

ORIGINAL

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Decision No. _____

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application
of General Telephone Company of
California for authority to
issue and sell 500,000 shares of
5% Cumulative Preferred Stock,
without competitive bidding.

Application No. 43169

Harry L. Dunn, of O'Melveny & Myers, and A. M. Hart,
for Applicant; Edward L. Blincoe for Utility Users
League, interested party; Sidney J. Webb for the
Commission Staff.

O P I N I O N

General Telephone Company of California has filed this application for authorization to issue and sell 500,000 shares (\$10,000,000 par value) of its 5% Cumulative Preferred Stock, without competitive bidding.

The application was filed with the Commission on February 17, 1961, and came up for public hearings before Commissioner Grover and Examiner Coleman in San Francisco on March 8, 1961, and in Los Angeles on March 17, 1961. The matter has been taken under submission and now is ready for decision.

Purpose of Financing

The purpose of the proposed financing is to provide applicant with funds for the acquisition of property and the construction, completion, extension and/or improvement of facilities; and/or for the improvement and/or maintenance of service; and/or for the payment, in whole or in part, of any indebtedness to banks which may have been incurred for said purposes at the time the stock proceeds become available; and/or for the reimbursement of moneys heretofore or hereafter expended for said purposes from income or from any other money in the treasury not secured by or obtained from the issue of securities. Applicant reports that at the end of 1960 it had expended for plant the sum of \$118,034,881, which had not been provided by the issue of securities but which represented, primarily, retained earnings and depreciation accruals invested in the assets, that its outstanding short-term borrowings aggregated \$18,000,000, and that during 1961, as shown in Exhibit B to the application, it will be faced with capital expenditures of \$61,055,000 which it estimates will be obtained from the following sources:

Internal sources		\$27,401,000
Current assets and miscellaneous		4,314,000
Sales of securities (net after expenses of issue) -		
Bonds	\$19,840,000	
Preferred stock	<u>9,500,000</u>	<u>29,340,000</u>
Total		<u>\$61,055,000</u>

Applicant reports that it has need for funds upon replenishing its treasury to liquidate outstanding obligations and to improve its cash position.

Financing of Properties

It has been applicant's practice, among other things, to borrow money from banks for interim financing of its requirements and to repay and reborrow such amounts from time to time and periodically to refinance primarily through the issue of bonds, debentures and shares of preferred and common stock. Its capital ratios, including short-term borrowings, as of December 31, 1960, and after giving effect to the proposed preferred stock offering, are as follows:

	<u>Dec. 31, 1960</u>	<u>Pro Forma</u>
Bonds	43.68%	43.03%
Notes	4.40	3.37
Preferred stock	13.44	15.66
Common stock equity	<u>38.48</u>	<u>37.94</u>
Total	<u>100.00%</u>	<u>100.00%</u>

Applicant seeks authorization to issue preferred shares at this time instead of some other form of security in order to take advantage of what it considers a favorable preferred stock market and also to provide a broader base of equity capital to support future debt financing. It will be observed in this connection that applicant is contemplating the sale of \$20,000,000 of bonds at a later time during this year.

Proposed Sale of Preferred Shares

Subject to receiving authorization from the Commission, applicant plans to dispose of its preferred shares by means of a negotiated underwriting with a group of underwriters under arrangements whereby such underwriters are given the option to take down the shares at one time, or from time to time, as they go forward with their sales program.

Applicant has not entered into any contract or agreement for the sale of its shares and, if authorized to do so, it will undertake negotiations and will file a supplemental application at a later date, setting forth the terms and conditions under which it proposes to dispose of its shares.

It appears that applicant intends to enter into arrangements similar to those it has employed on twelve occasions in the past.

Exemption from Competitive Bidding

Applicant seeks exemption from the Commission's competitive bidding rule with respect to security issues in order that it may proceed with negotiations for the sale of its preferred shares.

It appears from the testimony that as a result of past experience under negotiated arrangements the underwriters who participated in applicant's earlier offerings of preferred

shares have developed an active receptive market among individual investors in its service areas. Applicant asserts that its marketing methods have permitted advance preparation for the offerings and have resulted in a wide distribution of its shares at reasonable prices. It desires to take advantage of this market which appears to be available to it and it has concluded that this objective can best be accomplished through the use of the underwriters who have contributed to the establishment of such market.

In support of the requested exemption applicant's financial officers presented testimony and a series of exhibits which show, among other things, that in fifteen recent utility preferred share offerings which have characteristics somewhat similar to those of applicant there were nine sales made under negotiated underwritings and six under competitive bidding and that the cost of money to the issuing company was higher than the cost incurred by applicant during the same period in eight of the nine sales under negotiated arrangements and in three of the six sales at competitive bidding, the lower costs in each case being realized by gas and electric distributing utilities rather than telephone utilities. Moreover, the record shows that in the past applicant has been successful in negotiating sales of its preferred shares at prices competitive with prevailing market prices and that, in fact, the offering prices of its preferred

shares more nearly approached the yields on outstanding preferred shares than the prices of all but two of the offerings of the other utilities listed in the exhibits. In 1959, in applicant's most recent preferred stock financing, for example, the new shares were offered at \$20 while the over-the-counter quotations at the same time were \$19 bid, \$20-3/8 asked.

Protest

An appearance was entered in the proceeding by the president of the Utility Users League, an unincorporated nonprofit association of approximately 100 members, some of whom are reported to be subscribers to applicant's telephone service. While the appearance was entered as an interested party it appears that such appearance was in protest to the application and accordingly will be referred to in the discussion herein, for convenience, as protestant.

The protestant objected to the issue of stock by applicant, to the proposed methods of disposing of such stock, to the issue by applicant of short-term notes without Commission authorization, to the use of stock proceeds to pay short-term notes and to reimburse the treasury, and to the request of the company for an expedited effective date should the Commission conclude to enter an order approving the application. At the conclusion of the hearing, protestant made five motions as follows:

1. That the Commission state as a matter of basic policy that orders effective in less than 20 days are unlawful, being contrary to Sections 1705 and so forth, and 1713-33 of the Public Utilities Code intending to deny rights for rehearing and appeal contrary to constitutional requirements of due process of law.
2. That the Commission require that all costs, fees and expenses of every nature incurred by the utility under this application to issue equity securities be charged by the utility to earned surplus and not as an operating expense.
3. That the Commission state as a basic policy that reimbursement from sale of long-term securities will be permitted only for such lawful expenditures as the Commission shall have approved as proper in advance of their expenditure in conformance with Public Utilities Code Sections 816 and 817, or where the Commission finds as a result of investigation, which finding shall be presented at the hearing, that such reimbursement conforms to Section 817(h) and Rules 25 and 26.
4. That the Commission state as a matter of basic policy that depreciation reserves be treated as trust funds provided by the ratepayers for the retirement of plant or lessening of the base on which a rate of return is calculated, and, further, that the depreciation reserve is not treasury funds of the utility or for the use of the utility except as specifically provided in Public Utilities Code Section 795 both as to basic sums and income therefrom.
5. That the Commission state that citizens have the right and standing to be heard in a place convenient to the scene of operations of the utility.

Summary and Conclusions

A review and analysis of applicant's financial statements and exhibits of record indicate that its recorded investments and sources of funds, as of December 31, 1960, are as follows:

Investments:

Utility plant	\$484,831,781	
Miscellaneous	<u>66,327</u>	
Total investments		<u>\$484,898,108</u>

Sources of Funds:

Current accounts -		
Short-term notes	\$ 18,000,000	
Other current liabilities and deferred credits	<u>34,346,452</u>	
Subtotal	<u>52,346,452</u>	
Less: Current assets and deferred credits	<u>33,046,056</u>	
Net current accounts	<u>19,300,396</u>	
Depreciation reserves	75,681,097	
Long-term debt	179,218,000	
Preferred stock	54,983,480	
Common stock equity	<u>155,715,135</u>	
Total sources of funds		<u>\$484,898,108</u>

The common stock equity capital includes retained earnings of \$19,359,910. The current assets include cash and working funds of \$3,711,481. The current liabilities include accrued liabilities of \$19,790,595.

Upon full consideration of applicant's financial condition as reflected by the record, we conclude that it has utilized short-term borrowings and investor-owned funds represented by depreciation accruals and retained earnings in extending and adding to its plants and facilities, that its current cash resources and the internally generated funds it reasonably can expect to receive will not suffice to enable it to meet its obligations and to provide its capital requirements, and that it has need for additional funds from the sale of securities to improve its cash position and to replenish its treasury and thereby provide the means to go forward with its required construction program.

We are of the opinion, and so conclude, that applicant has sustained the burden of proof with respect to its request for exemption from competitive bidding. We conclude, further, that in the past applicant has endeavored to obtain, and has obtained, a satisfactory price for its preferred shares, that it has developed a ready source of preferred stock money, and that no good reason has been shown why it should not be authorized to continue financing methods it has successfully employed on other occasions with no adverse effect on the public.

Coming now to the protest made in this proceeding, it appears to be the position of the protestant that the company should engage in debt financing rather than stock financing in order to establish deductible fixed charges for income tax

purposes and that increasing the load of borrowed money will thereby redound to the benefit of the ratepayer.

This position has been urged in the past but has been rejected. As was pointed out in our Decision No. 59485, issued last year in connection with an application by The Pacific Telephone and Telegraph Company, it has been the policy of this Commission to allow to the management of each public utility a substantial discretion in deciding upon the proper debt-equity ratio. Many factors must be weighed in each case, and the fact that income taxes may be greater in the case of equity financing is only one consideration. Another is the effect which increasing the debt ratio would have upon the cost of capital. Increasing the debt ratio above a reasonable limit would adversely affect the asset coverage of the long-term debt and the interest coverage of the fixed charges and this, in turn, would add to the risk of the debt capital and, correspondingly, to its cost. Obviously, too, as a general proposition, the resultant decrease in the equity ratio would add to the risk and to the required return on equity capital.

Experience has shown that a well balanced capital structure is necessary if a utility is to realize the lowest possible cost of money and, what is probably more important, if it is to be able to obtain required capital funds under reasonable terms, in the amounts, and at the times when necessary, to enable the utility to serve the public adequately and to meet demands for additional and improved service. Adherence to sound financing practices in the past, by the California utilities and by the Commission, has been instrumental in making it possible for California utilities to meet problems caused by the growth of the state since World War II and by increasing demands for more and better service and has enabled the utilities to obtain capital funds under reasonable terms and to offer their utility services to the public at reasonable rates.

It is apparent that the protestant's argument in this respect goes to a broad question of Commission policy, and it is equally apparent that it cannot be adequately considered on the limited showing which protestant has made in this proceeding. Any change

in our policy should be undertaken, we believe, only on the basis of a thorough financial and economic study and in a proceeding in which all affected companies and interested parties may be heard. The stock issue here involved will not materially alter applicant's debt-equity ratio and in any event will be more than offset by the \$20,000,000 bond issue planned for later this year. Especially in view of the fact that this question necessarily remains open for our consideration at the next rate proceeding involving applicant, we do not believe it would be in the public interest to prohibit the issuance of these securities.

We have given careful consideration to protestant's motions and have concluded that they should be denied.

The first motion calls for a 20-day waiting period for all Commission decisions. The Commission, in its judgment, may lawfully shorten the 20-day waiting period, and there are many cases where it is obviously desirable and practical to do so. In financing matters especially, delays in the effective date of our authorizations could well have an unfavorable effect

on the price to be paid for securities and, accordingly, would be adverse to the public interest. Protestant will not be denied his right to petition for rehearing or to obtain appropriate review in the courts. It is rather the applicant who takes the risk, following the effective date of this decision, that our order may be modified on rehearing or judicially annulled. Moreover, protestant's concern is that a burden may be placed upon ratepayers; however, such a burden would not materialize until rates for this utility are again determined, which would be well after the time when action may be expected to have been taken on any petition for rehearing or review.

The second motion involves accounting for expenses incident to stock issues. Under the uniform system of accounts which has been prescribed by the Commission such expenses are not chargeable to operating expenses but to "Capital stock expense." The system of accounts provides that the expenses may be written off to surplus accounts. There is no need to repeat this directive.

The third motion would have the Commission approve construction expenditures before they are undertaken. The Commission now has authority, and does exercise such authority, in passing on security and rate matters, to inquire into the accuracy and necessity of reported capital expenditures. It is the Commission's practice to authorize the issue of

securities to reimburse the treasury only when it clearly appears that the utility has had earnings in excess of the proposed reimbursement, that such earnings have been invested in the assets and that the utility has need for the moneys with which it seeks to reimburse itself. If the utility has made permanent expenditures for plant it very properly may issue securities against such expenditures.

The fourth motion is not clear. The motion apparently confuses depreciation reserves with depreciation funds, a credit with a debit. The Commission does deduct from investment in plant the accumulated depreciation reserves in arriving at the rate base on which a return is calculated. The moneys represented by the annual accruals for depreciation of course belong to the company; the company has invested funds in property and by these annual depreciation accruals recovers its investment. If it chooses to place this sum so recovered in additions to plant it may properly be reimbursed at a later date by the issue of securities.

As to the last motion, the Commission endeavors to set hearings, so far as possible, to meet the convenience of all parties. There may be occasions where it is desirable and practical to hold a hearing outside the service area.

Findings

We have considered carefully the evidence given in this proceeding and the motions and arguments. We find -

1. That protestant's motions should be denied.
2. That it is in the public interest for applicant to establish and maintain a flexible capital structure with a reasonable balance between debt capital and equity capital and that the issue of additional preferred shares at this time will not be adverse to the public interest.
3. That the record warrants approval of applicant's proposed financing arrangements and exemption from competitive bidding with respect to the shares of preferred stock which are the subject of this proceeding.
4. That applicant has need for the proceeds from the sale of such preferred shares and that the purposes for which it proposes to expend such proceeds are proper purposes, including the payment of short-term notes and reimbursement of the treasury for expenditures made for capital improvements.
5. That the money, property or labor to be procured or paid for by the issue of the preferred shares herein authorized is reasonably required for said purposes, which purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income.

On the basis of our conclusions and findings we will enter our order granting the application. In making this order, we place applicant on notice that we will not regard dividends paid as fixing the rate of return applicant should be allowed to earn on its investment in plant and that we do not regard

the approval indicated herein as indicative of amounts to be included in a future rate base or in operating expenses for the determination of just and reasonable rates. The authorization herein granted is only for the issue of stock.

O R D E R

Public hearings having been held on the above-entitled matter and the Commission having considered the evidence and being fully apprised in the premises,

IT IS HEREBY ORDERED that -

1. The issue and sale by General Telephone Company of California of 500,000 shares of 5% Cumulative Preferred Stock hereby is exempted from the Commission's competitive bidding rule set forth in Decision No. 38614, dated January 15, 1946, as amended, provided applicant receives for said shares a price satisfactory to the Commission.

2. General Telephone Company of California, after the effective date hereof and on or before December 31, 1961, may issue and sell said 500,000 shares at a price to be fixed by the Commission in a supplemental order.

3. General Telephone Company of California shall use the proceeds to be received from the issue and sale of said shares for the purposes set forth in this application.

4. The authority herein granted to issue and sell shares of preferred stock will become effective when the Commission by supplemental order has fixed the price at which they may be sold. In other respects, the authority herein granted will become effective seven days after the date hereof.

5. General Telephone Company of California shall file with the Commission, as soon as available, three copies of its prospectus and a report, or reports, as required by General Order No. 24-A, which order, insofar as applicable, is made a part of this order.

6. The motions made by the representative of the Utility Users League are denied.

Dated at San Francisco, California, this 22nd
day of March, 1961.

[Signature] President
[Signature]
[Signature]
[Signature]
Commissioners