

**STATE PUBLIC SERVICE COMMISSION DISPOSITION
OF THE GAIN ON SALE OF UTILITY ASSETS**

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Introduction and Background

Fairly frequently, regulated utilities dispose of assets once regarded as necessary to the provision of utility service. Examples of circumstances that might cause utilities to sell assets are:

- A utility outgrows its headquarters office space. It builds elsewhere and sells the former headquarters.
- A utility sells land previously held for future use after it determines that the land will not be necessary for utility service.
- A utility sells productive assets or office space to an unregulated subsidiary with the intention of purchasing the services from the subsidiary or entering into a lease agreement for the use of the space.
- An electric utility sells excess generating capacity to another utility and enters into an agreement with it to share that capacity.
- A telecommunications utility sells rural exchanges to another provider.
- A gas company sells a gas field and storage facility to another gas utility.

In each of these instances and others, the disposition of the gain on the sale (or, in rare circumstances, the loss) is of concern to regulatory commissions and is the subject of intense debate. The gain, which is measured as the difference between the book value of the asset (the original cost less accumulated depreciation) and its selling price, could be allocated to ratepayers, to utility shareholders, or split between the two. Particularly if the asset has been held for a long period, the gain can be substantial. In a recent California case, the after-tax gain to a utility on the sale of a headquarters building exceeded \$24 million.

State public utility commissions across the country have treated gains on the sale of utility assets differently and have utilized a wide range of arguments to support their disposition of the gain. Recently, the California Public Utilities Commission (PUC) asked the National Regulatory Research Institute (NRRI) to survey states and determine how they had treated the gain on sale of utility assets. A total of forty-nine state commissions responded to the survey (out of a total of fifty two possible--fifty states, the District of Columbia, and an extra commission in New Mexico

where jurisdiction is split between two commissions).¹ This report presents the results of that survey and summarizes the arguments used to support alternatives to the disposition of the gain.² The survey instrument and a listing of the respondents are included as appendices.

The commission policies and actions described in this report for the most part deal with what could be regarded as extraordinary gains and losses by utilities on the disposition of assets. There is less controversy over "normal retirements" of assets which have outlived their usefulness. In the case of normal retirements, accumulated depreciation is adjusted for the gain or loss and the difference is commonly passed on to ratepayers.

The Prevalence of Gain-on-Sale Issues

Gain-on-sale issues are considered by state public utility commissions with surprising frequency. As Table 1 indicates, the issue most frequently arises with electric utilities, followed by telecommunications and gas utilities.³ In part because of limited state commission jurisdiction over water utilities, only eighty-eight gain-on-sale issues were reported for water utilities. Overall, respondents to this survey question (forty-three states) indicated that their state commissions had considered nearly 600 gain-on-sale issues in the past ten years.

TABLE 1
NUMBER OF GAIN-ON-SALE CASES HANDLED BY
STATE COMMISSIONS IN THE PAST TEN YEARS
BY UTILITY SECTOR

¹ The responses to specific questions may not tally to the total because some respondents did not answer all the questions asked. The Georgia PSC responded by letter indicating gain-on-sale issues have not been significant. The Utah PSC responded by phone and indicated that three gain-on-sale issues had arisen but had been deferred to rate cases which had not yet been heard.

² Where specific state commission actions are cited, the state citation is listed if it was provided by the respondent.

³ In those cases where a state commission provided a range rather than a specific number of cases, the lower limit of the range was used.

Electricity	238
Telecommunications	145
Gas	121
Water	88

Source: 1994 NRRI Survey, Question 1

In the near future, the incidence of gain-on-sale issues is likely to increase as utilities facing competitive pressures attempt to divest themselves of unproductive assets. As utility markets are segmented into competitive and non-competitive markets, the gain-on-sale issue will likely become more difficult as utilities sell assets to their affiliates that may not be subject to rate regulation. For utilities that are not subject to rate-base, rate-of-return regulation, regulators will still need to consider gain-on-sale issues to determine if the gains are to be regarded as exogenous or endogenous variables.

State Commission Policies on Gains on Sale by Regulated Utilities

Procedurally, state public utility commissions have two choices for dealing with gain-on-sale issues. They can develop a generic policy or they can respond to gain-on-sale issues on a case-by-case basis. As Table 2 indicates, the majority of state commissions (thirty-seven of the forty-seven commissions which responded to this question) deal with gain-on-sale issues on a case-by-case basis. Those states that have established a generic policy are listed in Table 3.⁴

TABLE 2

**NUMBER OF REPORTING COMMISSIONS WITH GENERIC
GAIN-ON-SALE POLICIES AND NUMBER THAT HANDLE
GAIN-ON-SALE ISSUES ON A CASE-BY-CASE BASIS**

⁴ Though the Georgia PSC did not directly respond to this question, it provided a copy of a state statute that mandates the treatment of gains on sale for electric utilities.

Generic Policy	10
Case-by-Case Basis	37

Source: 1994 NRR Survey, Questions 2 and 4

<p>TABLE 3</p> <p>STATES WHICH HAVE ESTABLISHED A GENERIC POLICY ON THE GAIN-ON-SALE OF UTILITY ASSETS</p>	
<ul style="list-style-type: none"> ● Connecticut (electric utilities) ● Illinois ● Maine ● Tennessee ● Washington 	<ul style="list-style-type: none"> ● Georgia ● Iowa ● Massachusetts ● Virginia ● Wisconsin

Source: 1994 NRR Survey, Question 2⁵

Table 4 identifies to whom the gain is allocated by those states with generic policies--to utility shareholders, ratepayers, or a split between the two. Descriptions of several of the generic policies follow the table.

<p>TABLE 4</p> <p>ALLOCATION OF GAIN-ON-SALE BY STATES WITH GENERIC POLICIES</p>	
Allocate the Gain to Ratepayers:	CT, IL, ME, MA, TN, WI
Allocate the Gain to Shareholders:	IL, IA, WI
Split the Gain:	VA, WA

⁵ The Missouri PSC response indicated that the Commission has maintained a consistent policy over time, but that it retains the right to examine each case on its own merits.

Source: 1994 NRRI Survey, Question 3⁶

The Iowa Utilities Board's generic policy allocates the gain to shareholders by placing the gain in an account that falls "below the line" unless the Board finds good cause for allocating the gain differently.⁷ The Wisconsin Public Service Commission's (PSC) generic policy allocates the gain to shareholders if the gain was related to an operating unit and to ratepayers if it was related to a non-operating unit. (For that reason, it was included in two categories in Table 4.) Like others, the Illinois Commerce Commission's generic policy is the result of consistent decisions rather than the result of a generic proceeding on the treatment of gains on sale. The Illinois policy is to allocate the gain on the sale of a depreciable asset to ratepayers by increasing the reserve for accumulated depreciation, which, in turn, reduces the ratebase and rates. The gain on non-depreciable assets is allocated to shareholders by recording the gain as non-utility income. Though the Ohio PUC did not report having a generic policy, it did indicate that it follows the requirements of the applicable Uniform Systems of Accounts (USOAs).

The Virginia State Corporation Commission and the Washington Utilities and Transportation Commission (UTC) have generic policies that split the gain between ratepayers and shareholders. The Virginia policy splits the gain 50/50 between ratepayers and shareholders, though ratepayers have been held harmless for losses on sales between affiliates. The Washington UTC, in a recent case dealing with the sale of former utility assets, split the gain in proportion to the time assets were in the ratebase and the time they were in non-utility accounts.

The other state commissions with generic policies allocate the gain entirely to ratepayers. For those states with a generic policy of allocation of the gain exclusively to ratepayers or those states that award a portion of the gain to ratepayers, Table 5 shows how the gain specifically impacts rates--through a reduction of ratebase or an offset against revenue requirements.

⁶ The survey question also asked if the allocation of the gain was based on specific criteria enumerated in the commission policy or if the gain was retained within utility operations. Neither question was responded to by a significant number of states and can be regarded as duplicating other questions. States are listed in two categories if the gain is allocated to ratepayers under some circumstances and to shareholders under others.

⁷ The Iowa survey response also indicated that it responds on a case-by-case basis because the accounting treatment does not necessarily dictate the ratemaking treatment.

<p style="text-align: center;">TABLE 5</p> <p style="text-align: center;">ALLOCATION OF GAIN TO RATEPAYERS BY STATES WITH GENERIC POLICIES</p>	
Through Reduction of Ratebase	IL, TN, WA, WI
Through Offset Against Revenue Requirements	CT, MA, ME, TN

Source: 1994 NRRRI Survey, Question 3

Both methods have the effect of reducing customer rates. A reduction of rate base decreases the amount on which the utility earns its allowed rate of return (i.e., it reduces rates by an amount equal to the gain times the allowed percentage rate of return). An offset against revenue requirements to reflect the gain directly reduces the amount of revenue the utility is allowed to collect in rates (i.e., it reduces rates by an amount equal to the gain). For those states with generic policies that allocate the gain to ratepayers, the methods applied are fairly evenly split, or a combination of the two is used (e.g., the Tennessee PSC uses either or both methods to apportion the gain to ratepayers.). The Connecticut Department of Public Utility Control, which has a generic policy for electric utilities, reported that it reduced rate year cost of service and revenue requirements for projected rate year gains on utility assets that are (or ever were) in the rate base.

As was indicated earlier, the majority of reporting state commissions handle gain-on-sale issues on a case by case basis. Table 6 identifies to whom the gain was allocated in the most recent commission action on gain on sale for those states without a generic policy.⁸ As was the case for those states with a generic policy, most states allocate the gain to ratepayers. Table 7 identifies the method used to allocate the gain to ratepayers by states without a generic policy. Though most either reduced ratebase or revenue requirements, several other methods of allocating the gain to ratepayers were employed. The Kansas Corporation Commission reported using a direct refund to customers, and the Maryland PSC amortized the gain to net income. The North Dakota PSC reported that no gain-on-sale issues had been dealt with but that a number of

⁸ Those states which deal with gain-on-sale issues on a case-by-case basis were asked how they responded in their most recent commission order. The most recent commission order may or may not be representative of all commission actions.

cases involving acquisition premiums had been encountered. An acquisition premium, the purchase of assets by a utility for a price in excess of the book value based on original cost, is the flip side of a gain on sale. The North Dakota PSC authorized the premium as an above-the-line cost to be reviewed later by comparing the cost of the premium to purchased gas adjustment reductions (PU-400-93-534). The Oklahoma Corporation Commission allocated a portion of the gain in a case to ratepayers by reducing the company's

TABLE 6 ALLOCATION OF GAIN-ON-SALE BY STATES THAT HANDLE GAIN-ON-SALE ISSUES ON A CASE-BY-CASE BASIS (MOST RECENT COMMISSION ACTION)	
Allocate the Gain to Ratepayers	AK, DC HI, ID, LA, MD, MI, MS, NY, OH, OR, RI, VT
Allocate the Gain to Shareholders	FL, KY, MO, NH, PA, SC
Split the Gain	AZ, CO, KS, NM(PSC), NC, ND, OK, SD, TX

Source: 1994 NRRI Survey, Question 5⁹

TABLE 7 ALLOCATION OF GAIN TO RATEPAYERS BY STATES THAT HANDLE GAIN-ON-SALE ISSUES ON A CASE-BY-CASE BASIS (MOST RECENT COMMISSION ACTION)	
Through Reduction of Ratebase	DC, HI, MD, NC, OH, SD, VT
Through Offset Against Revenue Requirements	AK, HI, ID, LA, MI, MS, NY, OH, OR, RI, SD

⁹ A fourth alternative, "Retain the gain within utility operations," was included in the survey instrument. Few states responded to that alternative, which was unclear and duplicated the other options. As a result, the responses to that alternative have not been included in this summary report. Some respondents, who had split the gain, treated the three options as not being mutually exclusive and, as a result, checked all three options. For the sake of simplicity, their responses have been listed in the "Split the Gain" category only. The Texas PUC provided an oral response by phone.

Other	AZ, KS, MD, ND
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Source: 1994 NRRRI Survey, Question 5¹⁰

revenue deficiency over two years. The remainder of the gain was granted to shareholders (Cause #29562, 12-20-85).

Two state commissions reported that they allowed the utility to retain the gain in return for investments in service or plant upgrades. The Montana PSC allowed the utility to retain the gain in return for an investment of a similar amount over three years in an expanded service program. The Wyoming PSC made retention of the gain conditional on investment of an equal amount in plant upgrades.

Table 8 and Table 9 combine the states with generic policies and those which deal with gain-on-sale issues on a case-by-case basis. As Table 8 indicates, of the three options, state public utility commissions allocated the gain exclusively to ratepayers most

TABLE 8	
ALLOCATION OF GAIN-ON-SALE ALL REPORTING STATES	
Allocate the Gain to Ratepayers	19
Allocate the Gain to Shareholders	9
Split the Gain	11

Source: 1994 NRRRI Survey, Questions 3 and 5

TABLE 9	
ALLOCATION OF GAIN-ON-SALE TO RATEPAYERS ALL REPORTING STATES	
Through Reduction of Ratebase	11

¹⁰ This table includes the responses of those states which split the gain as well as those which allocate the gain exclusively to ratepayers where enough information was provided to determine the method used to allocation the portion of the gain to ratepayers.

Through Offset Against Revenue Requirements	14
Other	4

Source: 1994 NRRI Survey, Questions 3 and 5

often. However, in slightly over half of the responses, shareholders were provided with at least a part of the gain. Table 9 shows that, of the states that allocate the gain to ratepayers, slightly more do so through an offset to revenue requirements rather than through a reduction of the ratebase.

Rationale for Disposition of Gain on Sale

Table 10 lists a number of potential rationales for allocation of the gain on sale of a utility asset and identifies those states that indicated that the specific rationale influenced the development of the commission's generic policy or the commission's case-by-case decisions.¹¹

TABLE 10 RATIONALE INFLUENCING COMMISSION ACTION	
a. Gains accrue to ratepayers for property in ratebase?	AK, CA, CT, DE, FL, HI, ID, KS, LA, ME, MD, MA, MI, MN, MS, MT, NE, NV, NH, NY, NC, OH, OK, OR, RI, SC, SD, TN, VT, WA
b. Different treatment of depreciable and non-depreciable assets?	DE, ID, IL, KS, KY, OK, MA, MS, MO, NH, NY, TN, VT
c. The obligation of the utility to provide on-going service (enduring enterprise principle)?	DE, HI, ID, KS, OK, NE, PA, SC, SD, WA, WY
d. Constraints embedded in a Uniform System of Accounts?	AK, DE, HI, IL, MD, MA, MI, MN, MS, NH, NY, OH, SC, TN, VT, WA, WI

¹¹ A positive response for any of the rationales should not be taken to mean that that rationale has influenced every commission decision on gain-on-sale issues.

e.	Intergenerational equity?	DE, KS, LA, ME, MD, MS, ND, OK, OR, SC, VT, WA
f.	Allocation/symmetry of risk?	AZ, CA, CO, DE, KS, LA, ME, MA, MN, MS, MT, NY, NC, ND, OK, OR, PA, SD, TN, WA
g.	The specific nature of the sale?	AZ, DE, MI, MO, ND, OR, PA, WA, WY
h.	Judicial or commission precedent?	AK, AZ, CA, CT, DE, FL, ID, IL, IA, KS, KY, MA, MI, MN, MT, NH, NY, ND, OK, PA, RI, TN, VT, VA, WA, WI
i.	Utility opportunity cost?	CA, DE, FL, ID, MO, MT, NH, NY, PA, WI
j.	Ownership interest (or lack thereof) by ratepayers in utility property?	AZ, CA, DE, ID, IL, MD, MI, MN, MO, MT, NH, NY, OK, OR, PA, SC, VA, WA, WI
k.	Level of need for investment in infrastructure improvements?	AZ, DE, KS, MI, MS, MT, NE, NH, OK, PA, SD, WA, WY
l.	Provision of incentives to company to invest wisely and sell at the financially appropriate time?	CA, DE, MI, MS, OK, OR, PA, VT, VA, WA
m.	Prudence of the utility investment and timing of the sale?	AZ, CA, FL, LA, MI, NH, NY, OK, OR, PA, SD, VT, WA

Source: 1994 NRRI Survey, Question 6

The rationale most frequently cited (thirty respondents) was "a," that gains should accrue to ratepayers for property included in the ratebase, though in at least one case (Pennsylvania), it was noted that the issue is still unresolved. As was noted earlier, the Washington Utilities and Transportation Commission allocated a gain in proportion to the time that the property that generated the gain was in ratebase. Similarly, the District of Columbia PSC noted in its response to the survey that it "has dealt with gains on the sale of property in rate base differently that it has dealt with gains on the sale of property that has been removed from rate base" and that "if ratepayers contribute to the cost...they should share in any profits..."

The Florida PSC's Digest of Regulatory Philosophies states that "Gains or losses on the sale of utility property or property that was formerly utility property should be amortized above the line over five years and should be considered in determining net operating income." The

Michigan PSC response to this survey stated that if assets were ever in the ratebase, the gain accrues to ratepayers. In a 1982 rate case (Boston Gas Company, D.P.U. 1100), the Massachusetts Department of Public Utilities stated that:

The Company and its shareholders have received a return on the use of these parcels while they have been included in rate base, and are not entitled to any additional return as a result of their sale. To hold otherwise would be to find that a regulated utility company may speculate in...utility property and, despite earning a reasonable rate of return from its customers on that property, may also accumulate a windfall through its sale.

The second most frequently cited rationale was commission or judicial precedent. Over half (twenty-six) respondents cited those precedents as having influenced development of commission policy on the disposition of gains on sale of utility assets.

The third most frequently cited rationale (twenty respondents) influencing commission decisions in gain-on-sale issues was the symmetry of risk (i.e., does the utility benefit from gains due to its own risk or do ratepayers benefit from gains because they have protected investors from the normal risks of owning property? Was the gain apportioned based on risk and incentive analysis?) Several commissions cited the Democratic Central Committee of the District of Columbia v. Washington Metropolitan Area Transit Commission (485 F. 2d 786 (D.C. Cir. 1973)) in support of the symmetry of risk argument. With regard to the allocation of risk, Commissioner Frederick Duda of the California PUC stated in a 1990 concurring opinion (A.87-07-041, D.90-11-031):

Ratepayers rightfully benefit because they bore most of the risk associated with the Flower Street headquarters. As the decision notes, ratepayers paid all operations and maintenance expenses, depreciation, and taxes associated with the headquarters property while it was in rate base, provided a fair return on the capital invested in the headquarters, and bore the risk the headquarters would be prematurely retired and that they would nonetheless have to pay depreciation and a return on the buildings until they were fully depreciated.

Shareholders, he continued, bore only the risk that the "value of the land component of the headquarters property would decrease in value between the date it was purchased and the date it was sold."

A Colorado PUC decision (No. C94-206) cited the Commission's opinion in that case that

"the Commission remains unconvinced that the Company has carried all the risk of its investments..." And the Delaware response to this survey cited a Federal Communications Commission 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.

A 1991 letter (quoted in #93-06946) from the Tennessee PSC's Deputy Director of the Utility Rate Division to a utility president said that, "...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."

Of course, the symmetry of risk argument does not always lead to the conclusion that all gains must be allocated to ratepayers. The North Carolina PUC concluded in a water and sewer case (Docket No. W-354) that, "The Commission...is not persuaded that the entire risks associated with the utility is assumed by either CWS (the utility) or its ratepayers."

Nineteen commissions cited their consideration of the issue of ownership interest (or lack thereof) by ratepayers in utility property. The preponderance of the case materials submitted with the survey responses indicated that state commissions generally conform to the doctrine that ratepayers pay for the use of assets but not the assets themselves.

The fifth most frequently cited argument (seventeen respondents) was the impact of constraints embedded in a Uniform System of Accounts (USOA) on allocation of the gain on sale (i.e., Does the required accounting treatment of gains under the Federal Energy Regulatory Commission (FERC) or Federal Communications Commission (FCC) USOAs or other systems affect the commission finding?). In a case before the New Hampshire Supreme Court (No. 80-384), that court affirmed the ability of the New Hampshire PUC to apply accounting rules for the disposition of gains on sale.

The FERC and FCC systems of accounts have been adopted by most states. The FERC and the FCC systems differ, however, on the allocation of the gain on sale. The general FERC

policy, which is subject to deviation in some circumstances, allocates the gain on sale to shareholders. The FCC general policy allocates the gain on the sale of land to ratepayers if the land was in the ratebase. The water and sewer USOAs, promulgated by NARUC, also allocate the gains on land sales to ratepayers. Though the required accounting treatment is often used as a guide, it does not, as the Iowa response to this survey points out, mandate ratemaking treatment.

The Iowa Utilities Board attempted to avoid inconsistent treatment of gains and losses by promulgating an administrative rule (#16.2(10)) that prescribes the accounting for gains and losses. As was noted earlier, Iowa administrative rule (199-16.2(9)) also allocates the gain to the shareholder unless the Board can show good cause for an exception.

Another rationale, which was cited by thirteen commissions, for the disposition of gains on sale was the difference between depreciable and non-depreciable property. As was stated by the Missouri PSC (Case Nos. 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 the sale of the property." The Illinois CC also treats depreciable and non-depreciable property differently. The gain on depreciable property is recorded as a credit to accumulated depreciation, and ratepayers receive the benefit of the gain. For non-depreciable property (land), the gain is recorded as a credit to non-utility income and shareholders receive the benefit of the gain. The Arizona CC response indicated that ratepayers are entitled to a portion of the gain if depreciation expense had been included in rates.

Several commissions cited the use of rationales related to the specifics of the sale, the benefit to ratepayers, the need for investments in infrastructure, and the provisions of incentives to utilities to buy and sell property wisely. In an Arizona case (Docket #U-1345-90-269), in rendering its decision the Commission considered the system reliability after the sale of assets. The North Carolina PUC response cited the fact that it had allowed water and sewer utilities to retain fifty percent of the gain on sale as an incentive to sell systems to municipalities. The Iowa Utilities Board considered allocating gains such that utilities would not have the incentive to place excess capacity on the market with the expectation that ratepayers would pick up any loss (Docket No. RPU-83-22).

In a Montana PSC declaratory ruling, the utility agreed to reinvest the amount of an after-tax gain in a utility program and to reduce rates. The Wyoming PSC ordered a utility to reinvest

an after-tax gain in facility upgrades (Docket No. 70000-TA-93-150 et al.). The Colorado PUC traded the gain on the sale of an asset for other regulatory concessions.

For the other rationales cited in Table 10, no specific documentation was identified.

Summary

It is obvious from a review of the responses to the NRRI survey that gains on sale of utility property are treated in a wide variety of ways. Overall, however, it can be inferred from the survey responses that:

- gain-on-sale issues arise with some frequency at state regulatory commissions;
- the majority of states deal with those issues on a case-by-case basis;
- the gain is more often than not allocated to ratepayers, though shareholders are allocated some portion of the gain in about half of the commission responses;
- for allocating a gain to ratepayers, offsetting revenue requirements was the method employed slightly more frequently than reducing the ratebase;
- and that the prior ratebase treatment of the asset is the most important consideration used by state commissions to allocate the gain, although other rationales are also employed.