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Decision 82 05 007 MAY - 4 1982

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY for authorization to merge with the Pacific Transition Corporation, a wholly-owned subsidiary of the American Telephone and Telegraph Company, and related authorization.	Application 61045 (Filed November 6, 1981)

(See Decision 82-01-94 for appearances.)

Additional Appearances

Pelavin, Norberg, Harlick & Beck, by Alvin H. Pelavin and William R. Haerle, Attorneys at Law, for Calaveras Telephone Company and 15 other independent telephone companies; Wolf, Popper, Ross, Wolf & Jones, by Stanley Nemser and David B. Flinn, Attorneys at Law, for Barnett Stepak; Darrell D. Pitts, for Lehman Brothers; and William Knecht, Attorney at Law, Greve, Clifford, Diepenbrock & Paras, by Thomas S. Knox, Attorney at Law, and Lester Hanley, for themselves; interested parties.

OPINION

The Pacific Telephone and Telegraph Company (PT&T or Pacific) owns and operates a general communications system in this State and, through its wholly owned subsidiary Bell Telephone Company of Nevada, in the State of Nevada. With respect to its California intrastate operations, PT&T is regulated by this Commission.

American Telephone and Telegraph Company (AT&T) is the parent company of the Bell System. The principal business of AT&T (as distinguished from its subsidiaries) is performing services for those public utility telephone companies (including PT&T) which form the Bell System, for resale or use in serving the public. In connection with its interstate telecommunication facilities and services, the Bell System is regulated by the Federal Communications Commission (FCC). AT&T owns approximately 91% of the common shares and 78% of the voting preferred shares of PT&T. The balance of PT&T stock is owned by the public.

Authority Sought

In this application, PT&T seeks approval of an Agreement and Plan of Merger with AT&T and the Pacific Transition Corporation (PTC) and the related Agreement of Merger with PTC under which PTC, as the disappearing corporation, will be merged into PT&T, the surviving corporation. As an integral part of the merger, the approximately 9% of PT&T's common shares not now owned by AT&T will be converted by operation of law into common shares of AT&T. The conversion ratio will be 0.35 of an AT&T common share for each common share of PT&T.1/ As a part of the merger, by operation of law, AT&T will pay $60 for each of PT&T's 6% voting preferred shares not now owned by AT&T. When the purchase is completed, all shares of common and 6% voting preferred stock will be canceled, with the result the

1/ Recent New York Stock Exchange closing prices for common shares were as follows:

December 10, 1981		April 2, 1982	
ATT	$59.375	ATT	$55.75
PacTT	$19.875	PacTT	$16.625
.35 of ATT	$20.78125	.35 of ATT	$19.5125

single previously issued outstanding share of PTC (wholly owned by AT&T) would become the sole voting share of PT&T, the surviving corporation. PT&T's nonvoting preferred shares would remain outstanding and unaffected by the merger. Any PT&T shareholders qualifying as dissenting shareholders would be entitled to dissenters' rights as provided by California law or the merger agreement.

PTC is a corporation organized under the laws of this State. PTC was incorporated September 18, 1980 and is a wholly owned subsidiary of AT&T. PTC was organized solely for the purpose of effecting a merger transaction as described in the application. It has dedicated no property to public utility service and has transacted no business.

Purpose of Merger as Stated in Application

The application states that the purpose of the proposed merger is to achieve needed flexibility to meet the demands of emerging competition in a rapidly changing regulatory and business environment. Legislation is currently pending before Congress which would provide for deregulation of those communications markets which are or will become competitive and for deregulation of terminal equipment. This legislation would permit Bell System companies to compete in these unregulated markets only through a fully separated subsidiary or subsidiaries. The FCC has adopted decisions which have detariffed all new "enhanced" services and would, after January 1, 1983, detariff new telephone terminal equipment.[2/] The FCC decisions require that such enhanced services now be provided by a separate subsidiary and impose a separate subsidiary requirement on new terminal equipment after January 1, 1983. After the effective dates of these FCC requirements, the regulated Bell System telephone companies, including Pacific, would no longer be

2/ For example, FCC order 81-481 in Docket 20828 adopted October 7, 1981, re Customer Premises Equipment.

permitted to directly provide new terminal equipment or new enhanced services. To permit compliance with possible legislation and the FCC decisions, AT&T was considering the establishment of a subsidiary to engage in the offering of enhanced services and terminal equipment.

The proposed merger assertedly would provide both PT&T and AT&T with greater flexibility in meeting the requirements of the proposed legislation and the FCC decisions. The merger would also allow elimination of various administrative and financing costs necessitated by the existence of publicly held voting shares of PT&T.

Public Hearing

After review of the application, the Commission concluded that a public hearing was necessary. The notice of hearing stated as follows:

> "In addition to applicant's showing to justify its proposal and relevant evidence on material issues, the Commission expects parties to address the effect of the proposed merger on the independence of applicant in any future negotiations with its parent; and the concern that the proposed merger eliminating minority shareholders could remove a safeguard for arm's-length negotiations between applicant and its parent on such matters as transfer of assets, purchase of equipment and services, and allocation of joint costs. The Commission would like to hear evidence and discussion on these and related questions."

A duly noticed public hearing was held before ALJ Mallory in San Francisco on December 23 and 24, 1981, at which all interested parties had opportunity to be heard.

On January 8, 1982, the United States Department of Justice and AT&T announced that a settlement had been reached in United States v American Tel. & Tel. Co., et al., (United States District Court for the District of Columbia, Civil Action No. 74-1698), and related proceedings, a complaint alleging violations of federal antitrust laws. A key part of the settlement would require AT&T to divest portions of PT&T and other subsidiaries providing local exchange service.

Application (A.) 61045 was reopened and Pacific was directed to supply additional data.[3/] Further hearing was held on February 22, 23, 24, and March 1, 1982 to receive evidence on the issues described in footnote 3. The matter was resubmitted upon the filing of concurrent briefs on March 24, 1982.

In the initial phase of the proceeding, evidence on behalf of Pacific was presented by Virginia A. Dwyer, Vice President and Treasurer of AT&T; by Herman E. Gallegos, Chairman of the Board of U.S. Human Resources Corporation, and a Director of PT&T; and by Robert G. Joses, PT&T Treasurer. Evidence on behalf of this Commission's Revenue Requirements Division, Finance Branch, was presented by Kent C. Nagel and John Bilci.

3/ Pacific was directed to file the following:

a. A copy of the settlement reached in the federal court proceeding.

b. An explanation of the effects, if any, that settlement may have upon the terms and conditions of service to local subscribers provided by PT&T.

c. An analysis of whether the continued existence of minority shareholdings better ensures protection of the interests of both PT&T and its ratepayers.

d. An explanation of the effect, if any, the settlement may have on the terms and conditions of the merger agreement for which approval is sought in A.61045; and explanation of whether the settlement will adversely affect the rights and privileges of minority PT&T shareholders.

e. Whether Pacific desires to proceed with the proposed merger and, if so, whether the merger terms require revision. (An amended application should be filed if the merger agreement or authority sought is changed.)

In the reopened phase, evidence was presented by Alfred Partoll, Vice President, State Regulatory Matters of AT&T, Robert N. Flint, Vice President and Comptroller of AT&T, and William Morrison, a PT&T Director.

Advantages of Merger to AT&T

Dwyer's testimony described the advantages of the merger and result of the merger on AT&T. That testimony also disclosed that PT&T is the only remaining Bell System operating company in which AT&T holds a majority interest which has not been merged into AT&T. The merger of other such operating companies assertedly was accomplished for the same reasons that underlie the merger here in issue.

The witness testified that AT&T has undertaken the merger for the following reasons:

1. AT&T's primary objective in the merger transaction is to obtain the flexibility that the Bell System needs to continue to meet the needs of its customers in a very rapidly developing, very unpredictable situation, involving the restructuring of the telecommunications industry, partial deregulation, and increased competition. The FCC has required that the Bell System divide itself into at least two separate segments, both in a new competitive environment, one that will be fully subject to tariff regulation, and the other a fully separated subsidiary or subsidiaries that will operate on a detariffed basis. The FCC's "Computer II" orders that are now in effect, require that new enhanced services offered by the Bell System must be provided by a separate subsidiary on a detariffed basis. In addition, after January 1, 1983, new terminal equipment must be provided on a similar basis. In the meantime the Senate has passed a bill, SB 898, that would mandate a similar result. Legislation is also pending in the House of Representatives. The problems involved in splitting the Bell System into two separate segments, united by common ownership but structurally separated, are enormous even without minority interests.

AT&T's ability to move quickly and to implement the necessary corporate changes in the very short time that will apparently be available could be severely impaired if there are minority interests in some of the operating companies. For example, AT&T's ability to reorganize could be delayed by only one shareholder whose shares were purchased at the instance of a present or prospective competitor, or who for other reasons is motivated by considerations other than the best interests of PT&T, its customers, and its investors.

2. The merger should give a positive signal to the financial community by underscoring AT&T's commitment to PT&T and California. In conjunction with appropriate earnings, this should result in improved financing conditions for PT&T which, in turn, will enable PT&T's management to continue to provide the capital necessary to meet the service needs of its customers. The ability of PT&T to obtain future equity will be simplified since there no longer will be minority shareholders with preemptive rights. Thus, PT&T will not have to file with the Securities and Exchange Commission (SEC) and encounter the delay and expense necessarily involved in the public offering of securities each time Pacific needs equity capital. Financing for the two segments of the Bell System, including PT&T, will be simplified and the costs of financing will be reduced if AT&T is the sole shareholder in each of the operating companies.

AT&T's View of the Future
<u>Independence of PT&T</u>

Dwyer further testified that each AT&T operating subsidiary manages its business in its territory independently of AT&T, subject to the direction of its Board of Directors and the oversight of the regulatory commission in its jurisdiction. She stated that AT&T's role in the management of such subsidiaries is essentially the same whether the subsidiary is 90% or solely owned by AT&T. AT&T expects that PT&T's management will be unchanged. PT&T's present Board of Directors consists of 16 members, of whom only one is an AT&T employee, and three are PT&T employees. Twelve are outside directors. The witness believes that PT&T will not be any less independent as a wholly owned company than it is now. She asserts that the manner in which the other wholly owned Bell System operating companies conduct their business bears this out. The existence of a 10% minority interest could not have prevented AT&T from controlling PT&T's Board in the past, but no such control was exercised, and the situation will not change because AT&T owns 100% instead of 90% of PT&T's voting shares.

Dwyer testified that the absence of minority shareholders should not enable AT&T to impact rates by overcharging PT&T for services and equipment, or to remove assets from PT&T or misallocate costs. It is her view that the merger and the conversion of minority voting shares should have no regulatory impact and no service impact except the favorable effects described in her testimony. She pointed out that the transfer of assets from the operating company must be approved by this Commission or the FCC, and that the existence of minority shareholders is not necessary to protect ratepayers' interests in such proceedings.

PT&T's View of the Merger

Gallegos testified with respect to the effect of the merger on PT&T and the reasons that PT&T believes the merger is to its advantage.

Gallegos stated that he is an outside director of PT&T, having served in that capacity since December 20, 1974, and a member of PT&T's Special Merger Committee. The committee was formed of outside directors to make an evaluation of the terms of the proposed merger. The committee engaged its own legal counsel, Edwin Huddleson of Cooley, Godward, Castro, Huddleson & Tatum, and its own financial advisor, John Mullin of Dillon, Read & Co. Inc. (Dillon Read) to assist in evaluating the fairness of the proposed merger. (A copy of the Dillon Read report and analyses of the merger terms was made part of the record as Exhibit 8.) After negotiating with AT&T the committee concluded that the terms of the merger proposal that resulted from the negotiations were fair and equitable to the holders of PT&T's securities. In reaching this conclusion, the committee gave consideration to the opinion of Dillon Read (Exhibit 7) that the offer was fair; and to various other factors, including the advantages to shareholders of acquiring an interest in the Bell System's nationwide business, the respective financial situations of AT&T and PT&T, the FCC's directives in its Computer II proceeding, and the need for flexibility in facing an uncertain future. The committee recommended that the merger be approved. The Board of Directors approved the merger in principle on October 25, 1981 and gave its final approval on November 5, 1981.

Gallegos testified that an advantage to PT&T of the merger is that it will enhance Pacific's ability to obtain financing and will result in an improved ability for PT&T to render service to the people of California. It is Gallegos's view that the cost of new debt will be less to PT&T after the merger because of the financial community's recognition that PT&T has the full support and backing of AT&T, which PT&T may not have had in the past.

Gallegos testified the merger committee placed heavy reliance on the Dillon Read report in Exhibit 8. That report states that the reasons for the merger are the following:

AT&T's reason for acquiring 100% ownership of PT&T is primarily to obtain greater flexibility to meet the demands of emerging competition in a rapidly changing regulatory and business environment. In addition, the proposed merger would allow the elimination of various administrative and financing costs necessitated by the existence of publicly held voting shares of PT&T.

On October 7, 1981 legislation was approved by the Senate (SB 898) which, if enacted, would result, among other things, in substantial restructuring of AT&T and its operating companies by requiring the establishment of one or more separate subsidiaries to provide services other than regulated telecommunications services. By acquiring 100% ownership of PT&T, the formation of such a subsidiary or subsidiaries would be facilitated.

FCC announced on October 7, 1981 a decision which would postpone until January 1, 1983 an earlier decision which would require the establishment of a fully separated subsidiary ("FSS") on March 1, 1982. To permit compliance with possible legislation and the FCC decision, AT&T is restructuring its operations into two areas: one to engage in regulated activities and the other to engage in offering competitive products and services such as enhanced services and customer premise equipment. Elimination of the minority interest in PT&T will facilitate the transfer of some of its assets, personnel, and so forth to the "FSS".

Joses presented Exhibit 10 which is a compilation of operating expenses that would be eliminated as a result of the merger. Such expenses cover maintenance of stockholder records, issuing dividends, and preparing proxy statements and annual reports. The total annual savings from the elimination of these activities are estimated to be $1,206,476.

PT&T's View of Its
Independence in the Future

Gallegos testified that the existence of the minority shareholders is not the factor which gives PT&T independence in its dealings with AT&T. As the owner of 90% of PT&T's voting shares, AT&T could at any time in the past have elected a Board of Directors that was dominated by AT&T employees. It has not done so. The current Board, for example, has 16 members of whom only one is an AT&T employee, and only three of whom are PT&T employees.

Gallegos stated that by law the Board of Directors is responsible for the business of PT&T, and all of the PT&T's corporate powers are exercised by or under authority of the Board. Gallegos asserted that he always made his decisions as a director based upon his own independent judgment of what was the correct action for PT&T to take, and that he would not change his conduct as a director after the merger. He is confident that all the directors will continue to act as they have in the past. Gallegos also stated that AT&T's power to remove outside directors would not influence his willingness to take positions he believes are in PT&T's best interests.

Fairness of the Merger's Terms to Minority Stockholders

Both Dillon Read, as financial advisor to PT&T, and Morgan Stanley and Co. Incorporated, as financial advisors to AT&T, issued statements to their principals stating that in their opinion the financial terms of the merger were fair and reasonable to the minority common and preferred stockholders of PT&T and to the shareholders of AT&T.

Dillon Read's report (Exhibit 8) points out that the exchange rate of .35 share of AT&T for each PT&T common share represents a conversion price at approximately 99.7% of book value. Based upon AT&T's average market price of $58.475 preceding the date of the agreement, the proposed exchange represented an equivalent offer price of $20.47 for PT&T's common shares. This price represents a 12.6% premium over PT&T's average market price of $18.175. Exhibit 8 also states that AT&T's offer of .35 shares of AT&T common for each common share of PT&T compares favorably with the market premium and relationship to book value of other recent control mergers among utilities.

The fairness of the exchange price for PT&T's common shares is being challenged by a class action suit in civil court initiated by Alexander F. Eagle, a PT&T minority stockholder, on behalf of himself and other minority stockholders. A copy of the complaint was made part of the record as Exhibit 12. At the close of hearing PT&T had not yet filed its answer to an amended complaint. A similar court action was filed by Barnett Stepak, a minority shareholder. A copy of that complaint was made part of the record as Exhibit 23.

The briefs filed by Eagle and Stepak contain analyses of the data supplied by Dillon Read designed to show that the merger terms are unfair to minority stockholders.

The staff witnesses presented no separate analysis concerning the fairness of the exchange price of PT&T's common stock held by the public, as they believe that issue is beyond the scope of this proceeding. However, the fairness of the merger terms is argued extensively in the staff brief.

Staff Testimony Re Minority Stockholders

Kent S. Nagel, Staff Financial Examiner III in the Commission's Revenue Requirements Division, testified with respect to his analysis on the effect of the elimination of PT&T's minority stockholders. Theoretically, in his view minority stockholders of PT&T can affect the business relationships between PT&T and AT&T and its affiliates in three ways:

1. Raising stockholders' proposals at annual shareholders meetings;

2. Filing shareholders' suits on behalf of PT&T or its minority shareholders; and

3. Retaining the threat or risk of future stockholders' suits.

The witness testified that presenting minority shareholders' proposals at annual meetings would not seem to be effective, because AT&T's 91% interest in PT&T would preclude adoption of any proposals with which AT&T did not agree.

The witness stated that a minority shareholder might wish to file suit if the shareholder perceives that his economic interests would be threatened by AT&T actions which could reduce the value of his shares or reduce dividends.

In the view of the staff witness, the interests of minority shareholders and PT&T's ratepayers may coincide with respect to the following issues:

1. License contract payments by PT&T to AT&T for services rendered to PT&T by AT&T subsidiaries.

2. Pending tax litigation (or legislation) which could relieve PT&T of any pending federal income tax liability resulting from ratemaking decisions of this Commission.

3. The amounts received by PT&T from fully separate AT&T affiliates formed to provide enhanced services and customer premise equipment to the public for the transfer of assets to such affiliates by reason of FCC orders or pending federal legislation.

4. Allocation of shared expenses between PT&T and such affiliates.

The witness indicated that the level of contract payments had been an issue in PT&T rate proceedings before this Commission for many years. Minority stockholders have taken no action in the courts or otherwise to seek reduction of PT&T's contract payments to AT&T.

The staff witness stated that he could locate only two stockholder suits involving PT&T and the Bell System. One such suit, initiated in the 1960's, was dismissed. The other is the Eagle complaint, supra. (The Stepak suit was filed subsequent to the presentation of the staff testimony.)

The witness acknowledged that this Commission and the FCC would scrutinize the transfer of assets from Bell System operating companies to unregulated Bell System subsidiaries and the allocation of operating expenses jointly incurred by regulated and nonregulated Bell System companies.4/

Effect on PT&T's Future Revenue Requirements of Conversion of Voting Preferred Shares

John Bilci, a staff Public Utility Financial Examiner IV, presented evidence concerning the effect on PT&T's capital structure and revenue requirements if the merger terms are approved. Bilci presented Exhibit 13, which contains the analyses supporting his conclusion that $11,480,000 additional annual gross revenue will be

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4/ Hearings are now in progress before this Commission in A.59849, et al., PT&T's general rate increase proceeding on the following subjects:

a. An appropriate method for allocating to the proper user any net stranded investment as a result of PT&T's migration strategy and the establishment of nonregulated operations on March 1, 1982, as required by the FCC Computer Inquiry II decision.

b. Capital costs and expenses of establishing the nonregulated operations by PT&T referred to in preceding paragraph.

c. Studies by PT&T and the staff to determine the kinds of equipment which may have been retired prior to being fully depreciated, the associated amount of undepreciated or stranded investment, and a method for recovering fairly any stranded investment.

d. A determination of equitable methods for developing cost of service studies for ratemaking such as the GE-100 method.

e. Sale of PT&T equipment to users.

f. Depreciation rates used for ratemaking.

required from PT&T's ratepayers if PT&T's 6% voting preferred shares are converted into common shares earning at the 17.4% return on equity authorized to PT&T in D.93367 of August 4, 1981. The following calculations appear in Exhibit 13:

TABLE 1

PT&T Capital Structure and Cost of Capital
Before and After Cancellation of 6% Voting Preferred Stock

Item	Capital Ratio	Cost of Capital	Weighted Cost of Capital
Before Cancellation of 6% Voting Preferred Stock			
Long-Term Debt	53.29%	9.87%	5.26%
Preferred Stock	5.17	8.08	.42
Common Equity	41.54	17.40	7.23
Total	100.00%		12.91%1/
After Cancellation of 6% Voting Preferred Stock			
Long-Term Debt	53.29%	9.87%	5.26%
Preferred Stock	4.50	8.39	.38
Common Equity	42.21	17.40	7.34
Total	100.00%		12.98%2/

1/ Table 34, D.93367
2/ Calculated by PT&T

TABLE 2

PT&T's Revenue Requirements
Before and After Cancellation of 6% Voting Preferred Stock

	Before Cancellation	After Cancellation	Increase
	(Thousands of Dollars)		
Intrastate Rate Base Adopted by D.93367	$8,650,000	$8,650,000	
Rate of Return:			
Adopted by D.93367	12.91%		
Calculated by Company		12.98%	
Increase in Rate of Return Required			.07%
Net Revenue Required	$1,116,715	$1,122,770	$ 6,055
Net to Gross Multiplier	1.896	1.896	-
Gross Revenue Required	$2,117,292	$2,128,772	$11,480

The increase in gross revenue requirement of $11,480,000 is 0.54% of the adopted gross revenue in D.93367.

Bilci made the following recommendations:

1. The Commission deny PT&T's request to cancel the 6% voting preferred stock, or
2. The Commission impute in future rate cases a rate of 6% on $82 million of common stock equity.

Either of the above proposals assertedly would eliminate the increase in revenue requirement shown in Table 2.

Inasmuch as PT&T contended at the hearing that the first recommendation was contrary to law or rules of the State Corporations Commission, the parties were requested to present argument on this point in their briefs.

PT&T Evidence in the Reopened Proceeding

PT&T filed a response to the order in D.82-01-94 which contained the information directed to be filed. The settlement agreement terms and conditions and its effect on PT&T and its ratepayers are discussed under subsequent headings.

PT&T presented William W. Morrison, a PT&T Director, and Chairman of its Special Merger and Divestiture Committees, to confirm the data supplied and views expressed in that filing.

Morrison explained that PT&T desires to proceed with the merger on the terms and conditions set forth in A.61045 and, that in the opinion of the members of the special committees, the settlement agreement had no effect on the merger conditions or on the rights and privileges of minority stockholders. The witness also explained that PT&T's evidence adduced in the initial phase of this proceeding with respect to the issue whether the continued existence of minority stockholders better ensures protection of the interests of both PT&T and its ratepayers, is still applicable. PT&T intends to fully comply with the divestiture order whether or not the merger is approved.

Evidence Concerning Divestiture

Exhibit 14 is an excerpt from the Federal Register of January 28, 1982, which sets forth the proposed modification of final judgment in United States v Western Electric Co., et al., (U.S. District Court of the District of Columbia, Civil Action No. 82-0192) and the stipulation for voluntary dismissal of the more recent antitrust complaint, United States v American Tel. & Tel. Co., et al. (U.S. District Court of the District of Columbia, Civil Action No. 74-1698).

Exhibit 15 is an excerpt from the February 17, 1982 Federal Register setting forth the Competitive Impact Statement prepared by the Antitrust Division of Federal Department of Justice in connection with the proposed modification of final judgment.

Exhibit 14 provides that not later than six months after the date of the modification of final judgment, AT&T shall submit to the

Department of Justice for its approval, and thereafter implement, a plan of reorganization. Following reorganization, portions of bell operating companies (BOCs) providing local exchange telephone services would be divested by AT&T. AT&T would continue to own a nationwide intercity network composed of its long lines department and the former intercity facilities of the BOCs, and would retain ownership of Bell Telephone Laboratories (Bell Labs) and Western Electric. AT&T also would provide customer premises equipment.5/ The to-be-divested operating companies would be required to provide, on a phased-in basis, exchange access to all intercity carriers equal to that provided to AT&T.

The proposed new consent decree would also provide:

1. The transfer from AT&T and its affiliates to the BOCs, or to a new entity subsequently to be separated from AT&T and to be owned by the BOCs, of sufficient facilities, personnel, systems, and rights to technical information to permit the BOCs to perform independently of AT&T, exchange telecommunications, and exchange access functions.

2. The separation within BOCs of all facilities and personnel between those relating to exchange telecommunications or exchange access functions, and those relating to other functions (including interexchange switching and transmission, and provision of customer premise equipment).

3. The transfer of ownership of the separate portions of the BOCs providing local exchange and exchange access services from AT&T by means of a spin-off of stock of the separated BOCs to the shareholders of AT&T or by other disposition. The BOCs may be consolidated. (The tentative reorganization plan is to consolidate the BOCs into seven regional companies. The spun-off portion of PT&T which would provide local exchange and exchange access service will be one of the seven separate operating companies.)

5/ The following types of service would remain with the separated BOCs: pay phone service, radiotelephone and paging services, local white page directory listings. Yellow page advertising services would be provided by AT&T or its unregulated affiliate.

Until September 1, 1987, AT&T, Western Electric, and Bell Labs shall provide, on a priority basis, all research, development, manufacturing, and other support services to enable the BOCs to fulfill the divestiture order requirements.

After completion of the reorganization, no BOCs shall:

1. Provide interexchange or information services,
2. Manufacture or provide telecommunication products or customer premise equipment, or
3. Provide any other product or service, except exchange telecommunications and exchange access service, that is not a natural monopoly service actually regulated by tariff.

Exhibit 15, the Justice Department's Competitive Impact Statement, sets forth in detail (a) the nature and purpose of the antitrust proceeding, (b) a description of the practices and events giving rise to the alleged violations of the antitrust laws, and (c) an explanation of the reorganization plan and the new consent decree.

The federal court adopted a procedure permitting interested parties to file comments, on or before April 20, 1982, on the proposed new consent decree, prior to the court's ruling on the proposal. This Commission, among many others, has finished its comments to the court.

<u>HR 5158 and SB 898</u>

HR 5158 and SB 898 are bills now pending in Congress which would substantially amend the Communications Act of 1934, the primary federal law regulating the telecommunications industry. There is a substantial possibility that such legislation will be enacted, varying some terms of the proposed new consent decree but still separating the Bell System into regulated and deregulated (or potentially deregulated) sectors and still requiring divestiture of PT&T and other Bell operating companies.

Effect of Settlement Agreement on BOCs

Exhibits 20 and 28 are excerpts from the January 25, 1982 and February 22, 1982 issues of a publication entitled "Credit Comments" published by Standard & Poor's, a national stock and bond rating organization. Exhibit 21 is an excerpt from the January 12, 1982 issue of Moody's Bond Survey. Both of these publications contain analyses of the financial effects of the proposed reorganization.

Exhibit 20 indicates that, under the divestiture structure as it now stands, roughly one-third of the rate base of the present operating companies is to be transferred to AT&T. About 50% of the BOCs' toll revenues would be eliminated, which would be partly replaced by access charges. Operating expenses of the BOCs would decline by only a modest amount. Standard & Poor's views the present rate of return and low depreciation schedules on customer premise equipment to be inadequate; therefore, loss of that portion of the business together with its associated assets may not harm the BOCs. However, depending on the manner in which asset transfers from BOCs to AT&T are to be accomplished, Standard & Poor's states that "reservations as to asset quality for the operating companies as well as financing flexibility are apparent." Exhibit 20 asserts that key factors in making up expected BOCs revenue deficiencies from loss of toll subsidies will be access charges and rate relief.

Exhibit 21 states that AT&T has provided a significant source of credit quality stability to the BOCs. Should each of the reorganized companies be spun off as a separate entity, their ability to raise capital will be reduced. It further states that the reconstituted local operating companies initially will be restricted to types of business that are characterized by low profitability, limited growth, and high (but declining) labor intensity. The vulnerability of those companies to competition based on emerging technology represents a significant increase in the business risk of the companies as it relates to credit quality.

Testimony of AT&T Witnesses
In Reopened Proceeding

Partoll described the terms of the new consent decree, its effect on AT&T and PT&T, and the means that AT&T intends to use in implementing that decree. Partoll testified that, in his opinion, implementation of the consent decree will have no immediate effect on local service, as AT&T is required to provide to PT&T sufficient personnel, facilities, systems, and access to technical information to permit PT&T to perform independently its local exchange and exchange access functions.

The witness explained that until September 1, 1987, AT&T, Western Electric, and Bell Labs are required to provide PT&T and other local exchange companies with support services on a priority basis.

It is Partoll's view that implementation of the consent decree will not increase the cost of local service; rather, any increases in the costs of that service will continue to result from inflationary and similar upward pressures. Local rates will not have to increase in order for PT&T to remain as a financially viable company because of the ability to assess access charges. As access charges are subject to regulatory agency approval, adequate levels of access charges assertedly will depend on regulatory agency actions.

After the consent decree is implemented, the present division of toll revenues between AT&T and the BOCs will cease, and that revenue source to the BOCs will be replaced by access charges. The level of access charges must be cost-justified, in order to assure nondiscriminatory access by interexchange carriers other than AT&T to local distribution facilities.

The witness explained that only a very broad outline of what is to be accomplished is set forth in the consent decree, and the detailed methods of compliance are being worked out by personnel of both AT&T and the BOCs. Such methods are subject to final approval by personnel of AT&T and the BOCs. One such task force will establish procedures under which assets will be transferred from the BOCs to AT&T.

The witness explained that the manner in which assets are to be transferred had not been fully developed, but that based on tentative plans and considerations, asset transfers could take place before or after divestiture. It was the position of the witness that under the methods tentatively adopted, no new asset valuations would be necessary nor are any contemplated. Nonetheless, as both the function and the assets necessary to perform the function are concurrently transferred from the BOCs to AT&T, the witness saw net book value as a reasonable basis for asset valuation. It is AT&T's present plan to make asset and stock transfers simultaneously with divestiture.

Witness Flint testified that completion or noncompletion of the merger will have no effect on implementation of the new consent decree, as the decree will be implemented whether or not the merger is completed. Flint also testified that on October 8, 1981, prior to the settlement agreement, PT&T filed with this Commission a plan to reduce its debt ratio to about 50% (Exhibit 22). The witness stated the plan was filed after consultation with AT&T. The plan indicated that AT&T shared with PT&T and this Commission a desire to improve PT&T's

financial ratios. The plan indicated that AT&T would attempt to meet the equity financing outlined in the plan of about $600 million in both 1982 and 1983.[6/]

Witness Flint stated that AT&T intends to meet the equity requirements set forth in PT&T's plan, subject to its ability to do so. Thus, AT&T expects PT&T's debt ratio would be substantially reduced prior to divestiture. It is AT&T's intent that, at divestiture, PT&T's debt ratio will be at the level contemplated in the financing plan,

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6/ Exhibit 22 is a PT&T compliance filing in A.59849, et al., D.93367. It contains a summary of proposed debt and equity financing as follows:

	FINANCING (Millions)	
Year	Long or Intermediate Debt	Equity
1981 (after Oct. 1)	$ 87	$ -
1982	250	630
1983 (through Sept. 30)	250	635

Exhibit 22 states:

"The financing plan contemplates that the Company will realize adequate and timely capital recovery rate relief throughout the period and will achieve earnings adequate to support the proposed financing.

"Depending upon operating results and the actual amount and timing of future rate increases and financings, a 50% debt ratio could be achieved by the first quarter of 1983.

"The common equity financing estimated above for 1982 and 1983 together with the common expected to be issued in 1981 produces a three year total of $2.0 billion. This would represent a 51% increase over year-end 1980 common equity outstanding."

although the methods are under study and no definite decision has been made. The witness testified that AT&T is committed by the terms of the settlement agreement to see that all local operating companies, including PT&T, are financially viable upon divestiture. The witness indicated that such financing could be accomplished by AT&T on behalf of PT&T more quickly and in a less costly manner if the merger is completed because the time and cost of public offerings would be eliminated. ✓

The witness also described the means by which assets, liabilities, and capital structures would be assigned between local exchange companies and AT&T. These assignments would be accomplished in a different manner to preserve PT&T's minority shareholders' interests in the event the proposed merger is not consummated. The witness indicated that the divestiture order would be simpler to comply with if the merger is accomplished because all local exchange companies could be spun off from AT&T in the same manner.

Jurisdictional Issue

In its application and in its brief, PT&T argues, alternatively, that the merger is not subject to Public Utilities (PU) Code §§ 816 through 854; that if the transactions are subject to these code sections, they should be exempted under PU Code §§ 829 and 853; we should hold that, although we may be without jurisdiction, we will approve the merger for all purposes over which we arguably might have jurisdiction, or hold that no authorization is necessary.

In their briefs, the Commission staff and other parties argue that we have jurisdiction to approve the merger. The staff argues that jurisdiction lies with the Commission under PU Code §§ 854, 818, and 822. Other parties urge jurisdiction under PU Code § 822.

We concur in the staff view. AT&T already controls PT&T through ownership of approximately 90% of the company's voting shares. Through the merger at issue in this proceeding AT&T would obtain the remaining voting stock presently held by minority shareholders. PU Code § 854 prohibits any person or corporation from acquiring or controlling any public utility doing business in this State without first securing authorization from the Commission.[7/] PU Code § 854 is not limited to persons or corporations seeking control of California public utilities. It also applies to persons and corporations seeking to "acquire" California public utilities. This distinction between obtaining control and full acquisition is not unique to § 854. The SEC for example, has recognized this same distinction and has promulgated special rules applicable to acquisitions or "going private transactions." (SEC, Rule 13e-3.)

Dillon Read, financial advisor to Pacific's Board of Directors employed the same distinction in evaluating the fairness of the proposed merger. In its report to the Board, Dillon Read distinguished going-private transactions from others involving the transfer of control.

> "...'going private' transactions have generally been defined as transactions in which the corporation itself or an existing controlling shareholder acquires the shares of some or all of the other existing shareholders of the corporation with the objective of eliminating or substantially reducing the public holdings of the corporation's stock." (Exhibit 8, p. 14.)

The wording of § 854 merely reflects the same distinction between going private transactions and transactions involving the transfer of control. Had the legislature intended § 854 to be limited to applications involving the transfer of control it would not have used the phrase "acquire or control." Since AT&T seeks to obtain the remaining voting stock and eliminate all public shareholders of PT&T, the merger at issue in this proceeding should be considered an acquisition within the meaning of § 854 requiring Commission authorization.

7/ PU Code § 854 reads as follows:

"No person or corporation, whether or not organized under the laws of this State, shall, after the effective date of this section, acquire or control either directly or indirectly any public utility organized and doing business in this State without first securing authorization to do so from the commission. Any such acquisition or control without such prior authorization shall be void and of no effect. No public utility organized and doing business under the laws of this State shall aid or abet any violation of this section."

Jurisdiction also lies under PU Code § 818, which requires public utilities to obtain Commission authorization prior to the issuance of securities.[8/]

Under the terms of the proposed merger, all the outstanding common and voting preferred stock of PT&T will be canceled and replaced by one new share of common. This would reduce PT&T's outstanding preferred by $82,000,000 and increase the company's outstanding common stock by a corresponding amount, altering PT&T's capital structure and increasing the company's cost of capital.

Although stock may be issued in order to readjust capitalization upon a merger, consolidation, or reorganization (PU Code § 817(f)), or for the retirement of or in exchange for outstanding stock (PU Code § 817(g)), authorization from the Commission under § 818 is required.

By eliminating PT&T's voting preferred and correspondingly increasing the amount of its common equity, the merger would appear to entail an issuance of stock subject to Commission jurisdiction under § 818. To argue as PT&T has, that the merger is not subject to Commission jurisdiction under § 818 because the only securities issued in conjunction with the merger were issued by PTC which allegedly is not a public utility, is clearly to argue form over substance. PTC was formed solely for the purpose of effecting the acquisition and merger at issue in this proceeding. It has never conducted any independent business in the past, conducts no business now, and will not conduct any business in the future. Moreover, the corporate existence of

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8/ PU Code § 818 reads as follows:

"No public utility may issue stocks and stock certificates, or other evidence of interest or ownership, or bonds, notes, or other evidences of indebtedness payable at periods of more than 12 months after the date thereof unless, in addition to the other requirements of law it shall first have secured from the commission an order authorizing the issue..."

PTC will cease upon its merger with PT&T leaving PT&T with $82,000,000 less preferred and $82,000,000 more common equity. Under these circumstances the issuance of stock by PTC, by which means the capital structure of PT&T will be altered, should be considered an issue of stock by a public utility subject to Commission approval under § 818.

No reason has been made to appear why an exemption from the applicable PU Code provisions should be granted.

Discussion

In exercising its authority over the transfer of ownership and control of utilities and utility property, the Commission is responsible for ensuring that the acquisition or transfer at issue is not adverse to the public interest and is fair to investors. In discharging this responsibility in the past, the Commission has considered a variety of factors, including the effect on utility service, the effect on utility rates, the impact on the financial viability of the utility, the effect on competition, and the effect on shareholders. When appropriate the Commission has granted approval of merger applications subject to conditions which would mitigate adverse effects.

Enhancement of PT&T Management Flexibility

In this proceeding, PT&T has argued that the merger would enhance the company's flexibility in responding to the requirements of the new consent decree, proposed legislation and FCC orders. PT&T contends that the existence of minority shareholders would complicate the transfer of assets from PT&T to other AT&T controlled entities due to the possibility of frivolous shareholder suits, the need for complex filings to comply with federal securities laws, and related problems. PT&T also argues that approval would reduce transaction costs relating to the issuance of equity capital. As indicated below we conclude that these benefits will flow from the merger.

Elimination of Administration and Financing Costs

The testimony of Joses shows that, following the merger, PT&T will save approximately $1.2 million annually in administrative and $0.5 million in financing costs by the elimination of minority shareholders. The savings result from the elimination of expenses incurred in maintaining shareholder records and stock transfer operations, and from providing public stock offerings.

These savings will occur only in the interim period until the divestiture of local exchange companies by AT&T in the 18-month period following the court's approval of the new consent decree. After implementation of the consent decree PT&T, as a local exchange company, would have many more shareholders than now, because AT&T shareholders would receive shares in each regional local exchange company.

Thus, the savings to PT&T from elimination of minority shareholders are nominal. In light of all other factors, the administative cost savings are de minimis, and not a major relevant factor in evaluating the effects of the merger.

Improvement in Ability to Finance

The record shows that in response to PT&T's last general rate order, AT&T plans to provide in the next 18 months sufficient equity to produce an approximate 50% debt/50% equity capital structure. The record also shows that AT&T recognizes the difficulty BOCs face in obtaining new debt and issuing new equity as a result of uncertainties associated with the implementation of the new consent decree and that AT&T has promised to make sure that BOCs are adequately financed during that period. AT&T's assurances that PT&T will be adequately financed appear to apply whether or not the merger is completed. Thus, the merger should have no effect on the financial community's view of PT&T's credit standing or the rating of PT&T's securities.

However, AT&T can more easily comply with its obligations if minority shareholders are eliminated because it would not have to incur the time and expense of public stock offerings or compliance with federal regulations governing such offerings. AT&T could merely transfer funds to its subsidiaries whenever it is timely to do so and funds are available. Thus, completion of the merger will facilitate both PT&T's compliance with our directive to balance its capital structure and AT&T's compliance with the provision of the new consent decree requiring financial assistance to BOCs in the period following divestiture.

We also recognize that our decision on this issue may affect investor attitudes towards California utilities. To the extent investors are able to take advantage of buyout offers on favorable terms, they may be encouraged to invest in California utilities. The Commission will not automatically approve all such merger proposals, and will indeed examine each on its merits, but the need for California utilities to remain attractive to investors must necessarily be a factor in such decisions.

Possible Drawbacks to the Proposed Merger

Given these conclusions, we must determine whether any aspect of this merger is adverse to the public interest, which would outweigh the benefits described above and lead us to disapprove or condition part or all of the application. In this regard, three major issues have arisen in the course of the proceedings:

1. Whether the merger will affect PT&T's behavior in future transactions with AT&T.
2. Whether the merger will increase rates due to higher rate of return requirements or any other reason.
3. Whether the merger is fair to minority shareholders.

<u>Effect of the Merger On
PT&T Transactions with AT&T</u>

In our Notice of Hearings for this application, the Commission raised the question of how the proposed merger might affect PT&T management decisions relating to transactions with AT&T. The relationship between AT&T and PT&T frequently has raised troublesome regulatory oversight problems. AT&T is both PT&T's principal owner and its main supplier of equipment and services. The Commission consistently has shown concern that AT&T could use its control as owner of PT&T to cause PT&T to overcompensate for equipment and services received from AT&T. Because PT&T attempts to pass whatever costs it incurs in payments to AT&T on to ratepayers, such transactions clearly would be contrary to the public interest. Insofar as minority shareholders inspire autonomous action by PT&T management in its dealings with AT&T, their existence may serve an important public interest.

In the past the existence of minority shareholders has not allayed this Commission's concerns about the relationship between PT&T and AT&T. The Commission staff has reviewed many of the transactions between PT&T and AT&T, and in many cases the Commission has made adjustments in PT&T rates for what were found to be unreasonable expenses. However, given the complexity and magnitude of the transactions involved, we cannot review every detail of all transactions. It is because of the limits of our capability to review these transactions that minority shareholders may serve an important public interest as an additional influence for PT&T management to act in its own independent interest instead of AT&T's.

With the announcement of the new consent decree, it is highly probable that PT&T will be divested from AT&T in the near future. This will eliminate a major regulatory problem relating to the relationship of PT&T and its principal supplier, AT&T. As an independent company, PT&T will be able to negotiate with all suppliers at arm's length, thus mitigating much of our concern about the appropriateness of PT&T transactions. Accordingly, the issue of the influence minority shareholders might have on the day-to-day transactions with AT&T largely becomes irrelevant.

An important issue remains, however, relating to the influence minority shareholders may have on the implementation of divestiture. The interests of PT&T and AT&T apparently diverge on many significant points relating to the terms and conditions of divestiture, including particularly the compensation price for assets transferred to AT&T, the availability of Bell Labs patents and licenses, and the scope of operations for PT&T. If the existence of minority shareholders compels PT&T to act independently in its own interest instead of AT&T's, we would need to consider seriously whether approval of the merger jeopardizes ratepayers' interests.

Based on the record before us, we do not find that the existence of minority shareholders would have a material effect on the outcome of divestiture. On the key issue of asset transfer, the record demonstrates that divestiture can be structured so that the minority shareholders remain neutral even while the interests of ratepayers and of what will remain of PT&T are impaired. By splitting PT&T into separate entities, minority shareholders would have an interest in both the assets that would be spun off from PT&T and in those that would remain. What the minority shareholders lose through inadequate compensation to the operating company they would gain through a higher valuation for assets that PT&T must spin off. Similarly, if the transaction were structured in this manner, minority shareholders would appear to be indifferent to the scope of activities left to PT&T after divestiture. The record provides no example of how the existence of minority shareholders might serve the public interest in the process of divestiture.

Even were we to conclude with certainty that divestiture may be structured in a manner detrimental to the interests of the minority shareholders, it remains questionable whether shareholder actions to protect their interests would parallel ratepayers' interests or, indeed, whether minority shareholders are likely to take any action at all. Consequently, we cannot conclude that the existence of minority shareholders during the divestiture process will serve ratepayers' interests.

This conclusion, does not imply that divestiture does not seriously imperil the future of PT&T. As the staff brief points out, if divestiture is improperly implemented, local rates could rise dramatically and the future financial viability of PT&T could be seriously impaired. We conclude however, that the existence of minority shareholders is not sufficiently likely to influence the outcome to outweigh the benefits of the merger described above. We will have to rely on other proceedings, both before this Commission and in other forums where we will actively participate, to protect the ratepayers' interest in proper implementation of divestiture.

Despite indications that the presence of minority shareholders would offer little protection to ratepayer interests in the divestiture process, we regret giving up even this small element of potential security for ratepayers who face the disturbingly uncertain future being planned by AT&T for submission to the U.S. Department of Justice. The record in this proceeding offers little ground for confidence that either of these parties to the proposed new consent decree is fundamentally concerned about the impact of their agreement on local telephone users. The proposed decree would drastically restrict the scope of Pacific's future business opportunities, thereby protecting AT&T from a potential source of competition. Yet AT&T denies any responsibility to compensate Pacific for assets of which PT&T would be deprived and has yet to clarify the extent to which it will assume PT&T liabilities.

In the face of the troubling uncertainties posed by the proposed reorganization, there is reason to preserve any element of the status quo which might augment our ability to defend local telephone user interests. Unfortunately, to the extent that existence of minority shareholders served that end, we would be able to do so only by, in effect, holding Pacific's minority shareholders ransom for the duration of the AT&T reorganization process. Delay or denial of the application also would deprive Pacific of vitally needed contributions of equity capital from AT&T and even of third party debt financing, which would likely be unavailable prior to completion of the merger. PT&T Exhibit 22 indicates that AT&T intends to contribute over $600 million in equity capital to Pacific in each of the next two years. We take that commitment most seriously and explicitly base our decision on the need to facilitate those capital contributions. Therefore, with great reluctance, we feel ourselves constrained to grant the authorization for which PT&T has applied.

Effect of Merger on Rates

Under the terms of the merger AT&T will acquire all the outstanding voting preferred and common shares of PT&T, which will thereafter be cancelled, leaving one share of PTC common stock as the sole remaining voting share of PT&T. PT&T has $82 million of voting preferred shares outstanding which are carried at a cost of 6%. When this 6% preferred is cancelled, PT&T's capital ratios of preferred and common will change. $82 million will shift from preferred on PT&T's balance sheet to common equity. In effect, the voting preferred will be converted into common equity, which at PT&T's last authorized return granted in D.93367 will be carried at a cost of 17.4%. The difference between the 6% cost of PT&T's outstanding voting preferred and the 17.4% cost of common equity will increase PT&T's revenue requirement by $11,480,000 annually.

Staff witness Bilci recommended two alternative remedies to eliminate the potential burden on ratepayers which cancelling the 6% voting preferred would entail:

1. The Commission should either deny Pacific's request to cancel the 6% voting preferred, permitting AT&T to acquire, but requiring the company to retain the 820,000 shares, or

2. The Commission should impute a 6% cost to $82 million of common stock equity in every future rate case of Pacific.

Either of these recommendations would eliminate the cost to ratepayers of cancelling the voting preferred and both are well within the Commission's broad jurisdiction to protect the public interest in securities transactions.

Denial to PT&T of authority to cancel the 6% voting preferred stock would probably necessitate repetition of the disclosure filings required by federal securities laws, thus substantially delaying the proposed merger. Protection of ratepayer interests thus compels us to adopt the second recommendation of the staff witness. In future PT&T general rate proceedings, we will impute a 6% cost to $82 million of common equity.

We are not pleased with having to make such a ratemaking adjustment for the indefinite future. We are painfully aware of the criticism to which we have been subjected in the past because ratemaking adjustments create a discrepancy between authorized and actually earned rates of return. It should be clear that this ratemaking adjustment is required solely by the utility's choice of how to structure the proposed merger.

Other than the impact which would result from the cancellation of PT&T's voting preferred stock, the merger would not appear to have any direct effect on the terms, conditions, or cost of service provided California ratepayers. Neither the management nor the operating policies of PT&T will be affected. Financing in the interim period prior to divestiture of the operating companies under the new consent decree can only be provided by AT&T. AT&T will have to meet its commitment in this regard whether or not the merger is consummated.

<u>Fairness to Minority Shareholders</u>

The record shows that an initial merger offer made in August 1980 was withdrawn and that the current merger offer was devised thereafter, increasing the amount to be received by minority shareholders.

In developing both the original and final terms of the merger agreement, PT&T's outside directors retained Dillon Read to act as its investment counsel. Under that agreement (Exhibit 5) Dillon Read performed the following advisory services:

1. Advised outside directors whether the exchange of shares is fair and equitable to the holders of PT&T securities.

2. Prepared presentations to PT&T's Board of Directors concerning the exchange and merger.

3. Furnished a formal opinion on whether the exchange is fair and equitable to the holders of PT&T securities (fairness opinion).

4. Gave reasons supporting Dillon Read's fairness opinion.

Exhibit 8 is the analyses and reasons supplied to PT&T's outside directors supporting its conclusion that the merger terms and exchange offer are fair to holders of PT&T securities. Relying upon these data, and the fairness opinion furnished by AT&T's financial counsel, the outside directors approved the terms of the merger and the exchange agreement.

In their briefs minority shareholders Stepak, Eagle, and Knecht, and the Commission staff strongly argued that the exchange agreement is unfair to minority shareholders of PT&T.[9/] Stepak and the Commission staff used the financial and other comparisons in the Dillon Read report to outside directors (Exhibit 8) as a basis for their analyses. The staff brief argues:

1. The common stock merger offer compares poorly to other merger offers, which provided a greater price premium over market price and over book value.

2. The current merger offer is taxable, while other recent merger offers were not, thus reducing the value of the exchange offer.

3. The merger offer gave no weight to the pending federal legislation which, if enacted, would relieve PT&T of a substantial recorded tax liability.

9/ As indicated above, Stepak and Eagle have filed civil suit seeking to block the merger on the basis that the exchange agreement is unfair to minority shareholders.

Stepak argues that the Dillon Read analyses are inappropriate or inadequate and that Stepak's substitute or additional analyses should be used as tests to measure the fairness of the exchange offer. Stepak argues:

1. Dillon Read did not adequately assess the current market value of PT&T's assets and liabilities. Stepak devised adjusted going concern values per common share, which he believes are more representative than those calculated by Dillon Read.

2. Dillon Read's analyses of accounting book values end September 30, 1981. Stepak extends those analyses to cover the period ending December 13, 1981.

3. Stepak furnishes estimates of the values at which the market place assertedly would capitalize PT&T's earnings, providing an additional analytical tool not included in the Dillon Read report.

4. Stepak uses different comparisons from the Dillon Read report to contest the fairness of the premium over market price of the merger exchange offer.

Stepak also argues that this is an involuntary squeeze-out merger; that by virtue of the proposed transaction, AT&T, soon to be able to fully use the potential of its unregulated lines of business, will receive enhanced values from its acquisition of what would have been unregulated businesses of PT&T. Stepak argues that on the proposed terms of the exchange agreement, PT&T's minority shareholders are receiving no allowance for the incremental value of these lines of business, which will be acquired by AT&T.

Each of the comparisons and analyses set forth in the briefs of Stepak and our staff have been given careful analysis. These comparisons, if valid, tend to show that a higher price for publicly held common shares could be substantiated. However, the exchange offer is not so low as to be unfair to the minority shareholders. In our view there is a range of reasonableness in measuring the fairness of the exchange offer, within which the exchange offer falls. PT&T's outside directors acted reasonably in relying upon Dillon Read's fairness opinion and the data supplied in its support. Based on the analyses supplied in the Dillon Read report, the exchange offer is fair, although it may not produce the dollars desired by some of the minority shareholders.

Exhibit 24 shows the results of the votes cast at the February 28, 1982 shareholders' meeting on approval of the merger agreement. That exhibit shows the total shares outstanding and total possible votes:

	Votes
Common	224,504,982
Voting Preferred (820,000 shares) (Each share has 7 votes)	5,740,000
	230,244,982

The total votes cast by shareholders other than AT&T were as follows:

TABLE A - COMMON SHARES

		% of Total Shares	% of Shares Voted
Total number of minority common shares	19,159,707	100.00%	100.00%
Number of minority common shares voted for the merger	11,829,341	61.74%	97.39%
Number of minority common shares voted against the merger	182,662	.96%	1.50%
Number of minority common shares as to which the owners abstained	134,802	.70%	1.11%
Number of minority common shares not voted	7,012,901	36.60%	-

TABLE B - PREFERRED SHARES

	Shares	Votes	% of Total Shares	% of Shares Voted
Total number of minority voting preferred shares (7 votes per share)	179,043	1,253,301	100.00%	100.00%
Number of voting preferred shares voted for the merger	91,578	641,046	51.10%	86.36%
Number of voting preferred shares voted against the merger	8,102	56,714	4.50%	7.64%
Number of voting preferred shares as to which the owners abstained	6,357	44,499	3.60%	6.00%
Number of voting preferred shares not voted	73,006	511,042	40.80%	-

Of the minority shares voted, 97.39% of common shares and 86.36% of the preferred shares voted for the merger. However, considering the abstentions and shares not voted, 36.6% of the total minority common shares and 48.9% of the total minority preferred shares did not vote for the merger.

We have no knowledge of the possible reasons that minority shares were not voted. Considering its importance, we must consider the overwhelming approval of the merger and exchange agreement to indicate that the terms of the merger agreement are satisfactory to the preponderance of the minority shareholders voting. We view this favorable vote as another indication of the fairness of the exchange agreement to minority shareholders.

The staff in its brief argues that PT&T appears to have violated the disclosure requirements of SEC Rule 13e-3 by failing to provide the minority shareholders access to the Dillon Read report on the fairness of the merger price. Whether the SEC rule was violated or not is a matter outside our jurisdiction. PT&T's alleged failure to provide the Dillon Read analysis does not in itself lead us to conclude that the merger price is unreasonable.

Motion for Oral Argument and Proposed Report

A motion for a proposed report under Rule 78 of the Commission's Rules of Practice and Procedure and for oral argument under Rule 76 was filed on February 24, 1982 on behalf of Barnett Stepak, Andrew Eagle, William L. Knecht and William Haerle (minority shareholders).

We see no need for oral argument, as the issues are well briefed by the parties. That request will be denied.

The issuance of a proposed report may delay the decision in this matter and is not necessary to aid us in deciding the issues raised in the proceeding. Therefore, the request for a proposed report will be denied.

<u>Findings of Fact</u>

1. PT&T is a California corporation operating as a public utility subject to the jurisdiction of this Commission.

2. PTC is a California corporation and a wholly owned subsidiary of AT&T. PTC was formed solely for the purpose of merging with PT&T, and will go out of existence when the merger is completed.

3. AT&T is a New York corporation regulated as a public utility by the FCC in connection with its interstate telecommunications services and facilities and is not subject to the jurisdiction of this Commission.

4. PT&T seeks authority to merge with PTC and into AT&T or, alternatively, an order finding that Commission approval is not required.

5. The terms of the proposed merger and exchange of stock are set forth in the agreement on Plan of Merger and the related Agreement of Merger attached to A.61045.

6. AT&T now exercises control of PT&T through ownership of 91.5% of PT&T's common shares and 78.2% of PT&T's preferred shares. AT&T is in the position to approve the merger without the affirmative vote of minority PT&T shareholders.

7. The merger, in effect, will be a "going private" transaction under which PT&T would acquire the shares of minority shareholders.

8. Completion of the merger will not impair our power or ability to regulate PT&T, nor will it adversely affect PT&T's ability to provide service to its customers in California.

9. Retention of PT&T's minority shareholders will not assure arm's-length negotiations between PT&T and its parent in intercorporate transactions.

10. As AT&T now controls PT&T through majority stock ownership, the dependence of PT&T on AT&T will not change in any material way if the merger is consummated.

11. The continued existence of minority shareholders would not significantly protect the interests of PT&T and its ratepayers.

12. The order in PT&T's last general rate proceeding (D.93367) directed PT&T to revise its capital structure by increasing its equity portion. AT&T has agreed to provide by 1983 sufficient additional equity capital to produce a capital structure for PT&T of approximately 50% debt and 50% equity (Exhibit 22).

13. Infusion of additional equity capital into PT&T can be accomplished more economically by AT&T if it is not required to make public offerings and to comply with the SEC's registration and other requirements.

14. On January 8, 1982, AT&T and the United States Department of Justice announced a proposed settlement of the Department's pending antitrust suit against AT&T. The proposed settlement (the new consent decree) would require a far-reaching restructuring of the telecommunication industry.

15. Prior to the filing of A.61045, the FCC had issued orders in its Computer II and related proceedings which would require restructuring of the telecommunications industry by formation of competitive equipment sales companies by BOCs separate from their regulated activities.

16. The actions required by the new consent decree or under the FCC orders described in the two prior findings can be accomplished more expeditiously and economically if PT&T is a wholly owned subsidiary of AT&T, as are other BOCs.

17. The proposed merger is for legitimate corporate purposes and sufficient justification has been provided to approve the merger.

18. The continued presence of minority shareholders cannot be expected to influence the outcome of divestiture, and so will do little to protect the interests of PT&T and its ratepayers during the reorganization required by the new consent decree.

19. The merger, in and of itself, will have no adverse effect on competition. Actions contemplated under the FCC's Computer II orders and under the new consent decree would have a material effect on competition. The merger would not change the competitive effects of the FCC's Computer II orders or the new consent decree.

20. The shift on PT&T's balance sheet of $82 million of 6% voting preferred stock to common equity earning at 17.4% would require an annual increase in revenues of $11.5 million.

21. In future rate proceedings of PT&T it will be reasonable to impute a 6% cost to the $82 million of common equity created by the conversion of the 6% voting preferred stock.

22. In the interim period between completion of the merger and divestiture required by the new consent decree, PT&T will save approximately $1.2 million annually by reduced work in PT&T's stock and bond office if the merger is approved.

23. Other than the impact described in Findings 20 and 22, the merger would not directly affect the terms, conditions, or costs of service provided California ratepayers by PT&T.

24. The Dillon Read report and fairness letter provide a competent basis for testing the reasonableness of the exchange offer.

25. The preponderance of PT&T's minority shareholders voting on the merger approved the merger and exchange agreement of PT&T's February 1982 shareholders' meeting.

26. The exchange offer is fair and reasonable.

27. The interests of minority shareholders will not be adversely affected by approval of the merger.

28. Disapproval of the merger would deny minority shareholders tangible benefits and could deprive Pacific of urgently needed capital financing.

29. The proposed merger is not adverse to the public interest, subject to the condition set forth in Finding 21.

Conclusions of Law

1. The proposed merger transactions are subject to the jurisdiction of this Commission.

2. The proposed merger is for legitimate corporate purposes.

3. The proposed merger and exchange offer do not adversely affect minority shareholders.

4. The proposed merger is not adverse to the public interest and should be approved, subject to the condition described in Finding 21.

5. The proposed settlement in the federal antitrust proceeding is subject to public notice and comment (Tunney Act, 15 USC 16) and requires judicial approval prior to implementation.

6. Public Utilities Code §854 applies to persons or corporations seeking to acquire California public utilities. The proposed merger falls within the purview of §854.

7. The motion for oral argument and for a proposed report should be denied.

8. The following order should be effective promptly in order to permit Pacific's urgent need for capital financing to be met.

O R D E R

IT IS ORDERED that:

1. Pacific Telephone and Telegraph Company (PT&T) is authorized to merge with the Pacific Transition Corporation, a wholly owned subsidiary of the American Telephone and Telegraph Company, in accordance with the Agreement and Plan of Merger and related Agreement of Merger attached to A.61045, subject to the condition that in applicant's next general rate proceeding (and in subsequent proceedings,

for so long as is appropriate) PT&T's actual capital structure shall be amended to impute a 6% cost to $82 million of common equity in accordance with Findings 20 and 21 of the preceding opinion.

2. The motion for oral argument and for a proposed report, and any other motions not ruled upon, are denied.

This order becomes effective seven days from today.

Dated May 4, 1982, at San Francisco, California.

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

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

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director

permitted to directly provide new terminal equipment or new enhanced services. To permit compliance with possible legislation and the FCC decisions, AT&T was considering the establishment of a subsidiary to engage in the offering of enhanced services and terminal equipment.

The proposed merger assertedly would provide both PT&T and AT&T with greater flexibility in meeting the requirements of the proposed legislation and the FCC decisions. The merger would also allow elimination of various administrative and financing costs necessitated by the existence of publicly held voting shares of PT&T.

Public Hearing

After review of the application, the Commission concluded that a public hearing was necessary. The notice of hearing stated as follows:

> "In addition to applicant's showing to justify its proposal and relevant evidence on material issues, the Commission expects parties to address the effect of the proposed merger on the independence of applicant in any future negotiations with its parent; and the concern that the proposed merger eliminating minority shareholders could remove a safeguard for arm's-length negotiations between applicant and its parent on such matters as transfer of assets, purchase of equipment and services, and allocation of joint costs. The Commission would like to hear evidence and discussion on these and related questions."

A duly noticed public hearing was held before ALJ Mallory in San Francisco on December 23 and 24, 1981, at which all interested parties had opportunity to be heard.

On January 8, 1982, the United States Department of Justice and AT&T announced that a settlement had been reached in United States of America v Western Electric Company, Inc. and AT&T, (United States District Court for the District of New Jersey, Civil Action No. 17-49), and related proceedings, a complaint alleging violations of federal antitrust laws. A key part of the settlement would require AT&T to divest PT&T and other subsidiaries providing local exchange service.

Application (A.) 61045 was reopened and Pacific was directed to supply additional data.[3/] Further hearing was held on February 22, 23, 24, and March 1, 1982 to receive evidence on the issues described in footnote 3. The matter was resubmitted upon the filing of concurrent briefs on March 24, 1982.

In the initial phase of the proceeding, evidence on behalf of Pacific was presented by Virginia A. Dwyer, Vice President and Treasurer of AT&T; by Herman E. Gallegos, Chairman of the Board of U.S. Human Resources Corporation, and a Director of PT&T; and by Robert G. Joses, PT&T Treasurer. Evidence on behalf of this Commission's Revenue Requirements Division, Finance Branch, was presented by Kent C. Nagel and John Bilci.

3/ Pacific was directed to file the following:

a. A copy of the settlement reached in the federal court proceeding.

b. An explanation of the effects, if any, that settlement may have upon the terms and conditions of service to local subscribers provided by PT&T.

c. An analysis of whether the continued existence of minority shareholdings better ensures protection of the interests of both PT&T and its ratepayers.

d. An explanation of the effect, if any, the settlement may have on the terms and conditions of the merger agreement for which approval is sought in A.61045; and explanation of whether the settlement will adversely affect the rights and privileges of minority PT&T shareholders.

e. Whether Pacific desires to proceed with the proposed merger and, if so, whether the merger terms require revision. (An amended application should be filed if the merger agreement or authority sought is changed.)

In the reopened phase, evidence was presented by Alfred Partoll, Vice President, State Regulatory Matters of AT&T, Robert N. Flint, Vice President and Comptroller of AT&T, and William Morrison, a PT&T Director.

Advantages of Merger to AT&T

Dwyer's testimony described the advantages of the merger and result of the merger on AT&T. That testimony also disclosed that PT&T is the only remaining Bell System operating company in which AT&T holds a major interest which has not been merged into AT&T. The merger of other such operating companies assertedly was accomplished for the same reasons that underlie the merger here in issue.

The witness testified that AT&T has undertaken the merger for the following reasons:

1. AT&T's primary objective in the merger transaction is to obtain the flexibility that the Bell System needs to continue to meet the needs of our customers in a very rapidly developing, very unpredictable situation, involving the restructuring of the telecommunications industry, partial deregulation, and increased competition. The FCC has required that the Bell System divide itself into at least two separate segments, both in a new competitive environment, one that will be fully subject to tariff regulation, and the other a fully separated subsidiary or subsidiaries that will operate on a detariffed basis. The FCC's "Computer II" orders that are now in effect, require that new enhanced services offered by the Bell System must be provided by a separate subsidiary on a detariffed basis. In addition, after January 1, 1983, new terminal equipment must be provided on a similar basis. In the meantime the Senate has passed a bill, SB 898, that would mandate a similar result. Legislation is also pending in the House of Representatives. The problems involved in splitting the Bell System into two separate segments, united by common ownership but structurally separated, are enormous even without minority interests.

PT&T Evidence in the Reopened Proceeding

PT&T filed a response to the order in D.82-01-94 which contained the information directed to be filed. The settlement agreement terms and conditions and its effect on PT&T and its ratepayers are discussed under subsequent headings.

PT&T presented William W. Morrison, a PT&T Director, and Chairman of its Special Merger and Divestiture Committees, to confirm the data supplied and views expressed in that filing.

Morrison explained that PT&T desires to proceed with the merger on the terms and conditions set forth in A.61045 and, that in the opinion of the members of the special committees, the settlement agreement had no effect on the merger conditions or on the rights and privileges of minority stockholders. The witness also explained that PT&T's evidence adduced in the initial phase of this proceeding with respect to the issue whether the continued existence of minority stockholders better ensures protection of the interests of both PT&T and its ratepayers, is still applicable. PT&T intends to fully comply with the divestiture order whether or not the merger is approved.

Evidence Concerning Divestiture

Exhibit 14 is an excerpt from the Federal Register of January 28, 1982, which sets forth the proposed modification of the final judgment in United States v American Tel. & Tel. Co., et al., (U.S. District Court of the District of Columbia, Civil Actions Nos. 74-1698 and 82-0192) and the stipulation for voluntary dismissal of that antitrust complaint.

Exhibit 15 is an excerpt from the February 17, 1982 Federal Register setting forth the Competitive Impact Statement prepared by the Antitrust Division of Federal Department of Justice in connection with the proposed modification of final judgment.

Exhibit 14 provides that not later than six months after the date of the modification for final judgment, AT&T shall submit to the

Department of Justice for its approval, and thereafter implement, a plan of reorganization. Following reorganization, local Bell operating companies (BOCs) providing local exchange telephone services would be divested by AT&T. AT&T would continue to own a nationwide intercity network composed of its long lines department and the former intercity facilities of the BOCs, and would retain ownership of Bell Telephone Laboratories (Bell Labs) and Western Electric. AT&T also would provide customer premises equipment.[5/] The to-be-divested operating companies would be required to provide, on a phased-in basis, exchange access to all intercity carriers equal to that provided to AT&T.

The proposed divestiture order would also provide:

1. The transfer from AT&T and its affiliates to the BOCs, or to a new entity subsequently to be separated from AT&T and to be owned by the BOCs, of sufficient facilities, personnel, systems, and rights to technical information to permit the BOCs to perform independently of AT&T, exchange telecommunications, and exchange access functions.

2. The separation within BOCs of all facilities and personnel between those relating to exchange telecommunications or exchange access functions, and those relating to other functions (including interexchange switching and transmission, and provision of customer premise equipment).

3. The transfer of ownership of the separate portions of the BOCs providing local exchange and exchange access services from AT&T by means of a spin-off of stock of the separated BOCs to the shareholders of AT&T or by other disposition. The BOCs may be consolidated. (The tentative reorganization plan is to consolidate the BOCs into nine regional companies. The spun-off portion of PT&T which would provide local exchange and access service will be one of the nine separate operating companies.)

5/ The following types of service would remain with the separated BOCs: pay phone service, radiotelephone and paging services, local white page directory listings. Yellow page advertising services would be provided by AT&T or its unregulated affiliate.

Until September 1, 1981, AT&T, Western Electric, and Bell Labs shall provide, on a priority basis, all research development, manufacturing, and other support services to enable the BOCs to fulfill the divestiture order requirements.

After completion of the reorganization, no BOCs shall:

1. Provide interexchange services,
2. Manufacture or provide telecommunication products or customer premise equipment, or
3. Provide any other product or service, except telecommunications and exchange access service, that is not a natural monopoly service actually regulated by tariff.

Exhibit 15, the Justice Department's Competitive Impact Statement, sets forth in detail (a) the nature and purpose of the antitrust proceeding, (b) a description of the practices and events giving rise to the alleged violations of the antitrust laws, and (c) an explanation of the reorganization plan and divestiture order.

The federal court has asked for comments on the divestiture plan before issuing its order, due April 22, 1982, approving the settlement agreement directing the terms of divestiture. This Commission, among many others, has indicated the desire to furnish comments.

<u>HR 5158 and SB 898</u>

HR 5158 and SB 898 are bills now being heard by congressional committees amending federal laws regulating the telecommunications industry. Congress appears to intend to exercise oversight in the terms and conditions of the final actions directed by the federal court as a result of the settlement agreement.

The President of this Commission has expressed his views before those committees on the appropriate means of implementing the divestiture order, and the intent of this Commission to monitor the implementation of the consent decree.

The witness explained the manner in which assets are to be transferred had not been fully developed, but that based on tentative plans and considerations, asset transfers could take place before or after divestiture. It was the position of the witness that under the methods tentatively adopted, no new asset valuations would be necessary nor are any contemplated. In the view of the witness, as both the function and the assets necessary to perform the function are concurrently transferred from the BOCs to AT&T, net book value of the asset is a reasonable basis for asset valuation. It is AT&T's present plan to make asset and stock transfers simultaneously with divestiture.

Witness Flint testified that completion or noncompletion of the merger will have no effect on implementation of the new consent decree, as the decree will be implemented whether or not the merger is completed. Flint also testified that on October 8, 1981, prior to the settlement agreement, PT&T filed with this Commission a plan to reduce its debt ratio to about 50% (Exhibit 22). The witness stated the plan was filed after consultation with AT&T. The plan indicated that AT&T shared with PT&T and this Commission a desire to improve PT&T's

although the methods are under study and no definite decision has been made. The witness testified that AT&T is committed by the terms of the settlement agreement to see that all local operating companies, including PT&T, are financially viable upon divestiture. The witness indicated that such financing could be accomplished by AT&T on behalf of PT&T more quickly and in a less costly manner if the merger is completed because of the time and cost of public offerings would be eliminated.

The witness also described the means by which assets, liabilities, and capital structures would be assigned between local exchange companies and AT&T. These assignments would be accomplished in a different manner to preserve PT&T's minority shareholders' interests in the event the proposed merger is not consummated. The witness indicated that the divestiture order would be simpler to comply with if the merger is accomplished because all local exchange companies could be spun off from AT&T in the same manner.

Jurisdictional Issue

In its application and in its brief, PT&T argues, alternatively, that the merger is not subject to Public Utilities (PU) Code §§ 816 through 854; that if the transactions are subject to these code sections, they should be exempted under PU Code §§ 829 and 853; we should hold that, although we may be without jurisdiction, we will approve the merger for all purposes over which we arguably might have jurisdiction, or hold that no authorization is necessary.

In their briefs, the Commission staff and other parties argue that we have jurisdiction to approve the merger. The staff argues that jurisdiction lies with the Commission under PU Code §§ 854, 818, and 822. Other parties urge jurisdiction under PU Code § 822.

We concur in the staff view. AT&T already controls PT&T through ownership of approximately 90% of the company's voting shares. Through the merger at issue in this proceeding AT&T would obtain the

PTC will cease upon its merger with PT&T leaving PT&T with $82,000,000 less preferred and $82,000,000 more common equity. Under these circumstances the issuance of stock by PTC, by which means the capital structure of PT&T will be altered, should be considered an issue of stock by a public utility subject to Commission approval under § 818.

No reason has been made to appear why an exemption from the applicable PU Code provisions should be granted.

Discussion

In exercising its authority over the transfer of ownership and control of utilities and utility property, the Commission is responsible for ensuring that the acquisition or transfer at issue is not adverse to the public interest and is fair to investors. In discharging this responsibility in the past, the Commission has considered a variety of factors, including the effect on utility service, the effect on utility rates, the impact on the financial viability of the utility, the effect on competition, and the effect on shareholders. When appropriate the Commission has granted approval of merger applications subject to conditions which would mitigate adverse effects.

Enhancement of PT&T Management Flexibility

In this proceeding, PT&T has argued that the merger would enhance the company's flexibility in responding to the requirements of the new consent decree, proposed legislation and FCC orders. PT&T contends that the existence of minority shareholders would complicate the transfer of assets from PT&T to other AT&T controlled entities due to the possibility of frivolous shareholder suits, the need for complex filings to comply with federal securities laws, and related problems. PT&T also argues that approval would reduce transaction costs relating to the issuance of equity capital. As indicated below we conclude that these benefit will flow from the merger.

<u>Elimination of Administration and Financing Costs</u>

The testimony of Joses shows that, following the merger, PT&T will save approximately $1.2 million annually in administrative and $0.5 million in financing costs by the elimination of minority shareholders. The savings result from the elimination of expenses incurred in maintaining shareholder records and stock transfer operations, and from providing public stock offerings.

These savings will occur only in the interim period until the divestiture of local exchange companies by AT&T in the 18-month period following the court's approval of the new consent decree. After implementation of the consent decree PT&T, as a local exchange company, would have many more shareholders than now, because AT&T shareholders would receive shares in each regional local exchange company.

Thus, the savings to PT&T from elimination of minority shareholders are nominal. In light of all other factors, the administative cost savings are <u>de minimis</u>, and not a major relevant factor in evaluating the effects of the merger.

<u>Improvement in Ability to Finance</u>

The record shows that in response to PT&T's last general rate order, AT&T plans to provide in the next 18 months sufficient equity to produce an approximate 50% debt/50% equity capital structure. The record also shows that AT&T recognizes the difficulty BOCs face in obtaining new debt and issuing new equity as a result of uncertainties associated with the implementation of the new consent decree and that AT&T has promised to make sure that BOCs are adequately financed during that period. AT&T's assurances that PT&T will be adequately financed appear~~s~~ to apply whether or not the merger is completed. Thus, the merger should have no effect on the financial community's view of PT&T's credit standing or the rating of PT&T's securities.

However, AT&T can more easily comply with its obligations if minority shareholders are eliminated because it would not have to incur the time and expense of public stock offering or compliance with federal regulations governing such offerings. AT&T could merely transfer funds to its subsidiaries whenever it is timely to do so and funds are available. Thus, completion of the merger will facilitate both PT&T's compliance with our directive to balance its capital structure and AT&T's compliance with the provision of the new consent decree requiring financial assistance to BOCs in the period following divestiture.

~~We conclude that PT&T's~~ position has merit. While PT&T could implement the ~~various~~ requirements with or without minority shareholders, their ~~existence probably would complicate~~ what already will be a difficult process of complying with various government requirements. ~~We also agree that approval would somewhat simplify~~ and facilitate future equity financing of ~~Pacific.~~ Ka

We also recognize that our decision on this issue may affect investor attitudes towards California utilities. ~~To the extent investors have the flexibility to trade shares under different arrangements, their willingness to provide financing for California utilities may be enhanced.~~ [illegible] Ka

Possible Drawbacks to the Proposed Merger

Given these conclusions, we must determine whether any aspect of this merger is adverse to the public interest, which would outweigh the benefits described above and lead us to disapprove or condition part or all of the application. In this regard, three major issues have arisen in the course of the proceedings:

1. Whether the merger will affect PT&T's behavior in future transactions with AT&T.

2. Whether the merger will increase rates due to higher rate of return requirements or any other reason.

3. Whether the merger is fair to minority shareholders.

To the extent investors are able to take advantage of buyout offers on favorable terms, they may be encouraged to invest in California utilities. The Commission will not automatically approve all such merger proposals, and will indeed examine each on its merits, but the need for California utilities to remain attractive to investors must necessarily be a factor in such decisions. Ka

1. Advised outside directors whether the exchange of shares is fair and equitable to the holders of PT&T securities.

2. Prepared presentations to PT&T's Board of Directors concerning the exchange and merger.

3. Furnished a formal opinion on whether the exchange is fair and equitable to the holders of PT&T securities (fairness opinion).

4. Gave reasons supporting Dillon Read's fairness opinion.

Exhibit 8 is the analyses and reasons supplied to PT&T's outside directors supporting its conclusion that the merger terms and exchange offer are fair to holders of PT&T securities. Relying upon these data, and the fairness opinion furnished by AT&T's financial counsel, the outside directors approved the terms of the merger and the exchange agreement.

In their briefs minority shareholders Stepak, Eagle, and Knecht, and the Commission staff strongly argued that the exchange agreement is unfair to minority shareholders of PT&T.[1] Stepak and the Commission staff used the financial and other comparisons in the Dillon Read report to outside directors (Exhibit 8) as a basis for their analyses. The staff brief argues:

1. The common stock merger offer compares poorly to other merger offers, which provided a greater price premium over market price and over book value.

2. The current merger offer is taxable, while other recent merger offers were not, thus reducing the value of the exchange offer.

3. The merger offer gave no weight to the pending federal legislation which, if enacted, would relieve PT&T of a substantial recorded tax liability.

1/ As indicated above, Stepak and Eagle have filed civil suit seeking to block the merger on the basis that the exchange agreement is unfair to minority shareholders.

supplied in its support. Based on the analyses supplied in the Dillon Read report, the exchange offer is fair, although it may not produce the dollars desired by some of the minority shareholders.

Exhibit 24 shows the results of the votes cast at the February 28, 1982 shareholders' meeting on approval of the merger agreement. That exhibit shows that the total shares outstanding and total possible votes:

	Votes
Common	224,504,982
Voting Preferred (820,000 shares) (Each share has 7 votes)	5,740,000
	230,244,982

The total votes cast by shareholders other than AT&T were as follows:

TABLE A - COMMON SHARES

		% of Total Shares	% of Shares Voted
Total number of minority common shares	19,159,707	100.00%	100.00%
Number of minority common shares voted for the merger	11,829,341	61.74%	97.39%
Number of minority common shares voted against the merger	182,662	.96%	1.50%
Number of minority common shares as to which the owners abstained	134,802	.70%	1.11%
Number of minority common shares not voted	7,012,901	36.60%	-

Findings of Fact

1. PT&T is a California corporation operating as a public utility subject to the jurisdiction of this Commission.

2. PTC is a California corporation and a wholly owned subsidiary of AT&T. PTC was formed solely for the purpose of merging with PT&T, and will go out of existence when the merger is completed.

3. AT&T is a New York corporation regulated as a public utility by the FCC in connection with its interstate telecommunications services and facilities and is not subject to the jurisdiction of this Commission.

4. PT&T seeks authority to merge with PTC and into AT&T or, alternatively, an order finding that Commission approval is not required.

5. The terms of the proposed merger and exchange of stock are set forth in the agreement on Plan of Merger and the related Agreement of Merger attached to A.61045.

6. AT&T now exercises control of PT&T through ownership of 91.5% of PT&T's common shares and 78.2% of PT&T's preferred shares. AT&T is in the position to approve the merger without the affirmative vote of minority PT&T shareholders.

7. The merger, in effect, will be a "going private" transaction under which PT&T would acquire the shares of minority shareholders.

8. Completion of the merger will not impair our power or ability to regulate PT&T, nor will it adversely affect PT&T ability to provide service to its customers in California.

9. Retention of PT&T's minority shareholders will not assure arm's-length negotiations between PT&T and its parent in intercorporate transactions.

18. The continued presence of minority shareholders cannot be expected to influence the outcome of divestiture, and so will do little to protect the interests of PT&T and its ratepayers during the reorganization required by the new consent decree.

19. The merger, in and of itself, will have no adverse effect on competition. Actions contemplated under the FCC's Computer II orders and under the new consent decree would have a material effect on competition. The merger would not change the competitive effects of the FCC's Computer II orders or the new consent decree.

20. The shift on PT&T's balance sheet of $82 million of 6% voting preferred to common equity earning at 17.4% would require an annual increase in revenues of $11.5 million.

21. In future rate proceedings of PT&T it will be reasonable to impute a 6% cost to the $82 million of common equity created by the conversion of the 6% voting preferred stock.

22. In the interim period between completion of the merger and divestiture required by the new consent decree, PT&T will save approximately $1.2 million annually by reduced work in PT&T's stock and bond office if the merger is approved.

23. Other than the impact described in Findings 20 and 22, the merger would not directly affect the terms, conditions, or costs of service provided California ratepayers by PT&T.

24. The Dillon Read report and fairness letter provide a competent basis for testing the reasonableness of the exchange offer.

25. The preponderance of PT&T's minority shareholders voting on the merger approved the merger and exchange agreement of PT&T's February 1982 shareholders' meeting.

26. The exchange offer is fair and reasonable.

27. The interests of minority shareholders will not be adversely affected by approval of the merger.

28. Disapproval of the merger would deny minority shareholders tangible benefits and could deprive Pacific of urgently needed capital financing.

for so long as is appropriate) PT&T's actual capital structure shall be amended to impute a 6% cost to $82 million of common equity in accordance with Findings 20 and 21 of the preceding opinion.

2. The motion for oral argument and for a proposed report, and any other motions not ruled upon, are denied.

This order becomes effective seven days from today.

Dated MAY 4 1982, at San Francisco, California.

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