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Decision No. 91984 JUL 2 1980

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of SAN DIEGO GAS & ELECTRIC COMPANY, to issue and sell not exceeding $75,000,000 of bonds and to execute a supplemental indenture.	Application No. 59633 (Filed May 6, 1980)

Guenter S. Cohn, Attorney at Law, for San Diego Gas & Electric Company, applicant.
William S. Shaffran, Deputy City Attorney for John W. Witt, City Attorney, for City of San Diego, interested party.
Ellen LeVine, Attorney at Law, James Pretti and Ida Goalwin, for the Commission staff.

OPINION

By Application No. 59633 filed May 6, 1980, San Diego Gas & Electric Company (SDG&E) requests authority to execute a supplemental indenture and to issue and sell not exceeding $75,000,000 of bonds either by competitive bidding or negotiation. The application was the subject of public hearing held in San Diego on June 16, 1980.

SDG&E's Showing

SDG&E seeks authority to issue and sell not exceeding $75,000,000 aggregate principal amount of its First Mortgage Bonds, Series T, and to execute and deliver a Twenty-First Supplemental Indenture. SDG&E's stated purpose for the proposed financing is the retirement of all or a portion of its outstanding short-term bank loans and commercial paper, and use of the balance, if any,

for reimbursement of SDG&E for capital expenditures. The application states that SDG&E's outstanding short-term obligations are estimated to currently total $200,000,000. Testimony confirmed the obvious conclusion that the proceeds from the proposed bond issue, if authorized, will be exhausted by retirement and discharge of a portion of SDG&E's outstanding short-term bank loans and commercial paper.

The capitalization ratios of SDG&E as of March 31, 1980, and corresponding ratios with pro forma adjustment to reflect the proposed sale of the bonds, assuming proceeds of $75,000,000 are as follows:

	As of March 31, 1980	Pro Forma
First Mortgage Bonds	36.7%	39.8%
Debentures	1.6	1.5
Other Long-Term Debt	8.4	8.0
Preferred and Preference Stock	14.5	13.8
Common Stock Equity	38.8	36.9

The bonds will be issued pursuant to a Twenty-First Supplemental Indenture, which will be substantially similar in form to the Twentieth Supplemental Indenture issued pursuant to Application No. 59366, supplementing SDG&E's Mortgage and Deed of Trust to The Bank of California, N. A., as Trustee, dated July 1, 1940, as heretofore supplemented and amended by twenty supplemental indentures. The final form of the Twenty-First Supplemental Indenture will provide for such terms and conditions as rate of interest, maturity and other payment dates, place and manner of payment, principal amount not exceeding $75,000,000, call protection not exceeding ten years, and other redemption provisions, including sinking fund, if any, deemed necessary and advisable by SDG&E.

SDG&E requests authority in the alternative to issue and sell the bonds either on a competitive-bid or a negotiated basis, depending upon market conditions existing at the time of the proposed sale, which is anticipated to be in August, 1980. If alternative authority is granted, SDG&E will proceed to issue and sell the bonds on a negotiated basis through a nationwide group of underwriters prior to the date of the proposed public offering of the bonds. The terms of a purchase agreement, and the terms of the proposed offering, including the price of the bonds, the interest rate, the aggregate principal amount, maturity date, sinking fund requirements, if any, call protection and other redemption provisions, and the underwriting commission to be paid, will be determined by negotiation between SDG&E and the underwriters shortly before the proposed public offering and will be based on market conditions existing at that time. If the issue and sale of the bonds is made on a negotiated basis pursuant to authority from this Commission, a form of purchase agreement will be submitted to the Commission prior to the proposed date of issuance. If the issue and sale of the bonds is made pursuant to a competitive bid, a form of agreement similar to that utilized in Application No. 57028 will be submitted to the Commission prior to the date of issuance.

SDG&E indicated its awareness that the Commission has concluded that it will not grant an exemption from its competitive bidding rule, established by Decision No. 38614, absent a compelling showing. Richard Korpan, treasurer of SDG&E, and George Schreiber, Jr., a vice president of Kidder, Peabody & Co., Inc., both offered testimony alleging the existence of circumstances unique to SDG&E sufficiently compelling to warrant an exemption from the competitive bidding rule.

Both witnesses for SDG&E testified that the most important advantage of a negotiated bond sale is the flexibility which this

method of financing provides. Uncertainty in the financial markets makes it desirable to have maximum flexibility provided by a negotiated offering to take advantage of short-term changes in interest rates and unstable market conditions.

Under competitive bidding, a fixed date and terms are set for the bidding and if this date is to be changed, it has to be changed to another fixed date. As a result, timing flexibility is lost and the issuer does not have the ability to make quick adjustments in the timing or terms to compensate for market changes. This could result in excessive interest rate bids by the underwriters to ensure the securities could be sold in light of that day's market conditions.

However, a negotiated offering can be brought to market before the offering date originally agreed upon if market conditions are favorable and sufficient investor interest has been developed. Furthermore, if conditions are not satisfactory on the scheduled offering date, it is easy to delay the offering to attract sufficient interest at a proper offering price. It is also easier to make last minute changes in the terms and conditions which could be crucial to a successful sale.

SDG&E further argues that a negotiated offering helps insure demand and a reasonable price for the securities by virtue of the pre-selling effort available under a negotiated sale. On a negotiated offering, after the Registration Statement is filed, the various underwriters begin their efforts to build up interest among institutions and individuals. Underwriters are much more likely to disseminate pertinent background information among prospective investors in a negotiated sale. The competitive bidding process is not conducive to the same quantity and quality of selling effort because salesmen cannot be assured of getting the bonds to sell. This selling effort requirement is especially important to SDG&E at

the present time because of fluctuating earnings, low coverages, and a weak credit rating.

In a competitive bid, institutions are unlikely to indicate their true demand for an issue because they are interested in obtaining the best price; and they do not know which bidding group will actually obtain the offering. Therefore the distribution effort of the syndicate is not as efficient in a competitive bid as the negotiated offering where a more definitive demand can be developed, thereby allowing underwriters to obtain the best price for the issue.

Also, during periods of high interest rates, investors can obtain high yields from strong credit companies which can also result in reduced demand for weaker credit securities, such as those offered by SDG&E. In order to compensate for this reduced demand, extra selling effort may be necessary.

In addition, some classes of investors may be overloaded with certain utility securities. These investors could decline to participate in a sale, thereby further reducing the potential investor base. This means a stronger selling effort to the remaining investors will be required. The "book-running" manager in a negotiated offering has the entire investment banking community to choose from and is able to assemble the best underwriting group for the job of distribution. The book-running manager will allocate the issue to those firms best able to market the securities. In competitive bidding, firms with relatively good underwriting and marketing abilities might well be members of an unsuccessful group.

SDG&E testified that its need for the flexibility provided by a negotiated offering is occasioned by three circumstances unique to the company: (1) its available short-term debt capacity; (2) its low interest coverage; and (3) its weak credit rating (Baa/BBB).

Mr Korpan testified that SDG&E's high short-term debt position which totals approximately $200,000,000 in outstanding obligations is the most important factor considered by SDG&E in determining to issue its securities via a negotiated sale. Normally, the company's short-term borrowings are utilized to fund only the construction program. However, due to a significant amount of energy cost adjustment clause (ECAC) undercollections, amounting to $70 million as of April 30, 1980, a significant portion of the company's short-term debt capacity has been absorbed in covering unreimbursed fuel expense. Short-term debt, including bankers' acceptances, represented eleven percent of capitalization as of April 30, 1980 which is far in excess of the rating agencies' guideline of a five percent maximum.

SDG&E urgently needs capital and does not have the option of passing an issue and allowing its outstanding short-term obligations to increase. Assuming that its outstanding short-term debt levels were relatively low, and the corresponding need for capital decreased, SDG&E contends that a competitive bid would be acceptable since SDG&E could open the bids and reject them if they were not favorable. Given its critical need for capital, SDG&E argues that it does not possess the flexibility to reject an unfavorable competitive bid.

SDG&E also argues that its current interest coverages restrict the company's alternatives for raising capital and correspondingly its ability to pass an unfavorable bid. With the positive impact of the 1979 general rate relief running out in May 1980, SDG&E's debenture indenture will severely restrict the issuance of additional long-term debt until new general rate relief is reflected in earnings. Even coverages for April preclude the issuance of more than $50-$55 million in new long-term debt financing

to help draw down the excessive short-term borrowings.

SDG&E contends that its weak credit rating is a significant factor in determining to seek the marketing flexibility which a negotiated sale allegedly offers. SDG&E maintains that during periods of economic uncertainty potential investors tend to focus on higher quality securities. The weak credit company may find a rather limited number of potential investors willing to take the extra risk without a substantial premium. This investor reluctance places more reliance on the selling effort of the investment banker.

In sum, given current unstable bond markets and given the company's high level of short-term debt, low coverages, low internal cash generation and high capital requirements, SDG&E requires the marketing flexibility inherent in a negotiated sale to achieve a bond issue consistent with the best interests of its ratepayers.

Finally, SDG&E urges the Commission to act expeditiously on the subject application in light of the company's pressing need for capital. The sooner the Commission acts, the more flexibility SDG&E will have in determining the optimum time to offer its proposed issue to the public.

<u>City of San Diego's Position</u>

While the City of San Diego (City) actively cross-examined the witnesses in the proceeding, it declined to make any recommendation whether SDG&E should be exempted from the competitive bidding rule. City did note that testimony was presented which indicated circumstances peculiar to SDG&E that might serve as reasons for exemption from the competitive bidding rule. City further noted that the Commission should review the present-day viability of its competitive bidding rule if it continues to grant exemptions as a rule rather than an exception.

Commission Staff Position

The staff concurred with SDG&E's contention that the company's outstanding short-term debt obligations demonstrated its need to raise capital by selling $75,000,000 of bonds. With respect to SDG&E's request for an exemption from the competitive bidding rule, the Utilities Division and the Revenue Requirements Division of the Commission took divergent positions.

The Revenue Requirements Division endorses the view of SDG&E and recommends that an exemption from the competitive bidding rule be authorized for similar reasons. The division's witness conducted an independent review and concluded that SDG&E's financial circumstances in current unsettled markets are sufficiently compelling reasons to justify an exemption from the competitive bidding rule as being in the best interests of the SDG&E ratepayer.

In contrast, the Utilities Division contends that a rule is no longer valid if the exceptions exceed conformance. Their witness concluded that no evidence was presented in this hearing or any other recent hearing which indicates that competitive bids are not the most reasonable approach to debt securities sales. The following rationale was provided.

It is agreed by all parties that money markets have been unstable this year. Investment bankers have been recommending negotiated bids and private placements in response to widely fluctuating interest rates. However, everyone also acknowledges that it cannot be established with any degree of certainty that the cost of bonds sold on a negotiated basis was higher or lower due to negotiated versus competitive bidding. Since both competitive and negotiated bids are marketed to the public, Utilities Division questions the assumption that a negotiated bid is superior in the context of a volatile market. It is their position that since a market exists, competitive bids should be used.

Exemptions pose problems. The Commission has no way to verify that the interest rate is indeed the best rate obtainable on that date. Because no two issues are in fact identical, there is no basis on which to make valid comparisons. Competitive bidding gives the Commission some assurance as to the market rate on a particular day for that particular issue.

Except for private placements, which sometimes include overseas buyers, most issues are marketed in the United States to the same group of institutional buyers that traditionally have bought and marketed bonds. Private investors in high tax brackets are not usually buyers of long-term corporate bonds. The net return after tax cannot compete with returns from nontaxable municipals. We are dealing then with a more or less static group of very sophisticated investors. The same information available to mortgage banking houses is available to them. If the bonds are priced right, they will sell. The Commission can be no surer of the right price through negotiated bid than by competitive bid; in fact, the Commission may be less sure.

In a negotiated sale, the Commission is obliged to rely on the utilities' and bankers' perception of the market or apply "hindsight" in evaluating equity or bond sales rates. Regulation by "hindsight" can lead to a decline in management skills over time. It can and does lead to an ultra-conservative stance in regard to new technologies, rate structures, and creative financing methods.

The whole rationale behind negotiated bids implies that money markets are tight, or interest rates are rising. If this is true, then any bid which does not exceed the market range for that day is reasonable. The Commission does not always agree with that premise. If the Commission will only allow such sales as will

result in lower interest rates than exist at the time they make their analysis (some 6-8 weeks after the bid), then in effect no negotiated bids or private placements are practical. Institutional investors have many other places to invest their money, especially when markets are volatile.

It is particularly destructive to apply sanctions or penalties based on "after the fact" analyses of management decisions. A good manager is one who makes more right decisions than wrong decisions. No one can be expected to be right all the time. Penalties which are threatened but not enforced are not penalties at all. Penalties which are based on facts which no reasonable person could have foreknowledge of are unreasonable.

The Commission, therefore, is in an untenable position. Either it must give carte blanche on negotiated bids or order unreasonable standards which will give negative signals to the investors who deal with California utilities. An unreasonable standard could be a "cap" on the rate which is lower than current market. The way out of the above dilemma is to enforce the competitive bid regulation which takes some of the uncertainty out of the market price question.

The Utilities Division contends that its recommendation should not be construed as an attempt to abolish all negotiated bid exemptions. However, it does conclude that if exemptions are granted, they should be the exception, not the rule.

Discussion

It has been agreed by all parties that SDG&E needs to raise $75,000,000 in the long-term market to retire and discharge a portion of its outstanding short-term debt and commercial paper. We find that SDG&E has demonstrated sufficient need for the financing to justify Commission approval of the proposed issue.

SDG&E's request for an exemption from the competitive bidding rule, however, proves to be a more nettlesome question. Our recent actions with respect to such requests, including an exemption granted in Decision No. 91845 issued June 3, 1980, tend to raise doubts concerning the vitality of the competitive bidding rule. We share the concern of the Utilities Division that a rule is no longer valid if the exemptions exceed conformance. To underscore our intent to abide by the competitive bidding rule and to prevent the rule from being swallowed by the exception, we will now clarify the nature of the compelling showing that must be made to warrant an exemption.

Clearly, any showing which proved conclusively that a negotiated sale would result in a lower cost of a money to the ratepayer than a competitive bid would constitute a compelling showing. However, the testimony has been uniform in its agreement that there are no objective indices that will show whether sale by negotiation on a particular day is preferable to a competitive bid or vice versa. Thus, this standard for a compelling showing proves to be both academic and illusory. In view of the realities of the bond market, no party can maintain with any degree of certainty that its method of sale, negotiated or competitive bid, will result in a lower cost of money on any given day.

The Commission, in the absence of a direct objective method to determine which type of sale best protects the interests of the ratepayer, finds itself in the difficult position of subjectively judging the importance of factors which may indirectly influence the ultimate cost of a debt issue to the ratepayer. To

illustrate the problem, let us examine the factors that have been introduced as compelling justification for an exemption from the competitive bidding rule.

The volatility and instability of current bond markets has been advanced as a prime factor justifying preference for a negotiated sale over a competitive bid sale. In an unstable market, it may be more difficult to complete a successful offering since investors may be more reluctant to risk their capital. It is then argued that in such circumstances a negotiated sale provides the necessary flexibility for the issuer to tailor the terms of its sale to reflect market conditions and investor interest and to ultimately achieve a successful offering. In a volatile market, the flexibility inherent in a negotiated sale is the key element.

The flexibility of a negotiated sale affords the underwriter the opportunity to "pre-sale" the issue. Through "pre-sale" efforts, the underwriters claim they are able to advise the issuers how to attract capital at the lowest possible cost and on the most advantageous terms. In a negotiated transaction, the issue size, maturity, offering date, and other terms of the issue can be easily modified to meet market conditions. Further, with a negotiated offering, the issue can be brought to market before the offering date originally agreed upon if market conditions are favorable and sufficient interest has built up. Conversely, if conditions are not satisfactory, on the scheduled offering date.

As a final argument favoring a negotiated sale in a volatile market, it is contended that such a sale maximizes the effectiveness of the underwriting group. The "book-running" manager in a negotiated sale has the entire investment banking community to choose from and can assemble the best underwriting account for the job of distribution. In competitive bidding, firms with relatively good underwriting and marketing abilities might be members of an unsuccessful group and their contribution to marketing the securities will be lost.

In sum, it is contended that the negotiated sale is superior to a competitive bid in a volatile market given its flexible nature and the opportunity to fully utilize the resources of the underwriting community. Notwithstanding recent decisions to the contrary, notice is now served that assertions regarding the volatility of the market, the flexibility provided by a negotiated sale, and the importance of maximizing the effectiveness of the underwriting group will not serve as compelling reasons, individually or collectively, for granting an exemption from the competitive bidding rule.

The sole question the Commission must answer is whether competitive bidding or a negotiated sale is in the best interests of the ratepayers. This question cannot be answered with any degree of confidence by analysis of the above-mentioned factors. No one can prove that the flexibility inherent in a negotiated sale is consistently correlated with lower costs of borrowing. In spite of dwindling numbers of investment banking firms due to consolidations, mergers, and business failures, no one can convincingly assert the absence of strong competition within the current investment banking community.

In a negotiated sale, the Commission is obliged to rely on the utilities' and bankers' perception of the market or to attempt the equally difficult task of applying hindsight in evaluating equity or bond sales. The way out of the above dilemma is to enforce the competitive bidding rule which removes some of the uncertainty from the market price question. Competitive bidding gives the Commission some assurance as to the market rate on a particular date for that particular issue.

This decision should not be construed as a proscription against negotiated sales. It merely clarifies that our requirement of a "compelling showing" to gain an exemption constitutes a very

high standard of proof. Such a standard requires that utilities, in most instances, proceed initially on a competitive bid basis with the ability to return to the Commission for an exemption if the bids are unacceptable. Hereafter utilities who file applications requesting exemption from our competitive bidding rule can expect to have the request for a competitive bidding exemption denied, with the application approved on the condition that competitive bidding will be used. We may do this absent public hearings. If utilities attempt a competitive sale and do not consummate it because the terms are unfavorable, they may petition for modification of the decision authorizing the sale and seek to demonstrate why competitive bidding is not in the public interest. The private placement of debt, where there is a known lender and interest rate, is not subject to these competitive bidding requirements, although the private placement is necessarily an exemption from competitive bidding. This is because we are advised of the interest terms in the application unlike the proposed public placement where the interest rate is an unknown when we issue our decision.

Now that we have reaffirmed our commitment to the competitive bidding rule, we will turn our attention to the merits of SDG&E's request for an exemption in this proceeding. It is ironic that the very decision which ratifies our belief that exemptions should be authorized only as the rare exception to the rule will grant SDG&E such an exception.

However, SDG&E has alleged more than the existence of a volatile market and its need for the flexibility which a negotiated sale offers. SDG&E has shown that it urgently needs capital with outstanding short-term debt approximating $200,000,000. It has demonstrated that its interest coverages are approaching the point at which the company will be precluded from issuing any further debt.

The record reflects that SDG&E is the only major utility that is rated Baa/BBB, the lowest investment category. SDG&E, in its current financial position, would lack the flexibility to reject any competitive bid, even if unfavorable. In view of testimony that SDG&E must finance in the next two to three months before coverage limits may be exceeded, we will not require SDG&E to first sample the competitive bid market. SDG&E has demonstrated sufficiently unique circumstances to warrant approval of a negotiated sale and an exemption from the competitive bidding rule will be granted. Further, basic fairness dictates that our clarification of the "compelling showing" standard of proof be given prospective effect.

Although SDG&E seeks authorization to sell its bonds on a negotiated basis, it requests alternative authority to sell them pursuant to competitive bidding in the event of substantially improving market conditions. We will grant alternative authority.

Findings of Fact

1. SDG&E 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. Given a volatile long-term debt market and given SDG&E's high short-term debt, low interest coverages, and low investment rating, 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.

7. The sale of the proposed debt securities is not required to be by competitive bidding.

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. SDG&E 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.

ORDER

IT IS ORDERED that:

1. The San Diego Gas & Electric Company (SDG&E) may issue, sell, and deliver, on or before November 30, 1980, not exceeding $75,000,000 aggregate principal amount of its First Mortgage Bonds, Series T, in accordance with the application, with the principal amount and 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. SDG&E is authorized to execute and deliver a Twenty-First Supplemental Indenture on terms and conditions as contemplated

by the application, with maturity, interest payment, and other relevant dates appropriate to the actual sale date of said debt securities.

4. SDG&E shall use the proceeds of the issuance and sale of not exceeding $75,000,000 principal amount of said debt securities for the purposes stated in the application.

5. Promptly after SDG&E 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 SDG&E 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, SDG&E shall file with the Commission three copies of each prospectus pertaining to said debt securities.

8. SDG&E shall file with the Commission a report, or reports, as required by General Order No. 24-B, which order, insofar as applicable, is hereby made a part of this order.

This order shall become effective when SDG&E has paid the fee prescribed by Section 1904(b) of the Public Utilities Code, which fee is $43,500.

Dated JUL 2 1980, at San Francisco, California.

President

Commissioners

I concur that SDG+E should be allowed this exception. I do not concur that the general policy herein enunciated is correct.

Claire T. Dedrick

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