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Decision 06-12-043 December 14, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

ORDER MODIFYING DECISION (D). 06-05-041 AND DENYING REHEARING OF DECISION, AS MODIFIED

I. SUMMARY

We have reviewed each of the allegations raised by of the application for rehearing of D.06-05-041 ("Decision"), filed by the Division of Ratepayer Advocates ("DRA") and The Utility Reform Network ("TURN") (collectively, "Applicants"), and are the opinion that allegations regarding *Redding II* and section 790 have no merit. However, the rehearing application shows that our discussion of the allocation of gain on sale for non-depreciable property was not clear or complete. The actual analysis in the Decision supported the conclusion that shareholders and ratepayers assumed different amounts of risk but the Decision allocated the same amount of gain to each group. This mismatch was not satisfactorily explained in the Decision and, upon reflection, we believe that a different result is warranted based on the evidentiary record. As a result, in today's order, we modify the Decision to adopt an allocation roughly proportionate to assumed risk: 33% to shareholders, and 67% to ratepayers.

II. BACKGROUND

The Commission commenced this proceeding in an Order Instituting Rulemaking ("OIR") on September 2, 2004. The OIR proposed that the Commission establish a single percentage allocation for the gains realized on the sale of all classes of assets. The OIR tentatively concluded that such an allocation should lie between 5% and 50%. (OIR, at p. 2 (slip op.).) The OIR also proposed eight criteria the Commission would use to guide its consideration of these issues. (OIR, at pp. 4-5.) These criteria focused the proceeding on the issue of risk, stating, for example, that, "for the majority of cases, ratepayers have borne most of the financial risk…[t]hus it will be typical for most of the gain to be allocated to the ratepayer." (Ibid.)

This rulemaking took submissions from the parties in the form of written comments. A number of parties also filed procedural motions asking to be dismissed from this rulemaking. Ultimately, in the Decision, the Commission dismissed local exchange carriers and two gas storage facilities. (D.06-05-041, at pp. 5-7.) On November 15, 2005, a draft decision of Commissioner Brown ("Brown Draft Decision") issued for comment. Parties filed opening comments on January 5, 2006, and reply comments on January 17, 2006. On March 28, 2006, Commissioner Chong issued an alternate decision ("Chong Alternate"). Comments and reply comments were filed on April 17 and 24, 2006, respectively. The Chong Alternate differed from the Brown Draft Decision in the way it allocated gains on sale. For property subject to this rulemaking,[1] the Brown Draft Decision proposed to allocate 100% of the gain on sale on depreciable property and 75% of the gain on sale of non-depreciable property to ratepayers. The Chong Alternate proposed a single allocation of 50% of all ordinary gains on sale to ratepayers, in cases where its rules applied. Both the Brown Draft Decision and the Chong Alternate proposed to continue the rule established in *Capital Gains from the Sale of a Public Utility System* [D.89-07-016] (1987) 32 Cal.P.U.C.2d 233 ("*Redding II*"). Both proposals concluded that property referred to as "CIAC" fell within the rules contained in section 790.[2]

[1] The Decision does not apply to extraordinary asset sales, sales of assets with a price over $50 million producing over $10 million in after-tax gain or loss, or routine retirements of minor assets.

[2] CIAC represents the abbreviation for Contributions in Aid of Construction. See Section II.B. In this document unspecified section references indicate the Public Utilities Code.

Both the Brown Draft Decision and the Chong Alternate underwent a series of revisions. Notably, the February 15, 2006 version of the Brown Draft Decision determined to allocate 67% of the gain on sale of non-depreciable property to ratepayers, instead of 75%. Subsequently, the May 9, 2006 version of the Brown Draft Decision determined to allocate 50% of the gain on sale of non-depreciable property to ratepayers. Similarly, the May 11, 2005 version of the Chong Alternate proposed a 50/50 allocation of the gain on sale for non-depreciable property.

At our May 25th, 2006 meeting, we adopted the Brown Draft Decision, as revised. DRA and TURN jointly filed a timely application for rehearing on June 29th, 2006. Applicants assert the Decision is in error in three respects. First, they claim that our conclusion that the gain on sale for non-depreciable assets[3] should be allocated evenly between ratepayers and shareholders is inconsistent with other portions of the Decision and received "scant explanation." (Rehrg. App., at p. 2.) Second, the rehearing application asserts that the Decision errs by failing to overturn *Redding II*. Third, and finally, Applicants claim our interpretation of Public Utilities Code section 790 is in error. Responses to the rehearing application were filed by a group of energy utilities, called the "Joint Parties,"[4] The California Water Association ("CWA"), Park Water Company ("Park"), and Pacific Gas and Electric Company ("PG&E").

III. DISCUSSION

A. The Allocation of Gain on Sale on Non-Depreciable Assets

Applicants contest the conclusion that gain on sale for non-depreciable assets should be allocated 50% to shareholders and 50% to ratepayers. They contend among other things, that this result is, "arbitrary and capricious and not the result of reasoned decisionmaking," and further is "a violation of section 1705." (Rehrg. App., at

[3] The application for rehearing does not claim that the allocation of gain on sale for depreciable assets is in error.

[4] The Joint Parties consist of: Southern California Edison Company, Pacific Gas and Electric Company, San Diego Gas and Electric Company, and Southern California Gas Company.

p. 3.) In support of this claim, the Application sets out various ways in which it believes that the Decision's analysis fails to match its conclusion. TURN and ORA claim that one of the Decision's key underpinnings is its determination that the party "that bears the burdens and risks of investment is due the majority of the gain arising from that investment upon its sale." (Rehrg. App., at p. 4 citing *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission* (D.C. Cir. 1973) 485 F.2d 786 and D.06-05-041, at p. 90, Conclusion of Law 2.) Applicants point to both discussion and Findings of Fact in the Decision that they claim: (i) establish that ratepayers bear the majority of risk, and (ii) rebut claims that utilities bear any significant amount of relevant risk. (Rehrg. App., at pp. 5-6). According to the rehearing application, the Decision also finds that shareholders should be allocated a limited amount of gain in order to avoid "perverse incentives to speculate" in real estate. (D.06-05-041, at p. 6.) Thus, Applicants contend it is "incongruous" and "inconsistent" to allocate the same amount of gain on sale to both ratepayers and shareholders. (Rehrg. App., at pp. 5, 7.) Applicants also claim that the Decision fails to explain this allocation, and that an equal sharing of gains is not supported by the record. (Rehrg. App., at p. 7.)

In response, the Joint Parties assert that the Decision is not vulnerable to legal challenge. (Response of Joint Parties, at p. 3.) The Joint Parties acknowledge that it is possible to "perceive[] discrepancies" in the Decision. (Response of Joint Parties, at p. 3.) The Joint Parties attribute this to the fact that state "the Final Decision reflects considerable compromise." (Response of Joint Parties at p. 4.) CWA also argues that the Decision's findings and conclusions are sufficient. Park argues that the application for rehearing should have been filed as a petition to modify since the Decision only requires minor modification to remove drafting errors. PG&E asserts that the Decision represents an acceptable compromise since shareholders are entitled to 100% of the gain on sale.

The Decision explains its determination to allocate gain on sale for non-depreciable property evenly in several places. We stated that the 50/50 allocation was "fair" and was adopted "partly to compensate for some financial risk borne by shareholders and partly as an incentive." (E.g., D.06-05-041, at p. 2.) The Decision also explains that the 50/50 allocation reflected shareholder risks, stating, “utilities in their comments raise some risks accruing to the purchase of non-depreciable property. A consideration of these risks leads us to alter the tentative conclusion, reached by the OIR, that ratepayers clearly and regularly bear the major portion of the risk associated with utility property.” (D.06-05-041, at p. 27.) Essentially, we concluded that a fair allocation lay at the mid-point, since we were persuaded that shareholders merited a non-trivial allocation but could not identify with further precision what allocation to choose. (D.06-05-041, at p. 44.)

Several of the responses to the rehearing applicant point out the compromise nature of this allocation. CWA describes the Decision as being the result of “an evolution” produced by “input … received during the course of this proceeding.” (Response of CWA, at p. 3.) PG&E continues to maintain that shareholders are entitled to a 100% allocation but recognizes the Decision “is the product of a deliberate balancing of the theories of risk and policy issues raised by the parties….” (Response of PG&E, at p. 2.) The Joint Parties state: “If the Final Decision reads as if it had been stirred by many cooks, perhaps that’s because it was. …the Final Decision reflects considerable compromise.” (Response of Joint Parties, at p. 4.)

However, Applicants are correct to point out that the Decision’s compromise result is not supported by the underlying analysis. Notably, the “Risk Analysis” portion of the Decision (and corresponding findings and conclusions) states that the allocation of gain on sale should not take into account shareholders extraordinary risks, regulatory risk,[5] or forecasting risk. Similarly, the Decision finds that basing the gain on sale allocation on certain shareholder risks would “skew the economic allocation….” (D.06-05-041, at p. 29.) The Decision also specifically considers and rejects the claim that utilities are entitled to 100% of gain-on-sale because ratepayers are

[5] The Decision includes within regulatory risk utility-identified risks associated with the time it takes to recover assets’ costs, the cost of capital, the obligation to serve and the absence of the ability to earn a return on the portion of a property’s value that has appreciated.

analogous to renters, and makes corresponding findings of fact. (D.06-05-041, at pp. 29-31, 87.) As a result, the Decision analyzes each category of shareholder risk identified in its summary of the record, and concludes that none of these types of risk are material to the allocation of gains from the sale of non-depreciable property.[6] The Decision also rejects the policy argument that the allocation should be based on ownership, not risk.

The Decision's discussion of incentives—the other basis for the conclusion that gains on sale should be evenly divided—also contains inconsistencies. That portion of the discussion begins by announcing that the Commission does "not believe law or good regulatory policy require that we set the shareholder portion of gain on sale at a high level in order to achieve prudent property management." (D.06-05-041, at p. 34.) The Decision continues, "we believe the motive for high profits—especially in a real estate market as volatile as California's—may skew management decisions regarding valuable real estate property holdings." (D.06-05-041, at p. 44 (slip op.).) Yet, the discussion also states that shareholders' allocation of gain on sale adopted should be set at the 50% level. (*Ibid*.)

As a result, we believe that the analytical discussion in the Risk Analysis portion of the Decision's Discussion, and the section titled "Allocation as Incentive for Prudent Asset Management" do not support the Decision's basic determination—that a 50/50 allocation properly balances the competing risks and policy factors that should apply to gain on sale. While the 50/50 allocation represents a compromise, it does not reflect our conclusion that a preponderance of the risk is assumed by ratepayers nor does the even split of gain reflect our finding that the allocation should match the "incidence of risk." (D.06-05-041, at p. 90.)

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[6] Another inconsistency appears in the summary of the Risk Analysis section. There, the Decision states that because ratepayers fully compensate shareholders for costs related to non-depreciable assets "ratepayers should receive an equal share of the gain." (D.06-05-041, at p. 28.) Applicants point out that this language is incongruous, and that in previous drafts the exact same predicate, "[b]ecause ratepayers fully compensate utilities for costs…" was used to justify the opposite conclusion: ratepayers should receive the majority of the gains from the sale of assets. (Rehrg. App., at p. 5.)

When we render decisions on ratemaking questions, such as gain on sale, there is "a strong presumption of the correctness of the findings and conclusions of the commission, which may choose its own criteria or methods of arriving at its decision, even if irregular, provided unreasonableness is not 'clearly established.'" (*Pacific Tel. & Tel. Co. v. Public Utilities Com*. (1965) 62 Cal.2d 634, 647, quoting *Market Street Ry. Co. v. Railroad Com.* (1944) 24 Cal.2d 378, 397.) Therefore, a desire to achieve compromise, in and of itself, is not an impermissible basis on which to render a decision. However, we also always believe in good decision-making, which requires setting forth a "reasoned analysis" in our decision that explains why we have exercised our discretion in a particular way. (*Pacific Tel. & Tel. Co. v. Public Utilities Com., supra.,* 62 Cal.2d at p. 648.) As explained, and upon further reflection, the analysis portion of the Decision does not meet this requirement. The Decision's reasoning in fact supports the conclusion that ratepayers bear more risk than shareholders. We are mindful of the California Supreme Court's admonition: "Often a strong impression that … the facts are thus-and-so gives way when it comes to expressing that impression on paper." (*Cal. Motor Transport Co. v. Public Utilities Com.* (1963) 59 Cal. 2d 270, 274-275.) The Decision does not articulate the chain of reasoning that leads to the conclusion that a 50/50 split is proper, showing that while this allocation made a "strong impression," it must "give way" to an allocation derived from a "reasoned analysis" of the record in this rulemaking.

As we have said many times, that analysis applies the principle that "risk is the best determinant of how to allocate gains and losses on sale." (D.06-05-041, at p. 90, Conclusion of Law 2 (slip op.).) The Decision's review of the record concludes that ratepayers bear a larger proportion of that risk than shareholders. As noted above, the Decision concluded that the identified shareholder risks are not germane to the allocation of gain on sale, and in fact, shareholders are already compensated for many of these risks. Even the portions of the Decision explain the 50/50 allocation acknowledged that shareholder risk was "minor" or that shareholders only assumed "some" risk. (D.06-05-

041, at pp. 2, 27, 44.) Under the analytic approach we have chosen, if ratepayers bear a majority[7] of the risk then ratepayers must be allocated a majority of the gain. Even though a 50/50 split is a superficially "fair" compromise, the even division of gain on sale does not match the uneven proportions of risk that ratepayers and shareholders each assume. The rehearing application focuses on this inconsistency, and we conclude that it cannot be explained away.

However, the rehearing application's claims of error can be resolved if the Decision is modified to adopt an allocation that reflects the uneven proportions of risk assumed by shareholders and ratepayers. Such a modification would remove the inconsistency the Applicants challenge and result in a decision with a complete explanation of its holding. Such a result would also achieve the purposes of the rehearing process. "The purpose of an application for rehearing is to alert the Commission to a legal error, so that it may correct it expeditiously." (Commission Rules of Practice and Procedure Rule 16.1, subd. (c).)

We propose to adopt an allocation that reflects these conclusions. A number of allocations achieving this result have been suggested in the course of this proceeding. The rehearing application asserts that a 90/10 allocation is required by the record. The OIR gave an 80/20 allocation as an example. (R.04-09-003, at p. 37.) Additionally, a 75/25 allocation and a 67/33 allocation were proposed in earlier draft decisions.

In selecting an allocation in response to the application for rehearing we want to avoid the inconsistency identified by rehearing applications. But we also want acknowledge some of the considerations that led to our endorsement of a 50/50 allocation. Those considerations included basic fairness and the realization that this is

[7] In several places the Application uses the term "lion's share" to describe to concept that more that half of the gains should go to ratepayers, and includes a summary of the classical Greek fable from which this phrase is derived. (E.g., Application at pp. 2, 3, fn. 1.) The Joint Parties protest the use of phrase and fable to make TURN and ORA's point, dismissing it as an "etymological analysis of a euphemism[.]" (Response of Joint Parties, at p. 4, fn. 6.) To avoid this name-calling dispute, this order uses the term "majority" to refer to a portion of gain or risk that is larger the remaining portion.

not a ratemaking proceeding where we can adopt precise numerical results. (D.06-05-041, at p. 44.) We also pointed out that over the course of the proceeding that our first, "tentative conclusion" on risk contained in the OIR had evolved. The OIR's discussion states, for example: "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." (R.04-09-003, at p.30.) The Decision acknowledges that shareholders do bear some risks under regulation, and that an incentive to management is necessary. While the risks identified by shareholders are generally extraneous to the question of gain on sale, the record does demonstrate that a certain amount of risk does exist in the business of running a utility. If we are to use a risk-based allocation methodology, we cannot entirely ignore the existence of risk. Therefore, while we do not believe that the risks are evenly balanced, we will choose an allocation nearer the top end of the range 5% to 50% range established in the OIR to reflect the difference between our initial conjecture and the demonstrated existence amount of some shareholder risk. Our selection of an allocation nearer the top of the range also reflects the need for shareholder incentives.

Thus we reject lower proposed shareholder allocations, such as the 10% allocation contained in the rehearing application and the 25% allocation initially proposed by Commissioner Brown. The record contains a direct rebuttal by Edison and other utilities of TURN and DRA's analysis in support of the 10% allocation. (See Response of Joint Parties at p. 5, fn. 10-12, citing evidentiary record.) The initially proposed 25% allocation is too close to the OIR's example of a 20% allocation to reflect the evolution of our thinking that occurred during the course of this proceeding. An allocation of 33% of the gain on sale of non-depreciable assets to shareholders (and 67% to ratepayers) better reflects the complexity of the proceeding and the complexity of the regulated industries subject to this OIR. By allocating a larger portion of the gain to ratepayers, this allocation is proportionate to the amounts of risk assumed by shareholders and ratepayers, and addresses the allegations raised in the rehearing application. By using an allocation previously circulated for comment we avoid further proceedings, and achieve the very important goal of efficient decisionmaking. (Appendix

A lists the proceedings waiting for this matter to be resolved before they can be completed.) Finally, we will delete Appendix B to the decision. The Decision's holding is contained in its discussion, findings and conclusions. No further elaboration is needed.

B. The *Redding II* Decision

The Decision determines that the principles set out in *Capital Gains From the Sale of a Distribution System* [D.89-07-016], *supra*, 32 Cal.P.U.C.2d at p. 233, should continue to apply "in the narrow circumstances" for which they were designed. (D.06-05-041, at p. 31 (slip op.).) D.89-07-016 is referred to as the "*Redding II*" decision. That decision only governs situations where a municipal utility takes over a portion of an up-and-running public utility system relieving the public utility of its obligation to serve.

Originally, the OII had proposed to discard any precedent that used a standard other than risk after a risk-based gain on sale allocation had been developed. (D.06-05-041, at p. 17 (slip op.).) Over the course of the proceeding, several utilities submitted comments supporting the continuation of the *Redding II* standards. These comments noted that *Redding II* standards had been used in numerous cases since they were established and had become clear, concise "established precedent." (D.06-05-041, at p. 24 (slip op.).) The utilities also pointed out that under the risk standard, the customers being transferred to the municipal utility, as opposed to the customers remaining with the public utility, should receive any ratepayer allocation of gain on sale. (D.06-05-041, at p. 25 (slip op.).) Consumer groups supported the proposal to discard the *Redding II* test on the grounds that the decision's analysis was faulty. (*Ibid.*)

Applicants claim that the Decision's retention of the *Redding II* standard is error. According to TURN and DRA, *Redding II* is "poor precedent" and should be overturned. They argue that the holding in *Redding II* is mistaken for a number of reasons. As an initial matter, Applicants allege that *Redding II* improperly describes the Commission's practice in total liquidation cases. (Rehrg. App., at p. 10.) TURN and DRA next claim that *Redding II* improperly uses the source of original investment in the property being sold as a criterion for determining how to allocate gain on sale. (Rehrg. App., at p. 11.) The Application claims that *Redding II* makes a finding on the ability to attract capital that is contrary to the record in that case. (Rehrg. App., at p. 12.) Further, Applicants contends that *Redding II* contains an incorrect risk analysis and fails to allocate gain on the basis of risk. (Rehrg. App., at pp. 12-13.) Finally, TURN and DRA argue that *Redding II* fails to properly reward ratepayers for the contributions they make towards maintaining and providing a regulated return on utility assets. (Rehrg. App., at p. 14.) Applicants assert that for these reasons the reasoning behind *Redding II* is inconsistent with the Decision's analysis and the record. According to the rehearing application, failure to overturn *Redding II* is thus an abuse of discretion.

These claims do not demonstrate error for two reasons.. First, the determination to retain the *Redding II* framework is properly explained in the Decision. Most notably, the Decision points out that the *Redding II* test was designed to apply in "narrow circumstances." Thus the Decision gives a reason for maintaining this precedent even if some of the logic behind it differs from the rationale of the Decision. The Joint Parties, in their response point out that the sale of a portion of a public utility system to a municipal utility "involves public policy considerations distinct from those to which the new gain/loss on sale rules will apply." (Response of Joint Parties at p. 6.) There is nothing arbitrary about the Decision's determination to create an exception from its general rule. Additionally, the record supports the continuation of the *Redding II* precedent not because the analysis that led to its adoption in 1987 is necessarily correct but because that decision's allocation of gain meets the need to provide certainty in the unique circumstances to which *Redding II* applies. The record contains comments supporting the continuation of a long-standing rule that is well-understood in the industry, and can be easily applied by the Commission.

Second, the *Redding II* standard is continued as an exception, not as the rule. As a result, comments on the the relationship of *Redding II's* reasoning to risk-based standards raise policy, not legal questions. The application for rehearing is incorrect to claim that criticism of the policies underlying *Redding II* has any bearing on our evaluation of the lawfulness of D.06-05-041. *Redding II* was decided in 1987, and claims that the Commission is now legally required to overturn that decision because of alleged faults it contains do not have merit. Those wishing to make a legal challenge a Commission decision must do so by filing an application for rehearing within the prescribed time period. (Pub. Util. Code, § 1731.) Subsequent proceedings should not be used to make a collateral attack on previously rendered decisions. Moreover, the *Redding II* standard is continued because it should be applied in limited circumstances, not because it is generally applicable. Thus, the Commission was correct to hold: "We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope." (Decision, at p. 32.) We will augment the Decision to make this point clear.

C. Public Utilities Code Section 790

Applicants' final claim concerns section 790, which applies only to water utilities. This statute deals with the proceeds water utilities obtain from the sale of "CIAC". CIAC is real property that water utilities obtain from a third party, as opposed to having been purchased with shareholder capital. The Decision concludes that the statute requires proceeds from the sale of CIAC to be reinvested in water utility infrastructure, and included in rate base. (Cf., Pub. Util. Code, § 790, subd. (a) (reinvestment) & subd. (b) (rate base).)

TURN and DRA allege that our interpretation of this section is "purblind" (i.e., obtuse) and "inconsistent with established Commission policies." (Rehrg. App., at pp. 15-16.) According to the Application, allowing the proceeds from the sale of CIAC to be included in rate base results in "unfair and inequitable rate base burdens" being placed on ratepayers. Applicants assert that this result is contrary to both the policies adopted in the Decision and previous Commission decisions addressing the ratemaking treatment that should be afforded to CIAC. The Application claims that departing from these policies is an illegal abuse of discretion. (Rehrg. App., at p. 15.)

The Decision, however, does not begin its interpretation of section 790 by asking what policies we might like to enforce. Rather, the Decision interprets section 790 by referring to the language of that statute and its legislative history. The statute provides, in pertinent part:

> 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… in water system infrastructure, plant, facilities and properties that are necessary or useful in the performance of its duties to the public. (Pub. Util. Code, §790.)

The trouble with the claim that we should not interpret section 790 to apply to CIAC is that it relies on ratemaking principles previously in effect and does not track the language of the statute. Because under previously adopted principles CIAC "is always excluded from rate base" even though it is used and useful, TURN and DRA claim it should not be subject to section 790's requirements. Section 790, on the other hand does not consider whether or not property has been previously included in rate base. It applies to "*any* real property" that was previously used and useful "at *any* time." (Pub. Util. Code, § 790 (emphasis added).)

The Decision also points out that this interpretation is consistent with the purpose of section 790. Citing the principle that the main goal of statutory interpretation is to "ascertain the intent of the Legislature so as to effectuate the purpose of the law[,]" the Decision points out that section 790 was designed to create a uniform standard that prevented the Commission from allowing gain on sale to flow to ratepayers. (D.06-05-041, at pp. 62-63, citing *Cal. Teachers' Ass'n v. Governing Bd. of Rialto Unified School Dist.* (1997) 14 Cal.4th 627, 632, Sen. Rules Com., Off. of Sen. Floor Analyses, 3d Reading analysis of Sen. Bill No. 1025 (1995-1996 Reg. Sess.) as amended April 5, 1995, p. 2.) The Decision points out that section 790's legislative history deliberately creates a bright line rule that was designed to provide certainty about how gain on sale would be treated and to encourage investment in water utility infrastructure. (D.06-05-041, at p. 64.)

As a result, the Decision in no way rises to the level of an abuse of discretion on this issue. Its holding is well-explained, and well founded in both the language and the legislative purpose of the statute. Moreover, longstanding California Supreme Court precedent holds that the Commission's interpretation of the Public Utilities Code "should not be disturbed unless it fails to bear a reasonable relation to statutory purposes and language." (*Southern California Edison Co. v. Peevey*, (2003) 31 Cal. 4th 781, 796, quoting *Greyhound Lines, Inc. v. Public Utilities Com.* (1968) 68 Cal.2d 406, 410-411.) Applicants advance no reason why the Decision's analysis fails to meet this test. Instead, the bulk of TURN and DRA's arguments address policy issues that are not properly raised in an application for rehearing. (Rule 16.1(c) of Rules of Practice and Procedure. Cal. Code of Regs., tit. 20, §16.1.) These policy arguments also have little effect because, as the Decision points out, the statute should be read to "limit Commission discretion" in this matter.

IV. CONCLUSION

After careful consideration of the application for rehearing, we are convinced that the Decision, as currently written, on the allocation for non-depreciable property is inconsistent and not fully explained. We can resolve the inconsistency by modifying the Decision so its allocation of gain better reflects its conclusions about the assumption of risk.

In all other respect, the rehearing application should be denied. The Decision's conclusion that the *Redding II* framework should be retained in specific circumstances is well-justified. We will modify the Decision to make this clear. Our interpretation of section 790 is supported both by the language of the statute and by the legislative intent behind this law.

THEREFORE, IT IS ORDERED that:

1. The Decision is modified as follows:

a. Footnote 1, on page 2, is deleted.

b. The allocation stated in the third line of the second paragraph on page 2 is modified to be 67% - 33%.

c. In the fourth paragraph on page 15, immediately before the beginning of Section VI, the last phrase of the last sentence, following the dash, is modified to read, "—67% to ratepayers, 33% to shareholders."

d. The first, partial, paragraph on page 23 is modified to add, at the end of that paragraph, this language:

"The record in this proceeding does not present sufficient reasons to justify broadening or narrowing *Redding II's* scope. The record shows that unique public policy considerations apply to the sales governed by the *Redding II* precedent. We are comfortable to allow this standard to continue to govern in the unique and narrow circumstances to which it applies without affecting other matters."

e. The first two numbered sub-sections of section IV. C., titled "Discussion—Risk Analysis" on pages 26 and 27 are restated to read as follows:

1. Summary

We conclude that incidence of risk is the best determinant of how to allocate gains and losses on sale. We find that the question before us is based more in economic theory and policy than on strict legal principles. We have discretion to adopt a gain or loss allocation methodology that reflects the regulatory framework that applies to utilities. Because ratepayers compensate utilities for costs related to land, improvements and other tangible and intangible assets dedicated to utility use, ratepayers should in most cases receive a greater share of the gain (and the loss) in most routine asset sales. Having said that, establishing the proportion of gain that is allocated to ratepayers involves a policy judgment and we must also recognize that the business of running a utility is not risk free. We hold that in routine sales of utility assets, the allocation should be as follows:

- Depreciable assets: 100% to ratepayer

- Non-depreciable assets: 67% to ratepayers and 33% to shareholders.

Our conclusion that ratepayers assume more of the risks of loss associated with utility assets is not new. The D.C. Circuit Court of Appeals so found in the *Democratic Central Committee* case. There, the court concluded after a lengthy analysis of precedent around the country that,

> In sum, the decisions outside the District [of Columbia Circuit] have not viewed capital gains on in-service non-depreciable utility assets as inevitably belonging to investors to the exclusion of consumers. Rather, in each of the cases -- although they are few -- the allocation has depended upon location of the risk of loss. These holdings, then, may be accepted as applications of the broader principle that the benefit of a capital gain follows the risk of capital loss.[33]
>
> The court further held that “[t]he ratemaking process involves fundamentally ‘a balancing of the investor and the consumer interest.’”[34] The court found that “[t]he proposition that capital gain rightly inures to the benefit of him who bore the risk of capital loss has been accepted in ratemaking law.[35]

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[33] 485 F.2d at p. 798.

[34] 485 F2d at p. 806.

[35] 485 F2d at pp. 807-808.

2. Risk Analysis Based on Economics of Utility Regulation

The OIR's risk analysis and our finding here are based on the economics of utility regulation. To ensure efficiency, rewards should go to those who bear the actual costs and burdens of the risks engendered by particular economic actions, such as the purchase of assets. While we acknowledge that incentives play a role in the allocation of gain, we reassert this fundamental finding here. To award gains in a manner that is disproportionate to the amount of risk assumed would tend to distort the capital markets.

However, the utilities in their comments discussed a number of risks they alleged accrue to the purchase of non-depreciable property. As discussed below, for the most part, these are general risks, that are not germane to the gain on sale issue, and for which the utilities are already compensated under our regulatory framework. Nevertheless, consideration of these risks leads us to the conclusion that the OIR was not fully cognizant of the existence of shareholder risk. Over the course of this proceeding out thinking has evolved, and we acknowledge that the business of running a regulated utility is not risk free. Further efforts to quantify the level of risks would provide a false precision. However, we wish to acknowledge this shift in our thinking by allocating shareholders an amount of gain towards the top end of the range established in the OIR.

f. A new sentence is added at the end of the second full paragraph on page 28 following the sentence ending, "…shareholder and ratepayer alike." The new sentence reads:

However, these comments show that the business of running a regulated utility is not risk free, and we wish to acknowledge this fact by allocating shareholders a percentage of gain on sale towards the higher end of the range established in the OIR.

g. The allocation stated in the third line of the first, partial, paragraph on page 36 is modified to be 67% - 33%.

h. The second allocation stated in the first line of the first full paragraph on page 38 is modified to be 67% - 33%.

i. Sub-section B. of section IX., titled "Discussion—Incentives," on pages 43-45, is restated to read as follows:

3. Discussion – Incentives

We do not believe law or good regulatory policy require that we set the shareholder portion of gain on sale at an unnecessarily high level in order to achieve prudent property management. Nor do we believe utilities are threatening to deliberately manage their property irresponsibly if we do not set shareholder gain at a high level.

Nonetheless, we believe the motive for high profits – especially in a real estate market as volatile as California's – may unduly skew management decisions regarding valuable real property holdings. As we stated in D.03-09-021, "the result of allocating all net proceeds to shareholders creates a powerful financial incentive for 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." Thus we believe shareholders should receive an insignificant portion of gain on sale, consistent with our basic finding that ratepayers assume the majority of the risk associated with non-depreciable assets.

Nothing in the comments changes our tentative conclusion, set forth in the OIR, that shareholders should receive a portion of the gain ("between 5% and 50% of the gain on sale under normal circumstances") but not a majority of it. As discussed above, we have settled on 33% on non-depreciable assets in the exercise of our discretion, and our expertise in regulating public utilities. We adopt the percentages (100%-0%) the IOUs agreed were appropriate in their original comments for depreciable property. The 67%-33% split recognizes the risks we acknowledge shareholders do face in the utility business, and provides a non-trivial incentive to manage property wisely.

We noted in the OIR that it was 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 circumstances, and to encourage utility management to negotiate a reasonably high sale price for their property. We cannot quantify an allocation with exact precision, but given the record, a 67% - 33% allocation is a fair and reasonable outcome for shareholders, partly to compensate for some financial risk borne by the utility, and partly as an incentive to manage assets wisely.

If we were convinced that many of the extraordinary risks the utilities cite (*see* "Discussion - Risk Analysis," above) were germane to the gain on sale allocation question, we might grant shareholders a greater portion of the gain. However, as our earlier discussion reveals, most of the risks to which utilities point – the energy crisis, Hurricane Katrina, utility bankruptcy, municipalization, inadequate rate of return – are either so extraordinary that no gain on sale policy could compensate shareholders, or are so ordinary that our normal ratemaking processes make shareholders whole.

Nor should – or can – our gain on sale policy compensate ratepayers for extraordinary risks they bear that are unrelated to property ownership. The Commission raised rates significantly during the energy crisis, but appropriately made no adjustment to its gain on sale policy to accommodate that emergency. Nevertheless, we cannot fully discount those risks, so we have chosen to adopt an allocation towards the top of the range to reflect the fact that the business of running a utility is not entirely risk free.

j. The third sentence of the last, partial, paragraph on page 56, which sentence beings, "Thus, for example…" is modified to read:

Thus, for example, if the property is in rate base for 20 years and out of rate base for 20 years, shareholders should receive 50% of the gain/loss, and the remainder should be allocated according to the 100%-0% and 67% - 33% rules applicable to property in rate base.

k. The first full paragraph on page 80, beginning, "Several utilities…" is restated to read:

Several utilities reiterate that they need compensation for extraordinary events such as the energy crisis and natural disasters. The draft decision concluded that these risks should not play any part in allocating gain on sale. While we believe that ratepayers bear risks more directly associated with the assets subject to this rulemaking, we believe we should acknowledge the existence of shareholder risk, since the business of running a utility is not entirely risk free.

l. The third sentence of the first full paragraph on page 81,, which sentence beings, "Though ratepayers bear …" modified to read:

Though ratepayers bear the major portion of the risks associated with such property, a 67% - 33% split is a fair and reasonable outcome, partly to compensate for some financial risk borne by utilities, and partly as an incentive to utility management to manage assets wisely.

m. The second bullet point following the first full paragraph on page 81 is restated to read:

- 67% - 33% allocation of gains from non-depreciable assets to ratepayers and shareholders.

n. The allocation stated in Conclusion of Law 5 on page 90 is modified to be 67% - 33%.

o. Finding of Fact 10, on page 86, is restated to read:

"10. The general ordinary risks utilities and their ratepayers face should for the most part determine overall proportion of the gains allocation outcome, but we do not believe demonstrated utility risk should be excluded completely from our allocation methodology."

p. Conclusion of Law 24, on page 93, is restated to read as follows:

24. Any water utility property that a utility disposes of that does not meet the Infrastructure Act's three criteria - (1) that an asset be sold, (2) that it no longer be used and useful, and (3) that it be real property - shall be accounted for in accordance with our general 100% and 67% - 33% percentage allocations.

q. Ordering Paragraph 1, on page 95, is restated to read as follows:

1. Except as noted below, utility ratepayers shall receive 100% of gains on sale of depreciable utility assets. Ratepayers shall receive 67% of gains or losses on sale of non-depreciable utility assets. The utilities' shareholders shall receive the remaining 33% of gains or losses on sale of non-depreciable assets. We will call the allocations in this ordering paragraph the "percentage allocation rule."

r. Ordering Paragraph 9, on page 96, is restated to read as follows:

9. If an asset causes a utility an after-tax loss greater than $50 million, the utility shall automatically seek case-by-case determination of how to allocate the loss. In cases involving losses of $50 million or less, the utility may seek allocation of the loss according to the allocation percentage rules we adopted here (100% for depreciable assets; 67% - 33% for non-depreciable assets). If any party, including ORA, contends that the Commission should allocate the loss, in whole or part, to utility shareholders, the party should seek case-by-case treatment in a protest to the utility application.

s. Ordering Paragraph 20, on page 99, is restated to read as follows:

20. Our percentage allocation default rule (100% depreciable and 67% - 33% non-depreciable) relating to gains on sale shall apply to water utility sale assets, except where the asset sold is real property that is no longer used and useful. In the latter instance, the proceeds shall be reinvested in accordance with the Infrastructure Act.

t. Appendix B is deleted.

3. Rehearing of D.06-05-041, as modified, is hereby denied.

This order is effective today.

Dated December 14, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
Commissioners

I dissent.

/s/ JOHN A. BOHN
Commissioner

I dissent.

/s/ RACHELLE B. CHONG
Commissioner