ALJ/ec



ORIGINAL

Decision No. 91845 JUN 3 1980

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. 59618
(Filed April 25, 1980)

Duane G. Henry, Attorney at Law, for The Pacific Telephone and Telegraph Company, applicant.
Sidney J. Webb, for himself, protestant.
William J. Jennings, Attorney at Law, for the Commission staff.

O P I N I O N

By Application No. 59618 filed April 25, 1980, 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 ("debt securities") having a term or terms each not exceeding forty years. Public hearing was held on the above-referenced application.

Pacific's Showing

Pacific's stated purpose for the proposed financing is to retire at maturity its Twenty-Three Year 5-1/8% Debentures due August 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 $3,031,634,501 as of March 31, 1980, as set forth in the following summary:

| | | Amount |
|---|---|---|
| Total capital expenditures, October 31, 1922 to March 31, 1980 | | $14,655,765,930 |
| Deduct proceeds of: | | |
| Stock issues | $3,149,814,207 | |
| Promissory notes | 241,808,000 | |
| Funded debt | 5,337,781,100 | |
| Other | 147,635,231 | |
| Total deductions | | 8,877,038,538 |
| Balance obtained from other sources | | 5,778,727,392 |
| Less: Reserve for Depreciation | | 2,747,092,891 |
| Unreimbursed balance | | $ 3,031,634,501 |

Pacific anticipates that the proceeds from the sale would be available on or about July 17, 1980. Accordingly, Pacific expects to use $90,000,000 of the proceeds to retire at maturity the outstanding 5-1/8% Debentures on August 1, 1980 as previously mentioned herein. In the interim period of about two weeks before such proceeds are used, 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, including consideration of the Debentures due August 1, 1980, are expected to be about $925,000,000 by the end of July of 1980.

Pacific's capital ratios as recorded on March 31, 1980 and as adjusted as of July 31, 1980 give effect to (1) retirement on

June 1, 1980 of $100,000,000 principal amount of notes, (2) the proposed sale on or before July 31, 1980 of 9,684,884 shares of common stock, assuming proceeds of $120 million, (3) the proposed sale of $300,000,000 aggregate principal amount of debt securities on or about July 9, 1980, (4) the issuance on July 16, 1980 of 600,000 non-voting preferred shares amounting to $15,000,000, and (5) the retirement of $90,000,000 principal amount of debentures due August 1, 1980. The capital ratios are as follow:

| | Recorded | Pro Forma |
|---|---|---|
| Common equity | 36.9% | 35.8% |
| Preferred stock | 6.2 | 6.0 |
| Funded debt | 54.5 | 52.3 |
| Short-term borrowings | 2.4 | 5.9 |
| | 100.0% | 100.0% |

Pacific estimates for the year 1980 indicate the need for $2,517,000,000 gross construction outlays related to customer growth and movement, and for plant modernization and replacement as follows:

| Item | |
|---|---|
| Customer growth | $1,405,000,000 |
| Customer movement | 556,000,000 |
| Plant modernization | 380,000,000 |
| Plant replacement | 176,000,000 |
| Total | $2,517,000,000 |

Pacific alleges a continuing need for capital for the acquisition of property and for the construction, completion, extension, and improvement of the facilities Pacific and its subsidiary, Bell Telephone Company of Nevada, used in both intrastate and interstate operations.

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, Pacific, in the interest of flexibility, seeks authority to determine on or about the sale date whether the debt securities will be nonredeemable or redeemable, and if redeemable the terms and conditions of such redemption. If authority is granted as sought, ultimate determination of the redemption provisions will be made by the chairman of the Board of Directors, the president, the vice president and secretary, or the treasurer of Pacific.

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.

Pacific indicated its awareness that the Commission has concluded that it will not grant an exemption from its competitive bidding rule, established by its Decision No. 38614, as modified, absent a compelling showing. Pacific requests the flexibility which an exemption from the competitive bidding rule would provide and cites the following reasons as compelling justification:

(1) Pacific believes that the size of the proposed offering necessitates the availability of a large number of underwriters and dealers in connection with its distribution. The important aspect is that, whether the proposed offering be a single issue or the aggregate of several, Pacific will be asking the investment banking community to commit up to $300,000,000 of its capital under market conditions that likely

will prove to be unstable and volatile. If competitive bidding were to be required, the number of such underwriters and dealers available for each bidding group would be considerably less, which, under unstable market conditions, could have an adverse effect on the bids and cost of money to Pacific. This is complicated by the fact that the number of underwriting firms has been decreasing as a result of acquisition, merger, or withdrawal. Moreover, Pacific's credit ratings have been lowered three times by Standard and Poor's and twice by Moody's since 1977.

(2) Preoffering marketing efforts by the underwriters in Pacific's previous debt issues have been a definite advantage and help in the successful sale of Pacific's debt securities. Pacific believes that in the presently proposed offering such efforts may be essential to a successful sale in view of not only the aggregate size of the offering, but also considering Pacific's lowered credit ratings, financial uncertainties facing Pacific, and the likelihood of continued unstable market conditions. Investment bankers and dealers who are part of a negotiating group would be in a position to engage in preoffering solicitation with assurance that they will be participants in the actual sale of the debt securities, whereas this cannot be done where two or more syndicates are formed for the purpose of bidding for the purchase of the securities. In the latter situation, an individual firm does not know that it will be in the distributing group or groups until after the bids are reviewed. The cost of money may therefore be higher than on a negotiated basis.

(3) 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. In addition, Federal

monetary policy as implemented by the Federal Reserve Board has created strong upward pressure on interest rates and added to their volatility. With respect to Pacific, as previously mentioned, this situation has been exacerbated by the fact that Pacific's credit ratings have been lowered. Due to current unstable market conditions and the apparent impact of inflationary considerations, large institutional buyers are very selective in buying debt issues, notwithstanding high yields. It is expected that these conditions will continue at least through late 1980.

(4) Because of financial uncertainties facing Pacific, Pacific has left open several decisions regarding the structure of the issue(s) until a time closer to the actual sale date. In particular, decisions as to the number of issues, the exact aggregate principal amount of securities to be offered, the term or terms, and the redemption provisions, if any, will be made later when it is determined what structure would most enhance the marketability of the issue(s). A competitive bidding schedule dictates that these decisions be made somewhat in advance of the sale date. If Pacific has the flexibility to sell the securities by means of a negotiated underwriting, these fundamental decisions may be made closer to the actual sale date, so that market conditions and Pacific's financial situation at the actual sale date may be better predicted and the issue(s) structured accordingly.

(5) The Commission has previously authorized sales of Pacific's debt securities by negotiated sales on March 31, 1970; October 14, 1970; March 9, 1971; October 16, 1974; November 9, 1978; February 7, 1979; June 28, 1979; November 14, 1979; and February 27, 1980. A report from the managing underwriting group in the February 27, 1980 issue is attached hereto and marked Exhibit D. In the November 14, 1979 issue,

Pacific estimates that it was able to achieve a cost of borrowing through the negotiated sale which was approximately 27 basis points lower than that achievable through a competitive bid, which difference translates into an aggregate savings of approximately $32,000.000. In the February 27, 1980 issue because the sale was through a negotiated underwriting, Pacific testified that it was able to sell the securities successfully despite an extremely volatile market characterized by relative illiquidity and an unprecedented level of interest rates. At the time the issue was sold there was substantial investor resistance to long-term bond issues and considerable investor skepticism that Pacific could sell any long-term debt. Yet, with the aid of active pre-marketing by the underwriters and by adjusting the offering terms to meet rapidly changing investor requirements, both of which are facilitated by a negotiated offering, Pacific claims it was able to successfully sell both intermediate and long-term debt.

(6) Pacific believes that under adverse market conditions the debt securities can be sold on a negotiated basis at as low a cost of money, if not a lower cost of money, as if they were sold by means of competitive bidding.

Although Pacific testified that its present plans are to sell the debt securities on a Commission-approved negotiated basis, Pacific seeks alternative authority to sell them pursuant to competitive bidding in the event of substantially improved market conditions.

Finally, Pacific requests that the Commission act promptly in this matter in view of recent improvements in the debt market and the opportunity afforded Pacific to realize possible substantial interest savings to the company and its ratepayers by accelerating the issue.

Protestant's Position

Mr. Sidney Webb, appearing on behalf of himself and as a shareholder of Pacific, protests the authorization of any issuance of future debt by Pacific on grounds that the company's capitalization ratio is currently too heavily weighted on the debt side. Mr. Webb recommends denial of the instant application of Pacific to issue $300,000,000 of debt, as well as future applications for debt issue, until American Telephone and Telegraph Company demonstrates a willingness to purchase common stock of its subsidiary, Pacific. Mr. Webb also strongly urges in the event the Commission grants the requested authority, that it do so subject to the competitive bidding rule.

Staff Counsel's Position

Staff counsel identified two major issues in the proceeding: (1) the need of Pacific to sell $300 million in debentures and/or notes at this particular time, and (2) the propriety of granting an exemption from the competitive bidding rule.

Staff counsel did not quarrel with Pacific's contended need for the funds as described in Application No. 59618. He did take strong exception to the request for an exemption from the competitive bidding rule. It is the contention of the staff attorney that the burden is upon Pacific to demonstrate by compelling showing the need for such an exemption and that Pacific has failed that burden. By staff counsel's interpretation, the word "compelling" requires Pacific to literally overpower the Commission with its rationale for an exemption from the competitive bidding rule. Staff counsel maintains that Pacific's request for an exemption on the grounds that it provides Pacific with additional flexibility in marketing its debt securities hardly constitutes an overpowering or compelling showing.

Discussion

We agree with staff counsel that the central issues in this proceeding involve two questions of need: (1) the need for Pacific to issue $300,000,000 of debentures and/or notes, and (2) the need for an exemption from the competitive bidding rule.

The uncontroverted evidence supports Pacific's contention that it needs to raise $300,000,000 in the long-term debt market to retire at maturity its Twenty-Three Year 5-1/8% Debentures due August 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. We find that Pacific has demonstrated sufficient need for the financing to warrant this Commission's authorization.

With respect to Pacific's request for an exemption from the competitive bidding rule and our requirement that the propriety of such an exemption be demonstrated by compelling showing, a more extensive discussion is appropriate.

In its testimony, Pacific indicated that the prime motivation for its request for an exemption from the competitive bidding rule stems from the volatility and uncertainty of the current long-term debt market. Pacific further indicated that it preferred to offer its debt securities on a competitive-bid basis given the existence of a stable market in which price movements are minimal and where interest rates do not fluctuate greatly from one day to the next. However, assuming the existence of a volatile long-term debt market, argument is made that a competitive bid may be more expensive in terms of the cost of borrowing and may be more difficult to generate investor interest and sell an issue on the magnitude of $300,000,000.

Testimony indicates that market volatility can affect the underwriting of new securities by: (1) increasing the market risk of holding a securities inventory; and (2) increasing the degree of uncertainty respecting the direction of interest rates. Such increased risk and uncertainty generally diminish the aggressiveness of competitive bidding while increasing underwriting spreads. Given market uncertainty, the investment bankers may well increase the margin of protection in their competitive bid and may price the issue on the high side as an exercise of caution. No testimony was presented suggesting that placement of issues on a competitive-bid basis in a volatile market results in a lower cost of borrowing. Testimony was presented estimating that Pacific was able to achieve a cost of borrowing through negotiated sale of its November 14, 1979 issue at approximately 27 basis points lower than that achievable through a competitive bid.

In addition to the potential lower cost of borrowing achievable through a negotiated sale in a volatile market, testimony demonstrates that the negotiated method of sale provides maximum flexibility to alter the timing of the issue, i.e., to accelerate or decelerate, and to alter the terms of the issue, i.e., amount, maturity, and call protection, to meet variable market conditions. This flexibility includes the possibility of improving the terms if market conditions permit as well as the possibility of adjusting the terms as may be necessary in order to permit the financing to go forward.

Finally, evidence indicates that a major advantage to the issues in a negotiated offering is the broader group of underwriters available to market the issue. It is posited that a well-managed and strong underwriting group generates substantially more market focus on the issue whereas competitive bidding has the effect of fractionating the market strength of the investment banking community among a number of bidding groups.

Pacific has stated its preference for placement of its debt issues on a competitive-bid basis given a stable market. However, given the existence of a volatile market, it is their contention that a negotiated sale offers the above-referenced significant advantages over a competitively bid placement. We think that the current long-term debt market can appropriately be characterized as volatile. In that context, we conclude that Pacific has marshalled sufficiently compelling reasons to warrant an exemption from the competitive bidding rule.

However, it is noted that this decision is not intended to modify the competitive bidding rule as initially set out in Decision No. 38614. It remains the Commission's firm belief that the competitive bidding rule, as a general proposition, affords the ratepayer the most consistent and reasonable protection in utility debt offerings. It is only the size of the proposed offering under current unsettled market conditions that justifies departure from our rule and approval of the negotiated offering of the debt securities. When stability returns to the long-term debt market, we will require compliance with our competitive bidding rule.

Although Pacific seeks authorization to sell the debt securities on a negotiated basis, it requests alternative authority to sell them pursuant to competitive bidding in the event of substantially improved market conditions. Even though Pacific has testified that it is unlikely that the market will stabilize in the near term, they would nevertheless like to reserve the option to proceed on a competitive basis. Accordingly, we will grant alternative authority.

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 of 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. There is no evidence that sale of debt securities in a volatile market at competitive bidding will result in a lower cost of borrowing to Pacific than a sale by negotiated placement.

7. In a volatile long-term debt market, a negotiated placement provides potential advantages of lower cost of borrowing, flexibility with respect to timing and terms, and the commitment of capital and resources of a broader group of underwriters to market the issue.

8. The sale of the proposed debt securities is not required to be at competitive bidding.

9. The debt securities being unsecured, no California property will become encumbered thereby.

Conclusion of Law

The application should be granted. 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. Pacific is put on notice that in its next general rate proceeding before the Commission its choice of alternative methods of financing authorized herein and the reasonableness of the resulting interest rate will be closely scrutinized and may result in a disallowance of interest expense if the most prudent and least costly choice has not been made.

# 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 September 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 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 5 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.

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.

This order shall become effective when Pacific has paid the fee prescribed by Section 1904(b) of the Public Utilities Code, which fee is $111,000 after taking credit for the retirement of $90,000,000 principal amount of Twenty-Three Year 5-1/8% Debentures due August 1, 1980.

Dated JUN 3 1980, at San Francisco, California.

I will file a ~~I dissent. See~~ written dissent. ~~attached statement~~.

John E. Bryson

Vernon L. Sturgeon
President

Richard D. Gravelle

Leonard M. Grimes
Commissioners

PUBLIC UTILITIES COMMISSION
STATE OF CALIFORNIA
PAID
99893
JUN 4 - 1980
111,000.-
By

Commissioner Claire T. Dedrick, being necessarily absent, did not participate in the disposition of this proceeding.

COMMISSIONER JOHN E. BRYSON, DISSENTING:

In this proceeding, the Commission has approved the issuance by Pacific Telephone and Telegraph Company (Pacific) of up to $300 million in securities on either a negotiated or competitive bid basis together with an exemption from our competitive bidding rule.

The Commission also has put the company on notice that, in the next general rate proceeding, it will analyze the reasonableness of the company's choice between negotiated and competitive bidding and may disallow a portion of the interest charge should Pacific fail to choose the most prudent and least costly method.

The Commission in this decision is setting on a course fraught with difficulty. While exempting Pacific from the competitive bidding requirement, the Commission has not agreed that the evidence clearly favors negotiated bids. Instead it has decided to wait until the next rate case to decide whether Pacific's choice between competitive and negotiated was appropriate. We have provided no standard for review, however, and given the complexities of evaluating such transactions, we can have little confidence in our ability to evaluate the matter months after the bonds will have been sold.

The Commission policy regarding bond issuance is that the utilities must seek competitive bids absent a compelling showing that negotiated bids would be preferable. The reasoning behind that policy is sound. Competitive bidding assures the integrity of the capital formation processes of utilities, but a negotiated bid always leaves doubt whether a better deal could have been obtained through another syndicate. While we do allow for exemption from the rule, there should be a strong presumption in favor of competitive bidding.

In the case before us, Pacific has not made an adequate showing to justify a negotiated bidding procedure. In view of the substantial rate relief Pacific has received in recent months, one should expect many investment firms to be interested in participating in a securities issue of the scale and quality proposed. I do not find persuasive the arguments that Pacific requires an exemption.

In my concurrent dissent to Decision No. 91889, I expressed concern that the Commission's rejection of Edison's application would jeopardize future opportunities for private placement of debt. Though favoring competitive bidding over negotiated, I also favor giving utilities the flexibility to seek funds through private placement.

Private placements can reach sources of financing not otherwise available, but negotiated bids do not. The investment banking syndicate chosen through a negotiated bid taps the same market as would a competitively selected syndicate. The only distinction is the procedure by which the syndicate is selected.

Under most situations, competitive bids are preferable to negotiated. While there may be circumstances under which negotiated bidding should be permitted, the Commission's liberal practice in current years of approving negotiated bids ignores the basic soundness of the competitive approach.

I would deny Pacific's application.

San Francisco, California
June 3, 1980

John E. Bryson

JOHN E. BRYSON, President