# What Others Think

## Gain on Disposition of Utility Land Is Other Utility Income

**By Gilbert L. Hamberg***

ON February 1, 1980, the Pennsylvania Public Utility Commission held that the gain on the disposition of watershed land formerly in a utility's rate base is considered to be other utility income.[1] On issue of first impression in Pennsylvania, the commission followed the principles adopted by a majority of jurisdictions which have considered this issue[2] and explicitly rejected the minority view[3] that gain be treated "below the line" and thereby not be considered other income. There are two major parts behind the minority view — accounting treatment is binding upon rate-making treatment, and depreciable property is different than nondepreciable property. However, the rationale for the minority view is unwarranted.

The gain on the disposition of land is a direct, substantial, and integral part of furnishing utility service. A utility receives revenue to pay all its legitimate expenses, but it is not entitled to windfall profit; i.e., an instance where ratepayers pay all the expenses, but investors receive all the profits resulting from the same utility operations. Since ratepayers reimburse investors for all wear, tear, and extraordinary losses to utility assets, they also should enjoy the full extent of gains on utility assets.[4]

*Statement of Facts*

In 1927 and 1928, Philadelphia Suburban Water Company purchased 147 acres of watershed land at one of its reservoirs for $74,433 and then transferred the land into its rate base. Years later, after performing an engineering study, Philadelphia Suburban decided that this land was no longer used and useful. Wherefore, after earning a return on this asset for fifty-two years, in 1978, Philadelphia Suburban transferred the land out of rate base[5] and into a "below-the-line" account. This was done to satisfy partially[6] an outstanding $87,128 dividend owed to its sole shareholder — its parent corporation. At the time of transfer, the land had been appraised at $935,000 and was subject to sale shortly thereafter for $1.1 million.

In its rate filing, Philadelphia Suburban proposed no rate-making recognition for the substantial increase in the appraised value of the land over its original cost. Nonetheless, two expert witnesses, one a certified public accountant, and the other, a holder of an MBA degree, testified that the proper, equitable rate-making treatment for this transaction was to amortize the $847,500 gain (the difference between the appraised value minus the transfer costs and original cost) on the disposition of the land over a reasonable period of time. Philadelphia Suburban objected. It contended that since the Pennsylvania Uniform System of Accounts would treat such a gain for accounting purposes as a "below-the-line" item, then for rate-making purposes, the commission was precluded from ruling otherwise.

Explicitly rejecting Philadelphia Suburban's position, the commission reasoned that since the ratepayers were liable for operating and maintenance expenses and state and federal taxes on the land, then equitably, they likewise should be entitled to the benefit of any extraordinary gains upon utility property. It ordered $84,700 to be attributed to Philadelphia Suburban's other income account for ten years.[7] This increase to the total level of operating revenues reduced Philadelphia Suburban's revenue requirement.[8]

*Accounting versus Rate-making Treatment*

According to the Pennsylvania Uniform System of Accounts for Water Utilities, Philadelphia Suburban

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accorded proper accounting treatment for the land revenue gain. It made no recognition thereof in its filing for rate-making purposes. By recording the gain "below the line," Philadelphia Suburban tried to remove the gain from rate-making consideration.

For rate-making purposes, the commission was not persuaded by Philadelphia Suburban's accounting entry and decided to accord equitable treatment to the land gain. In so doing, the commission followed the rule vis-a-vis the interaction between accounting and rate-making principles. Accounting treatment is *not* controlling over rate-making policy.[9] Essentially, a jurisdiction's Uniform System of Accounts for a given utility is merely a notation system — one without substantive significance in a rate-making forum.

Some jurisdictions have Uniform Systems of Accounts which require the gain on the disposition of an asset formerly in rate base to be treated "above the line" as other utility income. For example, both the Federal Communications Commission[10] and Connecticut[11] require this. The Federal Power Commission (now the Federal Energy Regulatory Commission) treated the gain on the disposition of assets classified as plant held for future use "above the line" as other income.[12] Since each jurisdiction maintains a separate Uniform System of Accounts for its utilities, this limits the comparability of Uniform Systems of Accounts.

Because of the conflicts among Uniform Systems of Accounts and the many exceptions to each,[13] reviewing administrative agencies may look to accounting principles for initial guidance, but then they must exercise their own discretion to form their final decisions.[14] Otherwise, "to permit an accounting device to dictate the rule of law is to allow the tail to wag the dog. To accept judicially an accounting method without inquiry is to prevent the law."[15]

Consequently, the portions of the minority view rationales which rely upon proper accounting treatment in their respective jurisdictions are inappropriate, unpersuasive, and not controlling. This was implicit in the commission's rationale which disregarded Philadelphia Suburban's accounting treatment argument.

### *Depreciable versus Nondepreciable Property*

The treatment of the gain on the disposition of an asset formerly in rate base is the same — regardless of whether it is depreciable or nondepreciable. "[N]o difference in principle can be justified solely on the ground that the asset in question . . . happens to be depreciable.[16]

Admittedly, it may be easier to understand why the gain on the disposition of depreciable property should inure to the benefit of customers. Depreciable property is subject to annual depreciation expense for which ratepayers are liable. Ratepayers bear the risk of loss on depreciable property. Each year, ratepayers pay a return on the amount of net capital invested and annual depreciation expense.

Nonetheless, an asset in rate base is an item upon which investors receive a return — regardless of its being depreciable or nondepreciable. Ratepayers pay for losses to all assets — whether they are depreciable or not, for maintenance expenses upon those assets — whether they are depreciable or not, for all taxes upon the assets — whether they are depreciable or not, and for extraordinary losses thereupon — whether they are depreciable or not. In this context, all assets formerly in rate base are and should be treated alike.

By relying upon a distinction between depreciable and nondepreciable property, the minority view actually ignores the concept of appreciation. Depreciation is the recoupment of the original cost less the salvage value over the life of the asset. Appreciation is the gain in the value of the asset over original cost upon its disposition. Regardless of whether the asset had been depreciated prior to its disposition, the treatment of the gain would be the same. Consequently, this segment of the minority view's rationales likewise is inappropriate, unpersuasive, and not controlling.

### *Majority View*

The commission decided to follow the precedents from 17 state and federal jurisdictions which treat the gain in the disposition of an asset formerly in rate base "above the line" as other utility income. Otherwise, flowing the gain "below the line" to investors would have allowed Philadelphia Suburban either to increase the amount of dividends it would have paid to its parent corporation or to reinvest the money in additional utility plant or equipment.[17]

Initially, it is important to realize "that there is no impediment, constitutional or otherwise, to recognition of a rate-making principle"[18] allowing ratepayers to enjoy the benefit of the gain on land revenues. Such a holding does not constitute a deprivation of private property without due process of law or just compensation.[19] Moreover, the commission's holding can withstand appellate attack on constitutional grounds except for proof that by attributing the land gain to other income, the commission somehow abused its discretion.[20] There is no commission abuse of discretion "unless the shareholders fail to receive a fair return on their investment."[21] Philadelphia Suburban proffered no record evidence to substantiate such a claim.

The object of rate making is to establish just and reasonable rates. This entails making a reasonable balance between the rates charged to customers and the returns earned by investors.[22] Two principles help to determine the competing ratepayers and investor claims to the land revenue gain in question.[23] One is that the right to gain follows the risk of loss. Two is that the economic benefit follows the one who bears the financial burden.

In an era of rising value on real estate, there was little risk of loss on Philadelphia Suburban's watershed land,[24] which was located in a prosperous suburban

Philadelphia area. Therefore, the critical analysis revolves about a determination of which party — ratepayers or investors — bore the financial burden on Philadelphia Suburban's watershed land. Without question, a review of the cases demonstrates the equity and reasonableness of assigning that burden, and the concomitant economic benefit, to the ratepayers.

The California Public Utilities Commission expressed the majority view with utmost persuasiveness.[25]

> [T]he appreciation in value of the subject utility assets should be flowed directly through to the consumer.
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> High risks justify larger returns while low risks more nearly guarantee the investment and thus may warrant smaller returns. The latter situation is most accurately demonstrated in the area of utility equity investment. Investors are foreclosed from any claim to an asset's appreciated value when they have been insulated against the risk of loss of their investment. On the other hand, significant risks associated with utility assets are typically imposed upon ratepayers. Many utility assets are susceptible to loss or damage from acts of nature and man, and risks of such casualties are generally passed on to the consumer. As a rule, the loss from premature retirement of assets because of obsolescence also rests with the ratepayer. Further, in the instant proceedings, the additional risks occasioned by withdrawal, such as potential gas capacity shortages and increased compressor fuel costs, are borne by the ratepayer. The investor — and it is the very nature of his investment — bears no comparable risk.
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> The equities are equally clear in our mind and dictate that the economic benefit should follow the economic burden. It is the ratepayer who bears the expenses of ordinary operation and maintenance and depreciation, including obsolescence and depletion. Fairness requires that consumers, whose payments reimburse investors for all wear, tear, and waste of utility assets in service, should benefit in situations where gain occurs and to the full extent of that gain. Investors who are afforded the opportunity of a fair return on a secure investment in utility property cannot claim they have not received their just due.

The ratepayers paid for the burden of any loss to Philadelphia Suburban's watershed land for the entire 52-year period when it was in rate base. Over the years, the investors recovered earnings attributable to this watershed land which were far in excess of their original investment. The ratepayers paid all of the maintenance costs and taxes on the land. They also paid for annual depreciation expense — including obsolescence — on depreciable assets. If Philadelphia Suburban had experienced extraordinary losses on the land, then standard Pennsylvania accounting and rate-making practice would allow "above-the-line" recovery as allowable operating expense for them.[26] In addition, for rate-making purposes, the commission allowed Philadelphia Suburban to treat the flood damage expense and the cold weather expense as "above-the-line" items and to amortize them over ten years.

The majority view holds that the profit or gain on the disposition of items formerly in rate base should inure to benefit ratepayers and not investors. The cases so hold on the disposition of land[27] and of many other items, including profits from the disposition of by-products incidental to utility production,[28] coal,[29] advertisements,[30] vessels,[31] nuclear fuel,[32] temporary cash investments,[33] reacquired debentures and preferred stock,[34] reserve for deferred state income tax funds,[35] rental fees,[36] and income tax refunds.[37] Since the ratepayers are liable for the risk of loss on utility property, then the equitable corollary is that profits likewise should be attributed to them.[38] Thus, upon the disposition of utility property, the gain should flow through to the other income account.

Only three cases form the minority view. Their rationales are readily distinguishable. As discussed above, they inappropriately fail to make a distinction between accounting and rate-making principles and inappropriately make a distinction between depreciable and nondepreciable property. Pennichuck did not recognize that there is no risk of loss on the sale of land. Thus, it does not matter that in New Hampshire, accounting principles precluded charging ratepayers for losses on the disposition of land.[39] One of the cases forming the Lexington rationale has since been rejected.[40] Boise is distinguishable because the commission had record evidence available to support its land revenue holding.[41] Since the premises behind the minority view rationale fail, therefore, the holdings in these cases do not provide persuasive precedent.

### *Conclusion*

By attributing the gain on the disposition of watershed land formerly in Philadelphia Suburban's rate base to other utility income, the Pennsylvania commission has abided by arguments from the majority of American jurisdictions which have considered this issue. The gain on the disposition of land was a direct, substantial, and integral part of furnishing utility service. The transfer of the gain "below the line" to investors may have been an incentive to a utility to purchase additional land beyond the level which was required in the hope of acquiring additional windfall profits in the future. This might lead to land speculation. In the interest of establishing just and reasonable rates, this is a practice which should not be condoned by rate-making forums.

# Footnotes

[1]Pennsylvania Pub. Utility Commission v Philadelphia Suburban Water Co. — Pa PUC — (filed February 1, 1980), mimeo at 23-25, as reviewed in 105 PUBLIC UTILITIES FORTNIGHTLY 66, June 19, 1980. The commission granted Philadelphia Suburban only $1.3 million of a proposed annual increase in rates of $4.1 million.

[2]Precedent from cases in 17 jurisdictions which generally or specifically can be used to support this holding are: Arkansas —commission; California — commission; Connecticut — state and federal courts; Delaware — commission; District of Columbia —commission and federal circuit court of appeals; Federal Communications Commission; Federal Power Commission (now Federal Energy Regulatory Commission); Maine — commission and state court; Maryland — commission; Michigan — commission and state court; Nebraska — commission; New York — commission and state court; ninth circuit federal court of appeals; North Dakota —commission; Pennsylvania — commission and state court; Wyoming — commission; Alberta, Canada — commission.

[3]Only three jurisdictions reviewing this issue support this position — Boise Water Co. v Idaho Pub. Utilities Commission (1978) 99 Idaho 158, 578 P2d 1089; Lexington v Lexington Water Co. (Ky App 1970) 458 SW2d 778; Pennichuck Waterworks v New Hampshire (1960) 36 PUR3d 374, 103 NH 49, 164 A2d 669.

[4]The commission's holding on this issue is of utmost importance. It affects other utilities which are contemplating disposing of assets formerly in rate base. It affects the decision to place the assets in rate base in the first place. See, for example, application of Pennsylvania Gas and Water Company for approval of transfer of real estate (Pa PUC 1980) A-00101378; Philadelphia Suburban's current rate case now pending before the commission at R-80041174 (1980); *1980 Annual Report, ABA Section of Public Utility Law*, at 308, 309.

[5]This was during the test year.

[6]Actually, this was part of a larger financial transaction involving other tracts of Philadelphia Suburban's watershed land.

[7]Ten years is often the length of time over which extraordinary losses are amortized.

[8]Philadelphia Suburban appealed this issue to the Pennsylvania commonwealth court. On April 6, 1981, in Philadelphia Suburban Water Co. v Pennsylvania Pub. Utility Commission (1981) — Pa Cmwlth —, — A2d — (No. 561 CD 1980), the Pennsylvania commonwealth court reversed the commission's holding in this case. However, on May 6, 1981, the commission filed with the Pennsylvania supreme court a petition for allowance for appeal of the commonwealth court's decision. Currently, the decision whether to permit the appeal is still pending with the Pennsylvania supreme court.

[9]This is the rule established by the United States Supreme Court in American Teleph. & Teleg. Co. v United States (1936) 299 US 232, 16 PUR NS 225, 81 L Ed 142, 57 S Ct 142; see also Alabama-Tennessee Nat. Gas Co. v Federal Power Commission (CA5th 1966) 64 PUR3d 81, 359 F2d 318; Washington Pub. Interest Organization v District of Columbia Pub. Service Commission (DC Ct App 1978) 28 PUR4th 153, 393 A2d 71.

[10]In Re American Teleph. & Teleg. Co. (1977) 64 FCC2d 1.

[11]Greenwich Water Co. v Houseman, — A2d — (Conn Super Ct No. 1008038, filed May 12, 1979).

[12]See (1971) 45 FPC 106, Order 420-A.

[13]According to Washington Public (see footnote 9), the exceptions essentially swallow up the rules. Also see Accounting Principles Board Opinion No. 2, Addendum No. 2, which infuses equitable rate-making principles to supplement generally accepted accounting principles.

[14]As a matter of fact, according to the Pennsylvania commonwealth court, "the application of accounting principles is within the discretion of the [Pennsylvania] Public Utility Commission, and in the absence of a manifest abuse . . . we are unwilling to interfere with its judgment." West Penn Power Co. v Pennsylvania Pub. Utility Commission (1980) 35 PUR4th 393, — Pa Cmwlth —, 412 A2d 903, 908.

[15]Democratic Central Committee v Washington Metropolitan Area Transit Commission (1973) 158 US App 7, 485 F2d 786, 819, 820, cert den in (1974) 415 US 935.

[16]Ibid at 818; see also footnote 10 at 66.

[17]See footnote 11, mimeo at 8.

[18]Re Southern California Gas Co. (Cal 1978) 32 PUR4th 423, 436; see footnote 15 at 800.

[19]See footnote 11, mimeo at 16, 27.

[20]City of Pittsburgh v Pennsylvania Pub. Utility Commission (1958) 25 PUR3d 273, 187 Pa Super Ct 341, 144 A2d 648.

[21]Bridgeport Hydraulic v Council on Water, Inc. (DC Conn 1977) 453 F Supp 942, 952.

[22]Pennsylvania Gas & Water Co. v Pennsylvania Pub. Utility Commission, — Pa —, — A2d — (No. 35, May term 1978, filed February 1, 1980); Federal Power Commission v Hope Nat. Gas Co. (1944) 320 US 591, 51 PUR NS 193.

[23]See footnote 15.

[24]See footnote 10 at 68; see footnote 15 at 810.

[25]See footnote 18 at 437.

[26]Pennsylvania Uniform System of Accounts for Water Utilities, Account 141 — Extraordinary Property Losses; see footnote 22, mimeo at 3, 4.

[27]See footnotes 10, 11, and 15; Re Consolidated Edison Co. of New York (1972) 12 NY PSC 630; New York Water Service Corp. v New York Pub. Service Commission (1960) 37 PUR3d 442, 12 AD2d 122.

[28]Re Panhandle Eastern Pipe Line Co. (FPC 1961) 38 PUR3d 332.

[29]Re Montana-Dakota Utilities Co. (ND 1958) 22 PUR3d 505.

[30]Re United Teleph. Co. of the West (Neb 1975) 12 PUR4th 462.

[31]Re Casco Bay Lines v Maine Pub. Utilities Commission (Me Sup Jud Ct 1978) 390 A2d 483.

[32]Re Detroit Edison Co. (Mich 1976) 14 PUR4th 223.

[33]Re National Fuel Gas Distribution Corp. (NY 1976) 17 PUR4th 138.

[34]Re General Teleph. Co. of Michigan (Mich 1977) 18 PUR4th 509.

[35]Michigan Bell Teleph. Co. v Michigan Pub. Service Commission (Mich Cir Ct 1977) 23 PUR4th 101.

[36]See footnote 18.

[37]Peoples Nat. Gas Co. v Pennsylvania Pub. Utility Commission (1980) — Pa Cmwlth —, 415 A2d 937; Peoples Nat. Gas Co. v Pennsylvania Pub. Utility Commission (1979) — Pa Cmwlth —, 409 A2d 446.

[38]Re Casco Bay Lines (Me 1975) 11 PUR4th 172, affirmed (Me Sup Ct 1978) 390 A2d 483; Re Detroit Edison Co. (Mich 1977) 20 PUR4th 1. There, the Michigan commission held that: since the "applicant's customers were charged for the property while it was in the rate base, they should receive the benefit of the gain on the sale." 20 PUR4th at 28; see also Re Calgary Power Ltd (Alberta 1980) 34 PUR4th 398, 412.

[39]See Pennichuck (footnote 3) at 672.

[40]Democratic Central Committee (see footnote 15) rejected Re D. C. Transit System, Inc. (Wash MATC 1963) 48 PUR3d 385.

[41]See Boise (footnote 3) at 162.