



PROGRESS OF REGULATION

Trends and Topics

Disposition of Utility Real Property — Rate-making Treatment of Gains

WHEN a regulated public utility disposes of real property and a gain is realized, there is a possibility of two rate-making events: above-the-line treatment or below-the-line treatment. Above-the-line treatment increases utility income and ultimately benefits ratepayers in the form of reduced rates or smaller rate increases. In contrast, below-the-line treatment characterizes revenue as non-utility income and benefits the utility's shareholders by making available surpluses with which to pay, or increase, dividends.

This article will examine the rationale of several recent decisions at the state regulatory level which have dealt with this issue. At the federal level, the reader is directed to orders issued by the former Federal Power Commission: Order No. 420 (1971) 45 FPC 106; Order No. 420-A (1971) 45 FPC 340.

Majority and Minority Views

Among the various state commissions, there is a clear majority and minority in the treatment of gains. The majority of jurisdictions has applied above-the-line treatment to gains from the sale of property included or previously included as part of a utility's rate base. See "Gain on Disposition of Utility Land Is Other Utility Income," by Gilbert L. Hamberg, 108 PUBLIC UTILITIES FORTNIGHTLY 41, August 13, 1981; see also *Re Tampa Electric Co.* (Fla PSC 1982) 49 PUR4th 547. The minority has afforded below-the-line treatment.

Although the line between the majority and minority positions is drawn clearly, the factors affecting the decision to apply above- or below-the-line treatment are not easily distinguishable. In many instances these factors are overlapping and intertwined.

Some of these factors are: (1) the relevance that should be attached to the fact that land is not a depreciable asset, (2) who owns utility land devoted to public service, and (3) who bears the risk of loss or shoulders the burden of carrying the property. All of these factors determine whether ratepayers or shareholders are to benefit.

Other factors reflect current economic and political problems. For instance, many natural gas and electric utilities today are faced with the prospect of diminished future load growth which may obviate the need to hold onto some parcels of land. Also, the decision to dispose of real property may not always be the utility's to make, since its property is subject to the sovereign powers of condemnation. As will be seen, the ability of a utility to time the disposition of this asset may affect the type of treatment a gain is afforded because of the possibility that the utility would have engaged in land speculation at the ratepayers' expense.

Below-the-line Treatment

The most recent gains treatment case, it is believed, was decided on February 28, 1983, by the commonwealth court of Pennsylvania. *Pennsylvania Gas & Water Co. v. Pennsylvania Pub. Utility Commission* (Pa Commw 1983) 52 PUR4th —, 456 A2d 1126. This decision, which held that gain from the sale of land was to be credited to a shareholder surplus account, is noteworthy for several reasons.

First, the court determined that the gain should not benefit ratepayers because shareholders had contributed the capital from which the land was purchased and bore the risk of any decline in value. *Id.* at —, 456 A2d 1137. Second, this decision was in accord with an earlier decision, discussed below, which was decided in 1981; thus the minority treatment of gains has some small measure of entrenchment in the state of Pennsylvania.

The court emphasized two distinct factors for consideration in choosing rate-making treatment: asset ownership and risk-reward. (However, many decisions applying a stricter risk-reward analysis have often made the determination of asset "ownership" a preliminary matter as part of a determination of who incurs investment risk.)

Before leaving this case, other points of the court's decision merit comment. The office of consumer advocate had asserted Pennsylvania's uniform system of accounts

should not control, and that it was unfair to allocate the gain to shareholders because of risk since land only appreciates in value. The court rejected these arguments.

A final argument of the consumer advocate, also rejected by the court, was that above-the-line treatment was necessary in order to prevent "manipulation" of lands to the ratepayers' detriment. *Id.* —, 456 A2d 1138.

On April 6, 1981, in an earlier case, the Pennsylvania commonwealth court had held that gain received from the sale of nondepreciable watershed property, no longer deemed to be used and useful, should accrue to the shareholders' benefit. The court acknowledged that the land had been included in rate base calculations that had provided a return to shareholders. Since this was the court's first encounter with this issue, its decision reviewed a wide spectrum of arguments. *Philadelphia Suburban Water Co. v Pennsylvania Pub. Utility Commission* (Pa Commw 1981) 43 PUR4th 133, 427 A2d 1244.

The commission had not disputed the shareholders' ownership of the gain. It had classified the gain as extraordinary utility income and had ordered the utility to pass its benefit onto the ratepayers. *Id.* at 134.

Confiscation and Asset Ownership. Philadelphia Suburban Water Company had argued the commission's order confiscated the utility's property without due process or just compensation. In agreeing with the utility's position, the court stressed the property involved was a nondepreciable asset and no longer included in the rate base.

Bolstering the court's rationale was the method by which the land had been acquired — by a "normal real estate transaction," not by the power of eminent domain. Further, there was no indication that the land had been purchased below market value. The court stressed that ratepayers, by paying utility bills, did not acquire any interest, legal or equitable, in property or funds dedicated to public use. *Id.* at 135, 136.

Depreciation. The keystone of the state court's decision was that the watershed land was a nondepreciable asset. This caused the court to conclude that "the utility gains no advantage as it does from depreciable assets for the noncash expense of depreciation." But because land was not consumed in the course of providing utility services, the court determined that the "ratepayer, though bearing the cost of taxes, pays only for the use of land, but gains no equitable or legal right therein." *Id.* at 136.

By paying depreciation charges, ratepayers might assert an equitable claim to ownership of utility property. However, because land is not depreciable, the court held that ratepayers were not equitable owners, and not having paid the cost of purchasing nondepreciable property, they were not to realize the profits or losses on its sale or other disposition. 43 PUR4th at 136, 137. See also *Boise Water Corp. v Idaho Pub. Utilities Commission* (1978) — Idaho —, 578 P2d 1089; *City of Lexington v Lexington Water Co.* (Ky App 1970) 458 SW2d 778, 779.

Risk and Reward. The commonwealth court rejected the commission's statement that because land generally appreciates there was no risk of loss on its sale. The court considered this to be a myopic view of the realities of the market system. 43 PUR4th at 136, Footnote 6.

Presumably, the commission made this statement to avoid any claim by the utility that the gain should be treated as a reward to shareholders for having assumed an investment risk, and to swing the issue of gains treatment solely upon the consideration of a benefit-burden analysis, thereby hoping to claim the gain for ratepayers since they "paid for the land" through rates which paid for taxes, and other expenses associated with land. However, this was negated by the court's stance that ratepayers only pay for the use of the assets; i.e., pay for services received.

Accounting Rules. The office of consumer advocate had asked the court to ignore the state's uniform system of accounts. The commission had wanted the court to rule that "appreciation in the sale or transfer of land should inure to the benefit of the ratepayer and that accounting procedures do not dictate rate-making policy." *Id.* at 137. The commonwealth court examined its uniform system of accounts (retired lands) and concluded that a net gain (or loss) from the sale of land should be treated below-the-line as a credit or debit to a shareholder's surplus account. *Id.*

The commonwealth court distinguished its decision from a federal court's decision that had reached an opposite result. See *Democratic Central Committee v Washington Metropolitan Area Transit Commission* (DC Cir 1973) 485 F2d 786, cert den (1974) 415 US 935. The first difference noted by the state court was the method of acquisition. In *Democratic Central Committee*, a transit utility had acquired a transit system pursuant to an act of Congress at a cost of \$10 million less than original cost. In that case ratepayers had paid for the acquisition of capital assets, a function usually performed by shareholders.

Furthermore the District of Columbia Public Service Commission at that time lacked a specific rule dealing with this type of gain. This absence of a "rational regulation" dictating the appropriate action for a commission to take forced the circuit court "to adopt a rational rule of accounting to accommodate equitable principles." *Philadelphia Suburban Water Co.* at 138.

Above-the-line Treatment

Sandwiched between the time of the two Pennsylvania commonwealth court decisions is a decision by the Massachusetts Department of Public Utilities which afforded above-the-line treatment. *Re Boston Gas Co.* (Mass DPU 1982) 49 PUR4th 1. The department's decision rested upon its application of a benefit-burden analysis. The state attorney general had argued that prior year inclusion in rate base had burdened the ratepayers because they had been required to pay a return on the land as well as associated property taxes. *Id.* at 26. See also *Re Detroit Edison Co.* (Mich PSC 1977) 20 PUR4th 1.

The utility's position was that because land was a nondepreciable asset, the company had recovered none of the cost of its investment from its customers. Further, since ratepayers allegedly incurred none of the risks of ownership, the utility claimed that the ratepayers were not entitled to any benefit. 49 PUR4th at 26. The Massachusetts department rejected the utility's position completely.

Depreciation. Most significant was the department's statement that the nondepreciable status of land was irrelevant. Instead the department determined that because the land had been treated as an above-the-line item and included in rate base, above-the-line treatment of the gain was warranted.

In contrast, the Pennsylvania commonwealth court decisions would appear to say the fact that an item is in rate base indicates only that it is used to render service to ratepayers, and unless that item is a depreciable asset, ratepayers pay only for its use. Thus, both positions acknowledge that ratepayers pay, in the form of a return on investment and taxes, etc., when land is present in rate base. However, their divergent treatments would appear to stem from how that payment is characterized: the Massachusetts department calls it a burden; the commonwealth court calls it a user charge or, more appropriately, it could be referred to as economic rent.

Compensation. In addition to holding that ratepayers bore the burden and, thus, should reap the reward on disposition, the department considered shareholders to have been adequately "compensated" by having received a return on the lands while they were in rate base. The department commented that the possibility of a windfall to the shareholders was an "uncharacteristic risk-reward situation for a regulated utility to be in with respect to its plant in service." *Id.* at 26.

Of interest to note is the department's position that a utility earning a reasonable rate of return would receive a windfall under below-the-line treatment. Under this theory, if a utility in a particular year, or over a period of years, failed to earn an adequate return and also sold property at a profit, it could lay claim to the gain.

Regulatory Status

Thus far, the majority and minority positions of the decisions examined have acknowledged several similar factors. Among these are that ratepayers pay a return on lands included in rate base and also pay the associated taxes. However, these positions are contradictory. The reason for this may be the undue amount of emphasis that some parties have placed on the term rate base.

"Rate base" as a concept for determining the price of a service exists only for regulated entities. But for this quasi-monopoly status, the price of utility services could

be determined without reference to rate base. Synonymous with rate base is the concept of "used and useful." This concept protects ratepayers from paying excessive or inflated rates. Thus, when land is no longer used and useful either the regulatory body or the utility will remove it from rate base. This would tend to affirm the minority's position, as exemplified by the Pennsylvania decision that land is used only to render service.

If there was no rate base or regulatory body, would a utility's customers lay claim to corporate profits from the sale of assets used to render services to those same customers? The answer would appear to lie in another concept: that the function of a regulatory body is to impose marketplace conditions on utilities so that ratepayers pay only just and reasonable rates.

After the regulatory process has fixed a utility's rates, ratepayers should be in the same position as if they had gone into the marketplace and purchased those same services. Thus, but for the presence of regulation and the rate base concept, it would be highly unlikely that customers would lay claim to utility assets. This viewpoint is supported by the Pennsylvania decisions, which adhere to the concept that ratepayers pay only for service and should not expect nor receive any benefit from the sale of assets.

Conclusion

The majority and minority positions for the treatment of gains from the disposition of utility real property are irreconcilable. This schism, although couched in terms of ownership, risks, burdens, accounting principles, and depreciation, centers on the resolution of one issue: What does a ratepayer pay for?

Is it just for services received — i.e., use of the land — or, is it for an interest, equitable or otherwise, that entitles one to benefit by a gain from the land's removal from rate base and subsequent disposition? The resolution of these questions is difficult because the regulatory process by necessity involves a balancing of the voiced interests of ratepayers and investors. It remains for the state commissions and courts to address this issue of payment when rendering future decisions on gains from disposition of utility real property.

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Review of Current Cases

WPPSS Bond Contracts Voided; Statutory Authority Lacking

The Washington supreme court has held that agreements between 19 state public utility districts, nine local municipalities, and the Washington Public Power Supply System for the payment of revenue bonds in connection with the construction of two nuclear power plants are void and unenforceable.

The Washington Public Power Supply System had en-

tered into agreements with 88 "participants," — nine Washington cities, 19 Washington public utility districts, one Washington irrigation district, seven Oregon cities, four Oregon peoples utility districts, five Idaho cities, and 43 rural electric cooperatives — whereby each participant had agreed to pay monthly its proportionate share of the cost of revenue bonds issued to build two nuclear plants, WNP units 4 and 5. In return each received the right to purchase a share of "project capability." However, the plants were canceled when both were approximately