

ORIGINAL

Decision No. 75393

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application)
of)
)
THE PACIFIC TELEPHONE AND)
TELEGRAPH COMPANY, a corporation,)
)
for an order authorizing it (a))
to issue and sell \$165,000,000)
principal amount of Thirty-Five)
Year % Debentures due)
July 1, 2003, (b) to execute and)
deliver an Indenture to be dated)
July 1, 1968, and (c) to do)
equity financing in the amount)
of approximately \$165,000,000)
by the offering of common shares)
for subscription and sale for)
cash to the holders of its)
common and preferred shares.)
)

Application No. 50105
Second Supplemental
Filed December 27, 1968

Arthur T. George, for applicant.
William C. Taylor, Deputy City Attorney, and
Robert R. Laughead, Rate Engineer, for City
and County of San Francisco, interested party.
Hector Anninos and Leonard L. Snaider, Counsel,
for the Commission staff.

THIRD SUPPLEMENTAL OPINION

The Pacific Telephone and Telegraph Company seeks an order of the Commission authorizing it to offer 8,215,995 additional shares of its common stock, for subscription and sale for cash at \$19 per share, to the holders of its common and preferred shares on the basis of one common share for each sixteen outstanding

common shares having a par value of \$14-2/7 each, and seven common shares for each sixteen outstanding preferred shares having a par value of \$100 each.

After due notice, a public hearing on the second supplemental application filed in this proceeding was held in San Francisco on January 20 and 21, 1969, before Commissioner Gatov and Examiner Fraser with Commissioner Morrissey in attendance on the first day and Commissioner Symons in attendance on both days. Although some cross-examination questions implied an opposition to applicant's present request, no party appeared as a protestant. Staff counsel took the position that the issue of equity should be denied but that if the Commission were disposed to authorize it, it should be on terms permitting not more than 10% underpricing. At the close of the hearing the matter was taken under submission subject to the filing of briefs which have been received within the required time limitations.

By Ordering Paragraph No. 8 of Decision No. 74389, dated July 9, 1968, in the above-entitled matter, subject to the filing of a supplemental application by applicant and a subsequent determination by supplemental order thereon, all pertaining to the precise number of shares of stock to be offered, the price at which the shares are to be offered, and other terms and conditions of the offer, the Commission authorized the company to offer not exceeding 8,763,728 additional common shares for subscription and

sale for cash to the holders of its common and preferred shares to realize approximately \$165,000,000 in proceeds.

Upon extending the expiration date of the contingent authorization from December 1, 1968 to June 1, 1969, the Commission, by Decision No. 75083, dated December 10, 1968, in the above-entitled matter, imposed a condition that "At the hearing on the contemplated supplemental application, applicant shall present evidence to justify continuance of authorization to issue approximately \$165,000,000 in common equity, based upon financial conditions current at the time of such hearing."

The second supplemental application now under consideration constitutes the filing contemplated by said Decisions Nos. 74389 and 75083. Assuming a full subscription, the proposed offering of 8,215,995 shares of common stock at a price of \$19 per share would result in proceeds of \$156,103,905. The 8,215,995 number for the additional shares is computed by adding seven-sixteenths of the 820,000 outstanding shares of preferred stock, or 358,750, to one-sixteenth of the 125,715,921 outstanding shares of common stock, or 7,857,245 whole shares. The \$19 price exceeds the \$18.53 book value of the company's common shares as of November 30, 1968.

With regard to Condition No. 2 of Second Supplemental Order (Decision No. 75083, dated December 10, 1968), on the subject of financial conditions current at the time of this hearing,

applicant's witness testified that changed circumstances did not justify withdrawal of authorization to issue common equity in that the market for debt capital is tight; interest costs are higher than they were in mid-1968, and that the market for equity securities continues to be strong.

The proposed offering price represents a 17% underpricing when compared with the market price of \$23 per share at the time applicant's Board of Directors arrived at the \$19 per share price on December 27, 1968. Although said market price has continued to range around \$23 per share, it is impossible to predict what the market price will be on the actual offering date. Considering that a 10% underpricing is regarded as proper for an underwritten offering, together with the absence of a substantial underwriters' compensation in connection with the offering under present consideration, and unpredictable fluctuations in the market price, the testimony of applicant's witness is convincing where he said the following:

"Basically the purpose of underpricing is to assure the sale of practically all of the offered shares. By underpricing, we try to offset the pressure on market price which may be caused by the new shares coming into the market. Also, we underprice because of the possibility of a market decline during the offering period. Obviously shareholders will not subscribe to the new shares if they can buy them in the market at a lower price. Then, by underpricing, we try to provide a sufficient rights value so that shareholders who do not wish to subscribe will sell their rights and make them available to others who will subscribe." (Tr. 236-237.)

Regardless of whether or not the offering price is closer to the market price, the proposed financing will have no effect on the applicant's rates. The total amount of invested capital, irrespective of the number of outstanding shares of capital stock, is the factor to be considered.

The cross-examination and the brief by the Commission staff counsel (supported by both the Attorney General and the Attorney for the City and County of San Francisco) pertained in part to applicant's unusually low debt ratio.

We stated in Decision No. 74389 that the applicant's conservative capital structure will not result in higher rates to its subscribers. This latter is true, of course, only to the extent this Commission disallows the additional expenses of equity financing in future rate proceedings. Applicant's low leverage policy results in dilution of shareholders' earnings and the Commission may well find it necessary to impute a debt ratio for rate-making purposes to assure that subscribers do not assume the burden of an unnecessarily conservative capital structure.

We affirm Findings Nos. 22 through 27, inclusive, of Decision No. 74389, and after consideration the Commission further finds that:

1. The terms and conditions of the proposed common stock offering are reasonable.
2. Current financial conditions justify continuance of authorization for applicant to issue approximately \$165,000,000 in common equity.

3. The proposed common stock issue is for a proper purpose.
4. Applicant has need for funds from external sources for the purpose set forth in this proceeding.
5. The money, property or labor to be procured or paid for by the issue of the common stock herein authorized is reasonably required for the purpose specified herein, and such purpose is not, in whole or in part, reasonably chargeable to operating expenses or to income.

On the basis of the foregoing findings we conclude that the second supplemental application should be granted. In issuing our order herein, we place applicant and its shareholders on notice that we do not regard the number of shares outstanding, the total par value of the shares nor the dividends paid as measuring the return applicant should be allowed to earn on its investment in plant and that the authorization herein granted is not to be construed as a finding of the value of applicant's stock or properties nor as indicative of amounts to be included in proceedings for the determination of just and reasonable rates.

THIRD SUPPLEMENTAL ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company may offer 3,215,995 additional shares of its common stock, for subscription and sale for cash at the price of \$19 per share, to the holders of its common and preferred shares in the proportion of one

common share for each sixteen outstanding common shares and seven common shares for each sixteen outstanding preferred shares held by each shareholder of record on its stock books at the close of business on a date fixed, or to be fixed, by its Board of Directors.

2. The Pacific Telephone and Telegraph Company may issue warrants evidencing the right to subscribe for the additional common shares to be offered pursuant to Ordering Paragraph No. 1 hereof.

3. The Pacific Telephone and Telegraph Company may issue and sell at the price of \$19 per share such portion of said 8,215,995 additional shares of its common stock as shall be subscribed for pursuant to the exercise of said warrants.

4. Upon receipt of properly executed subscriptions and the necessary funds, The Pacific Telephone and Telegraph Company may issue certificates for the appropriate number of shares of common stock herein authorized.

5. Within thirty days after the closing date of subscriptions for the shares of stock herein authorized to be issued, The Pacific Telephone and Telegraph Company shall file with the Commission a report showing the number of shares of stock subscribed for by American Telephone and Telegraph Company, the number of shares of stock subscribed for by others, and the consideration received. Such statement shall be filed in lieu of a report, or reports, under General Order No. 24-B.

6. The Pacific Telephone and Telegraph Company shall use the proceeds to be derived from the issuance and sale of said stock to reimburse, so far as possible, its treasury for funds expended as set forth in this proceeding.

7. As soon as available, The Pacific Telephone and Telegraph Company shall file with the Commission three copies of its prospectus relating to the common stock herein authorized.

8. The effective date of this order is the date hereof. Any authority herein granted will expire if not exercised on or before June 1, 1969.

Dated at San Francisco, California,
this 4th day of MARCH, 1969.

William J. J. J.
President

[Signature]
[Illegible Title]

[Signature]
Commissioners

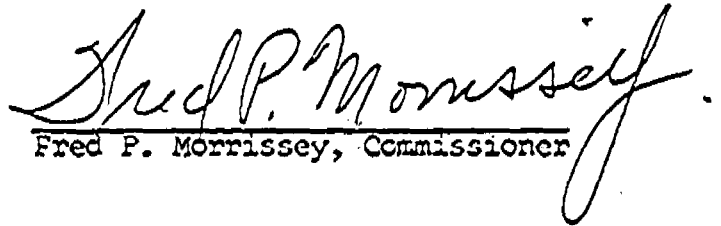
I will file a dissent.
Augusta

I will file a brief dissent
J.P. Monahan

COMMISSIONER FRED P. MORRISSEY DISSENTING

I dissent.

I would refer to my dissent of July 16, 1968 in Decision No. 74389 dated July 9, 1968. The circumstances, uncertainties and delays accompanying the present supplemental application and decision merely reinforce my arguments of July 16, 1968 on the inadequacies of this Commission's procedures for considering financing matters.


Fred P. Morrissey, Commissioner

San Francisco, California

March 4, 1969

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DISSENTING OPINION OF COMMISSIONER GATOV

I would first comment on the failure of the Pacific Company to meet the burden of proof placed upon it by Decision No. 75023, rendered December 10, 1968, which granted Pacific's second request to extend the expiration date for the issue of equity first authorized in Decision No. 74389, rendered July 9, 1968. Because the record was stale, the Commission imposed the condition that Pacific:

To me this condition clearly required that Pacific present evidence to justify the issue of equity as opposed to the issue of debt, and therefore made necessary an investigation into applicant's debt-equity ratio. The Pacific witness, in his prepared testimony, purported to meet this burden of proof by answering two questions with the bare conclusion that there had been no changes in market conditions which would justify a change from the proposed equity issue.

Such evidence is totally inadequate and was unresponsive to the Commission's directive in Decision No. 75023.

The issue of 8,215,995 additional shares of common stock will dilute the per share earnings of all outstanding common stock, as well as return on equity. Pacific's witness stated in fact that per share dilution would be five to six cents.

Pacific has professed deep concern and sympathy for its 10 percent minority of common shareholders, both in this proceeding and in the rate proceeding. It is claimed that shareholders are deserving of an increase in the \$1.20 dividend, in effect now for seven years. In the 1968 report to shareholders, for example, Pacific decries its 90 percent payout ratio, and states that the solution lies in higher earnings per common share which, unfortunately, the Commission declined to provide for in the rate proceeding. Pacific obviously does not advise its shareholders of the earnings dilution it creates with new common share issues. The solution for the minority shareholders appears to lie in their ability to impel management to increase the debt ratio. The shareholders cannot look to the ratepayers to bail them out from this penalty imposed on them by their management's unrealistic and improvident choice of capital structure.

The majority decision, having concluded that Pacific met its burden of proving that an equity issue rather than debt financing is justified at this time, proceeds to accept without qualification the terms proposed by Pacific. At a \$19.00 per share offering price, the underpricing below the \$23.00 market price on the date of the meeting of Pacific's Board of Directors amounts to an overly generous 17.4 percent. I would have authorized an underpricing of about 10 percent. The record indicates that other utilities in and out of California regularly dispose of shares preemptively for discounts of 10 percent or less, even without the assurance of a

corporate parent standing ready to take 90 percent of the new offering. The purpose of the statement in the majority opinion that a 10 percent underpricing is proper for an underwritten offer is beyond my comprehension.

Pacific's witness stated:

"Basically the purpose of underpricing is to assure the sale of practically all of the offered shares."

Whereas the expenses of an underwriting quite obviously affect the amount of money that the utility will realize in a stock offering, it is equally clear they do not affect the price, attractiveness and salability of the offer. If the Commission is disposed to provide a substantial underpricing to protect the company and the shareholder from a possible decline in market price during the offering period, it should also express concern for the eventuality of the equally likely possibility that the market price will rise during the offering period, thus increasing the already generous underpricing. This Commission's obligation to ratepayers, as well as to shareholders, should have required that any authorization of a preemptive issue provide for a subscription price not to exceed 90 percent of the closing price on the New York Stock Exchange on the day preceding the date the Board of Directors meet. The Board should then meet on a date immediately preceding the offering period. Such a procedure should adequately protect both ratepayers and shareholders.

As the majority suggests, I believe the time has come when rate making for this applicant should be on the basis of an imputed debt ratio.

San Francisco, California
March 5, 1969.



Commissioner