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Decision No. 89468 OCT 3 1978

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY to issue and sell not to exceed $300,000,000 principal amount of Debentures and to execute and deliver an Indenture; and for an exemption of such proposed issue of Debentures from the requirements of the Competitive Bidding Rule.	Application No. 58310 (Filed August 24, 1978)

William F. Anderson, Attorney at Law, for The Pacific Telephone and Telegraph Company, applicant.
Sidney J. Webb, for himself as a stockholder of applicant, protestant.
Patrick J. Power, Attorney at Law, and John Bilci, for the Commission staff.

OPINION

The Pacific Telephone and Telegraph Company (Pacific) requests authority to execute and deliver an indenture and to issue and sell, either by competitive bidding or negotiation, not to exceed $300,000,000 principal amount of debentures having a term of 36 years.

The purpose of the proposed financing is to retire Pacific's outstanding 6-1/4 percent Note due February 1, 1979, in principal amount of $75,000,000, and to reimburse Pacific's treasury for moneys actually expended for capital purposes from income and from other treasury funds of Pacific and of its subsidiary, Bell Telephone Company of Nevada. Such expenditures amounted to a cumulative total of $2,204,976,765 as of July 31, 1978, as set forth in the following summary:

		Amount
Total capital expenditures, October 31, 1922 to July 31, 1978		$11,839,255,904
Deduct proceeds of:		
Stock issues	$2,911,814,207	
Promissory notes	339,367,600	
Funded debt	3,947,781,100	
Other	147,082,442	
Total deductions		7,346,045,349
Balance obtained from other sources		4,493,210,555
Less: Reserve for depreciation		2,288,233,790
Unreimbursed balance		$ 2,204,976,765

Pacific anticipates that the proceeds from the sale would be available on or about November 16, 1978. Accordingly, Pacific expects to hold $75,000,000 for a period of about two and one-half months before applying said sum toward retirement of its 6-1/4 percent Note due February 1, 1979. In the interim, Pacific plans to use said funds to repay short-term borrowings. The remainder of the proceeds (other than accrued interest which would be used for general corporate purposes) would be applied toward reimbursement of the treasury as previously mentioned herein. When the treasury has been reimbursed, Pacific intends to apply an equivalent amount to repayment of its then outstanding short-term borrowings, which totalled $339,000,000 as of July 31, 1978.

Pacific's capital ratios as recorded on July 31, 1978 and as adjusted to give effect to the proposed sale of debentures are as follows:

	July 31, 1978	
	Recorded	Pro Forma
Funded debt	47.2%	49.8%
Short-term borrowings	4.0	1.4
Preferred stock	4.5	4.5
Common equity	44.3	44.3
	100.0%	100.0%

The proposed debentures are to be issued under an indenture between Pacific and Manufacturers Hanover Trust Company, as Trustee. Among other things, the indenture provides that the debentures may not be redeemed at the company's option until on or after a date five years from the date of the indenture. Pacific states that inclusion of this restriction would result in a lower cost of money for its debentures and would broaden the market further than would be the case if such provision were not included.

Public hearing was held on September 25, 1978, before Administrative Law Judge Robert T. Baer and the matter was submitted.

In its application, Pacific requests exemption from the Commission's competitive bidding rule in order to be in a position to sell the proposed issue of debentures on either a competitive bid or a negotiated basis. If the sale is on a negotiated basis a nationwide group of investment banking firms would purchase all of the debentures in accordance with a purchase agreement substantially in the form attached to the application as part of Exhibit C.

Pacific seeks exemption from the competitive bidding rule in order to be able to sell the debentures on the basis that will produce the lowest interest cost to Pacific and thus to the ratepayer. The issue date of the debentures is November 8, 1978. During the week of October 23rd, Pacific must decide whether to sell the debentures on a negotiated or competitive bid basis. If, during the week of October 23rd, it appears to Pacific's executives that a more favorable interest rate could be obtained by negotiation, there would be insufficient time for Pacific to seek exemption from the competitive bidding rule prior to the issue date of November 8, 1978.

The witness for Pacific testified that when the bond market is unstable a more favorable interest rate could be obtained through negotiation. He estimated that the bond market may well be unstable in November when the debentures are scheduled to be issued. He cited certain ominous factors which led him to so conclude:

1. Investor's expectations of high inflation rates.
2. Credit demands. The treasury is expected to come into the market very heavily in the fourth quarter of 1978.
3. On September 22, 1978, the Federal Reserve Board announced an increase in the discount rate to 8 percent, the highest it has been since December, 1974.
4. The federal funds rate is currently at 8-1/2 percent.
5. Economists are predicting a grim outlook for the bond market in the last quarter of 1978 with Aaa telephone bonds currently at 9 percent moving to 10 percent over the near term.
6. Banks are experiencing substantial loan demand and there is concern that there will be a credit squeeze.
7. Pacific's pension fund managers (professional investment counseling firms and banks) in July forecast long-term Aaa telephone bond rates ranging as high as 9.60 percent for the last quarter of 1978. Ten of 12 of these managers estimated interest rates over 9 percent and generally in the area of 9.35 percent.

The witness pointed out that Pacific is not an Aaa telephone company but is split rated, Aa by Moody's and A plus by Standard & Poor's. Thus, according to the witness, Pacific's securities sell at interest rates 50 basis points higher than those of Aaa telephone companies.

Pacific's witness also described under what conditions a negotiated bid would be less costly than a competitive bid. When the bond market is unstable, investment bankers would lack sufficient confidence in the future course of the market to come in with strong and truly competitive bids. On the other hand, in a negotiated offering the investment banking syndicate can be formed in advance of the issue date. Because the syndicate knows in advance that it will underwrite a particular debt issue, it can devote considerable resources to pre-offering solicitation of subscriptions. By the time the final terms of the issue are agreed upon, the syndicate knows what it is likely to be able to sell and at what price. In contrast, a syndicate involved in competition cannot economically devote its resources to sales efforts until after it has become the successful bidder. In an unstable market where the interest rates are fluctuating rapidly and the trend is toward higher interest rates, the greater risks to the competitor syndicates generate more costly bids to the utility.

According to Pacific's witness, just such a situation existed in July 1978 when Pacific issued $300 million of debentures. There was doubt immediately prior to the issue date whether Pacific would even receive two bids. However, the market improved in tone and two bids were received. In retrospect, Paine Webber, one of the underwriters, wrote to Pacific and stated its opinion that Pacific would have received a lower cost of money through a negotiated sale and that Pacific should keep that fact in mind for the future. Pacific's interest cost for this issue was 9.62 percent, an all time high for Pacific.

The difficulty of obtaining two truly competitive bids has been increased in Pacific's view by the following factors:

1. The proposed issue is of such size that a large number of underwriters and dealers should be available in connection with its distribution. However, the number of underwriting firms has decreased as a result of acquisition, merger, or withdrawal. In a competitive bidding situation the number of underwriters and dealers available for each group would be approximately halved which could increase the cost of money to Pacific.

2. Pacific's credit ratings have been lowered three times in the last year, twice by Standard & Poor's and once by Moody's. The rating agencies will announce their ratings in connection with this debt issue on October 23. A further downrating would increase the difficulty of obtaining two truly competitive bids.

3. Pacific's experience with its two competitive offerings in January and July of 1978 illustrate the difficulty of forming and holding together a bidding syndicate. In the January 1978 sale of Pacific's debentures, of a total of 102 members of the original group which formed the winning syndicate, 39 members dropped out completely and 17 members decreased their commitments, other members of the group were forced to pick up an additional $34 million.

   In the July 1978 sale, of a total of 80 members of the original group which formed the winning syndicate, 48 members dropped out completely and 13 members decreased their commitments. The co-managers were forced to increase their overall participation from $175 million to nearly $225 million.

It is noteworthy that the Commission has exempted a previous Pacific debt offering from competitive bidding citing evidence of adverse market conditions and the experience of Pacific in selling two offerings of debentures, one on a negotiated basis and the other by competitive bidding. The Commission stated:

"...on March 31, 1970 the company sold $150,000,000 principal amount of its thirty-five year 8.65% debentures due April 1, 2005 on a negotiated basis to underwriters, the effective interest cost being 8.73%. The corresponding cost was 9.2% for the same amount of applicant's debentures sold to underwriters through competitive bidding on December 2, 1969." (Decision No. 77577, dated August 4, 1970, in Application No. 51999, at p. 4.)

The Commission staff opposed exemption from the competitive bidding rule. The staff in Exhibit 3 recommended that Pacific's request for exemption be denied for the following reasons:

a. There is nothing in the application that shows that competitive bidding would be adverse to the company and its customers.

b. There is nothing in the application which indicates that the company has discussed the proposed issues with the investment banking community.

c. There is nothing in the application to indicate that the company will be able to obtain more favorable price and terms in a negotiated offering rather than through competitive bidding.

While it is true that the application lacked information on these three areas, these infirmities were corrected by Pacific on direct examination of its witness. There is evidence in the record from which the Commission could conclude that market conditions on the date of the offering, November 8, 1978, may result in a lower cost of capital on a negotiated basis than on a competitive bid basis. Such a result would be more favorable to Pacific and its customers. Moreover, Pacific has had recent contacts with the investment banking community regarding the proposed issue. In particular, the witness discussed the proposed issue with a principal at the First Boston Corporation on September 22, 1978 to get his evaluation of the market at the present time and his outlook for it and the role that negotiated offerings may play as compared with a competitive bid situation.

Sidney J. Webb appeared in the proceeding for himself as a stockholder of Pacific. He presented no evidence, but argued that the application should be denied in its entirety and that Pacific should be required to finance its capital requirements by the issue of common or preferred stock or some combination thereof. He argued that Pacific's bond ratings have dropped partially as a result of Pacific's increasing debt ratio. He also argued that market conditions do not justify an exemption from the competitive bidding rule. Finally, he contended that Pacific's intended use of the proceeds of the issue was in part unlawful since expenditures from Pacific's treasury involved the acquisition of property and the construction, completion, extension, and improvement of the facilities of Pacific and its wholly owned subsidiary, Bell Telephone Company of Nevada. Section 817 of the Public Utilities Code provides that the proceeds of security issues may be used for the purposes stated therein and not others. The section does not contemplate the use of any of the proceeds of a security issue for the benefit of a wholly owned subsidiary of a utility in another state. Accordingly, the following order will prohibit such a use.

The Commission has exempted previous debt issues of Pacific from the competitive bidding rule citing evidence of adverse market conditions similar to those which Pacific's witness estimates will exist on November 8, 1978. (Decision No. 83542, dated October 1, 1974, in Applications Nos. 55130 and 54775 and Decision No. 76760, dated February 10, 1970, in Application No. 51583.)

We are persuaded that the present unsettled market conditions, the size of the offering, and other factors justify a negotiated offering of the securities. We do not find that a sale on a competitive bid basis is always necessarily in the public interest. This decision is not intended to modify the competitive bidding rule as initially set out in Decision No. 38614 (46 CRC 281 (1946)).

Pacific is also concerned that the effective interest rate on the proposed debentures may exceed 10 percent per annum, in excess of the maximum generally permitted under the California Usury Law, and requests a finding that sale of the debentures at an effective interest rate in excess of 10 percent would be in the public interest.

In Decision No. 83411, dated September 4, 1974 (Southern California Gas Company), and Decision No. 88612, dated March 21, 1978 (San Diego Gas & Electric Company), among others, this Commission held that the California Usury Law does not apply to the issuance and sale of securities authorized by this Commission. We reaffirm this holding and conclude that if the interest limitation of the California Usury Law is exceeded, but it is determined that the transaction, whether negotiated or by competitive bid, is the best the utility can obtain because of market conditions, then the public interest requires this Commission to authorize the issuance and sale of the debt instruments.

After consideration the Commission finds that:

1. Pacific is a California corporation operating under the jurisdiction of this Commission.

2. The proposed debenture sale is for proper purposes if the proceeds thereof are not used for the benefit of Bell Telephone Company of Nevada.

3. The utility has need for external funds for the purposes set forth in these proceedings.

4. The terms and conditions of the proposed issue and sale of debentures, including the restricted redemption provision, are just and reasonable and in the public interest.

5. The money, property, or labor to be procured or paid for by the issuance and sale of the debentures herein authorized is reasonably required for the purposes specified herein, which purposes, except as otherwise authorized for accrued interest, are not, in whole or in part, reasonably chargeable to operating expenses or to income.

6. The sale of the proposed debentures should not be required to be at competitive bidding.

7. The debentures being unsecured, no California property would become encumbered thereby.

8. If prevailing market conditions necessitate that Pacific's debentures be issued and sold with a rate of interest exceeding the limitations provided in Article XV of the California Constitution, then the public interest requires that the Commission authorize said issuance and sale irrespective of limitations contained in the California Usury Law.

9. Pursuant to plenary powers granted to the Legislature by Article XII, Section 5 of the California Constitution, the Legislature is authorized to confer additional consistent powers upon the Public Utilities Commission as it deems necessary and appropriate, unrestricted by any other provisions of the California Constitution.

10. The Legislature has conferred upon the Public Utilities Commission the authority to regulate the issuance of public utility securities, including evidences of indebtedness, and to prescribe restrictions and conditions as it deems reasonable and necessary (Sections 816 et seq. of the Public Utilities Code).

11. Pursuant to the plenary powers granted to the Legislature in Article XII, Section 5 of the California Constitution, it conferred on the Public Utilities Commission the comprehensive and exclusive power over the issuance of public utility securities, including evidences of indebtedness, and the California Usury Law cannot be applied as a restriction on the Public Utilities Commission's regulation of such issuances of public utility securities, including its authorization of a reasonable rate of interest.

12. Judicial interpretation of the California Usury Law has exempted corporate debt securities of public utilities from operation of the Usury Law.

13. If the usury limitation contained in Article XV of the California Constitution and the Usury Law Initiative Act is exceeded, but the transaction is authorized by this Commission and the terms thereof are the best Pacific can obtain because of market conditions, Pacific, its assignees or successors in interest, will have no occasion to, and cannot, assert any claim or defense under the California Usury Law; further, and necessarily, because of lawful issuance by Pacific of debentures in compliance with authorization by the Public Utilities Commission, persons collecting interest on such authorized debentures are not subject to the Usury Law sanctions.

On the basis of the foregoing findings we conclude that the application should be granted. The Commission further concludes that this matter constitutes an unforeseen emergency condition. In order to avoid delay of Pacific's scheduled issue date of November 8, 1978, this order should be issued at the earliest conference after public hearing. An expedited decision will allow time for filing of applications for rehearing and Commission disposition thereof prior to November 8, 1978; it will also allow bond counsel time to render an opinion on the finality of the Commission's decision, thus, if the duties of the Commission are to be fulfilled, publication of this order on the Commission's agenda should not be required. The authorization granted herein is for the purposes of this proceeding only, and is not to be construed as indicative of amounts to be included in proceedings for the determination of just and reasonable rates.

ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company (Pacific) may issue, sell, and deliver, on or before December 31, 1978, not exceeding $300,000,000 principal amount of debentures in accordance with the application and the terms and provisions of a debenture purchase agreement substantially in the form filed as Exhibit C to the application, with a term not to exceed forty years and with a maturity date appropriate to the actual sale date.

2. Said sale is hereby exempted from the Commission's competitive bidding rule set forth in Decision No. 38614, dated January 15, 1946, as amended.

3. Pacific is authorized to execute and deliver an indenture substantially in the form filed as Exhibit B to the application, with maturity, interest payment, and other relevant dates appropriate to the actual sale date of said debentures.

4. Pacific is authorized to pay on such debentures an interest rate in excess of the maximum annual interest rate otherwise permitted under the California Usury Law, as contained in Article XV of the California Constitution and the Usury Law Initiative Act, if market conditions so require.

5. Neither Pacific nor any person purporting to act on its behalf shall at any time assert in any manner, or attempt to raise as a claim or defense in any proceeding, that the interest on said debentures exceeds the maximum permitted to be charged under the California Usury Law or any similar law establishing the maximum rate of interest that can be charged to or received from a borrower.

6. Pacific shall use the proceeds of the issuance and sale of not exceeding $300,000,000 principal amount of said securities for the purposes stated in the application (accrued interest may be used for general corporate purposes) and may apply $75,000,000 of said proceeds to the repayment of short-term borrowings for the period between the receipt of the proceeds and the retirement on February 1, 1979, of the 6-1/4 percent Note, except that no part of the proceeds of such issuance shall be used for the benefit of, or to reimburse the treasury of Pacific on account of expenditures in behalf of, Bell Telephone Company of Nevada.

7. Promptly after Pacific determines the price or prices and interest rate or rates pertaining to the securities herein authorized, it shall notify the Commission thereof in writing.

8. In the event Pacific utilizes competitive bidding, in lieu of the notification required by paragraph 7 hereof, it shall file with the Commission a written report showing as to each bid received, the name of the bidders, the price, the interest rate, and the cost of money to it based upon said price and interest rate.

9. As soon as available, Pacific shall file with the Commission three copies of each prospectus pertaining to said debentures.

10. Within thirty days after selling the debentures herein authorized to be issued and sold, Pacific shall file with the Commission a letter reporting the amount of such debentures issued

and sold and the use of the proceeds therefrom substantially in the format set forth in Appendix C of Decision No. 85287, dated December 30, 1975, in Application No. 55214 and Case No. 9832.

This order shall become effective when Pacific has paid the fee prescribed by Section 1904(b) of the Public Utilities Code, which fee is $118,500.

Dated at San Francisco, California, this 3rd day of OCTOBER, 1978.

Robert Batinovich
President

William Symons Jr.

Vernon L. Sturgeon

Richard D. Gravelle

Commissioners

I abstain
Claire T. Dedrick

PUBLIC UTILITIES COMMISSION
STATE OF CALIFORNIA
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By