

1-1976

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Richard D. Gravelle

Ira R. Alderson Jr.

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Recommended Citation

Richard D. Gravelle and Ira R. Alderson Jr., *Public Utility Debt Securities: A Transaction Exempt from the Usury Law*, 27 HASTINGS L.J. 825 (1976).

Available at: https://repository.uchastings.edu/hastings_law_journal/vol27/iss4/3

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Public Utility Debt Securities: A Transaction Exempt from the Usury Law

By RICHARD D. GRAVELLE* and IRA R. ALDERSON, JR.†

REPEATED securities offerings are both routine in and necessary to the operations of major public utilities. The regulation of utilities by the California Public Utilities Commission includes the regulation of these public utility offerings.¹ In the course of such regulation the Commission was presented, in 1974, with a question of first impression—the application of the California usury law² to a security offering. Never before had commission approval been sought for a bond offering with an interest rate exceeding 10 percent—the maximum permitted by the usury law. The resulting uncertainty threatened to disrupt the orderly course of utility financing, with unfortunate consequences for the utilities and their ratepayers.

The Usury Problem

Economic conditions generally, together with financial pressures unique to the operations of public utilities, resulted in steadily increasing interest rates for utility bond offerings during the first half of 1974.³ On August 1, 1974, Southern California Gas Company applied for authori-

* B.S., 1950, University of San Francisco; LL.B., 1954, University of San Francisco. Member, California Bar. Mr. Gravelle is General Counsel to the California Public Utilities Commission.

† B.A., 1966, San Francisco State University; J.D., 1973, San Francisco Law School. Member, California Bar. Mr. Alderson is a legal counsel for the California Public Utilities Commission, Legal Division.

1. See CAL. PUB. UTIL. CODE §§ 816-50 (West 1956 & Supp. 1975).

2. CAL. CONST. art. XX, § 22 (reference throughout is to the section 22 concerning usury); CAL. CIV. CODE §§ 1916-1 to 1916-5 (West 1954 & Supp. 1975).

3. See Exhibit No. 4, Southern Cal. Gas Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974). In January, 1974, utility bonds rated Aa yielded an average of approximately 8%, whereas by July of that year they yielded approximately 9.20%. See *id.* By the time of the hearing on the application on August 23, 1974, it appeared Southern California Gas Company's bonds would sell for more than 10%. See Transcript vol. 1, at 21, Southern Cal. Gas Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974).

zation to issue bonds.⁴ In its application, the company stated, "At the present time, money market conditions are such that, if the Series J Bonds are to be sold, the yield to the investor may of necessity exceed ten percent (10%) per annum."⁵ In an application filed August 23, 1974, Pacific Telephone and Telegraph Company also indicated that the interest rate on its proposed offering would exceed the maximum allowed by the usury law.⁶ Because of the substantial amounts involved,⁷ any potential conflict with the usury laws required quick resolution.

Proposed Solutions

Each application set out a method for avoiding the effect of the usury law. Southern California Gas Company proposed to issue and sell the bonds in a manner that would cause these activities to be governed by the law of New York, because the defense of usury is not available to corporations under New York law.⁸ Pacific Telephone and

4. Southern Cal. Gas Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974).

5. *Id.* at 9.

6. See Pacific Tel. & Tel. Co., Application No. 55130 (Cal. Pub. Util. Comm'n, filed Aug. 23, 1974).

7. Southern California Gas Company and Pacific Telephone and Telegraph Company had applied for authorization to offer bond issues of \$50,000,000 and \$300,000,000 respectively. See Southern Cal. Gas Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974); Pacific Tel. & Tel. Co., Application No. 55130 (Cal. Pub. Util. Comm'n, filed Aug. 23, 1974).

8. Southern California Gas Company's proposal stated: "Article XX, Section 22 of the California Constitution prohibits, in this State, the charging of interest on any loan or forbearance at an annual rate of interest in excess of ten percent (10%). At the present time, money market conditions are such that, if the Series J Bonds are to be sold, the yield to the investor may of necessity exceed ten percent (10%) per annum.

"In view of the foregoing, Applicant proposes to issue and sell the Series J Bonds in conformity with the following:

"1. Negotiations with the managing underwriter will be conducted in New York;

"2. The Underwriting Agreement, the Supplemental Indenture, the Bonds and other documents to be executed and delivered in connection with the offering will be executed in New York and delivered in New York;

"3. The proceeds of the offering will be delivered to and received by the Applicant in New York;

"4. All payments of principal, interest or otherwise will be payable in New York and will be paid in New York;

"5. An information meeting for the representatives of the underwriters will be held in New York;

"6. The managing underwriter's principal office will be in New York and Applicant has been informed, and believes, and therefore alleges that the underwriting group will be comprised principally of qualified underwriters who have offices in New York;

Telegraph Company's solution was simpler in form, but presented broader implications. The company proposed that it refrain from issuing or selling any debentures "in the State of California or to California residents if the interest rate thereon exceeds 10% per annum."⁹ In resolving the matter, the commission adopted neither of the suggested solutions.

The Commission's Solution

Public Policy Considerations

The commission emphasized at the outset that the usury laws were intended to shield necessitous borrowers from mercenary lenders¹⁰ and recognized that public utilities were not the sort of necessitous borrowers contemplated by the usury laws. Moreover, the commission found that public policy considerations strongly favored exclusion of the public utility bond offerings from the coverage of the usury laws.¹¹

The ability of the utilities to keep abreast of the needs of the consumer depends on their ability to obtain needed financing for construction and expansion of facilities.¹² The need for capital is relatively

"7. The Underwriting Agreement will expressly provide that it is for all purposes to be governed by the law of New York;

"8. The Supplemental Indenture and the Bonds will provide that the validity, enforcement and rights of the parties in and to the security for the Series J Bonds (mainly California Real Estate) will be governed by the law of California, but that, in all other respects the rights of the holders of Series J Bonds will be governed by the law of New York.

"It is respectfully submitted that the Series J Bonds, issued and sold in the foregoing manner, will not be subject to the California usury law, and thus may be sold on terms yielding an effective rate of interest in excess of ten percent (10%) per annum. Among other things the issue and sale would be governed by the law of New York and not by the law of California. Under New York law, corporations may not plead the defense of usury. Under the aforesaid conditions the transaction would not be subject to the California usury law." Southern Cal. Gas Co., Application No. 55080, at 9-10 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974), *citing* Ury v. Jewelers Acceptance Corp., 227 Cal. App. 2d 11, 38 Cal. Rptr. 376 (1964).

9. Pacific Tel. & Tel. Co., Application No. 55130, at 11 (Cal. Pub. Util. Comm'n, filed Aug. 23, 1974).

10. *See, e.g.*, Barnes v. Hartman, 246 Cal. App. 2d 215, 224, 54 Cal. Rptr. 514, 520 (1966).

11. Southern Cal. Gas Co., Decision No. 83411, at 7-9 (Cal. Pub. Util. Comm'n, Sept. 4, 1974).

12. The commission stated in a 1974 decision: "In addition to our authority to authorize a debt issue without regard to Usury Law, public policy demands that the issuance of public utility debt securities be unencumbered by the operation of the Usury Law. In authorizing a public utility debt issue, we recognize the utility's need to raise capital for proper purposes, such as construction and expansion of facilities to meet consumer needs and the extinguishment of prior indebtedness. Consumers directly benefit when the utility is able to keep abreast of their needs for its services.

independent of the conditions existing in the money market at the time of the need. Although the utilities may have some flexibility in trying to time their offerings to coincide with lower interest rates, it is often necessary that utilities enter the market when interest rates exceed 10 percent. To apply the usury law to these offerings, the commission found, would therefore "have the undesirable and detrimental effect of crippling the ability of utilities to raise needed capital when money market conditions necessitate payment of interest exceeding the maximum allowed by the Usury Law."¹³

The consequent delays in construction and expansion of facilities would have long-range effects on the quality of service and on employment opportunities.

The desire to keep interest costs as low as possible also influenced the commission's decision. The Pacific Telephone and Telegraph Company's proposed solution was thus rejected because excluding from the market a significant percentage of potential investors would foreseeably result in interest rates higher than otherwise required.¹⁴ The commission was also aware that the alternative to authorizing debt issues at interest rates exceeding 10 percent was requiring the utilities to borrow from institutional lenders, exempt from the usury laws, at interest rates still higher than the rates expected to be paid on the bond offerings.¹⁵

In seeking the solution involving the lowest cost, however, the commission realized that whatever result it reached would require endorsement by counsel for the underwriters, a necessarily conservative group. Thus, if the usury laws were to be held inapplicable to the bond offerings, the decision would have to be firmly grounded in the law.

Therefore, it is essential that the utility's ability to obtain needed capital not be impaired." Pacific Gas & Elec. Co., Decision No. 83504, at 6 (Cal. Pub. Util. Comm'n, Aug. 15, 1974) (citation omitted).

13. *Id.* at 7.

14. For example, testimony was adduced in *Southern California Gas Company* illustrating that approximately 30% of the bond market for California public utilities existed within California. Transcript vol. 1, at 28-29, Southern Cal. Gas Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974). The Pacific Telephone and Telegraph Company contended, however, that even if the market restrictions resulted in increased interest expense, that expense would be far less than the expense Pacific Telephone would incur if the proposed market restrictions were not adopted by the Commission and only a qualified legal opinion was rendered by counsel for the underwriters. Transcript vol. 1, at 20, Pacific Tel. & Tel. Co., Application No. 55130 (Cal. Pub. Util. Comm'n, filed Aug. 23, 1974).

15. Short term loans from lenders exempt from the usury law, would cost about 12%, whereas long-term debt would cost slightly over 10%. See Transcript vol. 1, at 21-22, Southern Cal. Edison Co., Application No. 55175 (Cal. Pub. Util. Comm'n, filed Sept. 16, 1974).

With policy dictating resolution in favor of authorizing the offerings, the commission staff contended that under applicable law the commission itself had jurisdiction to authorize the issuance and sale of the bonds, even if the interest rates would exceed 10 percent.¹⁶ Under this approach, the "conflict of laws" solution proposed by Southern California Gas Company was unnecessary. The staff view, which the commission adopted with no significant changes, is explained below.

The Commission's Jurisdiction

The regulation of public utilities is a matter that occupies a unique position in California law. Sections 22 and 23 of former article XII of the California Constitution provided the basic framework for this regulation.¹⁷ Section 23 stated, in part, that public utilities were "subject to such control and regulation . . . as may be provided by the Legislature"¹⁸ The Legislature's power to regulate was delegable to the Public Utilities Commission. Section 22 specified that

[n]o provision of this Constitution shall be construed as a limitation upon the authority of the Legislature to confer upon the Public Utilities Commission additional powers of the same kind or different from those conferred herein which are not inconsistent with the powers conferred . . . and the authority of the Legislature to confer such additional powers is . . . plenary¹⁹

Furthermore, section 23 provided, "[n]othing in this section shall be construed as a limitation upon any power conferred upon the [Public Utilities Commission] by any provision of this Constitution now existing or adopted concurrently herewith."²⁰ These sections thus describe the powers of the legislature and the Commission in broad terms. In the

16. See Brief of the Commission Staff at 6, Southern Cal. Gas. Co., Application No. 55080 (Cal. Pub. Util. Comm'n, filed Aug. 1, 1974).

17. CAL. CONST. art. XII, §§ 22, 23 (1911, *as amended*, 1946). In 1974 at the same time former article XII was repealed, the voters approved a new article XII, which streamlined the old provision. The new Section 9 of new article XII makes clear that no substantive change was intended in the power of the legislature or in the authority conferred upon the commission under former article XII: "[t]he provisions of this article restate all related provisions of this Constitution in effect immediately prior to the effective date of this amendment and make no substantive change." CAL. CONST. art. XII, § 9. For example, the plenary power of the legislature, formerly found in section 22, is now provided for in section 5 of new article XII, which declares that "[t]he Legislature has plenary power, unlimited by the other provisions of the constitution but consistent with this article, to confer additional authority and jurisdiction upon the Commission" Compare CAL. CONST. art. XII, § 5 with CAL. CONST. art. XII, § 22 (1911, *as amended*, 1946).

18. CAL. CONST. art. XII, § 23 (1911, *as amended*, 1946).

19. *Id.* § 22.

20. *Id.* § 23.

landmark case of *Pacific Telephone & Telegraph Co. v. Eshleman*,²¹ the supreme court interpreted sections 22 and 23 and offered some insight into the extent of these powers.

The court in *Eshleman* gave sections 22 and 23 an expansive reading, finding therein a source of almost limitless power and determining that "in all matters touching public utilities the voice of the legislature shall be the supreme law of the land."²² The court held that the constitution authorized the legislature to confer upon the Commission such of its regulatory powers "as it may see fit, even to the destruction of the safeguards, privileges, and immunities guaranteed by the [state] constitution to all other kinds of property and its owners."²³ It was Justice Sloss, in concurrence, who stated the limitation on this relationship that has become an integral part of public utilities law. He stated, "The powers conferred by the legislature on the [public utilities] commission must be such as are cognate and germane to the purposes for which the [public utilities] commission was created, i.e., regulation of public utilities."²⁴

The broad legislative powers confirmed in *Eshleman* have formed the basis of public utilities regulation and have been reaffirmed in subsequent cases. One such case, of primary importance to the usury problem, is *City of North Sacramento v. Citizens Utilities Co.*,²⁵ which involved a condemnation proceeding instituted under the Public Utilities Code.²⁶ A principal issue presented in that case was the applicability of the interest on judgments provision of section 22 of article XX²⁷ to a condemnation award under the Public Utilities Code. In holding section 22 inapplicable, the court stated:

Since the Constitution authorizes the Legislature to confer plenary power upon the Public Utilities Commission to fix the just compensation to be awarded a public utility whose property is being condemned, it must necessarily follow that *if* interest is a part of 'just compensation' then control over the question of its allowance is a legislative matter unhampered by the constitutional provision that general judgments bear interest.²⁸

21. 166 Cal. 640, 137 P. 1119 (1913). This case should still be good law under the new article XII. See note 17 *supra*.

22. 166 Cal. at 658, 137 P. at 1125.

23. *Id.*

24. *Id.* at 702, 137 P. at 1143.

25. 218 Cal. App. 2d 178, 32 Cal. Rptr. 308 (1963).

26. See CAL. PUB. UTIL. CODE §§ 1401-21 (West 1956 & Supp. 1975).

27. CAL. CONST. art. XX, § 22. Section 22 also contains the constitutional portion of the usury law. See note 2 *supra*.

28. 218 Cal. App. 2d at 187, 32 Cal. Rptr. at 313.

The implication for the usury problem is apparent: the legislature has plenary power to confer upon the commission jurisdiction over public utility security offerings. Therefore, the extent that rate of interest is "a part" of securities offerings, "control over the question" of the allowable rate is "a legislative matter unhampered by the constitutional provision" relating to usury.

The Commission's Authority

Sections 816 through 830 of the Public Utilities Code define the nature and extent of the commission's authority to regulate public utility securities offerings.²⁹ Section 816 makes plain that the legislature has indeed conferred broad powers upon the commission in this regard:

The power of public utilities to issue [securities] . . . is a special privilege, the right of supervision, regulation, restriction, and control of which is vested in the State, and such power shall be exercised as provided by law under such rules as the commission prescribes.³⁰

Section 818 provides that no utility may issue long term debt without first securing from the Commission an order authorizing the issue.³¹ Section 819 authorizes the commission to hold a hearing and to "make such additional inquiry or investigation, examine such witnesses, books, papers, documents, and contracts, and require the filing of such data as it deems of assistance" in determining whether to grant permission, "or refuse such permission, or grant it subject to such conditions as it deems reasonable and necessary."³² This language clearly contemplates that the commission is vested with the authority to consider interest rates as a matter "cognate and germane" to securities offerings, and there is no indication that the commission's jurisdiction in this regard is in any way limited, by usury law considerations or otherwise.

The interest rate to be paid has always been a part of the commission's concern with the prudent operation of public utilities, and the subject has been addressed in various commission decisions.³³ The matter of interest rates is one of the elements that supports the commission's rule requiring competitive bidding for the sale of debt securities.³⁴

29. CAL. PUB. UTIL. CODE §§ 816-30 (West 1956 & Supp. 1975).

30. *Id.* § 816 (West 1956).

31. *Id.* § 818.

32. *Id.* § 819.

33. *See, e.g.,* San Gabriel Valley Water Serv. Co., 40 Cal. R.R. Comm'n 461, 19 P.U.R. (n.s.) 168 (1937); Midland Counties Pub. Serv. Corp., 20 Cal. R.R. Comm'n 629 (1921); Southern Cal. Gas Co., 20 Cal. R.R. Comm'n 799 (1921).

34. *See also* Pacific Tel. & Tel. Co., 68 Cal. P.U.C. 490 (1968). Ordinarily,

Staff therefore contended that the commission had jurisdiction to approve an otherwise reasonable security offering regardless of the interest rate, and that this conclusion presented the best of the various alternatives.

The Commission's Decision

On September 4, 1974, the commission approved Southern California Gas Company's application and authorized the sale of the bonds at the "best" interest rate "the utility [could] obtain because of market conditions"³⁵ The commission relied on its authority to approve utility debt securities under the plenary power clause of article XII,³⁶ adopting essentially the position urged upon it by the staff. In addition, the commission noted that corporate bonds have been held to be exempt

unless the applicant can show good cause for waiver, the commission requires that debt securities be sold by competitive bidding, which under usual market conditions results in the lowest cost to the utility. *See* 46 Cal. R.R. Comm'n 281 (1946) (investigation of propriety of a competitive bidding rule for public utilities). On this issue the commission stated: "Much is said in this record about the price at which securities were sold. The price of securities is not static. It changes from day to day and varies with the vicissitudes of the business. No underwriter guarantees that the price at which he offers securities will not decline. The testimony shows that neither a negotiated sale nor a competitive bidding sale carries with it an assurance that the price will not rise above or drop below the offering price. That the price is affected by the terms of the securities, as well as by the standing of the issuer, is self-evident. It is in the public interest that utilities sell their securities at the highest price obtainable. We believe this can be achieved more readily when more than one investment banker is offered an opportunity to acquire their securities.

"During the course of the hearing, the Commission's authority to enter an order directing the utilities to invite publicly, written sealed bids for the purchase of their securities was questioned. Section 52(a) [now in substance Section 816 of the Public Utilities Code] of the Public Utilities Act reads as follows: 'The power of public utilities to issue stocks and stock certificates or other evidence of interest or ownership, and bonds, notes and other evidences of indebtedness and to create liens on their property situated within this State is a special privilege, the right of supervision, regulation, restriction and control of which is and shall continue to be vested in the State, and such power shall be exercised as provided by law and under such rules and regulations as the commission may prescribe.'

"Section 52(b) provides that the Commission may by its order grant permission for the issue of such stocks or stock certificates or other evidence of interest or ownership, or bonds, notes or other evidences of indebtedness in the amount applied for or in a lesser amount or not at all, and may attach to the exercise of its permission such condition or conditions as it may deem reasonable and necessary. A rule requiring competitive bidding would constitute merely a condition attached to a grant of authority to issue securities." *Id.* at 286-87.

35. *See* Southern Cal. Gas Co., Decision No. 83411, at 8, (Cal. Pub. Util. Comm'n, Sept. 4, 1974).

36. *See* note 17 *supra*.

from the limitations on interest specified in the usury laws.³⁷ Pursuant to section 1705 of the Public Utilities Code,³⁸ the commission set forth its findings of fact and conclusions of law, indicating that these particular findings and conclusions would be a model for subsequent decisions concerning offerings carrying an interest greater than the maximum allowed by the usury laws.³⁹ The commission also authorized South-

37. See *In re Washer*, 200 Cal. 598, 254 P. 951 (1927). In *Washer*, the court held that corporate bonds are not "loans" within the meaning of the usury law. *Id.* at 607, 254 P. at 955. The court noted that the broad power of the Railroad Commission (now the Public Utilities Commission) to supervise the issuance and sale of public utility bonds afforded the corporate borrower sufficient protection, obviating the need for application of the usury laws. *Id.* at 605-06, 254 P. at 954-55. Finally, the court noted that the practical effect of applying the usury law to such securities would be to hamper their free exchange and thereby to damage "our otherwise strong and healthy business fabric." *Id.* at 607, 254 P. at 955.

Washer was decided prior to the 1934 amendment to the usury law. That amendment added article XX, section 22 to the California Constitution. At the time of the 1934 amendment, California's usury law consisted of an initiative measure approved by the voters in 1918. Cal. Stat. 1919, at lxxxiii-iv (codified in CAL. CIV. CODE §§ 1916-1 to -5 (West 1954)). Although the 1918 measure was not made part of the constitution, the supreme court has declared that "the Usury Law is adamant and has the force of a constitutional provision." *Beneficial Loan Soc'y v. Haight*, 215 Cal. 506, 515, 11 P. 252, 258-59 (1932). Thus, *Washer* interpreted an initiative measure having the force and effect of a constitutional provision. It has since been held that the 1934 amendment did not supersede the 1918 law and is not otherwise inconsistent with it. See *French v. Mortgage Guarantee Co.*, 16 Cal. 2d 26, 34, 104 P.2d 655, 659 (1940); *Penziner v. West Am. Fin. Co.*, 10 Cal. 2d 160, 171-77, 74 P.2d 252 (1937); *Barnes v. Hartman*, 246 Cal. App. 2d 215, 220, 54 Cal. Rptr. 514, 518 (1966).

Since interest rates have only recently risen to a point causing a potential conflict between public utility debt offerings and the usury laws, few cases discussing *Washer* as it applies to this point can be found. Those few sources which do discuss the matter indicate that *Washer* is still good authority for the proposition that corporate bonds are exempt from the usury laws. See, e.g., *Berry Hotels Sys. v. Capitol Properties, Inc.*, 9 Cal. 2d 12, 12-15, 68 P.2d 974, 974-76 (1937); *Verbeck v. Clymer*, 202 Cal. 557, 563, 261 P. 1017, 1019 (1927); 49 CAL. JUR. 2D *Usury* § 5 (1959); Annot., 165 A.L.R. 657, 659 (1946).

38. CAL. PUB. UTIL. CODE § 1705 (West Supp. 1975).

39. Thus when it appears possible that because of market conditions the interest rate of debt securities will exceed 10%, it can be expected that the commission will find as it did in *Southern California Gas*:

"9. Prevailing market conditions may necessitate that applicant's proposed Series J bonds will be issued and sold with a rate of interest exceeding the limitations provided in Article XX, Section 22 of the California Constitution.

"10. Pursuant to plenary powers granted to the Legislature by . . . the California Constitution, the Legislature is authorized to confer additional consistent powers upon the Public Utilities Commission as it deems necessary and appropriate, unrestricted by any other provisions of the California Constitution.

"11. The Legislature has conferred upon the Public Utilities Commission the authority to regulate the issuance of public utility securities, including evidences of in-

ern's plan to structure the sale of its securities so that New York law would apply to the offering.

Postscript

Despite the Commission's decision, bond counsel remained uncertain whether underwriters and investors would rely on that decision without favorable judicial review by the California Supreme Court. Nevertheless, on October 16, 1974, Southern California Gas Co. bonds offered with an interest rate of 10.25 percent sold without incident.⁴⁰ On May 6, 1975, San Diego Gas and Electric Company bonds were sold at a 10.70 percent interest rate.⁴¹ The success of both of these offerings indicates general satisfaction with the Commission's resolution.

debtedness, and to prescribe restrictions and conditions as it deems reasonable and necessary.

"12. Pursuant to the plenary powers granted to the Legislature [by] the California Constitution, it conferred upon the Public Utilities Commission comprehensive and exclusive power over the issuance of public utility securities, including evidence of indebtedness, and the Usury Law cannot be applied as a restriction on the Public Utilities Commission's regulation of such issuances of public utility securities, including the establishment of a reasonable rate of interest.

"13. In addition to the plenary powers granted to the Legislature by the California Constitution pursuant to which the Legislature conferred upon the Public Utilities Commission exclusive authority to regulate the issuance of bonds by public utilities, irrespective of the Usury Law, judicial interpretation of the California Usury Law has exempted corporate bonds of public utilities from operation of the Usury Law.

"14. If the usury limitation contained in Article XX, Section 22 of the California Constitution and the Usury Law Initiative Act is exceeded, but the transaction is authorized by this Commission and is the best applicant can obtain because of market conditions, applicant 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 applicant of Series J bonds in compliance with authorization by the Public Utilities Commission, persons collecting interest on such authorized bonds are not subject to the Usury Law sanctions." Southern Cal. Gas Co., Decision No. 83411 (Cal. Pub. Util. Comm'n, Sept. 4, 1974).

40. See 1975 Moody's Public Utility Manual 1473.

41. See *id.* at 557.