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Decision No. 91327

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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 aggregate principal amount of Debentures and/or Notes and to execute and deliver an Indenture or Indentures; and for an exemption of such proposed issue or issues of Debentures and/or Notes from the requirements of the Competitive Bidding Rule.	Application No. 59327 (Filed December 12, 1979)

William F. Anderson, Attorney at Law, for The Pacific Telephone and Telegraph Company, applicant.
Sidney J. Webb, for himself, protestant.
Leonard L. Snaider, Deputy City Attorney, for George Agnost, City Attorney, City and County of San Francisco, interested party.
Grant E. Tanner, Attorney at Law, for the Commission staff.

O P I N I O N

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

The purpose of the proposed financing is to retire at maturity its Seven Year 7½ percent Notes due June 1, 1980 and to reimburse Pacific's treasury for moneys actually expended for capital purposes from income and from other treasury funds of Pacific and its subsidiary. Such expenditures amounted to a cumulative total of $2,793,038,682, as of October 31, 1979, as set forth in the following summary:

		Amount
Total capital expenditures, October 31, 1922 to October 31, 1979		$13,865,045,092
Deduct proceeds of:		
Stock issues	$3,111,814,207	
Promissory notes	414,308,000	
Funded debt	4,772,781,100	
Other	147,635,231	
Total deductions		8,446,538,538
Balance obtained from other sources		5,418,506,554
Less: Reserve for Depreciation		2,625,467,872
Unreimbursed balance		$ 2,793,038,682

Pacific anticipates that the proceeds from the sale would be available on or about March 5, 1980. Accordingly, Pacific expects to hold $100,000,000 of the proceeds for a period of about 11 weeks before those proceeds are used to retire at maturity the outstanding 7½ percent Notes on June 1, 1980 as previously mentioned herein. In the interim, Pacific will use an equivalent amount to repay short-term borrowings. Pacific expects to apply the remainder of the proceeds (other than accrued interest which would be used for general corporate purposes) 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 would otherwise exceed $600,000,000 by February 29, 1980. Such borrowings may be further increased when this Commission approves a refund plan in connection with another matter before it.

Pacific's capital ratios as recorded on October 31, 1979 and as adjusted at February 29, 1980 to give effect to (1) the sale on November 14, 1979 of $300,000,000 principal amount of debentures, (2) the retirement at maturity of $35,000,000 principal amount of debentures on November 15, 1979, (3) the proposed sale of $300,000,000 aggregate principal amount of debt securities on or about February 26, 1980, and (4) the retirement of $100,000,000 principal amount of notes due June 1, 1980 are as follows:

	Recorded	Pro Forma
Common equity	38.6%	36.7%
Preferred stock	6.1	5.8
Funded debt	51.0	53.2
Short-term borrowings	4.3	4.3
	100.0%	100.0%

Pacific's estimates for the year 1980 indicate the need for $2,376,000,000 gross construction outlays related to customer growth and movement, and for plant modernization and replacement as follows:

Item	
Customer growth	$1,395,000,000
Customer movement	420,000,000
Plant modernization	396,000,000
Plant replacement	165,000,000
Total	$2,376,000,000

Review of these estimates confirms that at this time they do not appear unreasonable. The Commission reserves the right, however, to reconsider the reasonableness of any construction expenditures in future rate proceedings.

The proposed debt securities are to be issued under an indenture or indentures between Pacific and The Bank of California, National Association, as trustee. In previous issues of Pacific's debt securities, the form of indenture provided that the securities could not be redeemed until on or after a date five years from the date of the indenture. Pacific expects that a similar provision will be employed for the proposed issue(s) of debt securities. However, market conditions and Pacific's financial situation on or about the sale date may require some alternative redemption provision. Thus, the debt securities will be either nonredeemable or redeemable, and if redeemable the terms and conditions of such redemption, all as the chairman of the Board of Directors, the president, the vice president and secretary, or the treasurer of Pacific shall determine.

If market conditions dictate, Pacific proposes to sell the debt securities by means of a negotiated underwriting by a nationwide group or groups of investment banking firms. In such event, the underwriters would purchase all of the debt securities, in accordance with a purchase agreement or agreements substantially in the form attached to the application as part of Exhibit E.

Accordingly, Pacific requests exemption from competitive bidding requirements because of the size of the proposed issue(s) and because substantial demands for funds, both in the private and public sectors, coupled with investors' expectations of high inflation rates have resulted in high interest rates and a volatile market. Pacific states in its application that these and other factors would make preoffering efforts by a large number of underwriters and dealers essential and that such efforts could best be obtained by the use of a negotiated underwriting.

Although the utility's present plans contemplate selling the debt securities on a negotiated basis, Pacific desires alternative authority to sell them pursuant to competitive bidding in the event of substantially improved market conditions.

On January 10 and 11, 1980, public hearings were held in San Francisco before Administrative Law Judge Robert T. Baer. Evidence was received from Pacific and the Commission staff and after oral argument the matter was submitted subject to the receipt of a late-filed exhibit which is now in hand. The proceeding is ready for decision.

Discussion

The central issue in this proceeding is appropriately introduced by the staff's recommendation, which is that "Pacific Telephone not be allowed to issue additional long-term debt securities until it has first issued additional shares of common stock which this Commission authorized in Decisions Nos. 90652, dated August 14, 1979 and...91114, dated December 18, 1979 in Application No. 58989." (Tr. 86.)

In order to understand the staff recommendation, it must be placed in its historical context. On July 31, 1979, the Commission issued Decision No. 90642 in Pacific's general rate proceeding, Application No. 58223. That decision adopted the staff's recommended capital structure of 50.04 percent long-term debt, 4.24 percent preferred stock, and 45.72 percent common equity. In the decision the Commission stated that:

> "The principal difference between the capital structure recommended by the staff and the applicant's witness is that the staff substituted an issue of $300,000,000 in common equity in place of one of the two $300,000,000 long-term debt issues proposed by Pacific." (Decision No. 90642, at p. 26.)

The reason for the Commission's adoption of the staff's recommended capital structure is explained as follows:

> "The staff's recommended capital structure is testified to as being the more reasonable in that Pacific's long-term debt ratio is maintained at approximately 50 percent, which is comparable to its December 31, 1977 level, and is in accord with the applicant's stated goal of decreasing its long-term debt ratio to 45 percent." (Ibid., p. 27.)

In Decision No. 90919[1] dated October 10, 1979, in Application No. 58223 et al. the Commission reaffirmed the capital structure which it had adopted in Decision No. 90642. The Commission specifically found that:

> "The capital ratios and return on common equity adopted in Decision No. 90642 are reasonable and are not subject to rehearing." (Decision No. 90919, p. 35.)

In Decision No. 91121,[2] dated December 18, 1979, in Application No. 58223 et al. the Commission also reaffirmed the capital structure adopted in Decision No. 90642. (See Decision No. 91121, pp. 2, 4, 5, 6, 7, and 11.) Regarding capital structure, the Commission stated:

> "Our use of a theoretical capital structure in Decision No. 90642 together with language contained in Decision No. 90884 in Application No. 59090 concerning Pacific's most recent request for authorization to issue $300 million of debentures clearly sets forth this Commission's position that additional common equity offering in the immediate future is considered critical by this Commission if Pacific expects favorable action by the Commission on its various requests." (Decision No. 91121, at pp. 11-12.)

On July 10, 1979, Pacific filed Application No. 58989, which sought authority to issue 10,000,000 common shares. The authority was granted August 14, 1979, by Decision No. 90652. By the terms of the order the authority was to terminate on December 31, 1979. On October 26, 1979, Pacific sought authority

1/ Order Modifying Decision No. 90642 and Granting Partial Rehearing.

2/ Order Modifying Decisions Nos. 90642 and 90919 Upon Partial Rehearing.

by a Petition for Modification to extend the termination date of the authority granted by Decision No. 90652 until July 31, 1980. The extension of time was granted by Decision No. 91114, dated December 18, 1979.[3/]

The Commission discussed the issue of capital structure in Decision No. 90884, dated October 10, 1979, in Application No. 59090. The Commission stated:

> "We have in the past stressed the importance of utilities maintaining a balanced capital structure in order to be financially sound, to maintain financial flexibility, and to be able to attract capital at reasonable rates. We are, therefore, deeply concerned with Pacific Telephone's postponement of its 10 million share common stock offering authorized by Decision No. 90652 on August 14, 1979, as we believe a common stock offering is necessary to balance the large debt offerings issued or planned for 1979. On the other hand, we are cognizant of recent materially important events and regulatory developments which may have an adverse effect on such common stock offering especially at a time when the capital markets are extremely unstable, which may justify a temporary postponement. We will place Pacific Telephone on notice that the Commission considers such deferral to be temporary and should Pacific Telephone seek authorization to issue additional debt securities before the common stock sale has been consummated, we will require Pacific Telephone to make a strong showing justifying such further postponement." (Decision No. 90884, p. 7.)

3/ It is noteworthy that Decision No. 91114 is not effective, since Pacific has not paid the additional fee prescribed by Section 1904.1 of the Public Utilities Code. It appears likely that the authority granted by Decision No. 90652 lapsed on December 31, 1979, and that since Decision No. 91114 was not effective prior thereto, it cannot now act *nunc pro tunc*, to preserve the authority granted by Decision No. 90652, absent further order of the Commission.

With this warning, the Commission authorized Pacific to sell $300,000,000 of debentures.

While the Commission has assumed that a long-term debt ratio of 50 percent is reasonable (Decisions Nos. 90642, 90919, and 91121), Pacific's long-term debt ratio has been increasing. On May 31, 1979, Pacific's recorded long-term debt ratio was 52.2 percent.[4] On July 31, 1979, it was 53.5 percent (Decision No. 90884, p. 3). On October 31, 1979, it was 53.3 percent. (Application No. 59327, p. 5.) On February 29, 1980, Pacific estimates its long-term debt ratio to be 55.6 percent.[5] Giving effect to the $100,000,000 issue of preferred stock for which Pacific sought authority in Application No. 59354, filed December 26, 1979, the long-term debt ratio last mentioned becomes 55 percent.

It can be readily seen how drastically Pacific's projected long-term debt ratio differs from that considered reasonable by the Commission in Pacific's last general rate proceeding. If the short-term borrowing of $332,000,000 (pro forma from Application No. 59354, p. 7) were added to the long-term debt, the ratio would be 56.5 percent.

4/ This figure and the succeeding long-term debt ratios exclude short-term borrowings.

5/ This figure is adjusted to reflect (1) the sale on November 14, 1979, of $300,000,000 of Forty-Year 12.70 percent Debentures, (2) the retirement of $35,000,000 of Twenty-Seven-Year 3½ percent Debentures on November 15, 1979, (3) the proposed sale of $300,000,000 of debt securities on or about February 26, 1980 (this application), and (4) the retirement of $100,000,000 of Seven-Year 7½ percent Notes due June 1, 1980.

Pacific's Showing

In the opinion of Pacific's witness the common equity portion of the financial market is realistically denied to Pacific at this time. This opinion was based on the following considerations:

(1) Pacific is confronted with a possible rate reduction of approximately $56,000,000 annually as the result of the remand case.

(2) Refunds resulting from the remand case currently exceed $365,000,000, and, depending upon the plan adopted by the Commission, the refunds in 1980 could range from $120,000,000 to $365,000,000.

(3) The adverse outcome of Application No. 58223, which originally sought $470,000,000, is still prominently in the mind of the investment community.

(4) As a result of the foregoing uncertainties, Pacific has been and is unable to assure continuity of the current annual common dividend rate of $1.40 per share.

(5) As noted above, Pacific's long-term debt ratio has been increasing.

(6) Short-term borrowings have been increasing as well, and will exceed $600,000,000 by the end of February without the instant financing.

(7) The credit ratings of Pacific's long-term debt issues have declined. Standard and Poor's reduced its rating from AAA in May 1973 to A in September 1979. Moody's Investors Service, Inc. lowered its ratings from Aaa to Aa in December 1977 and to A in January 1979. In November 1979 Moody's lowered its rating of Pacific's short-term unsecured notes from Prime-1 to Prime-2.

(8) For the period of January through November 1979, Pacific's post-tax interest coverage, reflecting all interest accruals, was 1.76, which reflects a continuing deterioration.

(9) Pacific's common stock was one of the Bay Area's worst performances in 1979, closing at 14-3/4 on December 29, 1978, and at 11-7/8 on December 31, 1979, a decline of 19.5 percent in market price. This is in contrast to book value of $21.50 to $22.00 per share.

(10) Lastly, Pacific's witness testified that prospective investors and purchasers can neither ignore nor minimize the serious adverse effects of recent materially important events and regulatory developments involving Pacific and the Commission.

Pacific cites "regulatory developments" as the factor upon which the remainder of the above ten points depend. Its failure to obtain substantial rate relief and the impact of the remand case are the primary, if not the sole, examples of these "developments."

Pacific points to Application No. 58223, and observes that instead of the $470 million rate increase it sought, it received a rate decrease of $42.2 million. However, later Commission actions have ameliorated to an extent the impact of the rate decrease, as follows:

1. In Decision No. 90919, dated October 10, 1979, in Application No. 58223, the Commission found that Pacific had an additional revenue requirement of $43.5 million. This finding resulted in a rescission of the $42.2 million rate decrease and the granting of a rate increase of $1.3 million.

2. In Decision No. 91121, dated December 18, 1979, in Application No. 58223, the Commission increased Pacific's rate of return from 9.73 percent to 10.25 percent, which in turn required an additional increase in revenues of $36.6 million.

3. In interim Decision No. 90842, dated September 28, 1979, in Application No. 57465 the Commission authorized Pacific to increase its rates for classified directory advertising by $23.3 million based upon a 1976-1977 test year. However, the Commission also found that "Pacific will not realize the full impact of the increase authorized herein for approximately two and one-half years after the effective date of this decision." (Ibid., p. 14.) The effective date was September 25, 1979. Interim Decision No. 90842 was made final by Decision No. 91059, dated November 20, 1979.

4. On November 13, 1979, Pacific filed, and the Commission accepted for filing, Pacific's Application No. 59269 for increased rates of $381 million to support financing requirements in 1980. The application sought rate relief on an interim basis and was filed outside the purview of the Commission's regulatory lag plan. (Resolution No. M-4706, dated June 5, 1979.) The test year for Application No. 59269 is 1980, whereas the regulatory lag plan requires Pacific's next test year to be 1981. The application specifically invokes the following language of Resolution No. M-4706:

"...utilities may always request emergency interim relief if a financial emergency exists because of a sudden, significant, and unforeseen change in operating conditions."

Public hearings commenced January 15, 1980, and the initial phase has been submitted subject to oral argument on February/9, 1980. √KR

Pacific also directs the attention of the Commission to developments concerning the remand cases. These developments are somewhat mixed in their impact on Pacific. On the one hand, the Internal Revenue Service (IRS) did not assess Pacific for back taxes for the years 1971, 1972, and 1973 before the statute of limitations expired on June 30, 1978. Accordingly, Pacific's potential exposure to additional tax liabilities was reduced substantially.[6] On the other hand, the IRS did assess Pacific for a deficiency for the tax year 1974. The assessment was $89 million principal plus $23 million of interest through January 1980, about $30 million less than Pacific had expected. Pacific expects to receive a bill for these sums in January, and has elected to pay the bill rather than pay further amounts of interest at 12 percent per annum. Pacific has retained outside counsel to dispute the assessment and, for the purposes of the litigation with the IRS, will argue that the Commission's position squares with the Internal Revenue Code and the regulations.

Recommendations of the Parties

Pacific, of course, would have the Commission authorize the issue of $300 million of debentures without condition and with all due dispatch in order to meet its target date of February 26, 1980.

The staff would have the Commission authorize the issuance of debentures but make the actual sale subject to a condition precedent that Pacific first issue and sell the 10,000,000 shares of common stock which Decisions Nos. 90652, dated August 14, 1979, and 91114, dated December 18, 1979, authorized.

The City and County of San Francisco recommended that the application be granted, but that the exercise of the authority be conditioned upon receiving from American Telephone and Telegraph

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6/ The record does not reflect the actual amount of the potential tax liabilities thus avoided, but the amounts suggested were in the $100 million to $300 million range.

Company (AT&T) an absolute assurance that it will subscribe to future equity offerings of Pacific in the immediate future.

Sidney J. Webb (Webb) recommended outright denial as the medicine that would, in his opinion, cure the financial sickness that is causing the parent AT&T to shun its child Pacific. Moreover, he suggested that an order prohibiting the distribution of dividends by Pacific to AT&T might be an even more effective remedy.

Of these four recommendations that of the staff appears most reasonable. First, it is consistent with our own decisions over the last several months, wherein we have repeatedly expressed great concern for Pacific's declining common equity ratio. Second, it is consistent with Pacific's own expressed goal of increasing the percentage of common equity in its capital structure. Third, such a recommendation, if adopted, would be likely to reinvolve AT&T in the financial affairs of its subsidiary.

Regarding the last item, the evidence showed that on June 19, 1978, AT&T issued a press release announcing that it would make no further common equity investments in Pacific as long as an "adverse regulatory climate" prevailed in California. It cited as the event which provoked its announcement the Commission's refusal to join with Pacific in petitioning the California Supreme Court to remand certain federal tax-related cases to the Commission for reconsideration in light of an IRS ruling of June 8, 1978. (Exhibit 2.) Until this proceeding it was not known that AT&T would not extend any short-term loans to Pacific except on a case-by-case basis. This policy went into effect at the same time the press release was issued.

We are, of course, concerned about ~~suspicious of~~ AT&T's decision to ~~policy in~~ inaugurate ~~inaugurating~~ these policies and are troubled by Pacific's docile attitude toward them. Apparently, Pacific has made no effort to counsel with AT&T regarding the revocation or revision of these policies. From Pacific's point of view it would be less expensive to borrow some of its short-term money from AT&T, and it would be easier to sell common stock if AT&T purchased its 90 percent of a given issue pursuant to its preemptive rights.

The staff cites a fourth reason for requiring an issue of common stock. The staff witness testified that Pacific must go before the rating agencies before it issues and sells the proposed debt securities. Since a debt issue further increases the company's long-term debt ratio, and, consequently, further erodes the company's interest coverage, such a financing proposal places the company in immediate danger of further down rating. Any down rating will increase the cost to the company of the funds it borrows. If Pacific were down rated to BBB, it is estimated that its interest cost would increase from 12 percent to 12.7 or 12.75 percent.

The staff further estimates that if a debt offering is postponed by an issue of common stock, the cost of debt may be more favorable. The staff witness cited the decline in the prime rate over the last two months as the basis for his estimate.7/

7/ The testimony was given January 10, 1980. Since that time the prime rate has increased again. Also, on January 16, 1980 the Wall Street Journal reported that Southwestern Bell Telephone Company's $450 million of new triple-A rated debentures met stubborn investor resistance even though they provided a record high interest return (11.47 percent yield) for any Bell System issue.

The beginning of a solution to Pacific's declining common equity ratio and increasing long-term debt ratio, and an answer to the recommendations of the parties generated thereby, appears to have been reached. On February 8, 1980, AT&T announced that it would again purchase Pacific's common stock. This change in AT&T policy will assure the success of Pacific's issue of common stock, which we authorized in Decision No. 90652, dated August 14, 1979, and Decision No. 91114, dated December 18, 1979, in Application No. 58989. The chief impediment to the issue of common stock having been removed, we need not act upon the recommendations of the staff, Mr. Webb, and San Francisco. We are confident that common stock will in fact be sold in a timely fashion even though the order which follows grants the authority sought by Pacific unconditionally. Were it not for the announced participation of AT&T in Pacific's equity offering we would have been constrained to condition the authority granted herein. We strongly believe that AT&T's action coupled with unconditional authorization of this debt issue on our part should constitute a significant improvement in Pacific's future financial prospects which must be recognized by the financial community in its treatment of Pacific's financing requirements.

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Findings of Fact

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

2. The proposed sale of debt securities is for proper purposes.

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

4. The terms and conditions of the proposed issuance and sale of debt securities 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 debt securities 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 debt securities should not be required to be at competitive bidding.

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

8. The present unsettled market conditions, the size of the offering, and other factors justify a negotiated offering of the debt securities.

9. A sale on a competitive-bid basis is not always necessarily in the public interest.

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Conclusions of Law

1. This decision is not intended to modify the competitive bidding rule as initially set out in Decision No. 38614 (46 CRC 281 (1946)).

2. The authorization granted herein is for the purposes of this proceeding only, and is not to be construed as indicative of the amounts to be included in proceedings for the determination of just and reasonable rates.

3. The application should be granted.

O R D E R

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company (Pacific) may issue, sell and deliver, on or before April 30, 1980, not exceeding $300,000,000 aggregate principal amount of debt securities in accordance with the application and the terms and provisions of a purchase agreement or agreements substantially in the form filed as a part of Exhibit E to the application, with a term or terms each not to exceed forty years, with a maturity date or dates related to the actual sale date and with redemption features appropriate to market conditions existing at about that time.

2. Said issuance and 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 or indentures substantially in the form filed as Exhibit B to the

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application, with maturity, interest payment and other relevant dates appropriate to the actual sale date of said debt securities, except that the redemption provision may be modified or deleted as provided in the application.

4. Pacific shall use the proceeds of the issuance and sale of not exceeding $300,000,000 principal amount of said debt securities for the purposes stated in the application (accrued interest may be used for general corporate purposes).

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

6. In the event Pacific utilizes competitive bidding, in lieu of the notification required by paragraph 7 hereof Pacific 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.

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

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

9. This order shall become effective when Pacific has paid the fee prescribed by Section 1904(b) of the Public Utilities Code, which fee is $106,000 after taking credit for the retirement of $100,000,000 principal amount of Seven-Year 7½ percent Notes due June 1, 1980.

Dated FEB 13 1980, at San Francisco, California.

John E. Bryson
President

Vernon L. Sturgeon

Richard D. Gravelle

Claire T. Dedrick

Leonard M. Grimes, Jr.
Commissioners

PUBLIC UTILITIES COMMISSION
STATE OF CALIFORNIA
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