Decision No. 1254

BEFORE THE RAILROAD COMMISSION
OF THE STATE OF CALIFORNIA.

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ORIGINAL

CITY OF SAN JOSE,

Complainant,

-vs.-

PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation,

Defendant.

Case No. 387.

John W. Sullivan for complainant.
Pillsbury, Madison & Sutro and Felix T. Smith for defendant.
B. S. Crittenden for Councilman F. R. Husted.

ESHLEMAN, Commissioner.

OPINION ON APPLICATION FOR REHEARING.

This case was decided on the 9th day of October, 1913. Thereafter, within the time allowed by law, the defendant and certain of the stockholders of the defendant company applied for a rehearing. Testimony was taken on the application for rehearing on December 28th and again on January 13th and 14th. On account of the unavoidable absence of the Commissioner hearing the case originally, Commissioner Thelen very kindly consented to take the testimony of the witnesses on January 13th and 14th. I have, however, carefully considered this testimony in reaching the conclusions herein set out.

The main objection of the defendant and of its stockholders to the decision heretofore rendered is directed against that portion of the decision which limits the American Telephone and Telegraph Company to 2½% instead of 4½% which it secures under its contract for services performed. In the decision heretofore rendered, the Commission took the position that inasmuch as this contract was between one corporation, the American Telephone and

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Telegraph Company, and another corporation, the Pacific Telephone and Telegraph Company,-which latter corporation is controlled through stock ownership by the former corporation-the contract should be scrutinized with the utmost care, and if the amount paid by the Pacific Company to the American Telephone and Telegraph Company was found to be excessive, only that amount should be allowed as a charge against the operating expenses of the Pacific Company which is a reasonable compensation for what is actually done and the lowest reasonable amount for which such service could be performed.

The Commission reached this conclusion because of the following considerations: Of course it is too well established to need citation of authority, that any improvident or extravagant expenditure made by a public utility should not be allowed in its entirety when rates are to be fixed, but only that amount which reasonably and providently should have been expended. Under the peculiar facts of this case and having in mind the far reaching effect of the practice here in question, I consider it necessary to announce the position of this Commission with reference to such practices in plain and unmistakable terms.

Nowadays, the owners of property devoted to a public use in a business which is what is commonly styled a natural monopoly are urging that such natural monopoly should be protected in its field of operation from competition, on the ground that competition divides the business and duplicates the property, thus producing a necessity for higher rates. On the theory that a natural monopoly, such as a telephone company, can give better service at lower rates to its patrons when operating alone in a field than can possibly be given when a portion of its business is taken from it and more property utilized in the particular field upon which an earning shall be required, these utilities urge that they should be permitted to operate free from competition. And this theory, upon which it is urged that natural monopolies shall be protected from competition,

is justified on the ground of a benefit to the public. While this theory may be ever so sound it does not lie in the mouth of a utility representative to urge such protection on the ground that such protection is good for its patrons, when, as a matter of fact, it does not accord to its patrons the benefits such monopoly is supposed to produce. The fact that better service and lower rates usually are attendant on competition even between natural monopolies, naturally leads to the conclusion on the part of patrons of natural monopolies that the better service and lower rates are the result of such competition. Of course such is not the fact, because however low the rate and however good the service may be given under competition between two agencies where one could do the work, the rate could be lower and the service better if the one were unmolested. This, of course, is capable of mathematical demonstration, but those of us who are engaged in public utility regulation have long ago lost patience with the contention of the monopolist that his monopoly shall be protected on the ground that it affords a benefit to the public, when as a matter of fact, it brings about and is attended by added burdens upon the public, and too often results in management oblivious to the public welfare. Life is entirely too short to be utilized in trying to make natural monopolies do what they say they can and ought to do without competition. If their own self interest does not lead them voluntarily to do that which they should do, they cannot long expect the public to protect them when such protection instead of benefiting the public as patrons rather subjects such patrons to abuses that do not exist under competition.

I cannot urge too strongly upon the utilities in this State that are now protected by a certificate of public convenience and necessity, the fact that however sound this provision is in theory, if it does not work out in practice it will be eliminated. It can only be justified in the minds of the public on the ground that it is good for the public and it can only be demonstrated that it is good for the public if, as a matter of fact, the public can be

shown benefits resulting from it.

In very few cases has this Commission refused to permit competition to exist, and in those cases we are beginning to be presented with charges that the agency thus protected from competition is becoming arrogant and forgetful of the rights of the public. Self interest apparently makes the most potent appeal, and if utilities are to be so short-sighted that they cannot see that self interest requires as considerate and honest treatment of their patrons when there is no competition as is accorded when competition exists and in addition lower rates and better service, then some other method than regulation must be found to make them realize this fact. This results because this Commission is not and cannot be equipped with sufficient employes to watch every utility employe and scrutinize every utility practice in this State.

What has just been said has a direct bearing on the case here presented, and led me to suggest to the representatives of the Pacific Company and the American Telephone and Telegraph Company that it was not enough for them to show that the Pacific Telephone and Telegraph Company for the 4½% which it pays secures as much or more than it could secure elsewhere than from the American Telephone and Telegraph Company, but that the American Telephone and Telegraph Company was getting no more out of the 4½% than the amount for which it could reasonably perform the services rendered. For if such is not the case there would be brought about a result where it is attempted to justify a condition of monopoly on the part of the American Telephone and Telegraph Company, while giving to it, the monopoly, the benefit which is supposed to be accorded to the public and which alone could give sanction to such monopoly.

The Pacific Gas and Electric Company serves many localities in this State with electricity and gas. I merely take this company as an illustration because of the extent of its operations. Suppose that company instead of dealing directly with all of the municipal-

ities within the territory served by it, should organize companies in each of such municipalities and then organize a holding company which would own the stock or a controlling interest in the stock of these local companies, and should sell its commodity in bulk to these subsidiary agencies which it controls and should arbitrarily fix the price which was not the price at which the holding company could afford to produce the commodity but the price which the controlled company could be induced to pay. Under the present condition the Pacific Gas and Electric Company, in a rate fixing inquiry, shows what it costs it to produce its commodity, but in the suggested instance such would not be the case, but the amount charged against the consumers would be that which the local company would have to pay for its electricity or gas and not the cost of production. Thus we have a condition exactly analogous to the one here where the American Telephone and Telegraph Company controls the Pacific Telephone and Telegraph Company, and various other telephone and telegraph companies throughout the United States, and performs for them certain services under contracts at rates dictated by itself. I submit that if this condition is to be permitted to exist, what it costs the American Telephone and Telegraph Company to perform the service which it actually performs for the Pacific Telephone and Telegraph Company is the only thing which this Commission ought to consider and the only thing for which either the Pacific Telephone and Telegraph Company or the American Telephone and Telegraph Company, in face of the relation which exists between them, has a right to contend.

This was the position taken in the original decision in the case before us, but nevertheless finding it impossible to apply it in its entirety we located all of the services which we could find are performed by the American Telephone and Telegraph Company in the San Jose area, and put upon that service the price for which these companies contend and found that the amounts thus arrived at

only equal 2½% of the gross collected in the area in question.

The American Telephone and Telegraph Company, hereinafter called the American Company, intervening as a stockholder, produces evidence along the line suggested by this Commission, and attempts to show that it actually costs it to perform the services which it performs for the Pacific Telephone and Telegraph Company, hereinafter called the Pacific Company, an amount approximating that which it receives.

The American Company controls twenty companies and has its operations grouped into eight divisions: the New England divizion, the eastern division, the southern division, the central division, the northwestern division, the southwestern division, the mountain division, and the Pacific division.

The Pacific division, wherein the Pacific Company operates, includes California, Nevada, Oregon, Washington and a part of Idaho.

The bonded indebtedness of the American Company amounts to $163,604,000, and it had outstanding on November 30, 1913, $344,606,400 par value of common stock. The bonds of this company bear interest at 4, 4½ and 5 per cent. This company owes on notes $12,550,000 and pays thereon 5% on all but $1,500,000, and 5½% on that amount. This borrowed money was used in the purchase of securities in the associated companies and in the purchase of telephone instruments, additions to long distance lines, and for working capital. Most of the property of this company consists of the stock and bonds of its associated companies. The American Company has regularly since 1907 paid 8% dividend on all of its stock and has in addition thereto been setting aside certain amounts to surplus, averaging more than $3,000,000 per year. The operation of this company is twofold. It carries on what it calls its long lines department, which consists of certain long distance development, none of which is in the territory of the Pacific Company, and its general department, which controls and manages the associated companies. Slightly less than $50,000,000 is invested in its long lines department, leaving the

remainder of the estimated value of its property, approximating $560,000,000, in its general department. Regardless of this fact it is in evidence that there are 4090 employes of this company in its long lines department, while there are only 574 employes in the general department. The company has an income of approximately $300,000,000 per year and it carries a surplus usually around $35,000,000.

The American Company and its predecessor, the National Bell Telephone Company, own the fundamental telephones covering the invention of Dr. Alexander Graham Bell, and those companies subsequently acquired other patents for improvements on telephones and transmitters. The American Company had the telephones and transmitters manufactured and licensed them to companies formed in various portions of the United States. The payment for the use of the instruments was originally a flat sum per instrument or pair of instruments. Subsequently, on the 29th of November, 1902, there was substituted for the payment for the licensed instruments used by the Pacific Company a straight 4½% of the gross income of the Pacific Company. As far as the contract, which is the basis of the 4½% payment, is concerned, the only obligation which rests upon the Pacific Company is the obligation to pay for the rental of telephones, and there is no legal obligation resting upon the American Company, so far as can be learned from the contract, requiring it to do more than furnish the licensed instruments. The practice has grown up, however, whereby the American Company performs various other services in addition to the mere rental of instruments for the Pacific Company, and it is urged that these services are of such a nature that the 4½% is justified.

The general department, in which there are but 574 employes, is the department which alone performs these services. It is in effect an organization of advisors who supervise the various departments of the local companies. For such advice and the other services heretofore referred to, the American Company received in 1912

from the Pacific Company $728,189.68. It is urged that the services are very valuable to the Pacific Company and costly to the American Company; and there is evidence that the services performed are both valuable to the Pacific Company and expensive to the American Company, but they are of such a general nature that it is impossible to compute them. It is apparent, however, that the expense of the business management of this holding company is also, by the method here involved, saddled upon the local companies. Aside from the admitted services performed by the American Company it is in effect a banking and bond house carrying a large surplus and loaning the same to its subsidiary companies when needed, but replenishing it from the revenues received from the dividends on the stock which it holds in the subsidiary companies and from the 4½% which it secures from them. Likewise, it holds stocks and securities of these local companies, and the business administration which would be necessary to take care of this tremendous fund would appear to require many of the employes in the general department whose services are, under the arrangement here in force, charged up against the subsidiary companies.

The fact that the long lines department, using one-tenth the property, has ten times as many employes shows the difference between the kind of an organization represented in the general department and that represented in the long lines department where actual telephone business is carried on. I believe that an arrangement has here been brought about where it actually would be necessary and advisable to protect and further its own interest, for the American Company to perform whatever services it does perform for its subsidiary companies, and that its own business, wherein it secures 8% for its stockholders, requires it to retain this organization; and it is certainly very apparent that the surplus which it is enabled to carry is the result of the monopoly and the control which it exerts over its subsidiary companies, and it is not proper to say that it would be more expensive for these companies to

finance themselves, if they were broken up, than is now the case, unless it is proper to say that a monopoly may justify its existence and also keep the benefits which are supposed to flow from the monopoly to the patrons thereof. Furthermore, by this arrangement, the American Company secures a market for the product manufactured by one of its subsidiary companies-the Western Electric Company-, secures a large field for the exploitation of any patented articles which it controls and is furnished a field wherein to operate with its experts looking to the betterments of telephone facilities, which latter, of course, benefits the public but likewise benefits the American Company. It makes a profit from the sale and rental of its instruments as well as the material and supplies furnished its subsidiary companies, because the agency manufacturing these instruments and dealing in these supplies is an agency controlled by the American Company and upon the stock of which it secures a dividend. In every field of its operation, if the American Company were performing the service directly for its own patrons and not for patrons of its subsidiary companies, the cost of performing the service would appear in operating expenses and no profit would be allowed. The profit which would be allowed to it under these circumstances would be a return upon the property actually devoted to the public service after all of the operating expenses and other legitimate charges had been paid, and would not include the profit which is now secured through the Western Electric Company or upon the patented articles in which it deals or the profit and advantage which comes to it by reason of its ability to have always available a large surplus, which we have already discussed.

The testimony does not show, even permitting the saddling of the expense upon the subsidiary companies of the management of this large financial concern which is carried on in the interest of the stockholders of the American Company and not primarily in the interest of the subsidiary companies, that even on this basis the cost of doing the business equals the amount received from it.

The Commission in the San Jose case reduced the 4½% to 2½%, thereby bringing about a 44% reduction in the amount allowed to the American Company, and it is in testimony that the cost of performing this service for the subsidiary companies has been from 10 to 20 per cent less than has been secured, even when the entire cost of doing what is, in my judgment, unrelated business, is put upon the subsidiary companies. I am very strongly of the opinion that although, as I have already said, the exact cost of performing these services if they were performed by a disinterested agency is impossible of computation, yet the additional reduction imposed by the Commission is justified, even admitting, as I do not, the propriety of taxing the subsidiary companies for the business management of the American Company. And finally, when we consider that this controlling company, even admitting the validity of its contract with its creature company here under consideration, is not obligated legally to perform the services upon which it seeks to justify a charge admittedly in excess of the proper payment for the service which it is legally bound to perform, we are led to conclude that there is small merit in its contention that it performs these additional services for the benefit of the subsidiary companies and their stockholders and not for the benefit of its own stockholders.

It is in testimony that over 90% of the investment of the American Telephone and Telegraph Company is invested in the subsidiary companies and less than 10% in the long lines company. The three sources of revenue of this company are from the long lines company, the dividends on securities of the subsidiary companies and the 4½% contract. If for each share of the American Company's stock there were held by this company one share of stock in the subsidiary companies, it of course would follow that unless 8% were earned on each share of the stock of the subsidiary companies owned by the American Company, the American Company could not earn 8% on its stock, to say nothing of a $3,000,000 accumulating surplus annually, unless the 4½% contract or the long lines business made up the difference.

It follows that if the subsidiary companies are not as prosperous as the American Company the 4½% contract must be a profitable contract to the American Company, and I am convinced from the evidence that it is, and I would expect to find it such, from the standpoint of the American Company, and am more confirmed in this belief by the very fact that it maintains this contract with companies in which it does not own all the stock, because we do not find commercial business agencies voluntarily and knowingly entering into a contract-and in this case a contract which could be forced, if the American Company desired it-in the benefits to which others, not parties to such contract, participate, unless the contracting agency thus voluntarily and knowingly entering into this relationship believes such contract does not work to the advantage of some one who does not pay for such advantage. In other words, we would not find this company originally willing to enter into a contract and now contending that it shall be upheld if the minority stockholders of the Pacific Company were getting something out of this contract for which they did not pay.

If instead of a holding company and these subsidiary companies we substitute a single agency, it will readily appear that a profit on these services here considered could not be permitted because it would be a profit on operating expenses and not an earning on property, and such being the case, an indirect profit which is a diversion through operating expenses to dividends of the American Company should not be permitted.

I have discussed these matters somewhat in detail and have given very serious and careful consideration to the evidence because I desire to present to this Company as clearly as I may the inclination of this Commission with reference to this matter. However, in the case before us, only a very small portion of this company's business is considered and it may be improper to conclude this matter in this proceeding. I believe the rates ordered in the case are just rates under all the circumstances of the case,

and while I think it will be apparent what the inclination of the Commission is with reference to this 4½% charge from what has been here said, still I am willing that it shall not be considered as concluded , and that although the amount allowed here must be permitted to stand under the conditions surrounding the San Jose exchange, yet in a subsequent proceeding this company may be permitted again to present the entire matter of its 4½% contract to the Commission, and preferably in some case where a larger portion of this Company's business is involved, in which event the effect of the arrangement between these companies may be more clearly seen.

I submit the following order:

O R D E R .

Heretofore, on the 9th day of October, 1913, this Commission having entered an order in the above entitled proceeding, and within the time allowed by law an application having been filed for a rehearing thereon, and testimony having been taken on such application and being fully apprised in the premises, and being of the opinion that a rehearing is not justified in this case,

IT IS HEREBY ORDERED that the application for rehearing herein, both on the part of the defendant and of certain stockholders of defendant, be and the same is hereby denied.

The foregoing opinion and order on application for rehearing are hereby approved and ordered filed as the opinion and order of the Railroad Commission of the State of California.

Dated at San Francisco, California, this 4th day of February, 1914.

John M. Eshleman

H. D. Loveland

Alex Gordon

Edwin O. Edgerton

Commissioners.