Decision No. 38614

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the matter of the investigation on the Commission's motion to determine the propriety of requiring public utilities to invite publicly, written sealed bids for the purchase of their securities.	Case No. 4761

APPEARANCES:

EDWARD C. RENWICK, for Interstate Transit Lines.

E. J. FOULDS, for Southern Pacific Company and Affiliated Companies.

REGINALD L. VAUGHN, for Vallejo Electric Light and Power Company.

G. C. LARKIN, for Southern California Edison Company Ltd.

JAMES S. MOORE, JR., for The California-Oregon Power Company.

CHARLES F. MASON and HARRY L. DUNN, for Associated Telephone Company, Ltd.

HUGH GORDON, for Pacific Freight Lines and Pacific Freight Lines Express.

D. L. KING, for California Electric Power Company and Interstate Telegraph Company.

RALPH ELSMAN, for San Jose Water Works and California Water Service Company.

J. MAATTA, for Pacific Greyhound Lines.

CHICKERING & GREGORY, by ALLEN CHICKERING, for San Diego Gas and Electric Company.

WILLIAM B. BOSLEY, ROBERT H. GERDES and R. W. DuVAL, for Pacific Gas and Electric Company.

ARTHUR T. GEORGE, for The Pacific Telephone and Telegraph Company and Southern California Telephone Company.

GERALD C. KEPPLE and JAMES S. CAMPBELL, for Consolidated Telephone Company.

H. G. HAYES, for Coast Counties Gas and Electric Company.

JOHN L. LILIENTHAL, for California Water and Telephone Company.

L. A. BAILEY and REGINALD L. VAUGHN, for California Warehousemen's Association and Pacific States Cold Storage Warehousemen's Association.

GIBSON, DUNN & CRUTCHER, by MAX EDDY UTT, for Los Angeles Transit Lines.

PAUL OVERTON, for San Gabriel Valley Water Service.

LEROY M. EDWARDS, for Southern California Gas Company and Southern Counties Gas Company of California.

HERMAN PHLEGER and B. J. FEIGENBAUM, for Investment Bankers Association of America, California Group.

ROBERT W. CROSS, for Pacific Mutual Life Insurance Company.

FRANK W. WALKER, Financial Vice President, for Stanford University.

BENJAMIN C. CORLETT, Superintendent of Banks for the State of California.

EDWARD M. DAUGHERTY, Commissioner of Corporations for the State of California.

G. M. CUTHBERTSON, for Securities and Exchange Commission.

JOHN FRANCIS NEYLAN, for Halsey, Stuart & Co., Inc.

BY THE COMMISSION:

O P I N I O N

Hearings were had in this proceeding on June 27, August 15, 17, 18 and 22, and September 6 and 17. The parties were given an opportunity to file opening concurrent briefs on or before October 17, and reply briefs on or before October 31. Some of them have filed briefs and the matter is now ready for decision.

At the initial hearing, which was before Commissioners Anderson, Craemer, Sachse and Rowell, utility representatives

and others made general statements for and against a competitive bidding rule. The statements were not made under oath and those making them were not subject to cross examination. The Commission at the opening of the hearing suggested that the statements be general, and that testimony and evidence be presented at subsequent hearings to be held by Examiner Fankhauser. He conducted the hearings on the days above mentioned subsequent to June 27.

During the hearings conducted by Examiner Fankhauser, representatives of nine utilities(1) submitted evidence against a compulsory competitive bidding rule, while Halsey, Stuart & Co., Inc., submitted evidence in support of such a rule. The Investment Bankers Association of America, California Group, who indicated in an earlier proceeding before the Commission that it desired an opportunity to present its views, called no witness. Its counsel did file an opening and reply brief. The other parties who entered an appearance at the initial hearing offered no evidence.

This case presents but one issue, to wit, should the Commission require certain utilities to invite publicly, written sealed bids for the purchase of their securities. The term "securities" as used herein, unless otherwise specifically stated, covers stocks and stock certificates or other evidence

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(1)
Pacific Gas and Electric Company
San Diego Gas and Electric Company
The California-Oregon Power Company
Southern California Edison Company Ltd.
California Electric Power Company
Southern California Gas Company
Southern Counties Gas Company of California
San Gabriel Valley Water Service
Los Angeles Transit Lines

of interest or ownership, and bonds, notes and other evidences of indebtedness.

The record shows that the sale of public utility securities under competitive bidding is no longer in an experimental stage. In 1926 the Interstate Commerce Commission announced that railroads as a condition precedent to the sale of equipment trust obligations should invite tenders therefor. By its Decision of May 8, 1944, effective July 1, 1944, in Ex Parte 158, that Commission found that for the proper administration, execution and enforcement of Section 20-a of the Interstate Commerce Act it should require as a condition to the approval of the sale of railroad bonds that they be offered for sale at competitive bidding.

On April 7, 1941, the Securities and Exchange Commission proceeding under the authority conferred upon it by the Holding Company Act of 1935, adopted its Rule U-50, effective May 7, 1941. Under this rule holding companies and their subsidiaries as defined in said act are required to invite publicly, sealed written proposals for the purchase of the securities which are not specifically exempt by the rule.

On May 23, 1939, the Federal Power Commission modified its rules of practice and regulations and requires an applicant seeking permission to issue securities to make a showing that it has in an adequate manner publicly called for and has made diligent effort to obtain competitive bids for its securities. The New York Public Service Commission and the Railroad Commission of California have recently in specific instances required utilities to invite bids for the purchase of securities.

The following table shows the volume of debt securities sold by public utilities and by railroads through negotiated sales and under competitive bidding from 1941 to August 1, 1945.

Year	Public Utilities: Negotiated Sales	Public Utilities: Competitive Sales	Railroads: Negotiated Sales	Railroads: Competitive Sales
1941	$330,575,000	$162,527,000	$36,418,000	$ 41,697,000
1942	31,000,000	205,500,000	5,995,000	9,500,000
1943	16,000,000	320,800,000	28,483,000	31,700,000
1944	300,450,000	675,343,000	4,500,000	401,825,000
To 8-1-1945	56,984,000	624,656,000	-	657,801,000

The principal reasons advanced by the utilities against a compulsory competitive bidding rule may be summarized as follows:

(a) A competitive bidding rule deprives the utilities of bankers' advice.

(b) Competitive bidding does not result in the best price.

(c) A competitive bidding rule is an unnecessary interference with the management of utilities.

The utilities also question the Commission's authority to enter an order prescribing a compulsory competitive bidding rule.

(a) Bankers' Advice

Some of the utilities submitted evidence showing that investment bankers to whom they sold their securities under negotiated sales advised them on interest rates, redemption prices, sinking fund provisions, maturity dates and on other matters. They reviewed the trust indentures securing the payment of bonds and rendered assistance in the preparation and filing of

registration statements. They advised them as to the time when an offering might be made to avoid competition with other offerings and to take advantage of favorable market conditions. One witness testified that the smaller utilities are not financially able to keep a professional security expert on their payrolls and therefore must of necessity depend on advice from investment bankers. For services thus rendered, the bankers' compensation is in the spread, that is, the difference between what the utility receives for its securities and the price at which the securities are offered to the public. They fear that under a compulsory competitive bidding rule they would not have the advice of the bankers in the particulars mentioned.

(b) Best Price

The evidence does not specifically define the term "best price". It points to a price at which securities can be sold to the public less compensation to the investment banker. It appears to be a price slightly below rather than above the current market value for comparable securities. Most of the utilities prefer to have their security issues sold quickly and, as one witness put it, not be "hanging around for a long time". They feel it adds to the prestige of the issuer if its securities can be promptly sold by the underwriter. The record on this point, however, is not unanimous. One utility witness looks upon the underwriter as a prime contractor on his own and if the market went bad it would be his misfortune. On the other hand, if the market went up it would be his good luck. He testified that none of his company's issues went "out the window" and expressed the hope that so long as he sold the company's securities no issue ever "goes out the window".

Another witness testified that the utilities have no way of knowing what prompts a sealed bid. The bid may be based on a desire to get some business away from someone else, or it may be actuated by a desire to show somebody up, or it may be submitted by someone hungry for business or prestige or it may be based on honest judgment of the market prices for securities. A price not predicated on current market price is viewed with suspicion and as not being in the best interest of the issuer. The evidence shows that neither a negotiated nor competitive bidding sale is any assurance that the investors will buy a security at its initial offering price.

(c) Interference with Management

The utilities, according to their evidence, should be permitted to sell their securities in the manner deemed by their management to be most advantageous to them. The evidence indicates that they have exercised some influence over the principal underwriter as to who should be included in the underwriting group. They seem to be fearful that a competitive bidding rule might force upon them a syndicate containing some undesirable members. The evidence shows a marked difference of procedure followed by the utilities in the sale of their securities. One utility determines the price at which it will sell its securities and then proceeds to find an underwriter who will pay that price. However, to date, the underwriter first contacted has always paid the price wanted by the utility. Other utilities select the underwriter and fix the price by negotiation with him. The fixing of the price is the final step in their negotiations. If they cannot arrive at a satisfactory price, they feel that they are free to consult another underwriter

The record does not show that they have ever conducted negotiations with a second underwriter. In either procedure, the choice of the underwriter is with the utility management. This choice, they state, is lost through competitive bidding, and under that procedure the investment banker makes the decision through his bid, which may be influenced by reasons other than the market price of the securities.

The utilities feel that a competitive bidding rule places upon the management an unnecessary regulation and that they should have the freedom to resort to competitive bidding when, in their judgment, it is desirable. They admit that in specific instances the Commission might be warranted in directing a utility to sell its securities by competitive bidding.

Evidence in Favor of Competitive Bidding

The adoption of a compulsory competitive bidding rule is advocated by Halsey, Stuart & Co., Inc., who submitted evidence in support of such a rule. The evidence is to the effect that a competitive bidding rule is in the public interest in that it results in a lower cost of money; that in a declining market a utility has a better chance to sell its bonds under a competitive bidding rule in that it would have the whole field to draw from, whereas under the present system it is limited to one banker; that competitive bidding itself will not result in too high a price; that the compensation of the bankers changes under different market conditions; that there is no better yardstick to test the adequacy of the price for securities to the issuer than competition among the banker-buyers; that competitive bidding has increased dealers' interest in the sale of

securities; that intensive and extensive investigations are made of an issue before bids are submitted; that the bids submitted are the result of price meetings by members of the underwriting syndicate; that the bankers' compensation has been lower in cases where securities were sold under competitive bidding than in cases of negotiated sales; that the investment bankers can perform the function they now perform in the distribution of securities and receive a fair profit for their services, and that the utilities would receive a fair price for their securities under the proposed competitive bidding rule in evidence in this proceeding.

Conclusions

There is in evidence the statement (Exhibit 5) of the Securities and Exchange Commission made at the time it announced its Rule U-50 requiring holding companies and their subsidiaries to sell certain securities under competitive bidding. There is also in evidence the Interstate Commerce Commission's decision (Exhibit 4) in Ex Parte 158 requiring railroads to sell certain of their securities by competitive bidding. Parts 22, 23 and 24 (Exhibits 27-1,-2 and -3) of the 1939-1940 hearings before the Temporary National Economic Committee covering testimony submitted by investment bankers are in evidence. The decisions of the Securities and Exchange Commission and of the Interstate Commerce Commission show that those Commissions had before them evidence in support of and against a competitive bidding rule similar to the evidence presented by the opponents and proponents of competitive bidding in this case. The Securities and Exchange Commission's competitive bidding rule has been in effect since

May 6, 1941, and that of the Interstate Commerce Commission since June 30, 1944. Both are in effect now. It is argued that the conditions which justified those Commissions to adopt competitive bidding rules do not exist in California.

The record in this case shows that some utilities depend for advice and guidance on the investment banker to whom they intend to sell their securities. Obviously, the banker is an adversary party. It is doubtful whether the utilities should depend upon him for advice. In several instances members of investment banking firms were on the Board of Directors of the utilities whose securities they purchased. The record lacks convincing evidence that the utilities shopped around to sell their securities. A competitive bidding rule may relieve the utilities from what seems an implied right that bankers have to purchase the securities of certain utilities.

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) 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.

Sections 52(a) and (b) of the Public Utilities Act have been in effect since March 23, 1912. In passing upon applications for permission to issue securities, the Commission's records show that it has granted some applications, granted some conditionally, and denied and dismissed some applications. The power to grant or deny implies the power to grant with qualification or condition. No utility has appealed to the Courts for relief from any Commission decision passing on a security application.

One utility takes the position that the directors of California utilities have the power and authority to determine the manner and mode of their financing, subject to the jurisdiction of this Commission under Section 52 of the Public Utilities Act. It alleges that the Commission is given supervisory power over utilities to protect the public interest, and that in the absence of a positive showing that the course of action proposed by the utility is detrimental to the public interest, the Commission should refrain from interfering with managerial judgment. This argument overlooks the plain and unambiguous intent of the statute, which was designed to protect the interest of the public.

While the Commission has positive authority to fix the price at which a utility may sell its securities, it should obviously do so only upon having before it competent evidence. The bids are a form of evidence helpful in determining the price at which the securities should be sold. In asking for bids a utility should reserve the right to reject any and all bids. It is for its management to decide what bid it will accept, and present to the Commission for its approval. Neither the utility nor the Commission is, under a compulsory competitive bidding rule such as is herein proposed, yielding any of its jurisdiction.

The Investment Bankers Association of America, California Group, in its brief states that it does not oppose the sale of securities by competitive bids where the issuer or any regulatory body at the time deems such sale advisable and in the interest of the issuer, the investor and the public. It thus concedes that the Commission has the power to order competitive bids. It does not, however, concede that such power is broad

enough to cover a compulsory competitive bidding rule.

There is judicial authority for the proposition that the sale of securities by utilities is no longer a matter that rests exclusively with the management of the utilities.(1) It is well-established that the Commission has the power to fix rates to protect the users of utility services and the utility itself. The regulation of security issues is an essential step in maintaining a just relation between the utility and its consumers. In fixing a fair return, the Commission takes cognizance of outstanding securities and the burden, in the way of interest and dividends, that they impose upon a utility. The price at which securities are sold enters into that determination. No one questioned the Commission's authority to fix the price at which utilities may sell their securities. As said, bids are evidence of the market value of the securities. In our opinion, Section 52 of the Public Utilities Act authorizes us to require utilities to invite publicly, written sealed bids for the purchase of their securities.

There remains the question as to what securities should be covered by the Commission's competitive bidding rule. The Commission is advised that the Securities and Exchange Commission regards an invitation for bids as a public offering for sale of securities under the Securities Act of 1933, and that

(1) 293 Federal Reporter, page 1001.

such invitation may not be announced until a registration statement has been filed with that Commission and by it declared in effect. Because of this situation, we believe that this Commission's rule should at the outset not apply to an issue of securities, the total proceeds of which do not exceed $1,000,000. Further, the rule should not apply to any security exchanged by the issuing utility with its existing security holders exclusively, where no commission is paid for soliciting such exchange, or to any security offered to existing security holders pursuant to any pre-emptive right or privilege. Further, it should not apply to any securities issued in exchange for outstanding securities in connection with any bona fide reorganization or financial adjustment pursuant to a decree of a court of competent jurisdiction. Neither should it apply to the conventional conditional sales contracts, if they are payable within five years after date, nor to notes payable in not more than five years after date provided no fee or remuneration is paid for negotiating the loan.

Upon the filing of an appropriate application and after a hearing had thereon, the Commission may exempt, after due showing, any security from its competitive bidding rule.

Bids should be opened only at such time and place as is specified in the invitation. A duly authorized representative of any person submitting a bid should be permitted to be present at the opening of the bids and examine each bid submitted. The utility, when inviting bids, should reserve the right to reject all bids and call for new bids or seek such other relief as may be warranted.

O R D E R

The Commission having considered the evidence and argument submitted in this case, finds that an order requiring public utilities to invite publicly, written sealed bids for the purchase of their securities coming within this order is in the public interest, therefore,

IT IS HEREBY ORDERED that public utilities, whose security issues come within Section 52 of the Public Utilities Act, shall invite publicly, written sealed bids for the purchase of their securities, except the following:

(1) The issuance of any security by a public utility in exchange for outstanding securities where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange.

(2) The issuance of any security offered pro rata to existing security holders pursuant to any pre-emptive right or privilege.

(3) Any security issued by a public utility in exchange for an outstanding security in connection with a reorganization or financial adjustment pursuant to the decree of a court of competent jurisdiction.

(4) Any note or conditional sale contract issued by a public utility and payable within five years after date provided no fee or remuneration is to be paid for negotiating the loan represented by said note or conditional sale contract.

(5) Any security issued and sold where the total consideration received by the issuing public utility is $1,000,000 or less.

(6) Any security as to which the Commission shall find, upon due showing by a public utility that the sale thereof at competitive bidding should not be required.

IT IS HEREBY FURTHER ORDERED that each public utility shall by newspaper publication invite the submission, at a stated date, hour and place, of sealed, written bids for the purchase of the specified security. Such invitation shall be given not less than ten days, unless a shorter time is authorized by the Commission, prior to the opening of the bids. The invitation shall state the name and address of the person from whom information regarding the public utility and the proposed issue may be obtained. The duly authorized representative of any person submitting a bid shall be entitled to be present at the opening of the bids and to examine each bid submitted. The public utility shall reserve the right to reject any or all bids.

IT IS HEREBY FURTHER ORDERED that no public utility shall accept any bid from any person who has received or is to receive, directly or indirectly, any fee for services rendered to it, directly or indirectly, in connection with or relating to the issuance and proposed sale of a security, or the issuance or proposed sale of a security. The term "proposed sale" contained in the foregoing shall not include a resale by an underwriter or purchaser.

IT IS HEREBY FURTHER ORDERED that as a condition precedent to the entering of an order authorizing a public utility to issue any security covered by this order, it shall file with the Commission an application setting forth each bid received and which bid it is ready to accept. The Commission reserves the right to deny the application or grant it conditionally.

IT IS HEREBY FURTHER ORDERED that this order is effective twenty days after the date hereof.

Dated at San Francisco, California, this 15th day of January, 1946.

Commissioners

C No. 4761 - DMC

Commissioner Rowell, dissenting:

I regret that I cannot concur in the foregoing decision. If there are facts of record that justify the action here taken, they should substantially be set forth in the opinion, and findings made, so that the Commission's reasoning processes be fully revealed. Nothing in the opinion points to the existence of evils in the issuance of utility securities in this State that would justify the prescription of such a competitive bidding rule as that here imposed. And I am convinced that the rule as prescribed is an unworkable one. I would readily join in the declaration of a policy that would continue our practice of judging the need for competitive bidding on debt securities of substantial amount when the facts presented upon the hearing of each application before us appear to justify that procedure. But the rule here imposed, made applicable to stocks as well as debt issues, and even to conditional sales contracts, is in my opinion without any justification whatever on the evidence presented in this proceeding.

Commissioner.