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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR APPROVAL OF THE SALE OF CERTAIN ASSETS	DOCKET NO. G-04204A-05-0002 **STAFF'S REPLY TO UNS GAS INC.'S RESPONSE TO STAFF REPORT**

This docket involves a request by UNS Gas, Inc. ("UNSG") for authorization to sell utility assets, pursuant to A.R.S. § 40-285. On March 22, 2005, Staff submitted its Staff Report in this docket. The Staff Report recommended that the proposed sale of the property and building located at 501 Sixth Street, Prescott, Arizona (the "Prescott Building") to the City of Prescott be approved. Given all the facts and circumstances surrounding the proposed sale, Staff recommended that the gain on the sale be deferred until the next UNS Gas rate case, at which time the amount of the gain (approximately $220,628) should be deducted from the cost of the new building.

On April 26, 2005, UNSG submitted a Response to the Staff Report ("Response") in this docket. The Response purports to agree with Staff's recommendation that the Commission approve the sale of the Prescott Building. However, the bulk of the Response consists of a lengthy series of objections to Staff's proposed treatment of the proceeds from the sale. In a rapid fire series of statements, UNSG asserts that Staff's recommendation is all of the following: 1) confiscation of UNSG's property, 2) an arbitrary predetermination of the prudence of UNSG's investment in the new building, and 3) a policy that would discourage utilities from selling assets that are no longer useful. UNSG asserts that Staff's proposed treatment of the gain is "unlawful, bad public policy and contrary to the public interest."

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Staff is admittedly more than a little taken aback by the vehemence of UNSG's response to the Staff Report in this matter. While Staff acknowledges that there is a legitimate policy debate to consider with respect to the proposed treatment of the gain herein, there is certainly no basis for that vehemence. Accordingly, Staff hereby responds to the arguments made in the UNSG Response.

I. STAFF'S PROPOSED TREATMENT IS LAWFUL AND NOT CONFISCATORY

UNSG asserts that Staff's proposal to defer the gain on the sale of the Prescott Building to be used to offset the cost of the replacement building is outside the Commission's authority and would constitute an unlawful confiscation of UNSG's property. UNSG is wrong.

Staff agrees that the Prescott Building is the property of UNSG and that, despite having been paid for with revenues collected from ratepayers in a manner calculated to allow recovery of the cost of the building, customers do not have an ownership interest in the building. However, the fact remains that by virtue of its inclusion in rate base, UNSG has had the opportunity to recover the undepreciated cost of the building directly from customers. In fact, UNSG has been authorized to earn a return on the undepreciated cost of the building in addition to the cost itself. Thus, while customers do not have an ownership interest in the building, they have contributed to its acquisition and are entitled to fair treatment upon any disposition of the asset.

The general rule is that when assets are sold due to changes in market or operational conditions, shareholders are allocated the gains from such sales. UNSG cites a number of cases predicated on this theory, and Staff understands and agrees that it states the general rule. The basis for such a rule is a regulatory philosophy under which return should follow risk. Considering the Prescott Building under this theory, the expectation would be that if the value of the building had declined, shareholders would have borne that risk, and for that reason they should be allocated the gain which will occur in the instant case. A discussion of the theory and cases embodying it can be found in Paul W. MacAvoy and J. Gregory Sidak, *The Efficient Allocation of Proceeds from a Utility's Sale of Assets,* 22 Energy L.J. 233 (2001). As indicated in the introduction, Staff doesn't dispute the general rule, only whether it is appropriate in this instance.

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The truth is that there are many instances in which gains from sales of utility assets have been found to be lawfully allocated to customers. MacAvoy and Sidak explain that, even under the traditional rule, there are circumstances when allocation of gain on sale of assets to customers is appropriate. For example, this is the case when a sale is precipitated by regulatory changes. *See* Williston Basin Interstate Pipeline Co. v. FERC, 115 F.3d 1042, 1044 (D.C. Cir. 1997) (denying petition for review of commission's order requiring utility to sell excess reserved gas at cost rather than at market prices), Re New York Telephone Co., 54 P.U.R. 4th 220, Case 28264, Opinion 83-11 (N.Y. Pub. Serv. Comm'n 1983) (directing that gain from sale of phone sets, as part of corporate divestiture, should flow back to customers as a credit to depreciation expense).

Indeed, notwithstanding UNSG's protestations to the contrary, there have been circumstances in which utility regulatory bodies allocated the gain from sales of depreciable assets to ratepayers based upon the rationale that, because ratepayers paid for asset depreciation they acquired an equitable interest akin to an ownership interest in those assets. *See* Casco Bay Lines v. Pub. Util. Comm'n, 390 A.2d 483, 489 (Me. 1978) (affirming commission's decision to allocate proceeds to ratepayers); Re Tampa Elec. Co., 49 P.U.R. 4th 547 (Fla. Pub. Serv. Comm'n 1982) (ordering that gains from the sale of utility headquarters be treated above the line to reflect that ratepayers, not shareholders, paid for capital cost and depreciation expense).

Thus, while Staff does admit that there is a basis for argument over whether the gain on sale in this instance should be allocated to ratepayers as opposed to shareholders; there is little doubt that the Commission has the authority to make such a determination based on the equities. In addition, where rates are calculated to include the capital costs, including a return, and all operating and maintenance costs, including depreciation on the original cost of the Prescott Building, it is hard imagine what property is confiscated if customers are allocated the gain from the sale.

II. STAFF'S PROPOSED TREATMENT OF THE GAIN IS FAIR

UNSG contends that Staff's proposed treatment of the gain from the sale of the Prescott Building is unfair, allocates more than 100% of the gain to customers and creates a disincentive for utilities to engage in sales of utility assets when otherwise prudent to do so. Staff couldn't disagree more with these assertions.

First, contrary to UNSG's assertions, Staff's proposal actually allocates substantially less than 100% of the gain to customers. UNSG focuses on the specific numbers utilized in the Staff analysis, suggesting that if those numbers are used, more than 100% of the gain would be deferred to be used as a reduction in the cost of the replacement building. However, the Staff Report explicitly recognizes that the numbers used are approximations, subject to correction when the transaction is completed. (*See* Executive Summary and Page 3 of the Staff Report, indicating that the deferral is approximately $220,628 and proposing that UNSG be required to file copies of executed sale documents and closing calculations).

Additionally, the Staff Report does not propose to require immediate refund to customers of the amount of the gain upon closing. Rather, Staff suggests that the amount be deferred and used to offset the cost of the replacement building when it is completed. Thus, UNSG will have the use of the proceeds from the sale until such time as the new building is included in rate base. Staff's proposal allocates substantially less than 100% of the gain to ratepayers.

Nor does Staff's proposed treatment constitute any comment on the prudence of the anticipated investment in a replacement building. Staff will evaluate the prudence of that investment when it is presented for inclusion in rate base. Staff's current proposal would anticipate that the entire investment is found to be prudent, but that the amount should be offset by the gain from the sale of the earlier building, reflecting the fact that UNSG's rates were calculated in such a manner as to allow recovery of the capital, O&M, and depreciation expenses associated with the building. Should the new building be found as an imprudent expenditure, additional reductions would be necessary to reflect that fact. Staff has made no conclusions at this time regarding the prudence of that anticipated expenditure.

III. CONCLUSION

Staff's proposed treatment of the gain on sale from the Prescott Building is lawful, fair, and reasonable based on the circumstances in this case. The fact that a new building is contemplated by UNSG should not rest entirely on the ratepayers who have been paying rates that included all expenses associated with the current building.

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UNSG discusses the Commission's treatment of sales of utility assets by APS, in which the Commission has routinely split the gains from those sales with 50% being accounted for above the line (benefiting customers) and 50% below the line (benefiting shareholders). UNSG points out that APS has acquiesced in this policy and initially proposed this policy. While all of the statements made about the Commission's policy towards APS are true, they are not particularly helpful in this instance. Most, if not all, of the sales that have been treated under the APS policy have been for assets which left the system and were not replaced by more expensive assets to serve the same function. The policy was developed in connection with the sale of street lighting assets to towns, which subsequently owned and operated those assets, without requiring APS to replace them at higher cost.

Finally, UNSG makes reference to the Staff's response to a data request submitted by UNSG. UNSG finds significance in the fact that Staff is unaware of any Commission Decisions allocating 100% of the gain on the sale of utility assets to customers. The truth is that Staff believes that each case presented should be assessed on its own merits, and the fact that the Commission hasn't treated any sales of utility assets in this manner is of little consequence. In this case, Staff believes that allocation of the gain to customers is fair and reasonable. UNSG also finds significance in the fact that Staff didn't cite specific authority for its proposed treatment of the Prescott Building in the course of responding to its data request. Suffice it to say that discovery is a device whereby parties explore the facts underlying a case, not the legal briefs in a matter. Staff believes that its proposed treatment of the gain from the sale of the Prescott Building is reasonable and lawful.

Staff's response to UNSG's data request indicated what Staff's factual basis was for taking the position taken. UNSG was advised that if it believed that there is a factual reason that the gain should be treated differently; Staff is willing to consider an alternative treatment. UNSG did not provide any such factual reason to Staff by way of reply to Staff's Response. Staff continues to be

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willing to consider an alternative treatment if the facts justify a different treatment. However, at the present time, Staff continues to believe the position taken in the Staff Report is fair and lawful.

RESPECTFULLY SUBMITTED this 6th day of May 2005.

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6th day of May 2005 with:

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