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Decision 91-07-067 July 24, 1991

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )  
 Francis H. Ferraro, an individual, )  
 to sell 1,000 shares of Madera )  
 Ranchos Water Co. Inc. capital )  
 stock, which are the total shares )  
 issued, to Ara Keoshian and for )  
 Madera Ranchos Water Co. Inc. to )  
 transfer such shares to Keoshian. )

**ORIGINAL**

Application 90-04-042  
(Filed April 25, 1990)

Steefel, Levitt & Weiss, by Lenard G. Weiss, Attorney at Law, for Francis Ferraro, applicant.  
Izetta C. R. Jackson, Attorney at Law, for the Water Utilities Branch.

INTERIM OPINION

By this application Francis Ferraro (Ferraro) and Ara Keoshian (Keoshian), jointly referred to as applicants (applicants), seek Commission approval under Public Utilities (PU) Code §§ 851 and 854 to transfer ownership and to execute a second deed of trust on the real property of Madera Ranchos Water Company (Madera Ranchos).

Madera Ranchos is a Class C water company located about 12 miles from Fresno and about the same distance from Merced. It serves approximately 720 customers.

Ferraro sold his 1,000 shares of stock in Madera Ranchos to Ara Keoshian on March 25, 1988. The total sales price was \$450,000: \$50,000 down and a \$400,000 promissory note dated March 11, 1988, bearing interest at 11% per annum, payable in the amount of \$3,920.46 monthly commencing July 1, 1988. The note is

secured by a second deed of trust on the real property of Madera Ranchos.<sup>1</sup>

An evidentiary hearing was held on November 15 and 16, 1990 in San Francisco. Concurrent briefs were filed on January 31, 1991. Notice of the application and hearing was provided to all customers. No protests to the application were received.<sup>2</sup>

#### Position of Applicants

Ferraro testified that he is 69 years old and suffers from severe heart disease. He is medically incapable of continuing to operate Madera Ranchos. He and his wife jointly own all the stock of Madera Ranchos. He sold all the stock to Keoshian. He was under the impression that such a stock transfer did not require Commission approval. On learning that Commission approval was necessary, he filed an application for such approval within three weeks after he sold the stock.<sup>3</sup> He had no intent to violate Commission regulations.

Keoshian testified that he is 53 and in good health. He is a lifelong resident of the Madera-Fresno area. He has been successful in several businesses, has extensive farm and equipment experience and has substantial personal resources. Keoshian believes that he is a responsible, sophisticated, and experienced businessman who knows exactly what he is getting into financially.

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1 The California Department of Water Resources holds a first deed of trust on the utility's real estate to secure its Safe Drinking Water Bond Act (SDWBA) loan to the utility recorded on March 28, 1984. The SDWBA funds were used to construct the utility's Fender well.

2 The Mary Short Main Extension Contract is not an issue in this proceeding since, apparently, it is settled.

3 To allow an audit to be performed, by agreement with the Water Utilities Branch, that application was withdrawn and refiled on April 25, 1990.

Further, Keoshian points out that he has successfully operated Madera Ranchos since May 1, 1988--over two-and-a-half years.

According to Keoshian, during these two-and-a-half years, there were only two service problems. One was a power outage caused by a burned out Pacific Gas and Electric Company transformer over which he had no control. The other involved a customer who complained about the presence of sand in the water. That problem was promptly corrected by the installation of a sand separator on the well that was causing the problem. There have been no other customer complaints; and there are no water quality problems.

Keoshian asserts that the water production and distribution system is relatively new, dating from the early 1960s and that it is in excellent repair. He has sealed all of the wells, added a sand separator to the Sparta well, and rebowled all three wells which has improved pump efficiency and reduced power costs.

Keoshian points out that the Commission staff auditors found the utility's accounting records were "adequate" but recommended changes to conform to the Commission's uniform system of accounts. He has made all of the recommended record keeping adjustments to the utility's books and records; and he will file the utility's 1990 Annual Report in full conformity with the Commission's rules.

Keoshian further testified that Madera Ranchos has 720 customers. He estimates system growth at about 30 customers a year. The present installation can accommodate 120-140 new customers with its existing wells and distribution system. Growth beyond that will require new wells and distribution piping.

Keoshian expects to fund future plant expansion through internally generated funds, traditional borrowing sources,

developer advances and contributions, and by connection and facilities fees.<sup>4</sup>

Keoshian addressed the Commission Water Branch's (Branch) concern that he does not have adequate cash flow to support the debt he has personally incurred to buy the system. He contends that he has personal financial resources which will permit him to "divert" his "salary" from the utility to repayment of loan or other obligations. He asserts that this is not a speculative investment. As a lifelong resident of the area, he expects to hold this asset indefinitely. He is confident that he has the ability to manage the system in an efficient manner and still make a reasonable personal return. He has in fact done so over the past two-plus years.

Keoshian explained why he is willing to pay 2.57 times the 1988 rate base for Madera Ranchos.<sup>5</sup> He is willing to pay that premium because this is a relatively new, well designed water system, with an assured, excellent quality water supply, located in a high growth area with no competition, and which for the foreseeable future he can operate primarily with his own labor and with very low out-of-pocket operating expenses. Based on his lengthy business experience, he is confident that with the utility's good plant, high growth potential and his ability to operate the system primarily by himself, this will be a profitable investment for him.

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4 D.91-04-068 authorizes Class C and Class D water utilities, and Class A and Class B utility districts or subsidiaries serving 2,000 or fewer connections, to accept from individual customers amounts in contribution as connection fees covering actual costs to the utility of installing new connections.

5 Applicants' 2.57 ratio figure includes plant added after the staff audit.

Lastly, applicants argue that in five Commission decisions<sup>6</sup> issued since 1983, the Commission approved such leveraged transactions. According to applicants, these Commission-approved transactions had leverage ratios ranging from 2.3 to 4.3. The 2.57 ratio in this case is at the low end of that spectrum. Therefore, applicants believe that there is substantial Commission precedent to approve this transaction.

Branch's Position

Branch recommends that the application be denied because approval of the transfer under the terms outlined would jeopardize the utility's ability to provide for adequate service and future growth. Accordingly, Branch requests that the property transfers, which Ferraro unilaterally transferred to Keoshian prior to seeking Commission approval officially be voided on the property records of Madera County, and that Keoshian return the stock and the management control of Madera Ranchos to Ferraro.

Branch notes that the Auditing and Compliance Branch of the Commission staff issued its audit report which estimated the utility rate base at \$173,895, as of December 31, 1988. On this basis, Branch contends that the sale price is excessive: 2.6 times book value. Branch believes that Keoshian cannot afford to operate the water company because of the debt incurred to Ferraro. Branch further believes that Keoshian did not seek any objective evaluation of the property's value. Branch points out that in a period of 29 months, Keoshian has missed 6 payments to Ferraro in order to make utility repairs.

Branch argues that because the Madera Ranchos property transfer and debt service were made without the permission of the Commission, those transactions are void, as a matter of law, and

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<sup>6</sup> D.83-12-041, D.85-01-022, D.86-05-075, D.87-10-028, D.88-01-006

can have no effect. Notwithstanding the actions of Ferraro and Keoshian, absent Commission approval of this utility transfer, under PU Code § 851, Ferraro cannot sell Madera Ranchos and under PU Code § 854, Keoshian cannot acquire Madera Ranchos.

Branch notes that the oft-repeated, well established purpose of PU Code § 851 (and by implication, § 854), most recently was expressed by the Commission in D.90-04-038, issued July 6, 1990:

"The design of PU Code section 851 is to prevent the impairment of the public service of a utility by the transfer of its property into the hands of agencies incapable of performing an adequate service at reasonable rates or upon terms which will bring about the same undesirable result. Transfers and reorganizations often are made which leave the utility so burdened with fixed interest charges and crippled financially that it is totally unable to perform its duty to the public; and to prevent the bringing about of such conditions, the Commission has been given the authority to regulate the transfer and encumbrance of its property by a utility. (Southern California Mountain Water Co. (1912) 1 CRRC 520.) The obvious purpose of the section is to enable the Commission, before any transfer of public utility property is consummated, to review the situation and to take such action, as a condition to the transfer, as the public interest may require." (San Jose Water Co. (1916) 10 CRRC 56.)

Branch further argues that it is not unreasonable to expect a utility owner and potential utility purchaser to know or to acquaint themselves with the laws that govern the sale and operation of the utility. But, even assuming arguendo that Ferraro's and Keoshian's claimed ignorance of the PU Code's requirements could be deemed reasonable, that would not dispose of this issue. Both Ferraro and Keoshian knew, or should have known, that Commission approval of the transfer was required. They had in their possession a document (the Safe Drinking Water Bond loan

contract), crucial to the operation of Madera Ranchos, that expressly mandates Commission approval of any transfer.

Further, Branch points out that the Commission has adopted a well reasoned policy which is an appropriate guide for determining this matter. Resolution W-3285 issued October 17, 1985 provides:

"WHEREAS: The Commission finds that Class D water companies are often sold at prices substantially in excess of depreciated historical cost due to investor speculation. When an owner cannot realize a profit through rates on the investment, this often results in deteriorating management of the system which affects ratepayers. For this reason, the Commission does not intend to approve water company sales at prices substantially above depreciated historical cost unless reasonable evidence is provided to justify the premium price. The affirmative burden of providing this evidence is on parties to the transaction. If the Commission is not assured of the financial soundness of the proposed sale, the sale will not be approved, without prejudice.

"The Commission also no longer intends to approve a sale involving the buyer's issuance of debt which places the company in a highly leveraged position."

Branch contends that the Madera Ranchos transfer clearly is unacceptable under the provisions of Resolution W-3285 and that the rationale underlying this resolution applies to this case.

Although Madera Ranchos technically is a Class C company, Branch submits that in size and operation it is very much like a Class D water company and the Commission policy underlying Resolution W-3285 and its expressed prohibitions should apply to this transfer.

Branch acknowledges that before W-3285 was adopted, the Commission authorized several small water utility transfers at prices substantially in excess of book value. However, Branch argues that the adverse impact on the public interest that resulted

from such transfers caused the Commission to reevaluate former practice and adopt a new policy. Since adoption of W-3285, the Commission has not approved disproportionately high price/book value sales, even in circumstances where the seller would receive a sales price substantially below that which he had actually paid for the utility (D.83-12-041 and D.85-01-022).

Further, Branch points out that Water Tariff Rule 15 (Main Extension Rule) is a standard rule, included in the tariffs of all water utilities. It prohibits utilities from accepting advances in aid of construction which would total more than 50% of the capital structure, or would cause the total debt owned by the utility to be more than 40% of the capital structure, without authorization from the Commission.

In the present case, Branch contends that the Ferraro-Keoshian agreement terms would encumber the utility with a debt which not only fails to increase the value of plant, but would increase Madera Ranchos indebtedness from 21% (advances) to more than 200% of net book value. Branch believes that this would endanger the utility, raising serious concern over the future financial solvency of Madera Ranchos.

#### Discussion

We will follow the policy stated in Resolution W-3285 in this case, because a Class C water company like Madera Ranchos faces problems and risks in raising capital similar to those of a Class D company.

Neither Resolution W-3285 nor subsequent decisions require us to deny an application for purchase of a small water company when the sale price exceeds the book value. We do scrutinize such sales carefully, however, and approve them only if the applicant meets the burden of proving that the sale will not harm ratepayers.

Our concern with the 2.57 sale price to book value ratio, financed with an 8:1 ratio of debt to equity is that the cash flow



from the utility will be too low for the utility to thrive. In this regard, Keoshian's evidence of other financial resources, including dividends, income from a note, a part-time consulting job and his wife's income, is not persuasive. He claims these other financial resources, totalling \$56,854 in 1989, might allow him to divert net revenues from the utility to repay the loan. But he cannot claim his wife's \$18,144 income for the purpose of this application; legally, it is hers, or at best one-half his under the community property laws. And we question whether Keoshian can continue to draw the \$26,749 part-time consulting income he reported in 1989 when his plan for the water company requires that he perform all office work and other labor himself. We must adjust Keoshian's estimate accordingly, and therefore cannot value his outside financial resources any higher than \$21,031 per year. That amount is not enough to overcome our concerns.

The applicant offers his record of performance as evidence that the sale should be approved. Though Madera Ranchos has historically had three employees, Keoshian has been doing all the work himself since 1988. In addition, he has continued to receive a consulting income, working 20 hours a week for it. The success of this water company depends on Keoshian continuing what he has done for three years, and on the absence of new financial or health pressures.

Keoshian is technically already in default on the \$400,000 note he gave to Ferraro, because he has missed six of his payments. Keoshian explained that he missed the payments because he used the money he saved for repairs. The loan payments are so large compared to the water company's revenues that Keoshian has had to choose between making a necessary repair and paying his loan, and we expect he will face this choice again. Even if Ferraro has formally waived this default, we cannot assume that he will do so in the future.

By scrutinizing highly leveraged sales closely, it is the Commission's intent to avoid sales which would require owners to plow a substantial amount of their net revenues into debt service rather than into maintenance and capital expenditures. We wish to avoid these sales for reasons outlined in Resolution W-3285 and subsequent decisions. The Commission is concerned that over time, service may decrease because the owner fails to pay for new wells or to maintain old pumps. Water quality may suffer because the owner does not have the money to pay for proper filtration or other necessary equipment. A poorly maintained water system will eventually begin to fail, requiring costly repairs and ultimately increasing rates.

We note, with concern, that Keoshian has already stopped paying liability insurance. Not only does this appear to us a symptom of inadequate cash flow, but a liability judgement against Madera Ranchos would accelerate its deterioration.

The possibility that the utility and its standard of service may suffer is high enough that we deny the sale as now structured. We encourage buyer and seller to negotiate further, reform the contract to state a purchase price which will permit sufficient cash flow to pay the debt service, help sustain Keoshian and keep the water utility operating.

We find that this sale is not in the best interest of the utility's ratepayers because the transaction is too highly leveraged. By this interim decision, we deny the sale based only on the purchase price and structure. If the seller and buyer are willing to reform the contract, we will reexamine the case, addressing the issues of purchase price and cash flow only.

#### Findings of Fact

1. Ferraro, owner of Madera Ranchos, is medically incapable of continuing to operate this water company.
2. Ferraro sold his shares of stock in Madera Ranchos to Keoshian on March 25, 1988 without Commission authority.

3. Keoshian paid \$450,000, with a down payment of \$50,000 and a note for \$400,000.

4. The Commission does not set an upper limit on the amount over depreciated rate base which it considers as the appropriate sale price for a water utility, but it does look carefully before approving sales which are heavily leveraged.

5. The \$400,000 note on the water company requires monthly payments of \$3,920.46, or an annual cost of \$47,045.52.

6. Keoshian has let the liability insurance on the water company lapse.

7. Keoshian has missed six payments since buying the water company in May 1988.

8. Madera Ranchos' rate base is \$173,895 as of December 31, 1988, based on a CPUC audit.

9. At a 11.5% rate of return, the rate base will entitle Keoshian to \$19,998 of yearly income.

10. If Keoshian does all the work himself, the utility will generate \$34,894 for him after paying for the debt service and reinvesting the depreciation expenses.

11. The Commission can recognize no more than \$21,031 as income gained by Keoshian outside of the water company.

12. The income generated by Madera Ranchos and Keoshian's outside income are not sufficient to pay off the \$400,000 note, maintain the utility's operations and viability, and provide Keoshian a reasonable rate of return on investment and compensation for services rendered.

13. All customers were notified of the change in ownership and management of the utility. No customer protested the change.

14. Keoshian has operated the water company competently for the last three years and has demonstrated ability to manage the utility.

15. The transfer of ownership to Keoshian is adverse to public interest only because of the sale's financing.

Conclusions of Law

1. Ferraro has not received authorization under PU Code § 851 to sell his shares of Madera Ranchos.
2. Keoshian has not received authorization under PU Code § 854(a) to control or acquire the shares of Madera Ranchos.
3. The sale of Madera Ranchos, as specified in Application 90-04-042, is void and of no effect.

INTERIM ORDER

IT IS ORDERED that:

1. Application 90-04-042 for sale of Madera Ranchos shall remain open.
2. The applicants shall have 90 days in which to renegotiate the sale price and seek authorization from the Commission for the sale.
3. If the parties fail to seek authorization for a renegotiated sale price within 90 days, the Commission shall dismiss the application without prejudice. In that event, Ferraro shall return whatever payments Keoshian has made and Keoshian shall return his shares to Ferraro.

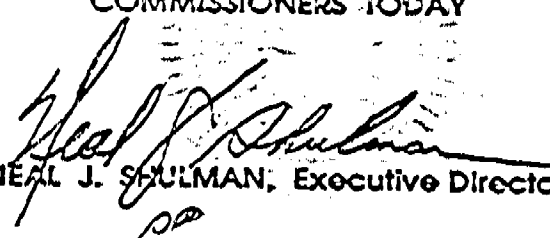
This order is effective today.

Dated July 24, 1991, at San Francisco, California.

PATRICIA M. ECKERT  
President  
G. MITCHELL WILK  
JOHN B. OHANIAN  
DANIEL Wm. FESSLER  
NORMAN D. SHUMWAY  
Commissioners

I CERTIFY THAT THIS DECISION  
WAS APPROVED BY THE ABOVE  
COMMISSIONERS TODAY

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NEAL J. SHULMAN, Executive Director