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Decision 97-11-004 November 5, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Application of Hillcrest Water Company and Daryl E. Morrison for authority to pledge all of the stock of Hillcrest Water Company as security for a loan to be issued by Feather River State Bank to Daryl E. Morrison.

Application 97-06-045
(Filed June 30, 1977)

Lenard G. Weiss, Attorney at Law, for Hillcrest Water Company & Daryl Morrison, applicant.
Peter G. Fairchild, for Legal Division.
Daniel R. Paige, for Water Division.

OPINION

Summary

Hillcrest Water Company (Hillcrest) and Daryl E. Morrison (Morrison) authorized to pledge all of the stock of Hillcrest to Feather River State Bank (Bank) as security for a loan to Morrison.

Discussion

Morrison is the sole shareholder of Hillcrest, a Class B public utility water corporation serving almost 4,000 service connections in and around Yuba City, California. Hillcrest obtained a loan from the Department of Water Resources (DWR) under the Safe Drinking Water Bond Act to finance improvements to its system. It also obtained authorization from this Commission to place a surcharge on the customers' bills to repay this loan (Decision (D.) 83-07-004). Because of unanticipated customer growth, Hillcrest collected sufficient money from this surcharge to completely discharge this loan. In March 1993, the Commission opened Investigation 93-03-056, to determine the amount obtained from ratepayers through the surcharge. As a result of a settlement reached between the Staff of the Commission (Staff) and Hillcrest, refunds were ordered to customers, representing the amount received from them in excess of

the DWR loan, and the surcharge was terminated. (D.95-01-038.) In addition, Morrison agreed to place three properties owned by him under a deed of trust to Hillcrest. Proceeds from the sale of these properties were to be used to pay off the DWR loan, which still remained on the utility books. Although the loan was maintained in a current status by Morrison, the properties have not sold. Hearings on the status of the loan and settlement agreement contained in D.95-01-038 were held, in which it was determined that Morrison failed to meet the requirements of past decisions of the Commission. A penalty on Hillcrest's rate of return was imposed. A more detailed explanation of these events is found in D.97-06-105. An application for rehearing of D.97-06-105 was denied (D.97-09-059, September 8, 1997).

This present application seeks authority by Morrison and Hillcrest to pledge all of the capital stock of Hillcrest to Bank. Bank would provide Morrison a personal loan with which he could retire the DWR loan. It is the pledge of stock that must be approved by this Commission, pursuant to §§ 851-854 of the Public Utilities Code.

A hearing was held on August 13, 1997 in San Francisco before Administrative Law Judge Rosenthal. Morrison testified that the current amount owed to DWR, as of July 1, 1997 was $755,463.68 and that he has $132,782.00 on deposit at Bank for payment of the next installment of the loan. (Tr., p. 3.) This leaves approximately $620,000 that must be borrowed by him to pay off the loan. (Tr., p. 9.) Staff did not dispute these numbers. Under the proposed loan from Bank, Morrison will make payments of $11,380.95 per month for five years, with a balloon payment of $236,172.62 due at the end of that time. He fully expects to be able to renegotiate the loan at that time to avoid a balloon payment, though the terms may be somewhat different than those presently offered.

At the present time the books of Hillcrest show a debt to DWR. This would be removed under the proposal in this application.

Should Morrison default on his loan Bank would become the sole owner of all of the shares of Hillcrest. Bank has joined in this application and has acknowledged that it has no recourse against ratepayers for recovery of Morrison's indebtedness should foreclosure be necessary. (Application, p. 10.) It also acknowledged that it may collect

"normal" rates while in possession. (Application, p. 10.) Under questioning, Morrison and his counsel stated that this term means rates as ordered by the Public Utilities Commission. (Tr., pp. 43-44.) Thus, Bank would not expect to reverse the rate decrease ordered in D.97-06-105 in order to recover any money should it have to foreclose on the shares pledged to it by Morrison.

Morrison testified that Hillcrest has a market value of approximately $1,000,000 to an existing public utilitiy water company. (Tr., p. 28.) This estimate is based on prices offered to him by two water utilities. He also testified that Yuba City is using a figure of $6,000,000 in its estimates of what it would cost to acquire the utility by condemnation, though he suggested that negotiations could lower this number. (Tr., p. 31.)

The Hillcrest Annual Report to the Commission, included as Attachment B to this application, shows that at the end of 1996 Hillcrest had cash of $477,248.07. Staff questioned whether this money could be used to help pay the loan. Morrison testified that this had never been considered by him, and that he did not know how much of that cash was actually available. (Tr., pp. 32-33.) He also testified that a receivable of $128,195.35 was a loan from Hillcrest to himself (the sole shareholder of Hillcrest) which carried no interest and no terms of repayment. (Tr., p. 21.)

At the hearing Hillcrest and Staff agreed on the method of accounting to be used should the application be granted. After Morrison obtains his loan from Bank, Hillcrest would book a loan from Morrison to Hillcrest on the same no-interest basis as Hillcrest's loan of $128,195.35 to Morrison. (Tr., pp. 56-62.) Hillcrest, in turn, would repay this loan on a monthly basis in an amount equal to Morrison's payment to the Bank. The purpose of the loan from Morrison to Hillcrest is to attempt to avoid income tax. If the money Morrison were to receive from Hillcrest could be considered as a repayment of a loan it would not be taxable to Morrison. If it is other than a repayment of a loan, it would be income and be taxable to Morrison. (Tr., pp. 56-57.) How the taxing authorities will construe this arrangement is not our concern.

For example, if we were to use figures for July 1, 1997, the outstanding loan to DWR would be $755,463.68. Morrison had on deposit with the Bank $132,782.00 for

payment of two installments of the loan. That leaves $622,661.68 of the DWR loan unfunded as of July 1, 1997, which would be the amount of the loan from Morrison to Hillcrest. Offsetting this sum is the loan from Hillcrest to Morrison of $128,195.35. Thus, the total loan from Morrison to Hillcrest would be $494,466.33.

At this point it is important to note that neither the present obligation of Hillcrest to DWR for the loan nor the monthly payments made by Hillcrest to pay off this loan are recognized for ratemaking purposes. As previously explained, and dealt with in great detail in D.95-01-038 and D.97-06-105, Hillcrest had already collected more from ratepayers than would have been required to pay off the DWR loan in full, and was even ordered to refund to customers the excess that it had collected. Had Morrison used the surcharge money to pay off the DWR loan, or had he retained the money in a separate account, we would not find ourselves in the present situation. The new loan from Morrison to Hillcrest contemplated by Hillcrest and Staff cannot place the ratepayers or Hillcrest in a more disadvantageous position than they are presently experiencing. Therefore, acceptance of the parties' agreement can only be on the express condition that neither the loan from Morrison to Hillcrest nor the obligation to repay that loan in monthly installments, with or without interest, can ever have any effect on ratepayers or be considered for ratemaking purposes by this Commission.

At the hearing the ALJ noted that a pledge of all of the shares of a utility was an unusual situation and asked if the parties could provide any authority either for or against such a pledge. In response, Hillcrest cited Application of Mammoth Cellular, Inc. et al., D.93-122-014 (1993) which states as follows:

> "n1 We understand that GenCel (holder of 100% of the stock of applicants) will be pledging the stock of Mammoth and Butte that it owns to secure its indebtedness. We remind GenCel and NMFC that if there is a default and MNFC seeks to acquire or control either of these California utilities, this Commission's approval is required, pursuant to P. U. Code Section 854."

We shall impose a similar caution to Bank in this proceeding.

Staff has two recommendations in this proceeding. Staff asks that the decision recognize the arrangement for the loan to Hillcrest by Morrison, as described above.

Staff also wants the loan from Bank to Morrison to be amplified or rewritten to either avoid a balloon payment or guarantee a renewal of the loan after five years and include the terms of the renewal. By letter dated August 22, 1997, counsel for Morrison and Hillcrest attached a revised commitment letter from Bank extending the term of the loan to seven years. Thus, the concern of Staff has been alleviated. This revised commitment letter was accepted by Morrison. We shall mark this new commitment letter from Bank as an Exhibit (Exh.) 2, sponsored by Morrison's and Hillcrest's counsel and accept it into evidence.

Findings of Fact

1. Morrison is the sole shareholder of Hillcrest.

2. Hillcrest has an outstanding loan from DWR.

3. Since Hillcrest has already collected sufficient money from customers to pay off this loan, it is no longer a ratemaking expense for Hillcrest.

4. Pursuant to a stipulation between Morrison, Hillcrest, and the Commission's Staff, approved and adopted by the Commission in D.95-01-038, this loan was to have been retired by January 1, 1996.

5. The loan to DWR was not retired as required by D.95-01-038, though it has remained current.

6. D.97-06-105 imposed a penalty of Hillcrest's rate of return for failure to comply with the obligations of D.95-01-038.

7. Morrison proposes a personal loan from Bank which will provide him funds to retire Hillcrest's loan from DWR.

8. By a revised commitment letter dated August 21, 1997, Bank is willing to provide a loan payable in equal monthly installments over a seven-year term. Morrison has accepted this new term. This letter has been accepted into evidence as Exh. 2 in this proceeding.

9. As sole shareholder, Morrison proposes to pledge all of the shares of Hillcrest to Bank as security for the loan.

10. Morrison presently has an outstanding debt to Hillcrest of $128,195.35. There is no interest paid to Hillcrest for this loan and there is no specified time for repayment.

11. Morrison intends to enter a debt on the books of Hillcrest equal to the amount that he will obtain from Bank, less the $128,195.35 that he owes to Hillcrest. This loan will be interest free, as was the debt from Morrison to Hillcrest.

12. The monthly payments from Hillcrest will equal Morrison's payments to Bank, though the payments to Morrison will be completed before the payments from Morrison to Bank because of the $128,195.35 offset.

13. Staff agrees with the accounting treatment described between Hillcrest and Morrison and asks that it be a condition in this decision.

14. The payments from Hillcrest to Morrison will not be a ratemaking expense.

15. Morrison testified that Bank has agreed that should it acquire the pledged shares it would collect the normal rates from customers. Normal rates mean the rates authorized by this Commission, including the penalty rate of return imposed by D.97-06-105.

16. There were no protests to the application.

Conclusions of Law

1. We conclude that the pledge of all of the shares of Hillcrest to Bank by Morrison, the sole shareholder of Hillcrest, will not be adverse to the public interest.

2. Should Bank acquire the shares of Hillcrest because of default by Morrison Bank must apply to the Commission for change of control of Hillcrest. Similarly, when Bank wishes to dispose of the shares, further authorization from this Commission must be obtained.

3. The books of Hillcrest should be permitted to show a loan from Morrison to Hillcrest in the amount of the loan from Bank to Morrison, offset by the presently stated loan from Hillcrest to Morrison of $128,195.35. This loan by Morrison must be without interest.

4. Morrison should be specifically restricted from disposing of the two properties in trust for repayment of the DWR loan other than to pay off the loan to Bank.

5. Should either of the properties be sold Morrison should be required to immediately notify the Water Division Staff of the event and of the use to which the proceeds have been put.

ORDER

IT IS ORDERED that:

1. The application of Morrison to pledge all of the shares of Hillcrest Water Company (Hillcrest) to Feather River State Bank (Bank) for a loan which will retire the Department of Water Resources loan is granted.

2. The request of Daryl E. Morrison (Morrison) and Hillcrest to show a non-interest bearing loan from Hillcrest to Morrison on Hillcrest's books is granted.

3. Should Bank acquire the shares of Hillcrest through default of the loan to Morrison, it must first apply to the Commission for authorization to control Hillcrest. Similarly, should Bank subsequently sell the shares of Hillcrest, prior authorization for that sale must be obtained from the Commission.

4. Application 97-06-045 is closed.

This order is effective today.

Dated November 5, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners