

Decision No. 87548 July 6, 1977

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of DEL ESTE WATER COMPANY,)
 a corporation, to issue two promissory)
 notes for \$300,000 each, and to execute)
 and deliver a Seventh Supplemental)
 Indenture and Security Agreement.)

Application No. 57334
 (Filed May 24, 1977)

O P I N I O N

Del Este Water Company (Del Este) requests authorization from the Commission to issue two promissory notes in the principal amount of \$300,000 each, and to execute and deliver a Seventh Supplemental Indenture and Security Agreement.

Del Este is a California corporation operating a public utility water system serving about 13,300 customer connections in suburban Modesto and in other portions of Stanislaus County. For the year 1976, the company reported operating revenues totaling \$1,335,316, depreciation expenses of \$117,844, and net income amounting to \$140,033. Exhibit I attached to the application sets forth a balance sheet dated February 28, 1977 which is summarized as follows:

<u>Assets</u>	<u>Feb. 28, 1977</u>
Current assets	\$ 183,545
Net utility plant	3,103,929
Other assets	58,806
Total	<u>\$3,346,280</u>
<u>Liabilities and Capital</u>	
Current liabilities	\$ 191,206
Notes payable-Wells Fargo	200,500
Long-term notes-Pacific Mutual	793,600
Advances for construction	646,078
Contributions in aid of construction	128,382
Common stock equity	1,386,514
Total	<u>\$3,346,280</u>

Under authority previously granted by this Commission, Del Este has issued several long-term promissory notes at various times to Pacific Mutual Life Insurance Company (Pacific Mutual), the unpaid principal of which aggregated \$793,600 on February 28, 1977. Such notes were issued pursuant to a loan agreement and original mortgage dated March 1, 1951, as subsequently supplemented and modified. Del Este presently proposes to issue two new promissory notes to Pacific Mutual in the principal amount of \$300,000 each maturing twenty years from date of issuance, and bearing interest at the rate of 10% per annum. Plans originally were to issue the first note on or before June 30, 1977 and the second on or before September 30, 1977. (Time required by the Commission staff for review of the application and processing of the decision draft has caused this schedule to be delayed.)

The notes would be subject to the provisions of a proposed Seventh Supplemental Indenture and Security Agreement, a copy of which is attached to the application as Exhibit II(b). The document declares the terms upon which the additional loans are to be made and confirms the lender's first lien on substantially all of the current and after acquired property of the borrower. Among other things, the supplemental agreement would require Del Este to request an increase in rates if its pre-tax net earnings for any one year period, computed on a quarterly basis, should fail to equal or exceed two times the amount of total interest expense on all indebtedness. Moreover, net proceeds received from utility property sold under threat of condemnation would, under certain conditions, require Del Este to prepay the notes with premiums of 5% during the first year such notes are outstanding and with declining annual premiums thereafter.

A copy of a proposed note is included with the application as Exhibit II(a). Del Este would have the option of prepaying either of the proposed notes at 110% of the principal amount if prepayment is made on or before the first anniversary of issue and thereafter at 110% less .526% for each year or fraction thereof

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elapsed before the nineteenth year. Neither note may be prepaid, however, within ten years of the issuance date with funds obtained from other borrowings at a cost of less than 10% per annum. Two years after the issuance of each note, Del Este would be required to make annual sinking fund payments of 4% of the original principal amount of each note. The aggregate of such payments would be \$24,000 annually.

Del Este proposes to use the loan proceeds for the following purposes:

- a. Repay \$200,000 of short-term bank loans which were obtained to finance costs of replacement and improvement of the water system;
- b. Reimburse the treasury approximately \$106,900 for a portion of moneys actually expended prior to February 28, 1977 for capital improvements; and
- c. Finance an approximate cost of \$293,100 for plant additions and betterments planned for the period March 1, 1977 to May 30, 1978.

The utility's capitalization on February 28, 1977, as recorded and pro forma after giving effect to the proposed note issues are summarized as follows:

	<u>Recorded</u>		<u>Pro Forma</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Promissory notes	\$ 793,600	36.7%	\$1,393,600	50.4%
Common stock equity	<u>1,370,281</u>	<u>63.3</u>	<u>1,370,281</u>	<u>49.6</u>
	<u>\$2,163,881</u>	<u>100.0%</u>	<u>\$2,763,881</u>	<u>100.0%</u>

By Decision No. 85335, dated January 13, 1976, the Commission granted Del Este an increase in water rates and a rate of return of 10.50%, which provided an after-tax interest coverage ✓

of 2.7 times. In that proceeding, we recognized the need for long-term construction financing and stated as follows:

"In the present state of the economy we cannot pretend to predict with any reliability the financial and economic conditions beyond the immediate future, but if long-term debt financing becomes available and is obtained by applicant under conditions wherein the amount of borrowings results in a ratio of total debt to total capital of 50 percent, and the effective rate of interest on total debt does not exceed 10 percent, applicant should have very little difficulty in servicing the additional debt."

Based on present estimates of the Finance Division, Del Este's cash flow would be sufficient to service the proposed new debt and interest coverage on the company's debt would be about 2.4 times after income taxes.

Del Este points out that if prepayment of the proposed notes should occur as the result of selling its property under threats of condemnation, the yield to Pacific Mutual might exceed the 10% limitation contained in Article XV, Section 1 (Interest Rates) of the California Constitution. Del Este, therefore, requests that the Commission make appropriate findings, consistent with Decisions Nos. 83411 and 83504,^{1/} that neither the maximum interest rate set forth in Article XV, Section 1 (Interest Rates) of the California Constitution nor the California usury laws apply to such provisions within the proposed notes.

^{1/} Decision No. 83411, dated September 4, 1974 in Application No. 55080, Southern California Gas Company.
Decision No. 83504, dated September 24, 1974 in Application No. 55116, Pacific Gas and Electric Company.

Decisions Nos. 83411 and 83504, among others, hold that this Commission in exercising its authority to regulate public utility debt securities is not restricted by the California Usury Law and its ramifications. We reaffirm this holding and conclude that if the interest limitation of the California Usury Law is exceeded but it is determined that the transaction is the best the utility can obtain because of market conditions, then the public interest requires this Commission to authorize the issuance and sale of the debt instruments.

Del Este states that it has carefully considered the interest rate and all other provisions of the proposed loan and has concluded that in light of its size and the market conditions prevailing at the time of negotiation, borrowing on a long-term basis would be extremely difficult, if not impossible, without inclusion of such provisions.

Decision No. 85335 previously mentioned herein made the following observation in this regard:

"The obtaining of long-term debt financing by applicant from another source is not a realistic alternative at the present time. Even if alternative sources were available, and the testimony of both applicant's and staff's witnesses is that they are not, the terms of the promissory notes held by Pacific require that the assets of applicant cannot be pledged as security on loans from other sources. Any mortgage loans from other lending institutions would necessitate applicant's retiring the existing debt to Pacific. The terms regarding prepayment of those loans within the next six to ten years make the cost of any such new financing virtually prohibitive, not only from the standpoint of the company itself but also from the standpoint of the ratepayers. The cost of servicing debt which has been approved by the Commission must be considered by the Commission in determining a reasonable return on the rates it establishes for applicant's service."

In a letter dated June 17, 1977 the attorneys for the parties point out that when the loan commitment was negotiated in October 1976, the prevailing interest rate for a loan of this type to a borrower of Del Este's credit standing was 10%. Among other things the letter states as follows:

"The Company decided to take the borrowing at this rate because of its immediate need for long-term financing and because prior thereto interest rates had been above the usury level for a considerable period of time. The provisions restricting refunding and providing for a premium upon redemption of the notes in the event of condemnation are provisions commonly required by regulated industry lenders such as Pacific, and will allow Pacific to maintain both liquidity and stability in its investment portfolio. In addition, the reasonableness of the interest rate and other terms of the loan is also supported by the findings made with respect to the Company's credit status and prospects for financing in the Commission's decision in the Company's 1975-76 rate case.

"Finally and most importantly, the Company is urgently in need of the proposed financing from Pacific in order to meet the needs of its current capital improvement program and to pay off its short-term bank indebtedness, which is already overdue. Failure to approve the financing would force the Company to halt its capital improvement program, severely harm its credit standing, and result in poorer service to its customers."

The problem confronting Del Este with regard to financing necessary construction was given consideration by the Commission in rendering Decision No. 85335. In light of subsequent events, the proposed issuance of notes subject to the terms specified in the application is the only practical alternative available to Del Este.

After consideration the Commission finds that:

1. The proposed notes would be for a proper purpose.
2. Del Este has need for external funds for the purposes set forth in this proceeding.
3. The proposed Seventh Supplemental Indenture and Security Agreement would not be adverse to the public interest.
4. The money, property or labor to be procured or paid for by the notes herein authorized is reasonably required for the purposes specified herein, which purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income.
5. In the event that prepayment of the proposed notes occurs as a result of Del Este involuntarily selling property under threats of condemnation so that Pacific Mutual's yield might exceed the 10% limitation contained in Article XV, Section 1 (Interest Rates) of the California Constitution, then the public interest requires that this Commission authorize said issuance and sale irrespective of limitations contained in the California Usury Law.
6. Pursuant to plenary powers granted to the Legislature by Article XII, Section 5 of the California Constitution, the Legislature is authorized to confer additional consistent powers upon this Commission as it deems necessary and appropriate, unrestricted by any other provisions of the California Constitution.
7. The Legislature has conferred upon this Commission the authority to regulate the issuance of public utility securities, including evidences of indebtedness, and to prescribe restrictions and conditions as it deems reasonable and necessary (Sections 816 et seq. of the Public Utilities Code).

8. Pursuant to the plenary powers granted to the Legislature in Article XII, Section 5 of the California Constitution, it conferred upon this Commission comprehensive and exclusive power over the issuance of public utility securities, including evidences of indebtedness, and the California Usury Law cannot be applied as a restriction on this Commission's regulation of such issuances of public utility securities, including the establishment of a reasonable rate of interest.
9. In addition to the plenary powers granted to the Legislature by the California Constitution pursuant to which the Legislature conferred upon this Commission exclusive authority to regulate the issuance of notes by public utilities (Sections 816 et seq. of the Public Utilities Code), irrespective of the Usury Law, judicial interpretation of the California Usury Law has exempted corporate notes of public utilities from operation of the Usury Law.
10. If the usury limitation contained in Article XV, Section 1 of the California Constitution and the Usury Law Initiative Act is exceeded, but the transaction is authorized by this Commission and is the best petitioner can obtain because of market conditions, petitioner utility, its assignees or successors in interest, will have no occasion to and cannot assert any claim or defense under the California Usury Law; further, and necessarily, because of lawful issuance by petitioner of bonds in compliance with authorization by this Commission, persons collecting interest on such authorized bonds are not subject to the Usury Law sanctions.

On the basis of the foregoing findings we conclude that the application should be granted. As set forth in said Decisions Nos. 83411 and 83504, among others, we further conclude that the usury limitations on interest contained in Article XV, Section 1 of the California Constitution and the Usury Law Initiative Act do not apply to the issuance of public utility securities, including evidences of indebtedness, lawfully authorized by this

Commission. The authorization herein granted is for the purpose of this proceeding only, and is not to be construed as indicative of amounts to be included in proceedings for the determination of just and reasonable rates.

There is no known opposition to Del Este's application and no reason not to grant the authority requested effective when Del Este has paid the prescribed fee. A public hearing is not necessary.

O R D E R

IT IS ORDERED that:

1. Del Este Water Company may execute and deliver a Seventh Supplemental Indenture and Security Agreement in substantially the same form as that attached to the application as Exhibit II(b).

2. Del Este Water Company may issue two promissory notes in the principal amount of \$300,000 each in substantially the same form as that attached to the application as Exhibit II(a).

3. Del Este Water Company shall apply the proceeds from the issuance of said notes to the purposes referred to in the application.

4. The lender's yield on the notes of Del Este Water Company authorized herein may exceed the maximum annual interest rate set forth in Article XV, Section 1 (Interest Rates) of the California Constitution or any other law of the State of California establishing the rate of interest that can be charged to or received from a borrower.

5. Neither Del Este Water Company, nor any other person purporting to act on its behalf shall at any time assert in any manner, or attempt to raise as a claim or defense in any proceeding, that, as a result of the provisions in the Promissory Notes relating to condemnation or other involuntary takings, the interest on the Promissory Notes exceeds the maximum set forth in Article XV, Section 1 (Interest Rates) of the California Constitution or any other law of the State of California establishing the maximum

rate of interest that can be charged to or received from a borrower and that neither Pacific Mutual nor any other persons entitled to the benefit of such provisions are subject to any sanctions provided for in any of said laws.

6. Del Este Water Company shall file with the Commission a report, or reports, as required by General Order No. 24-B, which order, insofar as applicable, is hereby made a part of this order.

7. This order shall become effective when Del Este Water Company has paid the fee prescribed by Section 1904(b) of the Public Utilities Code, which fee is \$1,200.

Dated at San Francisco, California, this 10th day of JULY, 1977.

Leobain
Chairman L.D. Smith

Robert B. Babin

President
William J. Lyons

Raymond L. Sturgeon

Richard D. Thaw

Commissioners

