Decision 93384 AUG 4 1981 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of PACIFIC GAS AND ELECTRIC COMPANY to issue and sell through a private placement not to exceed $75,000,000 aggregate principal amount of its First and Refunding Mortgage Bonds.	Application 60591 (Filed May 22, 1981)

Daniel E. Gibson and Bruce R. Worthington, Attorneys at Law, for Pacific Gas and Electric Company, applicant.
Richard Rosenberg, Attorney at Law, for the Commission Staff.

OPINION

Pacific Gas and Electric Company (PG&E) requests authority, under Public Utilities (PU) Code §§ 816 through 818, to issue and sell through a private placement up to $75,000,000 aggregate principal amount of its First and Refunding Mortgage Bonds (New Bonds), due August 1, 2011, and bearing a variable interest rate.

Public hearing was held before Administrative Law Judge Mallory in San Francisco on July 23, 1981 and the matter was submitted. Evidence was presented on behalf of PG&E and the Commission staff.

PG&E's Proposal

PG&E proposes to issue and sell, through a private placement with institutional investors, its New Bonds in the aggregate principal amount of up to $75,000,000 secured by its First and Refunding Mortgage as amended by 12 supplemental indentures.

The proposed terms provide that the New Bonds are to be dated June 1, 1981, to mature on August 1, 2011, and to bear interest at a rate that will be adjustable every two years, based on the published monthly average yields to maturity of U.S. Treasury securities adjusted to a constant maturity of 10 years and multiplying such Treasury rate by 120%. If the yields are no longer published, the Treasury rate for a constant maturity of 10 years will be determined by reference to quotes from government securities dealers. However, if the Treasury rate so computed is less than 9%, the interest rate on the New Bonds will be 180 basis points plus the Treasury rate, and if the Treasury rate is greater than 18%, the interest rate on the New Bonds will be 360 basis points plus the Treasury rate. Notwithstanding the above procedure, the interest rate on the New Bonds shall not exceed 25% or be less than 7%. The resulting interest rate would be in effect for the succeeding two-year period commencing on December 1 following the date of adjustment. The interest rate for the initial period (from the expected initial closing on August 5, 1981 to December 1, 1983) will be determined in early June 1981 based on the procedure described above for the month of May 1981,[1/] and the interest rate for each subsequent period will be determined in early August of each odd-numbered year based on the procedure described above for July of each year.

1/ The interest rate for the initial period is 16.9%.

If the interest rate on the New Bonds as determined above for any subsequent two-year period is 7% or 25%, but, according to the procedure described above, should have exceeded 25% or have been below 7%, then, upon at least six months' notice, PG&E shall have the option of calling all of the New Bonds at 100%, and each institutional investor shall have the right to have all of its New Bonds redeemed at 100%, plus accrued interest in each case, at the subsequent December 1 on which a new interest rate would have been effective.

The New Bonds will not be redeemable prior to December 1, 2001, except when conditions where the optional redemption procedure (as discussed above) are in existence. The New Bonds are redeemable thereafter, in whole or in part, at the option of PG&E commencing in the 21st year and declining ratably to 100% in the 30th year. The initial call price in the 21st year will be determined as if taking the initial interest rate for the period to December 1, 1983 and scaling it down on an equal annual basis to par over 30 years.

The Evidence

PG&E presented testimony through two witnesses, Stanley T. Skinner, Executive Vice President of PG&E, and Roger C. Grimm, Managing Director of Blyth Eastman Paine Webber, Incorporated (Blyth).

The purpose of Skinner's testimony was to present the rationale behind the request for authority to issue mortgage bonds on a private placement basis with a biennial adjustment of the interest rate over a 30-year term. Skinner testified that PG&E expects to raise over $1.1 billion in external capital from the financial markets in 1981, which is in addition to the nearly $9 billion of securities outstanding at the end of 1980. This enormous financing program averages $100 million per month. PG&E finds it difficult to attract new capital because so many investors in utility securities already own or can easily obtain PG&E securities from pools already outstanding; therefore, PG&E must constantly look for new markets and ways in which to offer its securities.

Skinner stated that increasing rates of inflation have made long-term, fixed-rate bonds relatively undesirable investments for insurance companies, the principal investors in utility long-term bonds. Insurance companies have reduced their purchases of such bonds and, instead, have been buying shorter term bonds or bonds with equity participation features. PG&E desires commitment of long-term capital because most of its assets are of a long-term nature, and it appears unwise to PG&E to finance long-term assets through issuance of short-term securities.

In order to attempt to match the large pool of insurance company capital for investment to the need of PG&E for long-term capital commitments PG&E, in cooperation with Blyth, developed the long-term mortgage bonds with features designed to provide inflation protection to the purchaser. To Skinner's knowledge, the only offering similar to the proposed issuance was the sale of 10-year bonds by General Motors Acceptance Corporation to the public, which used a 10-year Treasury constant as a base with adjustments each year.

Skinner urged that the proposed issue of long-term adjustable rate bonds is a pioneering effort and would break new ground for PG&E and for other electric utilities.

Grimm testified as follows. Approximately nine months ago, Blyth presented the concept of an adjustable rate First Mortgage Bond private placement to PG&E. PG&E authorized Blyth to contact various private placement institutional investors to determine possible interest in a long-term bond for PG&E in which the interest rate would adjust biennially. Blyth contacted approximately 25 institutions and had serious discussions with five. The institutions that were not interested in the deal rejected the concept because the 30-year term was too long or they felt they

could obtain a better return by locking up fixed-rate U.S. Government and corporate bonds at today's record interest rate levels. During the January to May 1981 period, Blyth narrowed its discussions to three institutions that were interested in pursuing the financing on terms believed to be advantageous to PG&E. In particular, one major institution, Teachers Insurance & Annuity Association (Teachers), showed significant interest and took a leadership role in the adjustable rate concept. Without Teachers' participation, the likelihood of consummating this financing under current volatile market conditions would be quite low. In early May 1981 the terms of the transaction as presented to the Commission were finalized between Teachers, PG&E, and Blyth.

The monthly data with respect to the monthly average of the 10-year Treasury constant maturities are published monthly by the Federal Reserve system in Statistical Release G.13. The monthly average is the arithmetic average of the corresponding daily yields for the month. The Federal Reserve system obtains its basic data from the U.S. Treasury Department's maturity yield curve. Blyth compared the cost of money on PG&E's long First Mortgage Bond public offerings from 1971 to the present with the 10-year Treasury constant for the month of issue and with the 10-year Treasury constant five months prior to the month of issue. The averages of the differentials between the First Mortgage Bond cost of money as a factor of the 10-year Treasury constant is summarized below:

	10-Year Treasury Constant for F.M.B. Month of Issue	10-Year Treasury Constant 5 Months Prior to F.M.B. Issue
Arithmetic Average	1.202x	1.201x
Dollar Weighted Average	1.197x	1.203x
Regression Analysis	1.198x	1.197x

From its analysis of this historical data, Blyth concluded that 120% of the 10-year Treasury constant was comparable to the cost of money of public PG&E issues of similar maturity and was fully justifiable to PG&E.

Grimm testified that the 10-year Treasury constant was selected as the basis for the pricing of the new issue because, in today's bond market, new corporate debt issues are often priced on the basis of a spread over comparable Treasury securities. The average life of marketable interest bearing U.S. Treasury debt held by private investors is only three years and 10 months. There are only a few Treasury issues with 30-year maturities and even less with 20-year maturities. Grimm stated that there are numerous Treasury securities in the one to seven year maturity range but due to the rapid movements in the yield curve little correlation can be drawn between these bonds and long PG&E First Mortgage Bonds. On the other hand, 10-year Treasury issues are numerous, and Blyth believes a valid correlation has been established between 10-year Treasuries and PG&E long-term bonds.

Grimm stated that typically, private placements in today's market are sold on a fixed rate basis for maturities shorter than 30 years. Most of the maturities are for 15 years or less and require amortization of principal for resulting average lives of about 10 years. The trend of debt maturities, whether they are public or private issues, is towards shorter maturities. During calendar year 1980 utility companies sold approximately $13.2 billion of corporate debt publicly of which approximately $4.3 billion (32.6%) had maturities of five to 10 years. Shorter maturities are a result of changing conditions in our debt markets and institutional lenders' unwillingness to commit to long-term bonds in view of sustained inflation.

Grimm testified that the pricing of the PG&E adjustable rate First Mortgage Bonds reflects the public market rate of approximately 17% for long-term utility bonds, and makes no premium for the 30-year term or the illiquidity of the issue. In addition, the lenders are assuming a credit risk if PG&E's bonds are downgraded during the life of the issue, and there is no formula adjustment if such an event occurs. Conversely, PG&E does not receive any benefit of an upgrading; however, downgradings have far exceeded upgradings in the utility industry over the past 10 years.

Grimm stated that the institutional investors have given PG&E a rate concession in this transaction. In Grimm's opinion, PG&E receives a rate break in this private placement because the transaction is priced right on the public market. The institutional lenders made a concession to PG&E by not requiring a rate premium due to (1) illiquidity, since the bonds are not registered with the Securities and Exchange Commission, or (2) the 30-year nature of the issue. The public offerings analyzed by Blyth on a cost of money basis incorporate seven financings prior to 1975 when PG&E was given a higher credit standing by the rating agencies.

Grimm also believes that there is no less risk to the institutional investors in this transaction compared to a fixed-rate offering, and, in his opinion the risk is higher for the following reasons. The investing institutions have tied up their funds for a period of 30 years. In a conventional fixed-rate long-term public offering, an active trading market exists so that bonds may be sold at any time. In a typical private transaction today, principal is returned relatively quickly since the average life will approximate 10 years. Also, there is a general consensus among government and private economists that interest rates which are presently at record high levels may trend downward in the future. In this event PG&E will adjust its cost of money for this issue downward without having to pay the high redemption penalties associated with conventional long-term bonds.

Blyth believes this innovative financing approach is a breakthrough in private placement financings; a new source of 30-year maturity funds has been secured at a cost comparable to that of long-term public financings. Blyth also believes that financings similar in character will assist future capital formation in the electric utility industry.

The witness presented by the staff was Dr. Stephen M. Schaeffer, Associate Professor of Finance, Stanford University. Schaeffer testified as follows. He agreed with Skinner about the merits of issuing a new type of long-term bond which has a biennially adjusted interest rate.

In Schaeffer's opinion, two important aspects of the new issue are highly arbitrary and, for that reason, it is difficult for him to form an opinion on whether the new issue actually favors PG&E or the prospective lender.

Schaeffer's first criticism of the issue is that, while the interest rate is adjusted every two years, the rate paid is linked to the 10-year Treasury Bond rate. From the point of view of interest rate risk, the proposed issue has a short-term maturity. It is his view that the rate should be linked to a two-year rate, as the New Bond is essentially a two-year instrument, and from the investor's point of view the proposed issue has essentially a short-term maturity. Short-term interest rates more accurately reflect the current rate of inflation, and short-term rates tend to stabilize the real return to the investor. By adjusting interest rates on the 10-year Treasury rate, the close relationship of the New Bond interest rate to the inflation rate is lost.

According to Schaeffer, the current two-year Treasury rate is approximately 16-17%.

In Schaeffer's opinion, the 205 basis point additive above the 10-year Treasury rate may not accurately measure the two components (other than the inflation rate component) of the total interest on long-term utility bonds. Those two components are the real interest, which Schaeffer estimated to approximate 3%, and the utility bond default rate (risk premium), which Schaeffer found difficult to measure because he could find no empirical studies on that subject.

Schaeffer stated that the 10-year Treasury Bond rate contains no risk premium, as Treasury Bonds are essentially risk free. The total interest rate on 10-year Treasury Bonds assertedly represents a combination of the real interest and inflation rate components. The risk premium component of a 30-year utility bond should be a constant, so that the bond holder is not compensated twice for inflation.

Schaeffer recommended that in lieu of establishing the biennial rate for the New Bond on the 20% additive above the 10-year Treasury rate, a fixed basis point premium should be added to the current short-term interest rate based on the differential between the current rates for 30-year utility mortgage bonds and 30-year Treasury rates. The current differential is approximately 240 basis points.

Using the short-term Treasury interest rate of 16-17% (representing the inflation rate component) and the fixed basis point premium of 240 points (representing the real interest rate and risk premium rate components), the interest rate on the initial offering of PG&E's New Bonds would be approximately 18.4 to 19.4% under Schaeffer's recommendations.

Schaeffer explained that he had not had the necessary time or information to calculate the interest rates that would result from his proposal for future periods. He agreed that his proposal could result in higher interest rates over the life of the 30-year bond than the use of the 20% additive proposed by PG&E.

Schaeffer also recommended that the bonds should be issued subject to competitive bidding so that the initial price could be set in the marketplace. In his view, private placement of such an issue makes it difficult to determine whether the most favorable interest rates have been achieved by the issuer.

The position of the staff, as set forth in its closing statement, is that it has no objection to the approval of this application in principle, but it believes that this decision should not be precedent for future matters involving the concept of adjustable rate bond financing. The purpose of Schaeffer's testimony was to show that the additive selected by Blyth and PG&E is arbitrary and that there may be more appropriate methods of adjusting the interest rate components than that selected in this application. Staff urges that these alternative methods be fully explored in a generic proceeding.

Adjustable Rate Feature Of Offering

This is the first request presented to us for approval of a long-term mortgage bond containing an adjustable rate feature. We recognize the need of electric utilities to reach out for new sources of capital and commend PG&E and Blyth for an innovative proposal.

As this application involves an entirely new concept in utility financing, neither the financial community nor this Commission can rely on past experience as a basis for judging whether the varying interest rates over the life of the bond will be fair and reasonable both to PG&E and to its prospective lenders. In approving this application, we rely upon the showing that the interest rate at the time of the initial offering will not exceed the comparable rate for long-term utility bonds without the adjustable rate feature, and that the biennial adjustments in the interest rate are to be predicated on the historical relationship of the average interest rates for PG&E 30-year Mortgage Bonds and 10-year Treasury Bonds.

The evidence produced by the staff shows that there may be other and more appropriate methods of determining the adjustable rates. Schaeffer did not have the necessary time to fully explore alternative methods. He had opportunity only to develop the initial interest rates for the offering under the methods proposed by him, and was unable to furnish data for later periods. Under his method, the initial offering rate would exceed that resulting from PG&E's proposal, and also would exceed the current rate for long-term utility bonds offered without the adjustable rate feature.

In approving the adjustable rate feature of this bond offering, we recognize the experimental nature of the offering and the need for more data concerning the fairness and reasonableness of the resulting interest costs over the life of the bond. This decision is not to be used as a precedent for approval of future offerings of this type.

Exemption From Competitive Bidding Rule

PG&E requests an exemption from the Commission's competitive bidding rule established by Commission Decision (D.) 38614, dated January 15, 1946, as amended from time to time in Case (C.) 4761, for the limited purpose of a negotiated private placement sale for the proposed issue and sale of the New Bonds. PG&E's reasons for requesting an exemption from competitive bidding requirements are set forth in its application and in PG&E's testimony are as follows:

1. This application is designed to raise debt funds from other than such traditional sources. This new source of capital could result in lowering the costs of other PG&E financings for the benefit of its ratepayers.

2. This is a source of capital which can be accessed principally in a private placement. Certain lenders will not buy bonds except on a negotiated basis because of their desire to structure the maturity, refunding, and other terms to their needs at the time.

3. A private placement eliminates the necessity to obtain a rating from the credit rating agencies at a time when PG&E's fixed charge coverages are at substandard levels for a good quality double-A-rated company.

4. A private placement has a lower cost of issuance than a competitive debt offering since certain issuance costs associated with a public offering, primarily in the form of printing costs, fees of the Securities and Exchange Commission rating agencies, and listing on the stock exchanges, are eliminated. The incremental costs of a public offering compared to a private placement of the New Bonds would be approximately $100,000. In addition, the underwriting commission or agent fee of a private placement is considerably less expensive than for a public offering.

The record shows that the issuance costs of debt securities of PG&E offered by a public sale, such as negotiated or competitive offering, would not be less costly than a sale by private placement.

In D.91984, dated July 2, 1980 in A.59633 (San Diego Gas & Electric Company), we discussed the granting of exemptions from the competitive bidding rule, and we clarified the nature of the compelling showing that must be made to warrant an exemption from the rule. We served notice 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.

In D.91889, dated June 3, 1980 in A.59515 (Southern California Edison Company), we denied the request for the private placement on the grounds that there was only one bidder (Saudi Arabian Monetary Agency or SAMA) and that the negotiated interest rate was higher than the interest rate obtainable in the then falling public marketplace for new debt issues.

Because the proposed New Bonds will be sold by private placement on terms which will be negotiated after the issuance of this decision, and because the evidence shows that the New Bonds will be sold with an initial issuance cost as low, if not lower, than would prevail if the New Bonds were to be sold at competitive bidding, we are of the opinion that applying the Commission's competitive bidding requirements and conditions set forth in D.91984 in this proceeding may not be in the best interest of PG&E or its ratepayers.

PG&E requests the Commission find that the California Usury Law does not apply to the proposed issuance and sale of the New Bonds. For the reasons discussed in D.83411, dated September 4, 1974 in A.55080 (Southern California Gas Company), and reaffirmed in numerous other Commission decisions, the Commission in exercising its authority to regulate public utility debt securities is not restricted by the California Usury Law (Article XV, Section 1 of the California Constitution).

Proposed Uses For Proceeds Of Bond Issue

Proceeds from the sale of the New Bonds (exclusive of accrued interest, if any) would be used to partially reimburse the treasury for capital expenditures and thereafter to repay a portion of outstanding short-term notes issued for temporary financing of capital additions and improvements to PG&E's utility plant. Accrued interest, if any, would be used for general corporate purposes.

As of March 31, 1981, PG&E's reimbursed capital expenditures amounted to $1,163,523,000 as shown in Exhibit B attached to the application. PG&E's unexpended balance of General Manager's authorizations for capital additions and improvements under construction as of March 31, 1981, totaled $2,816,860,486 of which $1,297,000,000 is estimated to be spent in calendar year 1981. The distribution of the above construction budget is summarized as follows:

Purpose	Amount
Electric Plant	$2,652,643,682
Gas Plant	105,511,171
Water Plant	393,561
Steam Sales	618,499
Utility Plant Held for Future Use	20,517,038
Common Utility Plant	37,176,535
Total	$2,816,860,486

The Commission's Revenue Requirements Division has reviewed PG&E's construction program and has concluded that PG&E's estimated construction expenditures are reasonable. The division has no objection to the use of the proposed security issue for the purposes specified in the application; however, the division reserves the right to reconsider the reasonableness of any construction expenditures in future rate proceedings.

PG&E's capital ratios as of March 31, 1981 adjusted to give effect to the following:

1. The proposed sale of PG&E's First and Refunding Mortgage Bonds in the aggregate principal amount of $75,000,000;
2. The sale of $250,000,000 aggregate principal amount of its First and Refunding Mortgage Bonds, Series 81A (D.92668, dated February 4, 1981, in A.60154); and
3. The sale of $60,000,000 aggregate principal amount of its First and Refunding Mortgage Bonds, Pollution Control Series B and C (D.92118, dated August 19, 1980, in A.59803)

are as follows:

	March 31, 1981	Pro Forma
Long-Term Debt	43.3%	45.6%
Preferred Stock	16.2	15.6
Common Equity	40.5	38.8
Total	100.0%	100.0%

Findings of Fact

1. PG&E, a California corporation, operates under the jurisdiction of this Commission.

2. The proposed New Bond issue is for proper purposes.

3. PG&E has need for external funds for the purposes set forth in the application.

4. The sale of the proposed New Bonds should be exempted from the requirements of the Commission's competitive bidding rule for the limited purpose of a negotiated private placement sale.

5. The money, property, or labor to be procured or paid for by the issue of the New Bonds is reasonably required for the purposes specified, which purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income.

Conclusions of Law

1. Under the 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 this Commission as it deems necessary and appropriate, unrestricted by any other provisions of the California Constitution.

2. The Legislature has conferred upon this Commission the authority to regulate the issuance of public utility securities, including evidence of indebtedness, and to prescribe restrictions and conditions as it deems reasonable and necessary (PU Code §§ 816 et seq.).

3. Under the plenary powers granted to the Legislature in Article XII, Section 5 of the California Constitution, it conferred on this 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 this Commission's regulation of such issuances of public utility securities, including its authorization of a reasonable rate of interest.

4. If the usury limitation contained in Section 1 of Article XV of the California Constitution is exceeded, but the transaction is authorized by this Commission, PG&E, 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 PG&E of the New Bonds in compliance with authorization by this Commission, persons collecting interest on such authorized New Bonds are not subject to the California Usury Law sanctions.

5. The application should be granted to the extent set forth in the order which follows.

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

This decision is not intended to modify the competitive bidding rule initially established in D.38614 as amended by the Commission in subsequent decisions in C.4761.

O R D E R

IT IS ORDERED that:

1. Pacific Gas and Electric Company (PG&E), on or after the effective date of this order and on or before December 31, 1981, may issue and sell its First and Refunding Mortgage Bonds, having substantially the same terms and conditions contemplated by the application, in the aggregate principal amount of $75,000,000, by private placement.

2. The proposed issuance of PG&E's First and Refunding Mortgage Bonds is exempted from the Commission's competitive bidding rule set forth in D.38614, dated January 15, 1946, as amended in C.4761, for a private placement only.

3. PG&E is authorized to pay on its First and Refunding Mortgage Bonds an interest rate in excess of the maximum annual interest rate otherwise permitted under the California Usury Law, as contained in Section 1 of Article XV of the California Constitution, if market conditions so require.

4. Neither PG&E 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 its First and Refunding Mortgage Bonds 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.

5. PG&E shall use the net proceeds from the sale of its bonds for the purposes referred to in the application.

6. PG&E shall file the reports required by General Order Series 24.

The authority granted by this order to issue First and Refunding Mortgage Bonds will become effective when the issuer pays $43,500, the fee set by PU Code § 1904(b).

Dated AUG 4 1981, at San Francisco, California.

President

Commissioners