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Decision 82 03 010 MAR 2 - 1982

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of CP NATIONAL CORPORATION, a California corporation, for an order authorizing it to issue and sell up to 100,000 shares of its Common shares, $5 par value.	Application 60318 (Filed March 3, 1981)

Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for applicant.
Lynn T. Carew, Attorney at Law, for the Commission staff.

OPINION

CP National Corporation (CPN) requests authority under Public Utilities (PU) Code §§ 816 and 818 to issue and sell, under its Employee Stock Option Plan (Plan), up to 100,000 shares of its common stock, $5 par value, having a value of $1,825,000 based on the February 23, 1981 closing price of $18-1/4 on the New York Stock Exchange.

Public hearings were held before Administrative Law Judge O'Leary at San Francisco on September 16 and 28, 1981. The matter was submitted subject to the filing of concurrent briefs which were filed on October 30, 1981.

CPN presented the testimony of three witnesses:

1. Clifford L. Steward, CPN's executive vice president - Business Development and Administration;
2. Keith L. Beekman, vice president of Towers, Perrin, Forster & Crosby, a management consultant firm; and

3. Dennis E. Ross, a certified financial analyst and vice president, Institutional Research, of Davis, Skaggs & Co., Inc.

Testifying on behalf of the Commission staff (staff) were:

1. John Bilci of the Revenue Requirements Division who supported the application, and

2. Ida F. Goalwin of the Utilities Division, who opposed the application.

For purposes of the Plan, CPN has reserved a maximum of 100,000 shares of its authorized but unissued common stock having a par value of $5.00 per share. Administration of the Plan is the sole responsibility of the Compensation Committee of the Board of Directors, whose task is to grant options to purchase specified amounts of plan shares to selected key employees of CPN and its subsidiaries.

Selected key employees are defined as those individuals "who are in a position to make significant contributions to the long-term performance of the corporation" (page 1, Exhibit A to the application).

The purpose of the Plan is to increase incentive and to encourage stock ownership on the part of selected key employees and to provide such employees with a proprietary interest or increase their proprietary interest in CPN and its subsidiaries, encouraging them to remain in the employ of CPN or its subsidiaries.

In accordance with the terms and conditions of the options, optionees agree to remain in the employ of CPN (or subsidiary) for a period of one year post-date of grant; termination of employment prior to this one-year period results in termination of the option; termination of employment on or after one year from the date of grant also results in termination of the option, except in the cases of retirement or death; in these cases, options remain exercisable within one year by the retiree or by decedent's heir to the extent the option was exercisable immediately prior to optionee's retirement or death.

The Plan provides for awards of stock options alone or stock appreciation rights in conjunction with stock options. Stock options must be granted at a price not less than 100% of the fair market value of the subject common shares on the date of grant. An option granted under the plan is exercisable during the period beginning one year post-date of grant, and ending ten years post-date of grant. Since options may be granted until November 1990, it is conceivable that options could be exercised until November 2000, under the terms of the Plan. Stock appreciation rights (SARs) in conjunction with stock options may be granted by the Compensation Committee either at the time of grant or by amendment to the related stock option agreement. The Plan provides:

> "A stock appreciation right shall entitle the optionee to surrender to the Committee unexercised the related option, or any portion thereof, and to receive from the Corporation in exchange therefor a cash payment and/or shares of common stock having an aggregate fair market value equal to the excess of the fair market value of one share of common stock over the option price per share provided for in the related stock option, but not greater than such option price, multiplied by the number of shares called for by the option, or portion thereof, which is surrendered. The Committee shall have the sole discretion to determine the form in which payment is to be made upon the exercise of a stock appreciation right (i.e., whether in cash, in shares of common stock or partly in cash and partly in shares). In no event will fractional shares be issued but cash will be paid in lieu thereof." (page 9, Exhibit A to A.60318.)

The Plan provides that relevant shares shall be used not more than once to calculate the cash or shares to be received by the grantee exercising a SAR.

The Plan was approved by CPN's stockholders at the Annual Meeting held on May 15, 1981. The Plan is subject to regulatory approval in the States of Oregon, Utah, and Arizona, as well as California. The Plan has been approved by the appropriate authorities in Oregon and Utah.

Steward testified that the expansion and growth of CPN's telephone business (36% of total operations) necessitates retention of the company's current managers and attraction of additional capable telephone personnel. Steward testified that stock options are an essential competitive tool needed to attract and retain capable telephone personnel because this type of incentive is generally offered in the telephone industry.

Beekman testified that:

> "The use of stock options in industry generally is so widespread as to be commonplace. Options have traditionally been the long-term incentive employed in corporations of all sizes, particularly those with a public market for their stock."

Beekman testified that stock options, as a form of long-term incentive, are appropriate for several reasons:

> "1. They can provide incentive to achieve a balance between short and long-range results.
>
> "2. Stock options are very motivational yet more cost-effective than annual incentive plans (bonus plans) that pay cash awards.
>
> "3. They tie the interests of the executives to those of the stockholders of the company."

Beekman acknowledged that other long-term incentive devices aside from stock options can be equally effective in balancing short- and long-range results. Beekman also indicated that stock prices, in contrast to other long-term incentives, tend to reflect more gradually over time a company's performance, and are therefore more cost-effective.

CPN's Plan is based upon the market price theory which theorizes that "Long-term executive performance is best measured by the trend in the market price of the company's stock over several years." Presumably, a rational market would be one in which market price reflects improved performance by executives of the company.

CPN's Stock Option Plan is, in Beekman's view, basically conventional and indeed more conservative than other plans in prohibiting cancellation of previously granted higher price options and preventing the return of shares to the pool which may have gone unexercised as a SAR. Provisions of the recently enacted Economic Recovery Tax Act of 1981 proscribe cancellation of previously granted higher price options in the context of incentive stock option plans; therefore, for those companies opting to use the new incentive stock option provisions, the noncancellation feature would become a matter of course.

One of the most sensitive issues raised by the reserving of stock for corporate executives is dilution of existing stockholder equity. Beekman states:

> "There are few rules or guides about acceptable levels of dilution. Over a period of years, dilution of stockholders equity is inevitable and will occur any time additional shares are issued for the myriad of reasons requiring additional shares."

Beekman calculates that CPN has reserved 4.2% of its presently outstanding shares in connection with the Plan (100,000 shares reserved ÷ 2,346,583 shares outstanding = 4.2%). This allocation is slightly higher than the mean, or average, of (i) the 100 larger U.S. industrials (High: 17.3%, Mean: 3.5%; Median: 3.0%; Low: 0.8%) (pp. 10-11, Exhibit 4), and (ii) the sample utility companies listed in Exhibit 4. Indeed, the CPN Plan reserves more shares as a percentage of shares outstanding than any of the utility company plans listed in Exhibit 4, with the exception of Southern Union Co. (4.4%) and Entex, Inc. (7.1%).

Finally, in the context of dilution, Beekman does not believe that shareholders of a company with a high-debt ratio (such as CPN) would suffer greater dilution than shareholders of a company with a low-debt ratio.

Ross analyzed the Plan from the securities analyst perspective, testifying that analysts have been somewhat wary of recommending investment in public corporations whose senior management hold little or no stock ownership, because:

> ". . . Lack of stock ownership could be indicative of static or caretaker management, while managers who have equity ownership are generally recognized as having more of an incentive to increase profits." (Pages 1-2, Exhibit 2.)

Bilci testified that based on analysis of the materials submitted with A.60318 prior to hearing, Commission approval of the Plan is recommended as submitted.

Bilci points out that the Commission has authorized key employee stock option plans in the past and states that the proposed CPN Plan is necessary since CPN must have a competitive method of attracting executives capable of directing its increasingly diversified regulated and nonregulated operations.

Bilci believes that CPN's improved earnings situation (1978 to the present) and the increased book value of CPN's common shares are indicative of good management. Bilci also maintains that the mode of obtaining and compensating CPN's executives is strictly within management's discretion.

Goalwin recommended against routine approval of this application.

In essence, Goalwin's analysis rejects the market price theory, based on the lack of empirical data indicating either a direct or indirect link between higher executive compensation and stock prices:

> "There have been many proponents of the so-called efficient market theory. This theory says that the Stock Market being a free market assigns a realistic value to all listed stocks. But almost any follower of the market can tell you that stocks of a particular industry such as the utilities move up and down in tandem. Both good and bad management gain or lose due to market perceptions which are not based on individual company performance. In 1980 all oil stocks moved up rapidly, in late 1980 and early 1981 all of these stocks moved down even more rapidly. Obviously some of these oil companies had better management or earnings potential, the market however moved all of them as a group. Utility stocks are no exceptions to this phenomenon. In fact all evidence points to investors valuing the group in comparison to fixed instruments such as bonds, since they generally move with interest rates." (Page 3, Exhibit 6.)

Goalwin's analysis reveals that utility stocks are sensitive to interest rates and inflation. Goalwin further maintains that both stockholders and ratepayers are harmed by stock option plans because they dilute stockholder's equity, reduce earnings per share, and burden ratepayers with higher rates due to capital loss resulting from the sale of stock below market value.

Goalwin suggests more effective employee incentives, such as bonuses based on earnings performance. Alternatively, she supports, as more equitable, an employee stock ownership plan made available to all employees. These incentives could provide a source of capital and improve employee motivation at all levels throughout CPN.

We agree with Bilci that the mode of compensation used to attract and retain key management employees is within management's discretion subject to disallowance by the Commission for ratemaking purposes. Furthermore, the goal of CPN's plan is to encourage retention of certain key employees, and not all employees.

We will therefore authorize the Plan. We expect our staff to examine the Plan in future rate proceedings to determine whether the Plan as implemented is in the best interests of the ratepayers.

Findings of Fact

1. CPN has reserved 100,000 shares of its common shares $5 par value under options granted under its Plan.

2. The number of shares reserved represents 4.2% of CPN's outstanding shares.

3. The Plan provides for the granting of stock options to selected key employees at a price not less than 100% of the fair market value of the subject common shares on the date of grant.

4. The Plan is administered by the Compensation Committee of CPN's Board of Directors, which consists of not less than 3, nor more than 5 persons, each of whom shall be ineligible to receive or hold options or stock appreciation rights under the Plan within one year prior to his or her appointment to the Committee.

5. Selected key employees, as defined by the Compensation Committee, are those employees of CPN and its subsidiaries who are in a position to make significant contributions to the long-term performance of CPN. CPN plans to restrict the Plan to approximately 4.5% of its total employees.

6. Under the terms of the Plan, no option shall become exercisable until one year has elapsed from the date of grant; no option granted under the Plan shall be exercisable after the expiration of 10 years from the date of grant.

7. The Plan is effective November 20, 1980, and unless terminated sooner in the discretion of the Board of Directors of CPN, shall terminate on November 19, 1990. The Plan was approved by CPN's shareholders at the Annual Meeting held on May 15, 1981.

8. Awards under the Plan may be of stock options alone or SARs in conjunction with stock options. A SAR shall entitle the optionee to surrender to the Compensation Committee unexercised the related option, or any portion, and to receive from CPN in exchange a cash payment and/or shares of common stock having an aggregate fair market value equal to the excess of the fair market value of one share of common stock over the option price per share provided for in the related stock option, but not greater than such option price, multiplied by the number of shares called for by the option, or portion of it, which is surrendered.

9. The Plan as proposed is designed to attract and retain key employees necessary to CPN's increasingly diversified operations.

10. The Plan as proposed is designed to increase incentive among key employees, leading to improved overall earnings performance and increased market price of CPN stock; thus benefiting both CPN stockholders and ratepayers.

Conclusions of Law

1. The Plan as proposed will reasonably accomplish the goals intended.

2. The Plan is reasonable and not contrary to the public interest.

3. CPN should be granted authorization to issue and sell 100,000 shares of its common stock, $5 par value, under options granted under the instant Plan.

4. CPN is placed on notice that the Commission reserves the right to review this issuance in future rate proceedings. Further, the number of shares outstanding, the total par value of the shares and the dividends paid do not determine allowable return on plant investment. This authorization is not a finding of the value of the utility's stock or property, nor does it indicate the amount to be included in ratesetting proceedings.

O R D E R

IT IS ORDERED that:

1. CP National Corporation, on or after the effective date of this order may issue, sell, and deliver up to 100,000 shares of its Common Stock, $5 par value, under its Plan in accordance with the terms and conditions set forth in Exhibit A attached to the application.

2. CP National Corporation shall apply the proceeds received at the time employees exercise their stock option purchases in the manner set forth in the application.

3. CP National Corporation shall file with the Commission a report, or reports, as required by General Order 24-B, which order, insofar as applicable, is made a part of this order.

4. This order shall become effective when CP National Corporation has paid the fee prescribed by PU Code §§ 1904.1 and 1904.2, which fee is $902.

Dated MAR 2 1982, at San Francisco, California.

JOHN E. BRYSON
President
RICHARD D. GRAVELLE
LEONARD M. GRIMES, JR.
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

PUBLIC UTILITIES COMMISSION
STATE OF CALIFORNIA
PAID
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By

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director