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Decision 97-04-022 April 9, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of of Pacific Bell for an Exemption Pursuant to the Public Utilities Code Section 853(b) or, in the Alternative, Authority Pursuant to Public Utilities Code Section 851 for the Lease and Sale of Assets to Pacific Telesis and Affiliates.	Application 95-12-054 (Filed December 15, 1995)

OPINION

1. Summary

Today's decision disposes of the two remaining matters in this proceeding. The first matter, reserved for further consideration by our interim opinion (Decision (D.) 96-11-019), concerns the request by the applicant, Pacific Bell (Pacific), for approval of the lease and sale of certain assets to an affiliate, Pacific Telesis Legal Group (PTLG). We now grant our approval. The second matter concerns the petition of the California Association of Long Distance Telephone Companies (CALTEL) for modification of D.96-11-019. We deny this petition. With the disposition of these two matters, we close this proceeding.

2. Lease and Sale of Assets to PTLG

2.1 Background

Pacific seeks approval of the sale to PTLG of most of the assets, with one exception, used by Pacific's former Legal Department. The exception is certain modular furniture at Pacific's San Ramon Valley facility. This furniture is currently leased to Pacific's corporate parent, Pacific Telesis (Telesis); Pacific now wants to lease the furniture to PTLG. Pacific

represents that these sales and leases follow the applicable affiliate transaction rules.[1]

Pacific summarizes allowable compensation under the affiliate transaction rules as follows. For leases of Pacific's property to an affiliate, the affiliate must pay Pacific the higher of the market rate or fully distributed costs plus 10%. For sales, the affiliate must pay Pacific the higher of the market price or net book value plus incremental transaction costs. As we discussed in the interim opinion (see D.96-11-019, mimeo., p.6), requiring adherence to the affiliate transaction rules reasonably protects the interests of the utility and its ratepayers as to the price terms of the proposed transactions.

There were no protests to Pacific's application. In D.96-11-019, we granted approval for the bulk of the leases and sales covered by the application.[2] We noted, however, that the proposed transactions with PTLG raised some distinct issues beyond the price terms of those transactions. Today, we are ready to address those issues.

2.2 Joint Ruling

By joint ruling issued September 16, 1996, the assigned Commissioner and Administrative Law Judge requested more information on Pacific's dealings with PTLG. As described in the

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1 Pacific indicates that it follows applicable rules of this Commission and of the Federal Communications Commission when it enters agreements for the lease or sale of assets to affiliates. Regarding the applicable rules, Pacific cites D.86-01-026, 20 CPUC2d 237 (1986), D.87-12-067, 27 CPUC2d 1 (1987), and 47 CFR §§ 64.902 and 32.27. In addition, Pacific indicates that it has followed its own "Category III Below-The-Line Affiliate Guidelines," adopted pursuant to D.92-07-072.

2 These other leases and sales were to several Telesis subsidiaries (specifically, Pacific's former Corporate Communications, Public Affairs, and Corporate Television Groups); the transactions did not involve PTLG.

application, PTLG could provide legal services to any member of the Telesis corporate family, not just to Pacific. Such provision of legal services raised concerns regarding protection of ratepayer interests and prevention of anti-competitive conduct. The ruling therefore asked Pacific to respond to the following questions:

1. How would the creation of PTLG affect the way Pacific obtains legal services?

2. Do Pacific's ratepayers benefit from the creation of PTLG? If so, describe.

3. Some members of the Telesis corporate family may become competitors of Pacific. This circumstance suggests that there may be potential conflicts if PTLG were to represent both Pacific and a competing member of the Telesis corporate family.

    a. Do PTLG and Pacific plan to screen situations for potential conflicts of the kind described? If so, how would such screening be performed?

    b. How would PTLG and Pacific address and resolve potential conflicts of the kind described?

    c. If PTLG becomes privy to any information (e.g., trade secrets, privileged communications) that Pacific would not voluntarily disclose to a competing entity, how would PTLG secure the confidentiality of such information?

    d. Who would make the decision to retain outside counsel (PTLG or the Telesis company being represented)?

    e. If the decision is made to retain outside counsel, who would supervise outside counsel, and who would be the client (PTLG or the Telesis company being represented)?

2.3 Pacific's Response

Pacific made the following general representations in response to the joint ruling. The reason for reorganizing the delivery of legal services to the Pacific Telesis Group and its subsidiaries, including Pacific, was to improve efficiency through (1) consolidating attorneys and legal staff in-house, and (2) requiring the new PTLG to cover its own costs by charging Pacific and other Telesis clients for services rendered. These clients, in turn, would gain greater control over their legal costs through the ability to retain outside counsel if PTLG could not demonstrate superior service at lower cost. In particular, Pacific would be able to negotiate both the charges for and the nature of the legal services it gets from PTLG. Pacific believes that it will realize substantial savings from the new arrangement, and that these savings will ultimately benefit ratepayers. See Pacific's Response at pages 1-2.

Pacific makes the following three arguments regarding potential conflicts of interest. First, Pacific asserts that as a matter of antitrust law, wholly owned subsidiaries of one corporation do not "compete" with each other. The ultimate "clients" are the shareholders of the corporation, and there is no "conflict" in their interests. See id. at pages 3-4.

Second, Pacific notes that the Rules of Professional Conduct do not preclude a lawyer or law firm from representing competitors. However, Pacific acknowledges that "[t]he Rules... bar representation of adverse interests in a matter without the informed, written consent of the parties....If contrary to expectations, Pacific...were to take a legal position adverse to another Telesis entity, PTLG could either obtain the requisite written consent, or one or both of the affiliates could retain outside counsel." Id.

Third, Pacific stresses that "the creation of PTLG does not, as a practical matter, change the situation. The same issue

[regarding adverse interests] could have arisen in the former [corporate] structure. In fact, before AirTouch Communications was spun off, there were occasional differences of opinion between subsidiaries, and pleadings stating opposing points of view were filed, after oversight from the Pacific Telesis Group holding company." Id. In short, Pacific asserts that the ability to identify potential conflicts has been enhanced by creation of PTLG, and that if such a conflict were actually to arise, it would require resolution regardless of how Telesis organizes its in-house legal resources. See id. at pages 4-5.

Pacific makes the following argument regarding Pacific's proprietary information to which PTLG becomes privy. Material that a client provides to its attorney, including the client's proprietary information and intellectual property, belongs to the client, not to the attorney. PTLG attorneys continue to have access to Pacific's material that they had used in the past, but the material still belongs to Pacific. Moreover, "[m]aterial received by PTLG attorneys from [Pacific] is not shared with other Telesis affiliates." Id. at page 7. Pacific asserts that its attorneys observed this restriction before the creation of PTLG, and the transfer of attorneys to PTLG has not changed the situation: "In short, PTLG attorneys understand that they must protect valuable client information from disclosure to others, including other client groups." Id.

2.4 Discussion

We have not previously addressed, in connection with PTLG, the issues posed by the joint ruling. While the transactions proposed in the application do not directly raise these issues, ratepayer interests and the public policy supporting development of full and fair competition in the telecommunications industry suggest that we carefully demarcate the scope of what we are approving in today's decision.

The lease and sale of office furniture and equipment to PTLG, which is the authority specifically requested in the application, should be approved for the reasons supporting the approvals previously granted in D.96-11-019. Those reasons are, first, that the price terms proposed by Pacific, pursuant to the affiliate transaction rules, are reasonable; and second, that the assets subject to lease or sale are not the kind of property whose control would confer unique advantages on Pacific's affiliates.

Access to or control of Pacific's proprietary information through PTLG would confer a unique advantage on Pacific's affiliates; however, such access or control is not contemplated by this application, and is expressly disavowed by Pacific in its response to the joint ruling. We agree with Pacific that the creation of PTLG does not affect Pacific's ownership interest in its proprietary information and intellectual property.

We also agree with Pacific that the potential for business conflicts and actual adversity was present within the Pacific Telesis Group before the creation of PTLG. Pacific may be correct in saying that it will more easily identify and respond to such situations now than before PTLG existed.

We caution Pacific, however, that the conflict-of-interest problem is not defined solely by the treatment of wholly owned subsidiaries under antitrust law.[3] Pacific should also bear in mind, in addressing this problem, both the ethical rules governing attorney conduct and our general telecommunications policies. Furthermore, our specific rules on affiliate transactins have broader relevance to this problem than simply setting the requisite compensation PTLG owes to Pacific under the sales and leases. We discuss these rules and policies below.

3 We express no view regarding Pacific's analysis of antitrust law.

Attorneys have ethical obligations regarding conflicts of interest. In California, these obligations arise both from the Business and Professions Code and the Rules of Professional Conduct. Those obligations, as we understand them, require PTLG attorneys to devote the same loyalty and zeal to Pacific as any unaffiliated attorney would devote to a client when that attorney is asked to represent another entity whose business or litigation interests conflict with the client's. Pacific, in turn, should demand the same loyalty and zeal from PTLG that Pacific would demand from unaffiliated counsel.

A more immediate concern for this Commission is the harm to our telecommunications policies that would result from Pacific's affiliates getting improper access to Pacific's proprietary information. We are trying to create the conditions for full and fair competition in the provision of telecommunications services in California, so that consumers may enjoy the benefits of a competitive market for those services. Clearly, competition would suffer if Pacific were to directly subsidize market entrants affiliated with Pacific.[4] We have analyzed Pacific's response to the joint ruling and have concluded that Pacific is aware of this concern and is committed to conduct its relationship with PTLG accordingly.

Finally, we note that our existing affiliate transaction rules require that Pacific be compensated for any proprietary information or intellectual property it provides to an affiliate.

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4 Prevention of cross-subsidization is the chief purpose of the affiliate transaction rules discussed in today's decision. See note 1 above and the accompanying text.

Pacific's own "Category III Below-the-Line Affiliate Guidelines," developed and implemented pursuant to D.92-07-072, contain a detailed tracking procedure to ensure compliance with this requirement. Under the procedure, whenever Pacific provides an affiliate with such information or property, and such provision is not associated with an underlying good or service, Pacific tracks the employee who provides the information or property and the affiliate employee who receives it; identifies the information or property provided (with the date it was or will be provided); and specifies the compensation paid by the affiliate (with explanation of how the compensation amount was derived).

The affiliate transaction rules and guidelines clearly apply to a Pacific employee performing legal services for Pacific. Pacific must continue to ensure it complies with these rules and guidelines when it gets legal services from an affiliate. Bearing in mind this continuing compliance obligation, Pacific should review its Category III Guidelines. If Pacific concludes that additional or modified guidelines are needed in order to clarify, consistent with today's decision, its relations with outside attorneys, Pacific should submit proposed changes to the Telecommunications Division for approval. Pacific should complete its review and submittal within 30 days of the effective date of this decision.

We emphasize that we are not objecting to the creation of PTLG, nor are we endorsing it. In general, we believe the management of Pacific or any other regulated utility can and should decide how best to run the enterprise, including the allocation of work between utility personnel and outside contractors. Nothing in today's decision runs counter to that belief.

3. Petition for Modification

In this application, Pacific had sought, both for these transactions and for all future sales or leases to Telesis or affiliated entities, an exemption from Public Utilities (PU) Code §

851.[5] That statute says in relevant part that a public utility, such as Pacific, may not "sell, lease...or otherwise dispose of its...line, plant, system, or other property necessary or useful in the performance of its duties to the public...without first having secured from [this Commission] an order authorizing it so to do." We denied this request in D.96-11-019, and CALTEL, supported by Pacific, has petitioned to modify the decision regarding the basis of our denial. We deny CALTEL's petition for reasons discussed below.

In requesting the exemption, Pacific relied on § 853(b), which says in part:

> The commission may...by order or rule...exempt any public utility or class of public utility from [the requirement of prior approval] if it finds that the application thereof with respect to the public utility or class of public utility is not necessary in the public interest. The commission may establish rules or impose requirements deemed necessary to protect the interest of the customers or subscribers of the public utility or class of public utility [so] exempted....

We rejected Pacific's request for a blanket exemption under § 853(b) from the requirement of obtaining prior Commission approval for sales or leases of assets to its affiliates. As we explained (D.96-11-019, mimeo., pp. 4-5):

> The statute does not authorize us to exempt a class or classes of transfers per se from the requirements of § 851. Rather, the statute allows us to exempt a "public utility or class of public utility."
>
> The increasing competition in electric and telecommunications services [cited by Pacific as supporting the requested exemption] does not in itself justify exempting either electric or

5 All code section ("§") citations are to the PU Code.

> telecommunications utilities, as a class, from the requirement of § 851. Indeed, in such an environment, transfers between a utility and its affiliates may raise concerns about competitive impacts, beyond the traditional regulatory concern that the utility receive appropriate compensation for the transferred property.

CALTEL contests our statement above, which is repeated in the first conclusion of law in D.96-11-019, that § 853(b) does not allow exemption "of a class or classes of transfer per se" from § 851. CALTEL notes that the Commission has regularly granted exemptions from § 851 to individual CALTEL members, who are nondominant interexchange carriers (NDIECs). For example, recent decisions granting a certificate of public convenience and necessity to such applicants typically have contained an ordering paragraph that says the applicant is exempt from § 851 for transfer or encumbrance of property, whenever such transfer or encumbrance serves to secure debt. Thus, according to CALTEL, the Commission has exempted a specific "class of transfers" in these instances.

We have no problem with the exemptions that CALTEL has cited. We disagree, however, with CALTEL's view that those exemptions are premised on the class of transfer per se, irrespective of the class of utility involved.

The starting point for our § 853(b) exemption analysis is the characteristics of the utility applying for such exemption. Specifically, what generic characteristics of the applicant, as a particular type of public utility or as a member of some subset of that type, make the requested exemption appropriate?

In the case of CALTEL's members, the Commission has analyzed, starting as far back as 1984, the characteristics of NDIECs as a subset of telephone utilities. That analysis has led the Commission to conclude that NDIECs should be exempted from certain otherwise applicable requirements for review, under § 851,

of specific transactions.[6] Such analysis exemplifies the regulatory process that § 853(b) contemplates and that we endorsed in D.96-11-019. Nothing in our discussion in that decision would jeopardize, directly or by implication, the exemptions we have previously accorded NDIECs.

In contrast, Pacific has offered no such analysis to support its application for a blanket exemption in this proceeding. Pacific merely asserts that the Commission has or can impose safeguards to protect the public interest. As we noted in D.96-11-019, the availability of such safeguards would justify approval of the proposed transactions under § 851; the safeguards do not justify, without some further showing (e.g., that the telephone industry has evolved to the point that ratepayers are now indifferent to transactions between local exchange companies and their affiliates), a generic exemption for Pacific from § 851 review.

Pacific, in its filing in support of the CALTEL petition, suggests that the Commission could apply § 853(b) to exempt transfers that are less than a specified dollar amount. Again, we emphasize that any such exemption should relate to the characteristics of the utility; in Pacific's example, we would have to consider at least the size of the utility to which the dollar threshold would apply. A small transaction (in total dollar value) from Pacific's perspective could represent most of the value of the assets of a small water company or local exchange carrier. In the latter cases, an exemption in effect would allow transfer of the utility without Commission review or approval, which was not the

6 See, e.g., D.85-01-008 (in Application 84-03-092), where we exempted NDIECs from §§ 816-830, dealing with issuance of stock and debt.

intent of the Legislature in allowing us to craft exemptions where § 851 review "is not necessary in the public interest."

In short, the Commission must examine the utility or class of utility to which it grants an exemption under § 853(b), and this is true regardless of whether the exemption is a blanket exemption or is limited to a specific class of transfers. We conclude that D.96-11-019 is a correct statement of the law and needs no modification on this point.

<u>Findings of Fact</u>

1. The remaining issue in Pacific's application, which is disposed of in this decision, is Pacific's request for approval of the sale to PTLG of most of the assets, with one exception, used by Pacific's former Legal Department. The exception is certain modular furniture at Pacific's San Ramon Valley facility. This furniture is currently leased to Telesis; Pacific now wants to lease the furniture to PTLG. Pacific represents that these transactions follow the applicable affiliate transaction rules.

2. Requiring adherence to the affiliate transaction rules reasonably protects the interests of the utility and its ratepayers as to the price terms of the proposed transactions.

3. Pacific is one of several subsidiaries of Telesis.

4. Telesis intends that PTLG could provide legal services to any member of the Telesis corporate family, not just to Pacific.

5. This application does not concern access to or control of Pacific's proprietary information. Although PTLG attorneys will continue to have access to Pacific's proprietary information as they had when they were employees of Pacific, the proprietary information continues to belong to Pacific. Furthermore, Pacific represents that PTLG attorneys are trained to protect Pacific's property from disclosure to others, including other client groups.

<u>Conclusions of Law</u>

1. No competitive or other concerns bar the granting of the requested authorization of Pacific's sale and lease of certain assets used by PTLG. These transactions should be approved subject to Pacific's compliance with the affiliate transaction rules.

2. Attorneys have ethical and legal obligations to deal with conflict-of-interest problems.

3. Pacific should ensure, consistent with the Commission's general telecommunications policies and the affiliate transaction rules, that no undue business advantages accrue to its Telesis affiliates through Pacific's use of PTLG's services.

4. In granting an exemption under § 853(b), the Commission must examine the generic characteristics of the utility applying for the exemption. This is true whether the exemption is a blanket exemption from § 851 review or is an exemption limited to a specified class of transfers.

5. There is no need for a public hearing.

6. In order to avoid further delay and complication in Pacific's business planning, today's decision should be made effective immediately.

O R D E R

IT IS ORDERED that:

1. Pacific Bell (Pacific) is authorized to lease certain San Ramon Valley furniture assets (listed in Exhibit F of Pacific's application) to Pacific Telesis (Telesis), pursuant to Exhibit B of the application. Effective January 1, 1996, Pacific is authorized to lease these assets to Pacific Telesis Legal Group (PTLG), pursuant to Exhibit G of the application. The Telesis and PTLG leases shall comply with the affiliate transaction rules, as set forth in Decision (D.) 86-01-026, D.87-12-067, and D.92-07-072 of this Commission and in the regulations of the Federal

Communications Commission codified at Title 47 of the Code of Federal Regulations.

2. Pacific is authorized to sell to PTLG certain assets (listed in Exhibit H of the application). Pending the sale, Pacific is authorized to lease these assets to PTLG, pursuant to Exhibit B of the application. Such sale and lease shall comply with the affiliate transaction rules, as specified in Ordering Paragraph 1.

3. The petition by the California Association of Long Distance Telephone Companies for modification of D.96-11-019 is denied.

4. This docket is closed.

This order is effective today.

Dated April 9, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners