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Decision 93786 DEC - 1 1981**ORIGINAL**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of)
 CP NATIONAL CORPORATION, a)
 California corporation, to acquire)
 control of Trident Energy)
 Systems, Inc.)

Application 60360
 (Filed March 16, 1981)

Orrick, Herrington & Sutcliffe, by
David W. Alden and James F. Craffs,
 Attorneys at Law, and
 Marvin S. Litt, Attorney at Law,
 for CP National Corporation,
 applicant.
Lynn T. Carew, Attorney at Law, for
 the Commission staff.

O P I N I O N

Under Public Utilities (PU) Code § 2775.5 CP National Corporation (CPN) seeks authority to acquire control of Trident Energy Systems, Inc. (Trident), a manufacturer and supplier of solar space conditioning and water heating systems.

Public hearings were held before Administrative Law Judge O'Leary at San Francisco on August 11 and September 18, 1981. The matter was submitted on September 30, 1981 with the filing of concurrent briefs by the only appearances, CPN and the Commission staff.

Applicant's Utility Operations

CPN owns and operates electric, gas, and telephone systems in various parts of California, Oregon, and Nevada, and electric systems in Utah and Arizona. (The electric system in Utah was sold on September 30, 1981.) Within California CPN provides service as an electric, gas, water, and telephone utility. It

operates electrical distribution systems in the City of Susanville and adjacent areas in Lassen, Tehama, and Plumas Counties, the City of Weaverville, and the City of Needles. The Needles distribution system is interconnected with applicant's electrical distribution system in Nelson and Searchlight, Nevada. The remainder of its California systems are not interconnected. CPN provides natural gas service in South Lake Tahoe and vicinity, and in Needles. CPN provides telephone service in Weaverville, Susanville, Tuolumne, and Needles. It also owns and operates a water system in Susanville.

Applicant's Diversification Program

As a result of a 1978 Stanford Research Institute operational analysis, CPN commenced a program of diversification, including disposition of certain water and electric properties and acquisition of certain communications entities, most recently Tuolumne Telephone Company and Great Southwest Telephone Corporation. CPN's diversification program also encompasses expansion into the nonregulated sphere, as reflected by the recent acquisitions of Tel-Logic Communications, Inc. (an entity involved in the sale and service of customer-owned or leased telephone terminal equipment) and RAI Public Utility Consultants, Inc. (a firm which provides management consulting and engineering services to regulated industries, chiefly telephone utilities).

The rationale behind the diversification program was expressed by the executive vice president and chief financial officer of CPN as follows:

"...the idea being that we want to have a strong regulated base of earnings, but recognizing that regulated earnings are limited, and that particularly in the energy area, it is unlikely that we will

ever be in a position to earn our allowed rate of returns, and to enhance the return, we believe the extraordinary opportunities for higher return offered by nonregulated activities would combine with the regulated to give us the overall return we seek for our stockholders as a corporation."

Consistent with this statement CPN now seeks to acquire Trident.
Operational Scope of Trident

Trident, founded in January 1980, is headquartered in Davis, California. Building on the record of its predecessor, Tandem Properties, Inc. Trident has developed a complete packaged solar system designed to provide space heating, space cooling, and domestic hot water for new residential dwellings. The system uses four components which are a roof-mounted collector array, a radiant floor slab installation, a hydronics package which consists of tanks, pumps, and motorized valves, and an automatic controller. It is what is classified as a close-loop vented system which circulates water through the collectors to provide heating from the sun during the day, and which then stores and distributes that heat. And in the summertime, it circulates water through collector panels at night and provides cooling through a phenomenon called night sky radiation. The system is ideal for installation in new single- or multiple-unit construction using standard slab-on-grade architectural designs.

Because the Trident system is suitable only for new construction, its marketing efforts are aimed at home building developers in California and other western states. Trident estimates that it would be able to provide the space conditioning and hot water systems for less than 1% of all solar installations in California.

In addition to Trident's marketing program, it conducts a comprehensive information program directed toward city planning and zoning staffs and commissions, the Department of Energy, the Solar Energy Research Institute, and other public and quasi-public agencies, financial institutions and trade associations and unions, so as to promote acceptance of solar energy.

Terms of Acquisition

CPN has entered into a Stock Purchase and Option Agreement (the agreement) with Trident which provides that CPN will acquire a 30% ownership interest in Trident in return for the sum of \$1,000,000 which sum will be used by Trident primarily for working capital to expand its sales and manufacturing program. The agreement also gives CPN the option to acquire an additional 30% equity ownership interest in Trident from its present shareholders for \$3,000,000 if the option is exercised by December 31, 1982, or \$4,000,000 if exercised by December 31, 1983. If the foregoing option is exercised, applicant also will have the option to purchase the remaining 40% ownership interest in Trident from its present shareholders by December 31, 1985 for \$7,000,000. Should the second option expire unexercised Trident's shareholders are granted an option by CPN to sell the second option shares for an aggregate price of \$7,000,000. The total purchase price is \$11 or \$12 million depending on the time of exercise of the first option.

Pending approval of the acquisition CPN has made available to Trident its guarantee of a short-term bank line of credit totaling \$650,000. At the time of the hearing Trident had drawn \$500,000 on this line of credit; the rate of interest is 2% above prime, and \$25,479.85 interest has been paid by CPN through July 31, 1981. CPN considered this as part of the cost of acquisition. Upon receiving approval CPN will convert the \$650,000 guaranteed loan

to an equity investment and pay Trident an additional \$350,000 to complete the initial 30% investment.

Staff Analysis of Application

The Commission staff believes there are two principal issues raised. The first issue is the question whether the application meets the requirements of PU Code § 2775.5 which sets forth the standards the Commission must apply prior to authorizing utility involvement in the solar energy market.^{1/} The second issue relates to the Commission's role in analyzing the financial impact of the Trident acquisition on CPN in order to ensure there is no resultant adverse impact on CPN's California ratepayers.

The staff retained Professor Kellman (Kellman), a teacher of corporation, antitrust, and energy law, who testified in OII 13,^{2/} for the purpose of analyzing the specific facts of the Trident application in the context of the analytical framework developed by him during OII 13 as well as the criteria of PU Code § 2775.5. Kellman focuses three potential anticompetitive consequences of utility involvement in the solar market. The first problem is that the utility may be predisposed to develop and market technology which

1/ § 2775.5(b) reads, in part, as follows:

"(b) . . . The commission shall grant the authorization sought if it finds that the proposed program will not restrict competition nor restrict growth in the solar energy industry nor unfairly employ in a manner which would restrict competition in the market for solar energy systems any financial, marketing, distributing, or generating advantage which the corporation may exercise as a result of its authority to operate as a public utility. Before granting any such authorization, the commission shall find in addition that the program of solar energy development proposed by the corporation will accelerate the development and use of solar energy systems in this state for the duration of the program."

2/ Investigation into intended programs for the sales, leasing, installation, and related servicing of solar devices of various respondent utilities.

is overly expensive and overly capital intense. The second problem is that the utility could use its monopoly power over electric distribution to monopolize the market for solar energy devices. The third problem is that the utility could cross-subsidize solar operations by passing the cost of producing and marketing solar devices on to its electric ratepayers.

Kellman believes that resolution of these potential problems does not require imposition of an absolute ban on utility involvement in the solar market. Concluding that § 2775.5 standards track the requirements of basic federal antitrust law principles, Kellman asserts that the better course is to allow utilities to market solar energy devices through a financially distinct and unregulated affiliate, in accordance with the concept of maximum separation first developed by the Federal Communications Commission (FCC) in the American Telegraph and Telephone expansion context (Exhibit 25, pp. 2-3; see discussion of "The Telecommunications Precedent" in Appendix A to Exhibit 25, pp. 32-44).

According to Kellman maximum separation is primarily designed to protect against the third anticompetitive consequence. Cross-subsidization refers to the ability of the utility to support its nonutility operations by passing the costs associated with those operations on to its utility ratepayers. In this context, cross-subsidization is considered an improper practice because it (1) burdens utility ratepayers with costs extraneous to utility operations and (2) provides utilities with an unfair advantage over their nonutility competitors (in this case nonutility competitors in the solar market).

The maximum separation model discussed by Kellman is "essentially an accounting technique by which the regulatory commission allows the utility to pass on to its ratepayers only those costs of providing the utility service."

Kellman concludes that the instant application itself raises no anticompetitive concerns. Kellman believes that the acquisition

plan is consistent with the maximum separation model. CPN is on record as intending to operate Trident as a separate unregulated subsidiary. Furthermore, the CPN witness testified the utility is willing to adopt the appropriate accounting techniques to ensure that the ratepayer does not cross-subsidize Trident's operations.

With respect to the second issue (the Commission's role to consider the financial impact on CPN ratepayers) the staff is concerned about several financial issues as follows:

1. The Acquisition Price

Assuming exercise of both options, the total acquisition price will range from \$11 to \$12 million, exclusive of additional loans or guarantees the CPN witness refused to rule out. This is an undeniably substantial investment, despite the CPN witness' attempt to downplay its significance. CPN's managers determined this offering price on the basis of Trident's future profit potential. This is obviously a business judgment matter; however, staff stresses the dollar amount in the context of the remaining financial issues.

2. CPN Debt-Equity Ratio

Staff witness Pretti expressed concern about CPN's low equity ratio (32%) stating:

"CP National does not generate all of its capital requirements internally, and over this period of years, I believe that this \$11 or \$12 million will have to come from external...sources...."

"And the staff and the Commission would be concerned that because of this need for an additional \$11 or \$12 million, it may have some effect on the company's capital structure, its embedded cost of debt, so therefore, we would like to have this information^{2/} available in

^{2/} The information Pretti refers to is contained in the last 12 pages (pp. 39-46) of the Trident Business Plan; pp. 1-38 of the plan were produced by CPN (Exhibit 7), but pp. 39-46 were not produced on the grounds that that information is proprietary.

order to review it and to determine what if any effect this has on the future capital structure and interest and financing costs."

3. Trident charges include all applicable overheads; and
4. The reporting procedures developed by CPN be adequate in terms of the staff's obligation to trace the involved costs and identify those items chargeable to Trident and not to utility operations.

CPN witness Salquist made downward revisions in the initial sales projections contained in Application (A.) 60360, pp. 6-7 (500 systems to be sold in 1981, and an additional 4,500 systems estimated to be sold in 1982 and 1983;). During cross-examination, Salquist, president of Trident, stated that if sales continue at present depressed levels, Trident will place only 3,300 units through 1983. Salquist maintained these lower revised sales figures were attainable assuming a return to normalcy (12% long-term mortgages) of the residential market within the next six months and the infusion of capital from CPN assuming Trident maintains present sales levels. Obviously, if Trident's sales levels decrease, additional downward revisions would be necessary. ✓

Salquist also testified that acceptance of Trident by the major builders will be a requisite to reaching the revised sales projections, though, he also testified that Trident's marketing program does not focus on these large builders, claiming they are stubbornly resistant to change. |

Trident's marketing efforts are primarily targeted to the medium size of builder, who is not encumbered with corporate overhead and elaborate decision-making processes, and building in

multiple locations where it is very difficult to change the product.

Staff Recommendation

The staff makes no recommendation with respect to the grant or denial of the application. Should the Commission approve the application, the staff recommends that such approval be conditioned on the following:

1. Development by CPN of a reporting procedure relative to allocated overheads, submission of same to the Commission staff, and staff notification to the Commission that the reporting procedure is adequate from the standpoint of cost traceability as between CPN and Trident.
2. Imposition of necessary restrictions on CPN within its California service areas to ensure that CPN is nondiscriminatory in its treatment of Trident, assuming Trident markets in those service areas (i.e., no common sales force, all inclusive list of local solar suppliers).
3. Should CPN choose to exercise the first and second option that it be required to notify the Revenue Requirements Division in accordance with the stipulation between the parties (Exhibit 27). The stipulation provides that CPN will give notification at or about the time notice is given to the escrow agent. At or about the same time CPN will furnish the most recent financial statements of Trident and will discuss with Revenue Requirements Division personnel the principal basis for its decision to exercise the options.

The staff points out that one of the findings the Commission must make if the application is to be approved is that

the program of solar energy development proposed by the corporation will accelerate the development and use of solar energy systems in this State for the duration of the program. The staff further points out that the record clearly and strongly indicates Trident's present financial weakness and its total dependence on the new housing market. All witnesses acknowledged the depressed state of this market. The staff questions how the acquisition would operate to accelerate the development of solar energy in this State.

Discussion

Authorization of acquisitions by utilities in nonregulated fields ordinarily is not required. Section 2775.5 was added to the PU Code in 1978 under legislation commonly known as "the Bates Bill." Section 2775.5(b) requires that the Commission grant the authorization if it finds that the proposed program will not restrict competition nor restrict growth in the solar energy industry nor unfairly employ in a manner which would restrict competition in the market for solar energy systems any financial, marketing, distributing, or generating advantage which the corporation may exercise as a result of its authority to operate as a public utility. The record in this proceeding undoubtedly supports such findings.

Section 2775.5 also requires an additional finding that the program of solar energy development proposed by the utility will accelerate the development and use of solar energy systems in this State for the duration of the program. The record fully supports this finding as well. Not only will a unique solar technology receive stronger financial support, but the infusion of capital by CPN at this time may help Trident survive one of the most severe declines in new construction in recent history.

✓

We are not as concerned as is the staff with the acquisition price. As the staff indicates that is obviously a business judgment matter. We are concerned with a provision of the agreement, upon which inquiry was not made at the hearing, namely, Part IV entitled, "Shareholders' Option to Sell Common Stock." This option provides that if CPN's second option expires unexercised, CPN grants to the shareholders of Trident an option to sell the second option shares to CPN for the same amount CPN is committed to if it should choose to exercise the second option, namely, \$7,000,000. The terms of the agreement are also a business judgment, but we must take care to protect the interests of CPN's ratepayers in its regulated actions. However, CPN's view of the issues we must now consider is pointed out in its brief:

"At issue in this proceeding is not the effect of the proposed acquisition on Applicant or on Applicant's ratepayers or utility service generally, although these issues inevitably will be before the Commission for review in the course of its regular proceedings, such as applications for rate increases and the like. Rather, in this proceeding the Commission has been vested with the unique responsibility of determining the antitrust consequences of the solar energy program proposed by Applicant." (Emphasis added.)

We disagree. PU Code § 701 provides that:

"701. The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

Our overall responsibility is to ensure utilities do not undertake financial commitments which could reasonably encumber utility asset or property necessary for providing utility service; likewise, transactions that may jeopardize cash flow, including a utility's credit rating to the ultimate detriment of its ratepayers, warrants close scrutiny.

No serious issue has been raised in this proceeding that the initial capitalization of Trident by CPN will have any negative impact on CPN's ratepayers. We find no basis to deny CPN authority to proceed with this first phase of its contractual agreement.

We have serious reservations whether the "Shareholders' Option to Sell Common Stock" is in the best interest of CPN's ratepayers. Because of this provision of the agreement, should CPN exercise its first option, it is committed to the purchase of the remaining 40% for \$7,000,000 regardless of its value in December 1985, either through exercise of its second option; or should they choose not to exercise it, the exercise of the shareholders' option. The only possibility that CPN would not be committed to the expenditure of the final \$7,000,000 would be for both CPN and the Trident shareholders not to exercise their options.

While we think the acquisition of Trident might be worthwhile under the proper conditions, we believe the "Shareholders' Option to Sell Common Stock" effectively negates CPN's right to not exercise the second option. Thus, subsequent to exercise of the first option (\$3 or 4 million) CPN is effectively committed to expending \$7 million in connection with the second option regardless of the undertaking's success or failure, and CPN's California ratepayers could be the eventual losers if the investment turns out to be a financial disaster. Further, there is nothing in the record to indicate how the funds will be raised to acquire the stock authorized by the first and second options. Depending upon how the funds are to be raised, further approval could be necessary.
(PU Code § 816 to 854, inclusive.)

Therefore, while we authorize CPN to proceed with the initial capitalization of Trident, we shall accept the conditions proposed by staff as necessary to protect CPN's ratepayers from any negative implications that may flow from the exercise of the first and second options. In addition, we shall require CPN to seek our prior authorization to exercise the first option and shall require CPN to demonstrate at that time that its ratepayers will not be harmed or exposed to undue risk as a result of exercising that option.

Findings of Fact

1. CPN is a privately-owned public utility, whose California utility operations consist of electrical distribution systems in the City of Susanville, adjacent areas in Lassen, Tehama, and Plumas Counties, and the Cities of Weaverville and Needles. CPN also provides natural gas service in the South Lake Tahoe vicinity, and in Needles. Telephone service is provided in the areas of Weaverville, Susanville, Tuolumne, and Needles. It also owns and operates a water system in Susanville.

2. At the present time CPN is not a generating utility; rather it purchases 100% of the energy required by the aforementioned operations from outside sources, namely, PG&E, Nevada Power Company, and Southwest Gas Corporation.

3. As part of its ongoing diversification program, including expansion into nonregulated industries, CPN proposes to acquire Trident, a company based in Davis, California.

4. Trident has developed a packaged active solar system designed to provide space heating, space cooling, and domestic hot water; this system is sold to builders for installation in new single- or multiple-unit construction using standard slab-on-grade architectural design.

5. The Trident acquisition is to proceed in three stages, involving a total acquisition cost of \$11-\$12 million. CPN proposes

to proceed with the acquisition in stages due to the risks associated with Trident's dependency on the volatile, and presently depressed, housing market.

6. In 1978 the California Legislature enacted the Bates Bill (PU Code § 2775.5), giving the California Public Utilities Commission (CPUC) an explicit mandate to regulate the involvement of privately-owned public utilities in solar energy development, and to ensure that the solar energy industry develops in a manner which is competitive and free from the potential dominance of regulated electrical and gas corporations.

7. On March 16, 1981, CPN filed A.60360 with the CPUC, seeking authorization to acquire control of Trident under PU Code § 2775.5.

8. CPN proposes to operate Trident as a financially distinct subsidiary in accordance with the concept of "maximum separation," which is essentially an accounting technique by which the regulatory commission allows the utility to pass on to its ratepayers only the costs of providing utility service, and none of the costs associated with the nonregulated venture.

9. CPN has not yet developed an accounting procedure for allocating appropriate overheads to Trident.

10. The proposed acquisition of Trident by CPN will not restrict competition.

11. The proposed acquisition of Trident by CPN will not restrict growth in the solar energy industry.

12. The proposed acquisition of Trident by CPN will not unfairly employ in a manner which would restrict competition in the market for solar energy systems, any financial, marketing, or distributing advantage which CPN may exercise as a result of its authority to operate as a public utility.

13. The acquisition of Trident by CPN will accelerate the development and use of solar energy systems at this time.

14. The agreement contains a provision for a "Shareholders' Option to Sell Common Stock" in the event CPN allows its second option to expire unexercised.

15. The provision set forth in Finding 14 commits CPN to the purchase of the remaining 40% for \$7,000,000 even if it should choose to not exercise its second option. ✓

Conclusions of Law

1. The Stock Purchase and Option Agreement may not be in the best interests of CPN's ratepayers because of the provision of the "Shareholders' Option to sell Common Stock" could impair the financial health of the utility.

2. Authorization should not be granted to exercise the first option to acquire an additional 30% equity interest in Trident until prior authorization from the Commission has been obtained. |

3. The application should be granted subject to additional conditions proposed by staff as set forth on page 9, herein.

O R D E R

IT IS ORDERED that A.60360 is granted subject to the conditions contained herein.

This order becomes effective 10 days from today.

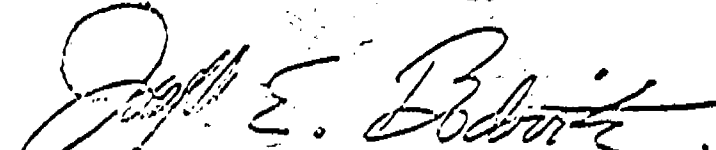
Dated December 1, 1981, at San Francisco, California.

I dissent.

/s/ RICHARD D. GRAVELLE
Commissioner

JOHN E. BRYSON
President
LEONARD M. GRIMES, JR.
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

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


Joseph E. Bodovitz, Executive Director

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RICHARD D. GRAVELLE, Commissioner, Dissenting:

I dissent.

Public Utilities Code Section 2775.5, subdivision (b), requires this Commission to find that granting a utility authorization to enter the solar energy industry will not adversely impact competition or growth in that industry, and "in addition that the program of solar energy development proposed by the corporation will accelerate the development and use of solar energy systems in this state" (Emphasis added.) I cannot find any basis for deeming the second requirement satisfied in this case and for that reason alone must dissent. Merely assisting Trident to survive does not accelerate the use of solar energy systems in California.

More importantly, I cannot accept the majority's conclusion that allowing CPN to acquire Trident will not adversely impact competition. The ordinary person, faced with a choice between comparably priced systems of Trident and non-utility backed competition, will almost invariably choose Trident because of the secure market position which its regulated parent enjoys. Trident and/or CPN will "always be around" to meet future maintenance and/or warranty requirements, while a competitor may not (and under today's order, probably will not) survive. Even if there is no cross-subsidization, as asserted by Professor Kellman, I am not persuaded there will be no impact on competition. I think CPN will clearly dominate the market for systems such as those Trident is offering. Ultimately this will retard the development of solar energy in California.

Finally, it is evident that the majority have many deep concerns about the business judgment used by CPN in entering into this transaction to acquire Trident. Thus, only conditional approval for the entire transaction is granted by today's decision. I see no warrant in the PU Code for our undertaking this review. I

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fear it dooms us to giving such approvals in the future, with the probable result that we will have to protect CPN if this venture turns into a steady stream of red ink. Instead of using PU Code Sections 701 and 2775.5 as a bootstrap for finding jurisdiction over the utility's non-regulated activities, I would put CPN clearly on notice that any losses generated by this venture will have to be borne by its shareholders, alone, up to and including the point of corporate bankruptcy. It is not our role to express dubieties about utilities' financial wisdom in unregulated activities. That is the role of CPN's shareholders and directors and a task to which I would most earnestly direct their attention.


RICHARD D. GRAVELLE, Commissioner

San Francisco, California
December 1, 1981