

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: September 20, 2007**

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

DATE: August 16, 2007

TO: Public Utility Commission

FROM: Michael Dougherty

THROUGH: Lee Sparling and Marc Hellman

SUBJECT: AVION WATER COMPANY, INC.: (Docket No. UI 268) Affiliated Interest Application with Jan M. and Christine M. Wick.

STAFF RECOMMENDATION:

Staff recommends that the Commission approve Avion Water Company's (Avion or the Company) affiliated interest application with Jan M. and Christine Wick (Owners) to receive loan guarantee payments 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 the Owners.
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. Avion 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.
4. Annual loan guarantee payments to the Owners shall be limited to 1.58 percent of the Company's calendar-year average debt balance. 2007 payments would be \$125,591.

DISCUSSION:

Background

Avion Water Company filed this affiliated interest application on May 17, 2007, pursuant to ORS 757.495 and OAR 860-036-0730 for authorization to pay the Owners an annual 2.5 percent guarantee fee associated with all of the Company's long-term debt. Because of the requirement for additional review of the application, on July 27, 2007, the Company agreed to a 60-day extension beyond the 90-day statutory timeline for the Commission to issue an order pursuant to ORS 757.495(6). The Owners own 95 percent of the stock of Avion and therefore an affiliated interest relationship exists.

Avion requests that the Company pay the Owners 2.5 percent of the highest guaranteed loan balances during the year. The 2007 amount is calculated by the Company at \$215,215.

The Company has three outstanding loans, two with the Bank of Cascades (Bank) and a bond with the ODOE. All three loans required personal guarantees from the Owners.

Avion's UW 122 (filed July 17, 2007) outstanding loans and weighted cost of debt are:

		Capital		Weighted
<u>DEBT</u>		<u>Structure</u>	<u>Cost</u>	<u>Cost</u>
Bank of the Cascades	\$3,821,305	27.73%	7.50%	2.08%
Bank of the Cascades	\$2,600,000	18.87%	8.12%	1.54%
ODOE Bond	<u>\$1,520,127</u>	11.03%	4.62%	<u>0.51%</u>
	\$7,941,432			4.12%

Issues

Staff investigated the following issues:

1. Terms and Conditions of the Loans and Guarantees
2. Transfer Pricing
3. Public Interest Compliance
4. Records Availability, Audit Provisions, and Reporting Requirements

Terms and Conditions of the Loans and Guarantees

The Company's primary lending institution, Bank of the Cascades, has required both a guarantee of payment with the Company's stock held as collateral and personal guarantees from the Owners for the two outstanding loans. The Company provided Commercial Pledge Agreements that demonstrate both Jan and Christine Wick have signed as guarantors for the two Bank loans made to Avion.

In a response to a Staff data request, the Company provided a letter from the Bank Vice President that stated that the Bank requires personal guarantees from all principals who have a 20 percent or more ownership position in the borrowing utility. In addition, the Bank would not be obligated to make any concessions in the loan and may chose to go straight to the guarantors for payment of the loan. This information was verified by Staff in a telephone conversation with the Bank Vice President.

The Company also has a bond agreement through the ODOE. Staff examined the bond documents that show personal guarantees from owners with 10 percent or greater ownership. Additionally, Staff verified with the ODOE Loan Officer that a personal guarantee was required to obtain the bond.

Staff also verified from two additional banks in the Bend area, Columbia River Bank and South Valley Bank and Trust that for small business loans, personal guarantees are required from owners who have 10 percent or more ownership position to guarantee repayment of the entire outstanding loan balance. If small business owners do not make these guarantees, the banks will not issue loans to the small business. A third bank, Liberty Bank, within the first two years of operation of the small business, requires personal guarantees from owners who have 20 percent or more ownership position. After two years, the bank will look at each company on a case by case basis, considering factors such as cash flow, collateral, financial strength, and other similar criteria.

As a result, the terms and conditions of the loans requiring personal guarantees from the owners appear to be standard lending guidelines for small businesses in the Bend area. Additionally, if the Owners were not willing to make these guarantees, the Company would not have been able to obtain the loans for the required capital improvements.

Transfer Pricing

Because the Company is required to comply with the lower of cost or market transfer pricing pursuant to OAR 860-036-0739, Allocation of Costs by a Water Utility, Staff is required to compare market loan guarantee rates to the cost incurred by the Company.

The Company provided information from both its attorney and certified professional accountant that place market loan guarantee rates at 2 to 5 percent.

To determine cost, Staff compared Commission authorized rates for the two Bank loans with actual rates. For the ODOE Bond, Staff compared bond market rates with the actual ODOE bond rate.

In the most recent financing docket for Avion (UF 4234, Commission Order No. 07-031, dated January 1, 2007), the Company was authorized to recover total loan fees which excluded the guarantee payment. In that docket, the total interest rate for the \$2.6 million loan would convert to 9.25 percent. In order to determine 2007 cost, Staff subtracted the current loan interest rates from the UF 4234 rate of 9.25 percent¹ and multiplied the difference by the beginning-year outstanding balance of each Bank loan.

For the ODOE bond, Staff used the State and Local Bond Rate taken from the Federal Reserve Statistical Release² for June 1, 2004,³ of 5.05 percent plus 150 basis points. Staff used this rate as a comparison to the lower than market rate that Avion was able to achieve. Being that ODOE adds 150 basis points to the rate of the bond for overhead, Staff added 150 basis points to 5.05 percent to get a rate of 6.55 percent. In order to determine 2007 cost, Staff subtracted the current bond interest rate from the 6.55 percent and multiplied the difference by the outstanding balance of the bond. The following table highlights the calculations.

Loan	Balance	Difference Between Market Rate and Current Rate	Result
Bank of the Cascades	\$3,821,305	1.75%	\$66,873
Bank of the Cascades	\$2,600,000	1.13%	\$29,380
ODOE Bond	<u>\$1,520,127</u>	1.93%	<u>\$29,338</u>
Total	\$7,941,432		\$125,591

As a result, the 2007 cost should be limited to \$125,591. The \$125,591 represents a guarantee fee of 1.58 percent based on the Company's UW 122 outstanding debt.

While the application requests the payment to the Owners be based on the maximum outstanding loan balance for a calendar year, Staff proposes an alternative for subsequent year costs. The alternative is to apply the 1.58 percent factor to the calendar-year average balance. The calculation would reflect the average repayment

¹ The UF 4234 rate of 9.25 percent equals the current prime rate (8.25 percent) plus 1 percent.

² <http://www.federalreserve.gov/releases/h15/data.htm>.

³ The June 1, 2004, rate was used as the bond was reissued on June 29, 2004.

risk during the year and avoid instances where the loan balance fluctuates during the year for unclear reasons. This method, recommended by Staff, should be used for the guarantee payments since it would satisfy the lower of cost or market transfer pricing policy.

Public Interest Compliance

Because Avion does all its banking with the Bank of Cascades, the Company did not seek competitive bidding from alternative banks in order to potentially forego the personal guarantee requirement. However based on information gathered by Staff from three other banks in the Bend area, the Company would have been required to provide personal guarantees for loans from at least two of these institutions.

Additionally, as a result of the long-standing relationship with the Bank, the Company believes that the rate received would be competitive with other local banks that make loans to small businesses. The most recent loan Avion received from the Bank is currently at 8.12 percent,⁴ which is 13 basis points lower than the current prime rate⁵ of 8.25 percent⁶. This lower than market rate substantiates the Company's claim of receiving a competitive rate from the Bank. The loan is currently capped at 9.5 percent.

The 2003 loan is currently at 7.5 percent and is capped at 8.5 percent. Again, this loan is lower than the current prime rate. The ODOE bond interest rate is set at 4.62 percent which is considerably lower than the State and Local Bond Rate in effect at issuance of the bond.

As a result of the lower than market costs calculated in Staff's recommendation, the contract is fair, reasonable, and not contrary to the public interest. Additionally, since the loans were obtained for system capital improvements, customers benefit from both the system improvements and overall reasonable requested rate of return of 8.36 percent that has resulted from the lower than market loan rates.

Records Availability, Audit Provisions and Reporting Requirements

Order Condition Number 1, listed above in the Staff recommendation; affords the necessary Commission examination of Avion's records concerning this application.

⁴ The interest is based on the interest rate of the Federal Home Loan Bank of Seattle 5-Year Long Term Funding Rate (5.42 percent at the date of the loan) plus a margin of 2.75 percentage points. The Federal Home Loan Bank of Seattle supports affordable housing and economic development initiatives in Alaska, Hawaii, Idaho, Montana, Oregon, Utah, Washington, Wyoming, American Samoa, Guam, and the Northern Mariana Islands.

⁵ The Prime Interest Rate is the interest rate charged by banks to their most creditworthy customers (usually the most prominent and stable business customers). The rate is almost always the same amongst major banks.

⁶ 8.25 percent was also the prime rate in effect on January 25, 2007, when the loan was obtained.

Based on the review of this application, Staff concludes the following:

1. The application involves an affiliated interest transaction that is fair and reasonable and not contrary to the public interest, with the inclusion of the proposed ordering conditions.
2. Necessary records are available.

Avion has reviewed Staff's recommendation and does object to the recommendation.

PROPOSED COMMISSION MOTION:

Avion's application to enter into a loan guarantee payment to Company owners be approved subject to the four recommended conditions.