ITEM NO. 2

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: August 28, 2018

REGULAR X **CONSENT** ____ **EFFECTIVE DATE** N/A

DATE: August 21, 2018

TO: Public Utility Commission

LK mm

FROM: Lance Kaufman and Matt Muldoon

EP for EP for

THROUGH: Jason Eisdorfer and John Crider

SUBJECT: PORTLAND GENERAL ELECTRIC: (Docket No. UI 405) Affiliated Interest Application for Lease of World Trade Center.

STAFF RECOMMENDATION:

The Commission should approve Portland General Electric's (PGE or Company) Application Requesting Approval of an Affiliate Interest Transaction with 121 SW Salmon Street Corporation (121 SW Salmon), subject to the following conditions:

1. The Company shall provide the Commission access to all books of account, as well as all documents, data, and records that pertain to any transactions with 121 SW Salmon.

2. The Commission reserves the right to review, for reasonableness, all financial aspects of this transaction in any rate proceeding or alternative form of regulation.

3. PGE shall notify the Commission in advance of any substantive changes to the contract, including any material change in price. Any such change shall be submitted in an application for a supplemental order (or other appropriate format) in this docket.

DISCUSSION:

Issue

Whether the Commission should approve PGE's Application Requesting Approval of an Affiliate Interest Transaction with 121 SW Salmon Street Corporation (Application), related to the lease of the World Trade Center.

Applicable Rule

"Affiliated interest," as defined in ORS 757.015, includes every corporation five percent or more of whose voting securities are owned by any corporation or person owning at least five percent of the voting securities of a public utility or by any person or corporation in any chain of successive ownership of at least five percent of voting securities of the utility. *See* ORS 757.015(3). ORS 757.495 requires a public utility to seek approval of contracts with affiliated interests within 90 days after execution of the contract. The required process for submitting an agreement for review by the Commission is set forth in ORS 757.015(2) and OAR 860-027-0040.

ORS 757.495(3) provides that the Commission may approve an affiliated interest agreement if the agreement is fair and reasonable and not contrary to the public interest. However, the Commission need not determine the reasonableness of all financial aspects of the agreement for ratemaking purposes, and may reserve that issue for subsequent proceedings.[1]

Under OAR 860-027-0048(4)(e), for cost allocation purposes, "[w]hen services or supplies (except for generation) are sold to an energy utility by an affiliate sales shall be recorded in the energy utility's accounts at the approved rate if an applicable rate is on file with the Commission or with FERC. If services or supplies (except for generation) are not sold pursuant to an approved rate, sales shall be recorded in the energy utility's accounts at the affiliate's cost or the market rate, whichever is lower." The Commission need not determine the reasonableness of all financial aspects of the contract for ratemaking purposes, but, rather, may reserve that issue for subsequent proceedings. *See* Commission Order No. 11-071.

Analysis

Background
This docket concerns an affiliated interest transaction between PGE and 121 SW Salmon, , an existing PGE affiliate, for a 25-year lease for the majority of the rentable

[1] *See* Order No. 11-071 in Docket No. UI 306.

square footage of the World Trade Center (Agreement). The World Trade Center (WTC) is a three building complex in downtown Portland with approximately 500,000 rentable square feet. PGE currently occupies 340,000 square feet in the WTC pursuant to a lease with 121 SW Salmon.[2] 121 SW Salmon in turn leases the WTC from IEH Portland LLC, an independent third party. The Agreement would replace the existing lease upon the sale of the property from IEH Portland LLC to 121 SW Salmon. The terms of the Agreement are similar to the terms of the pre-existing agreement, under which the parties began transacting on September 11, 1978.[3]

PGE was the original owner of the property, having purchased the property upon which the WTC is now located from US Bank on November 17, 1975. PGE conveyed the property to 121 SW Salmon the same day and 121 Salmon subsequently constructed the WTC. In September 1978, 121 SW Salmon sold the property and then rented back the property from the new owners subject to a 65 year lease. PGE guaranteed the obligations of 121 Salmon's lease with the new owners.[4] PGE subleases from 121 SW Salmon.

121 SW Salmon entered into a purchase agreement for the WTC on May 29, 2018, for a confidential amount.[5] This amount is substantially below the market value for the building.[6] One reason the purchase amount is below the market value is that there remains 25 years on the existing lease with PGE, and the lease price is below the market price for similar rental space.

PGE performed an internal analysis of whether PGE should buy the building and include in rates, purchase through an affiliate, or maintain the lease with no purchase. Under PGE's assumptions, the optimal choice for ratepayers was to purchase through an affiliate.

Summary
In addition to reviewing the Company's Application, including attachments, Staff investigated the following issues in considering whether the Agreement is fair, reasonable, and not contrary to the public interest:

2 Application page 12.

3 PGE's response to Staff IR 12. Attachment 1 page 63.

4 PGE's response to Staff IR 11. Attachment 1 page 62.

5 See Attachment 1 page 14.

6 According to Multnomah County Tax Assessors, the market value is around $170 million. Also see Attachment 1 page 57.

1. Terms and Conditions of the Agreement, inclusive of ability to perform utility functions;
2. Transfer Pricing and Historical Trends;
3. Public Interest Compliance; and
4. Records Availability, Audit Provisions, and Reporting Requirements.

Staff's review of this filing raises two general concerns:

1. The terms and conditions of the agreement are generally more favorable to the affiliate than to PGE.
2. The lease price may not satisfy the lower of cost or market standard.

Terms and Conditions of the Agreement
Staff examined the terms of the Agreement, comparing proposed terms against current lease terms, including price and duration of the lease.[7] Staff finds that a comparison to the existing lease provides an appropriate baseline to review the reasonableness of the Agreement because it will continue to govern PGE's lease of the space in the event that the sale does not close. However, given the length of time and evolving safety standards, Staff does not find that the public interest standard is met by a lease that contains the exact same terms as the current lease. As such, Staff raised concerns over these terms that the Company addressed through the addendum included with this memo as Attachment 1. In general: Staff's review of the proposed Agreement identified three material concerns:

Consent Not Unreasonably Withheld
Staff noted that the proposed Agreement consent standard (which appears throughout the lease), allowed consent to be withheld within the landlord's sole discretion. Staff asked that this language be modified to state that such consent will not be unreasonably withheld.

Mutual Indemnification in Equal Terms
Paragraph 7.1 of the Agreement contains an indemnity clause. Staff asked the Company to modify language to a mutual indemnification clause. As filed, 121 SW Salmon would not be indemnifying PGE in the event of its willful misconduct or gross

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7 In response to Staff IR 12, the Company provided Attachment 012-A, the current lease agreement between 121 SW Salmon Street Corporation and the owner of the WTC (currently IEH Portland LLC) dated September 11, 1978; Attachment 012-B, first amendment to the lease, effective December 5, 1997; and Attachment 012-C, the related sublease agreement 121 Salmon Street Corporation and Portland General Electric Corporation. Attachments 012-A through Attachment 012-C are protected information and subject to Protective Order 18-261.

negligence, but PGE would be indemnifying 121 SW Salmon for like cause. Staff requested that the Agreement be revised to provide a mutual indemnification on the equal terms. Staff suggests that it would be peculiar and onerous for PGE and its ratepayers to be disadvantaged and potentially harmed financially or legally in the future by an Agreement with a wholly owned subsidiary. Further, in the event that the building is subsequently sold by 121 SW Salmon, the indemnity clause would reduce the risk to PGE's ratepayers. PGE has declined to modify the agreement to allow for mutual indemnification. Staff is concerned that PGE may not have negotiated for the mutual indemnification clause with its affiliate in good faith. Staff recommends that if at some future date PGE incurs costs that could have been avoided with a mutual indemnification, the Commission should explore whether the costs are appropriate to recover from ratepayers, given PGE's questionable contract negotiations.

Critical Infrastructure Protection
The third area of concern is critical and bears directly upon the Company's responsibilities in regard to the human condition and critical infrastructure within its service territory. As filed, Staff found the Agreement was incompatible with current and emerging oversight by the new National Risk Management Center of Homeland Security announced Jul. 31, 2018, and by the new Electricity Information Sharing and Analysis Center (E-ISAC) now headed by Bill Lawrence Vice President and Chief Security Officer of the North American Electric Reliability Corporation (NERC). Staff also noted that The Federal Energy Regulatory Commission (FERC) in Order No. 848 in Docket No. RM18-2-000 directs NERC within 6 months to modify the critical infrastructure protection reliability standards to require mandatory reporting of failures: structural, organizational or otherwise likely to lead to physical or cyber security incidents.

PGE recognized Staff's concerns and revised language in the Agreement to remedy the first two deficiencies listed above. Further, the Company provided an "Addendum to Office Lease Agreement" (Addendum) to the Agreement clarifying PGE's role as a regulated electrical utility and identifying associated priorities and preemptive rights of PGE in that capacity. Staff is satisfied that this Addendum serves to remove risk otherwise present that the Agreement would impair PGE's ability to perform as a Commission jurisdiction electrical utility, inclusive of meeting heightened physical and cyber security standards going forward. PGE filed the Addendum on August 23, 2018.

Transfer Pricing and Historical Trends
Staff reviews the pricing of affiliated interest applications in order to ensure that ratepayers are not harmed by virtue of the transaction between a utility and its affiliate compared to a transaction involving a third party negotiated at arm's length. Part of this analysis includes a verification of the "lower of cost or market" standard as set forth in

OAR 860-027-0048(4)(e). PGE provided several work papers comparing lease price of the WTC complex with market rates for similar leases and the cost of ownership. PGE's work papers show that the lease rate is below the market rate for similar leases. However, PGE's work papers evaluating the cost of ownership contain two assumptions that may not be accurate. Staff found that under a range of reasonably conservative alternative assumptions, the lease price is higher than the cost of providing the lease. The process of evaluating the transfer price also revealed that PGE's decision to have 121 SW Salmon purchase the building and subsequently lease to PGE may not have been prudent. However, Staff notes that an Affiliated Interest (AI) proceeding is not a ratemaking proceeding, and that the Commission's approval of an AI agreement does not constitute a prudence determination for future ratemaking treatment. Rather, in an AI proceeding, the Commission is looking to the four corners of the Agreement in order to determine whether the desired transaction is just and reasonable, but does not constitute a determination that the utility's decision to enter into the agreement, when compared with an alternative such as the "buy" alternative in this case, was the prudent course of action.

Market Rate
The transfer price for the lease is $5 per square foot[8] plus a proportionate share of all WTC operating and maintenance expense.[9] The rental rate including the operating and maintenance expense is confidential and provided in Attachment 1 page 21. Market rates are confidential and provided in Attachment 1 page 21. This shows that the starting lease rate is below the market rate for similar services. If market rates escalate at a conservative rate the market rate will exceed the lease rate for the term of the lease. Staff notes that the lease rate is identical to the terms of the lease that the current application is replacing.

Cost
PGE provided Staff with two financial models evaluating the ownership cost of the affiliate owning the WTC. Under PGE's assumptions for model inputs, 121 SW Salmon's ownership cost of the WTC is higher than the proposed lease rate. However, under Staff's assumptions for the model inputs, 121 SW Salmon's ownership cost of the WTC is *lower* than the lease rate.

Specifically, Staff disagrees with the following input assumptions:

1. Mortgage rate

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8 See Initial Application, pp. 6-7. Calculated as $2,486,549 per year divided by 506,710 Rentable Square Feet.

9 See Initial Application, pp. 23-24.

PGE assumes a mortgage rate equal to the regulated cost of capital. A more appropriate mortgage rate would be the current market rate for a thirty-year or longer first mortgage bond issuance with a coupon rate of 4.25 percent or less, or a mortgage secured by the building itself of 4.58 percent or less, whichever generates a lower all-in-cost after considering when money would be needed at closing and any associated delayed draw in private placement as appropriate.

2. Net Salvage Value or Sale Value
   PGE assumes a salvage value of negative five percent. A more appropriate salvage value would reflect the market value of the WTC at the end of life or the end of the lease period. The current market value is approximately $170 million.[10] If property values increase at 2 percent annually, the property would be worth approximately $280 million at the end of the 25 year lease.

Even if PGE's assumed mortgage rate for 121 SW Salmon is accepted, and the terminal value of the property is only 50 percent of the expected value, the proposed lease price is above the cost of ownership. If Staff's mortgage rate is used and the full value of the property is assumed for the terminal value the lease rate is substantially higher than the cost.

Staff held several conference calls with PGE regarding whether it is appropriate to include the terminal value of the building when performing a cost analysis. Staff considers a terminal value equal to the expected market value, less any related sale costs, to be appropriate for the following reasons:

1. The potential future sale of a property captures the on-going value of the property and allows a time-bound analysis. An investor evaluating a short term purchase of a property will include the future sale value of the property in the financial analysis.
2. The purchase price is substantially below the market value of the building. The reason the price is substantially below market value is that any owner would be obligated to a 25 year lease for the whole building at a price per foot that is below the market rate. Once this lease obligation is fulfilled in 25 years, there will no longer be a contractual obligation depressing the value of the lease, and it is reasonable to expect the property to sell at full value.
3. PGE guaranteed the financial performance of 121 SW Salmon.[11] This guarantee enabled 121 SW Salmon to enter a 65 year lease at preferential rates. It is the

[10] Based on Multnomah County Property Tax Records.

[11] PGE's response to Staff IR 11.

presence of the 65 year lease that is enabling the low purchase cost of the property.

Staff's analysis demonstrates that the transfer price may not satisfy OAR 860-027-0048(4)(e). Staff notes that the Commission can determine an appropriate transfer price for ratemaking purposes in the proceeding in which rate recovery is sought.

Staff's analysis also demonstrates there is sufficient evidence to warrant a closer prudence analysis in PGE's next rate case. In a future prudence analysis, the Commission should consider:

1. The ownership costs inclusive of the terminal value of the property.
2. The risks of ownership;
3. The risks of leasing under the contract as written;
4. The risks of leasing under a PGE centric contract;
5. The costs and risks of leasing under a longer contract term;
6. The costs and risks of relocating to office space with lower annual rent; and
7. Whether the Commission has any current or forward looking aversion to PGE owning the WTC and assuming the risks and benefits of ownership directly.[12]

The above analysis should be performed in PGE's next rate case regardless of the ultimate ongoing arrangement for WTC, even if neither PGE nor 121 Salmon Street finalize the purchase of the property.

Public Interest Compliance
The Application contains terms and conditions that mirror the current agreement, with appropriate adjustments to reflect the new ownership structure and concerns about security. Further, PGE agreed to amend the landlord consent standard and the indemnity clause in order to better protect ratepayers, particularly in the event that the building is subsequently sold by 121 SW Salmon—a transaction over which the Commission will have no jurisdiction.

Records Availability, Audit Provisions and Reporting Requirements
Order Condition Number 1, listed above in the Staff recommendation, affords the necessary Commission examination of PGE's records concerning this Application.

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12 Staff searched for but found no memorialization of any durable prohibition by the Commission preventing PGE from direct ownership of the WTC. Should the Commission corroborate Staff's determination, that would possibly afford PGE other options to consider. While time is of the essence, in response to Staff IR-1, PGE provided that the earliest closing date is November 1, 2018, allowing consideration of practicable alternatives to the proposed transaction.

Conclusion

Based on the review of the Application, Staff concludes:

1. The Application with the Addendum concerns an affiliated interest agreement that Staff concludes is fair and reasonable and not contrary to the public interest with inclusion of the proposed ordering conditions; and
2. Necessary records are available.

No Harm
Staff finds that the application satisfies the public interest, no harm standard and with the inclusion of the amended lease terms and the addendum, the agreement appears to be fair and reasonable. However, an AI is a limited, non-contested proceeding and does not provide the ability for parties to develop evidence and arguments related to the prudence of PGE's decisions. Due to the limited nature of an AI proceeding, Staff recommends that the Commission determine the prudence of the contract in a future PGE rate case.

PROPOSED COMMISSION MOTION:

Approve PGE's Application for an Affiliated Interest Agreement with 121 SW Salmon, subject to the conditions recommended by Staff.

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