new infrastructure will become part of the water utility's ratebase, on which the utility earns a rate of return from ratepayers.

We will examine in this proceeding whether the statute requires such property to earn a full rate of return. 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.¹⁴

With respect to water utilities, here are some specific ratemaking issues that need to be addressed in this proceeding:

¹³ For example, the Department of Health Services recently announced that state grant funds from Proposition 50 proceeds shall be available to investor owned water utilities of all sizes. For the most part, such funds will be used to construct water utility infrastructure in low-income areas.

¹⁴ *See, e.g., Alisal Water Corp.*, D.90-09-044, *mimeo* at 11, *as quoted in California Water Service Company*, D.94-02-045, 53 CPUC 2d 287 (1994), *mimeo* at 14 (“[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 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.”).

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 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?

VI. Risk under Various Scenarios

In this proceeding, we are generally concerned with the following types of risk:

- (a) The risk of not recovering the acquisition cost of the asset;
- (b) The risk of not recovering the asset’s maintenance and other carrying charges;
- (c) The risk of not being compensated for the asset’s opportunity cost;
- (d) The risk of incorrect valuation of the asset.
- (e) Inaccurate estimate of the useful life of the asset.
- (f) The risk of disallowance by the Commission.

Almost all of the financial risks are borne by the owners in the competitive market, but they are generally borne by ratepayers under utility regulation. Only the risk of the Commission’s disallowance of a utility’s asset purchase can be said to be borne by shareholders. As we have discussed above, under regulation, the risk of the asset’s acquisition cost recovery is covered by ratepayers through the payment of depreciation expense; the risk of ensuring the asset’s servicing is covered through operating and maintenance expenses in

rates; the asset's recurring carrying charges, such as taxes, insurance, licenses, and fees, is also paid by rates; finally, the risk of not covering the opportunity cost of the investment is addressed by the allowance of a just and fair return on its equities and debt securities, once again as part of the calculation of rates.

We will discuss some of these risks here in more detail. First is the risk that an incorrect valuation is assigned to an asset when it is placed into ratebase. When an asset is placed into ratebase, it is assigned a specific value. That value is recoverable through depreciation, and there is a rate of return on the assigned value. The value is determined by the Commission. In the vast majority of cases, the Commission's assigned value is exactly the value proposed by the utility. If the Commission accepts the utility's valuation, there is virtually no risk for shareholders as the utility would not knowingly propose a valuation that is too low. However, the utility may propose too high a valuation. A valuation by the utility that is too high may occur due to purposeful overstatement of value (impermissible), purposeful erring on the side of a high valuation along a range of reasonable valuations (permissible, but subject to Commission adjustment within the reasonable range), or simple error.¹⁵ In this case, there is a risk to the ratepayer of overpaying capital costs, as well as excessive return. Shareholders bear the risk of the rare occasion that the Commission might adopt a valuation that is too low. However, given that the utility largely controls the information and the Commission almost always accepts utility proposals for valuation of assets, the ratepayer valuation risk far outweighs the shareholder valuation risk.

¹⁵ If the utility imprudently errs and proposes too low a valuation, this is a shareholder risk which should not be allowed to result in a countervailing claim of compensation through allocation of gain on sale.

Except in the case of land, assets are assigned useful lives which are reflected in a depreciation schedule. An asset may in fact have a useful life which is shorter or longer than the assumed period. If the asset's useful life is shorter than the assumed period, the ratepayers continue to pay the depreciation, return on capital, and associated operation and maintenance costs for the asset unless it is removed from ratebase. There is an obligation under accounting rules and under the Public Utilities Code §455.5(b) to take such an asset out of ratebase, but this obligation is not always honored, in part because implementing rules have not been clear. This situation constitutes a risk for the ratepayer. The utility may need to prematurely replace the asset if its useful life is truncated. This constitutes a risk to the shareholders if the replacement costs are not accounted for in rates. However, this risk is mitigated because the utility will have the opportunity (in the next general rate case or elsewhere) to request revenues to cover the increased costs. If the asset's useful life exceeds the depreciation period, the utility and the ratepayer benefit from the ability to make use of the asset beyond its expected life without additional capital expense. However, if the utility chooses to propose replacement of the asset at the end of the assumed useful life, despite the fact that the asset is still useful, ratepayers bear the risk of overpayment for an unnecessary or premature replacement. Since this decision is within the utility's control, shareholders do not face an associated risk.

The Commission may decrease the upfront amount allowed into ratebase for an asset. This is the valuation risk faced by shareholders discussed above, which occurs infrequently. The Commission may also disallow recovery of all or part of an asset once it is in ratebase, if the Commission determines that the investment was imprudent. Generally, such a determination will stem from the

standard that the investment must have been prudent based on information known or knowable by the utility at the time the investment was undertaken. Such after-the-fact disallowance constitutes a risk to shareholder. However, the Commission has rarely disallowed significant amounts in this manner. It can also be argued that ratepayers face the symmetric risk that assets that should not be allowed into ratebase may in fact pass prudence reviews. Finally, the Commission's ability to pursue after-the-fact prudence review for electric utility generation investments has been constrained by the Legislature.¹⁶

There may be various circumstances when an asset is sold. We summarize the risks at the time of sale (apart from the risks discussed above) under the following scenarios.

- (1) The asset is fully depreciated and is always in ratebase. The asset is used and useful.

Under this scenario the ratepayers bear all the financial risk. The ratepayers pay back the utility for the entire cost of the asset over the estimated life of the asset through annual depreciation. The utility bears zero risk under this scenario, because each year the utility gets a portion of the investment back and a rate of return on the unrecouped investment.

Even when the fully depreciated asset remains in ratebase and may not be used and useful at some point, the ratepayers once again bear all financial risks and the utility bears none. Under this scenario, the ratepayers each year continue to pay the operations and maintenance, as other carrying charges.

¹⁶ We invite respondents and parties to comment on the nature, importance, and frequency of these risks.

However, since the asset is fully depreciated, there will be no depreciation allowance or a return on the asset.

(2) The asset is not fully depreciated and is always in ratebase. The asset is used and useful.

Under this scenario the ratepayers bear all of the risks. Ratepayers bear operating expense allowances in rates. It is well settled under Commission ratemaking that if the asset is not fully depreciated, in most instances the ratepayers' financial obligation remains. Should the partially depreciated asset be retired early or sold at a loss, ratepayers bear the risk of that loss. Even when an asset becomes unsuitable by reason of obsolescence before investors have fully recouped their investment, the loss is passed on to the ratepayers. It would thus be logical to assign any gain, if any, to ratepayers as they bear the risks under this scenario.

(3) The asset is removed from the ratebase when it becomes no longer used or useful for utility service.

The ratepayers have paid depreciation, maintenance, other carrying charges, and a rate of return on the undepreciated amount of the asset, up to the time it is removed from the ratebase. Therefore, even though it is no longer being used for utility service, the risk of the investment has been borne by ratepayers. Once it is removed from ratebase, the ratepayers' obligation is over. At this point, the utility bears any further risk and cost associated with the asset. However, since the asset's cost has been returned through depreciation payments in rates, any further risk borne by shareholders may be small.

(4) Land

When land is in ratebase, the ratepayers bear the risks as above except that land is not depreciable. Shareholders are not given depreciation payments, but they will earn a return on the book value of the land in perpetuity. If the utility

sells land that has been in ratebase, any loss is to be compensated by the ratepayers. Thus the treatment of gain or loss from the sale of land in ratebase should be no different than the sale of a depreciable asset; any gain or loss should flow to the ratepayers. If land is sold after it has been removed from ratebase, an allocation of the gain or loss from the sales should be made that reflects the risks shared by both the ratepayers and the utility.

VII. Discussion

Gain on sale as a regulatory concept is not well-discussed in regulatory literature or statute, with limited exceptions for the water industry. Most of the thinking on the topic has been developed through experience in regulatory proceedings here in California and in other states. A review of practices in other states reveals a wide range of outcomes related to differential emphasis on various aspects of the gain on sale question. A review of the history of CPUC decisions relating to gain on sale also reveals shifting and inconsistent policies. 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.¹⁷

It is clear that by most measures, and under most circumstances, this risk is primarily borne by the ratepayer under utility regulation, as we have explained above. In most cases, even though the initial capital investment is provided by shareholders, that capital is generally fully paid back by ratepayers through depreciation in rates. Further, usually all costs associated with the asset, such as maintenance, insurance, taxes, administrative costs, interest expense, and other carrying costs are paid by ratepayers. Shareholders also retain the proceeds from an asset sale up to the book value of the asset. Further, a rate of return on the undepreciated value of the asset is included in rates. In the case of land, shareholders earn a return on its initial cost for as long as it is in ratebase. In addition to the financial risk, under the regulatory compact, the regulated utility is generally protected from the risk of entry by competitors. Shareholders face a real, but relatively smaller, risk of disallowance.

The use of a “ratepayer indifference” standard, however defined, is necessary but not sufficient for a reasonable allocation standard for use by this Commission. Of course, if ratepayers are harmed by the sale of the asset, or by the transaction that engenders this sale, this harm must be mitigated in some way, either by voiding the sale or compensating the ratepayers.

It is apparent from the discussion in Section IV, above, that the usefulness of the Uniform System Of Accounts is limited only to the accounting and

¹⁷ This includes the loss of the capital investment; the costs of maintenance, insurance, taxes, administrative costs, interest expense, and other carrying costs; and the ROR on investment.

recording of a transaction, but is not useful in the determination of how the gain is to be allocated.

We found in D.90-04-028 that it was desirable to provide SoCalGas shareholders a small portion of the gain as a “reward and incentive for seeing that its headquarters was put to the highest and best use in the economy.” We agree and note that it is our goal to encourage prudent investment in and continued ownership of property that is necessary for utility service, to ensure that utilities dispose of properties that have been rendered unnecessary by change of circumstance, and to encourage utility management to negotiate a reasonably high sale price. This may require that shareholders be given an incentive of a percentage of the gain. We also recognize that shareholders bear some risk of disallowance by the Commission, as discussed above.

It is therefore correct to allocate a portion of the gain from sale to shareholders, partly to compensate for financial risk borne by the utility, and partly as an incentive to utility management to manage its assets wisely. An allocation of the gain to shareholders would promote efficiency to the extent it fairly compensates shareholders and presses utility management to further the above goals. However, an allocation to shareholders that is too great would lower efficiency, would not be necessary to achieve these goals, will transfer money needlessly from the ratepayers who bore the greater risk burden of the investment, and will encourage speculation by utility management. We tentatively conclude that a share as high as 50% of the gain may provide an incentive for management to speculate, especially given the variable nature of

capital markets in California.¹⁸ On the other hand, if we choose a percentage as low as 5%, management may find that this would neither fairly compensate shareholders for their risks nor cover their costs sufficiently to act as an incentive. To compensate shareholders for risks and to provide a reasonable incentive without making an unfair and inefficient allocation, we seek comments on the appropriate level within the range of 5% and 50% of the gain allocated to shareholders, with the concomitant range of 50% to 95% of the gain allocated to ratepayers, in recognition of their respective risks. We intend as a result of this Rulemaking to adopt a specific allocation (e.g. 20/80) to shareholders and ratepayers, respectively, that would apply generally under normal circumstances.

VIII. Proposed guidelines for allocation of the gains.

We propose that the following principles be adopted for the allocation of gains realized upon the sale of any utility asset:

1. These guidelines should apply to the allocation of both gains and losses upon the sale of an 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.

¹⁸ We note that the net gain on the 1987 sale of the SoCalGas headquarters building, addressed in D.90-04-028, was \$24 million.

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 nondepreciable assets (land) for the purpose of allocating the gain. If land that has been taken out of ratebase 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 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. When allocating the gain, there should be an incentive to encourage prudent management of utility assets.
8. The allocation should be applied to after-tax gains only.

IX. P.U. Code §455.5.

As we have discussed, it is important that the regulated utilities use their assets efficiently, and dispose of their assets when they are no longer useful for the provision of utility service. It is also important that this Commission be informed when an asset is taken out of service. P.U. Code §455.5 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. . . .

(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. . . .

This section also discusses ratemaking issues associated with the change in status of the facilities, as well as the potential for restoration of these assets to utility use.

Section 455.5(b) says that specified utilities are to report assets that are out of service “as required by the commission.” The Commission has not yet unambiguously required the cognizant utilities to submit the reports required under §455.5. This information is important for the purposes of accurate and timely ratemaking. We therefore propose 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 propose that the utilities be required to estimate the effect of this action on their revenue requirement and ratebase. This proposed report is to be provided through an Advice Letter filed either within 9 months of the

assets's cessation of use or by March 30 of each year. The Advice Letter is to be served on parties to the last filed GRC or PBR. Further, we propose to prohibit any public utility from selling any capital asset for which such Advice Letter has not been filed and to render void ab initio any sale not complying with this rule. Subsection f of §455.5 states:

(f) For purposes of this section, an electric, gas, heat, or water generation or production facility includes only such a facility that the commission determines to be a major facility of the corporation, and does not include any facility determined by the commission to constitute a plant held for future use.

We propose to define a “major facility” as any asset that has an initial acquisition price of \$500,000 or more. Note that this Code section refers not only to these facilities, but to any portion of the facility as well. The acquisition price of this portion may be less than \$500,000, but the requirements of this section would still apply.

X. Preliminary Scoping Memo

This rulemaking will be conducted in accordance with Article 2.5 of the Commission's Rules of Practice and Procedure. As required by Rule 6 (c)(2), this order includes a preliminary scoping memo as set forth below.

The scope of this proceeding will be to 1) investigate and identify the correct criteria for the efficient and appropriate allocation of gains from the sale of utility assets; 2) identify past tests we have used for determining allocation of gains on sale; 3) determine the types of situations in which utilities incur gains on sale; and 4) develop specific tests to apply to each of the situations identified in item 3, based on the criteria identified in this Order, or on rationales developed in the record of this proceeding.

XI. Category of Proceeding

This rulemaking is preliminarily determined to be quasi-legislative, as that term is defined in Rule 5 (d). We anticipate that evidentiary hearings will not be required. It is contemplated that this proceeding shall be conducted through a written record and that an order will issue on the merits based on the pleadings timely filed in this docket. However, parties will have the opportunity to comment on the necessity of hearings, and we may re-evaluate both the categorization and need for hearings after review of the comments. Any person filing a response to this OIR shall state in the response any objections to the Order regarding the category, need for hearing, and preliminary scoping memo.

XII. Respondents

Respondents are all investor owned gas and electric utilities and incumbent local exchange carriers with at least \$100 million in annual revenues. Respondents also include all Class A water utilities. All other investor owned gas and electric utilities, incumbent local exchange carriers and Class B, C and D water utilities, in addition to the named respondents, will be bound by the rules we adopt in this proceeding regardless of whether they are named respondents. Thus, if these non-respondent utilities wish to affect the outcome of this proceeding, they should participate in the proceeding regardless of whether they are named as respondents.

XIII. Parties and Service List

In addition to the named Respondents, we will serve the OIR on parties to several proceedings: Rulemaking (R.) 04-04-003, our comprehensive proceeding on energy utility procurement activities subsequent to the California energy crisis; A.00-11-038, our proceeding to determine the state Department of Water Resources revenue requirement; R.01-09-001/I.01-09-002, our pending

examination of the performance of the large NRF carriers; R.04-01-025, our proceeding to establish policies and rules to ensure reliable, long-term supplies of natural gas to California; and I.98-03-013, our investigation into water quality issues.

Anyone else wishing to be placed on the service list for this rulemaking should submit his or her request to the Commission's Process Office, 505 Van Ness Avenue, San Francisco, California 94102, or appear at a prehearing conference for this proceeding. Parties should reference this rulemaking number and indicate whether they wish to be on the service list for this proceeding and, if so, if they wish to be an appearance, state service or information only.

An appearance means that the party will actively participate in this rulemaking by filing comments, etc.

Those persons employed by the State of California who are interested in this proceeding may be added to the "state service" section of the service list either by appearing at the prehearing conference and filling out an appearance form, or they may mail a written request to the Process Office. All of the names that appear on the state service list shall be served with all documents that parties may submit or file in connection with this proceeding.

Those persons who do not want to be parties, and only want notice of the hearings, rulings, proposed decisions, and decisions, may either appear at the prehearing conference and fill out an appearance form, or they may mail a written request to the Process Office requesting that they be added to the service list for information only.

Persons wishing to be on the service list should also include their name, the name of their representative (if any), their address, and telephone and

facsimile numbers, and an e-mail address, unless the party states that no e-mail address is available.

A service list will then be prepared and posted on the Commission's web site at www.cpuc.ca.gov as soon as practicable.

We also intend to utilize the Electronic Service Protocols set forth in Appendix A to this OIR. Any party requiring paper service of documents in this proceeding should so note that requirement in their request to be added to the service list.

XIV. Schedule

Respondents and interested parties may file and serve comments on the issues delineated herein no later than 30 days from the effective date of this order. Respondents and interested parties may file reply comments 15 days after the filing of comments.

Following review of the parties' submissions and opening comments, the assigned ALJ shall convene a prehearing conference to discuss the issues, scope, and schedule of this proceeding. After the prehearing conference, the Assigned Commissioner will issue a scoping memo that finalizes the category, scope, and schedule of this proceeding. (See Rules 6(c)(2) and 6.3.) After the scoping memo is issued, parties may file and serve an appeal to the Commission regarding the ruling on category. (See Rule 6.4.)

Consistent with rule 6(e), we expect this proceeding to be concluded within 18 months.

XV. Public Advisor

Any party interested in participating in this rulemaking who is unfamiliar with the Commission's procedures should contact the Commission's Public

Advisor's Office in San Francisco at (415) 703-2074, (866) 836-7875 (TTY-toll free) or (415) 703-5282 (TTY), or in Los Angeles at (213) 649-4782, or send an e-mail to public.advisor@cpuc.ca.gov.

XVI. Ex Parte Communications

This proceeding is subject to Rule 7, which specifies standards for engaging in ex parte communications and the reporting of such communications. Pursuant to Rules 7(a)(4) and 7(d), *ex parte* communications will be allowed in this proceeding without any restrictions or reporting requirements until the assigned Commissioner makes an appealable determination of category as provided for in Rules 6(c)(2) and 6.4. Following the Commissioner's determination, the applicable *ex parte* communication and reporting requirements shall depend on such determination unless and until the Commission modifies the determination pursuant to Rule 6.4 or 6.5.

Findings of Fact

1. The Commission needs clear guidelines for the allocation of the gain from the sale of a utility asset between ratepayers and shareholders.
2. The Commission has often, in the past, allocated these gains on an ad hoc basis.
3. This Rulemaking will consider assets sold by electric and gas utilities, certain telecommunications carriers, and water utilities.
4. Utilities should have guidelines related to gain on sale of public utility property that are easy to follow, and provide incentives for prudent investment in and continued ownership of property necessary for service to utility customers.
5. Utilities should not have incentives that lead to unnecessary and speculative investment in the asset markets.

6. Utilities should have guidelines that provide them with necessary incentives to dispose of properties that have been rendered unnecessary by change of circumstances.

7. Utilities should notify this Commission when a property ceases to be necessary and useful for utility service pursuant to P.U. Code 455.5, and the Commission should promulgate rules to enforce this section.

8. The utilities should invest generally in real estate and plant only to the extent that it is needed to serve their customers.

9. If utility shareholders receive an unnecessarily large share of the gain on sale, they may have an incentive to add properties that are not really needed for service to customers but have the potential to bring them high profit at some later date when sold.

10. Proper gain on sale guidelines should result in the right kind and level of investment and divestiture.

11. Utilities should have specific guidelines for specific types of sales, so that the determination of the proper gain on sale for a specific sale is easy and clear-cut. Only where the sale is unusual or especially complex should the guideline be more open-ended.

12. To date, most of our determinations of how to allocate gains on sale have been conducted on a case-by-case basis. This case-by-case analysis is cumbersome for the Commission and for parties, and often does not provide clear guidance on how to allocate gains.

13. We deferred determination of the correct allocation of the gain in several recent cases because the guidelines for how to allocate the gain were difficult to follow. The guidelines we develop in this proceeding will also provide direction

for how to allocate the gains – currently held by the utilities in memorandum accounts or otherwise in suspense – in those cases.

14. We identify the cases in which we deferred the gain on sale allocation determination in Appendix B to this decision. The utilities named as Respondents should supplement the list in Appendix B if they are aware of other cases – whether or not they affect that Respondent – in which we deferred the question.

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

16. These guidelines should apply to the allocation of both gains and losses upon the sale of the asset.

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

18. For most cases, ratepayers have borne most of this financial risk and have paid for the asset.

19. While the initial capital is provided by shareholders, that investment is repaid in rates by ratepayers through depreciation. Ratepayers also pay for maintenance, taxes, insurance, fees and other carrying costs of the asset. In addition, a rate of return is provided in rates on the undepreciated value of the asset. Further, shareholders are allowed to retain the proceeds of a sale up to the book value of the asset. Finally, an opportunity to achieve a fair rate of return is guaranteed in rates on the undepreciated value of the asset. All of this should be considered whenever the gain is allocated between ratepayer and shareholder.

20. There should be no difference in the treatment of depreciable and nondepreciable assets (land) for the purpose of allocating the gain. If land that has been taken out of ratebase 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.

21. 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 bore the financial risk of the investment.

22. The Uniform System Of Accounts is useful for the accounting and recording of a transaction, but is not useful in the determination of how the gain is to be allocated.

23. Shareholders should have an incentive for prudent investment in and continued ownership of property that is necessary for utility service, but they should not be given incentives for unnecessary and speculative investment. They should also be given the appropriate incentive to dispose of properties that have been rendered unnecessary by change of circumstances, and management should be encouraged to obtain a reasonably high price for the sale.

24. A share of the gain will provide shareholders an incentive sufficient to achieve these goals, whereas a too-high or too-low share would promote inefficiency in this decision process. Shareholders should also be compensated for the small risk they bear of disallowance of utility purchases by the Commission.

25. Under monopoly regulation, the regulatory compact minimizes the risk posed by competitive entry for the utility.

26. Under regulation, asset costs are calculated in rates paid by the ratepayers, including a return of the investment through depreciation. Other costs such as maintenance, insurance, taxes, licenses, fees, and interest payments are also put into rates.

27. If the asset is retired before it is fully depreciated, the undepreciated amount, if not covered through sale of the asset, is usually paid for by the ratepayers. Once again, there is no risk borne by the shareholders from the sale of the asset.

28. Land is not depreciated, so the shareholder receives no depreciation payments in rates. However, the entire cost of the land is put into ratebase and the shareholder receives a return on that amount for as long as the land is in ratebase.

29. The carrying costs for the land, such as maintenance, insurance, taxes, fees, and interest payments, are still paid in rates. Further, in the unlikely event that the land is sold at a loss, the ratepayer usually must cover the loss in rates. Once again, there is no financial risk borne by the shareholder.

30. In the case of monopoly regulation, it is often argued that if the gain from the sale of an asset is not given to the shareholder, this will suppress future investment. This conclusion is not supported by microeconomic theory. Because investment is not influenced by fixed costs, it is also not limited by the potential to shareholders of one-time benefits. Rather investment is influenced by the opportunity to earn profit on an ongoing basis.

31. Just as fixed costs do not affect investment, fixed benefits are equally irrelevant to the investment decision of the firm.

32. Fixed benefits such as the gain from the sale of an asset are also not part of the investment decision process. The magnitude of the gain is determined exogenously, by the dynamics of the asset market governing the sale.

33. Profit maximizing utility management is not considering the potential gain in value of the asset twenty years hence, but is looking at the increase in output

and/or decrease in average cost represented by this new asset, in line with the utility's underlying requirement to provide service.

34. As the shareholders have not shouldered most of the risk of the investment, shareholders should be allowed to retain no more than 50%, but no less than 5% of the entire gain when the asset is sold.

35. The majority of public service commissions in other states treat gains on the sale of utility assets on a case-by-case basis.

36. The most common rationales cited by other states for allocating the gain were whether the asset had been in ratebase, the existence of judicial or commission precedent, and who bore the financial risk of the investment.

37. The relative burden of financial risk has been often used by this Commission when deciding the appropriate allocation of the gain from sale.

38. In D.85-11-018, we pointed to Democratic Central Committee etc. v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir., 1973) as a leading case using the risk theory of allocations.

39. Further interpretation of Water Utility Infrastructure Improvement Act of 1995, P.U. Code §§ 789, *et seq.*, is merited. This Commission has not previously considered how to reconcile this statute with our statutory obligations pursuant to Public Utilities Code § 451 and 851.

O R D E R

Therefore, **IT IS ORDERED** that:

1. A rulemaking is instituted on the Commission's own motion to set policies applicable to gains on sale for electric, gas, telecommunications and water utilities.

2. Respondents are all investor owned gas and electric utilities and incumbent local exchange carriers with at least \$100 million in annual revenues. Respondents also include all Class A water utilities. All other investor owned gas and electric utilities, incumbent local exchange carriers and Class B, C and D water utilities, in addition to the named respondents, will be bound by the rules we adopt in this proceeding regardless of whether they are named respondents. Thus, if these non-respondent utilities wish to affect the outcome of this proceeding, they should participate in the proceeding regardless of whether they are named as respondents.

3. The Executive Director shall cause the Order Instituting Rulemaking (OIR) to be served on Respondents, and the parties to the following existing Commission proceedings: Rulemaking (R.) 01-10-024, Application (A.) 00-11-038, R.01-09-001/Investigation (I.) 01-09-002, I.98-03-013, R.04-01-025.

4. Any person or representative of an entity interested in monitoring or participating in the rulemaking shall send a request to the Commission's Process Office, 505 Van Ness Avenue, San Francisco, 94102 or e-mail ALJ_Process@cpuc.ca.gov., asking that his or her name be placed on the service list, or appear at a prehearing conference and fill out a yellow appearance form.

5. The category of this rulemaking is preliminarily determined to be "quasi-legislative" as that term is defined in Rule 5(d) of the Commission's Rules of Practice and Procedure.

6. Any person filing a response to the OIR shall state in the response any objections to the Order regarding the category, need for hearing, and preliminary scoping memo. At or after the prehearing conference if one is held, the assigned Commissioner will rule on the category, need for hearing and scoping memo.

7. Respondents shall and interested parties may file and serve comments on the issues identified in this OIR no later than 30 days from the effective date of this Order.

8. We delegate authority to the Assigned Commissioner and Administrative Law Judge to set a prehearing conference, or more than one, as appropriate in this proceeding.

9. Respondents and interested parties may file and serve reply comments no later than 15 days after the filing of comments.

10. All parties shall abide by the electronic service protocols attached as Appendix A hereto.

11. This order is effective today.

Dated _____, at San Francisco, California.

APPENDIX A
ELECTRONIC SERVICE PROTOCOLS
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Party Status in Commission Proceedings

These electronic service protocols are applicable to all “appearances.” In accordance with Commission practice, by entering an appearance at a prehearing conference or by other appropriate means, an interested party or protestant gains “party” status. A party to a Commission proceeding has certain rights that non-parties (those in “state service” and “information only” service categories) do not have. For example, a party has the right to participate in evidentiary hearings, file comments on a proposed decision, and appeal a final decision. A party also has the ability to consent to waive or reduce a comment period, and to challenge the assignment of an Administrative Law Judge (ALJ). Non-parties do not have these rights, even though they are included on the service list for the proceeding and receive copies of some or all documents.

Service of Documents by Electronic Mail

For the purposes of this proceeding, all appearances shall serve documents by electronic mail, and in turn, shall accept service by electronic mail.

Usual Commission practice requires appearances to serve documents not only on all other appearances but also on all non-parties in the state service category of the service list. For the purposes of this proceeding, appearances shall serve the information only category as well since electronic service minimizes the financial burden that broader service might otherwise entail.

Notice of Availability

If a document, including attachments, exceeds 75 pages, parties may serve a Notice of Availability in lieu of all or part of the document, in accordance with Rule 2.3(c) of the Commission’s Rules of Practice and Procedure.

Filing of Documents

These electronic service protocols govern service of documents only, and do not change the rules regarding the tendering of documents for filing. Documents for filing must be tendered in paper form, as described in Rule 2, *et seq.*, of the Commission’s Rules of Practice and Procedure. Moreover, all filings shall be served in hard copy (as well as e-mail) on the assigned ALJ.

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Electronic Service Standards

As an aid to review of documents served electronically, appearances should follow these procedures:

1. Merge into a single electronic file the entire document to be served (*e.g.* title page, table of contents, text, attachments, service list).
2. Attach the document file to an electronic note.
3. In the subject line of the note, identify the proceeding number; the party sending the document; and the abbreviated title of the document.
4. Within the body of the note, identify the word processing program used to create the document. (Commission experience indicates that most recipients can open readily documents sent in Microsoft Word or PDF formats.

If the electronic mail is returned to the sender, or the recipient informs the sender of an inability to open the document, the sender shall immediately arrange for alternative service (paper mail shall be the default, unless another means is mutually agreed upon).

Obtaining Up-to-Date Electronic Mail Addresses

The current service lists for active proceedings are available on the Commission's web page, www.cpuc.ca.gov. To obtain an up-to-date service list of e-mail addresses:

1. Choose "Proceedings" then "Service Lists."
- Scroll through the "Index of Service Lists" to the number for this proceeding.

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ELECTRONIC SERVICE PROTOCOLS
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- To view and copy the electronic addresses for a service list, download the comma-delimited file, and copy the column containing the electronic addresses.

The Commission's Process Office periodically updates service lists to correct errors or to make changes at the request of parties and non-parties on the list. Appearances should copy the current service list from the web page (or obtain paper copy from the Process Office) before serving a document.

Pagination Discrepancies in Documents Served Electronically

Differences among word-processing software can cause pagination differences between documents served electronically and print outs of the original. (If documents are served electronically in PDF format, these differences do not occur.) For the purposes of reference and/or citation in cross-examination and briefing, all parties should use the pagination found in the original document.

(END OF APPENDIX A)

APPENDIX B

**List of Cases in Which Gain on Sale Question
Deferred to This Proceeding**

D.03-12-056

D.03-03-008

D.02-10-022

D.02-09-024

D.02-09-027

D.02-07-027

D.02-07-026

D.02-04-005

(END OF APPENDIX B)