

ORIGINAL

Decision No. 7542

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA

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In the Matter of the Application of SANTA BARBARA TELEPHONE COMPANY for Modification of Toll Rates)	
)	
)	Application No. 4933.
and)	

In the Matter of the Application of SANTA BARBARA TELEPHONE COMPANY, a Corporation, for an Order to Increase its Rates.)	
)	
)	Application No. 5039.

.....

Chickering and Gregory by Allen L. Chickering for the Applicants.

W. P. Butcher for the City of Santa Barbara.

J. F. Frick for the City of Lompoc.

C. L. Preisker for the City of Santa Maria.

N. P. Powley for the Pacific Telephone and Telegraph Company.

J. F. Frick, C. L. Preisker, S. J. Stanwood, John Torrance and E. S. Dedwich (Members of the Board of Supervisors) for the Board of Supervisors of the County of Santa Barbara.

Dr. E. O. Campbell and E. S. Peek for the Goleta Improvement Club.

LOVELAND, Commissioner.

O P I N I O N

On September 8, 1919, Applicant filed with the Commission Application No. 4933, asking for a modification of its toll rates and requesting the Commission to put into effect for its system the rates which were then established for toll service by the Postmaster General under Federal control.

On October 10, 1919, Application 5039 was filed, asking for an investigation into all of Applicant's rates and for an order establishing such increases as might seem just and reason-

able under the circumstances. At a hearing in Santa Barbara held on November 24, 1919, these two applications were consolidated. At that hearing Applicant introduced its exhibits on investment, valuations, operating revenues and expenses and estimates of future operations, and it was agreed that the Commission's Engineering Department should make a report dealing with these matters and with the service of the Company. Copies of the report were to be furnished to all of the parties to the proceeding and it should then be decided whether or not an additional hearing would be necessary. The Engineering Department's report has been made, copies have been given out as agreed upon and the matter is now ready for a decision.

Applicant states that the rate schedules, both toll and exchange, under which operations have been carried on since the business was taken over by the present Company, have never been sufficient to earn a reasonable return on investment, that operating expenses have been increasing on account of increased costs of labor and material in a much greater proportion than the increases of operating revenues, and that unless an increase in rates is granted, it will be impossible to earn operating expenses, a reasonable depreciation annuity and interest on bonded indebtedness.

The telephone properties of the Applicant represent a consolidation of several telephone companies heretofore operating in Santa Barbara County. In this Commission's Decisions Nos. 3747 and 3856 authorization was given for this consolidation and the new Company (the present Applicant) was authorized to issue certain bonds and preferred and common stock as set forth in the

two decisions referred to. The effect of the consolidation was to combine the Home Telephone and Telegraph Company of Santa Barbara County, the Home Telephone and Telegraph Company of Santa Barbara, and certain property of the Pacific Telephone and Telegraph Company into one telephone property, the Santa Barbara Telephone Company -- the present Applicant.

Applicant operates exchanges in Santa Barbara, Goleta, Carpinteria, Santa Ynez, Guadalupe, Los Alamos, Lompoc, Montecito, Santa Maria (all in Santa Barbara County) and also an independent toll service connecting these communities and in addition connecting toll service with the Pacific Telephone and Telegraph Company and with the United States Long Distance Telephone and Telegraph Company.

There is now outstanding common stock to the par value of \$80,500 and preferred stock to the par value of \$350,000 -- a total par value of \$430,500. The Pacific Telephone and Telegraph Company owns Applicant's preferred stock to the par value of 276,000. First mortgage 5 per cent bonds are outstanding to the face value of \$396,500.

These facts of the consolidation appear to be of importance since, in my opinion, the general principles laid down by the Commission in its decisions in the consolidation proceeding should be considered in this proceeding.

Applicant, since organization, has met fixed charges but has not paid any dividends on preferred or common stock. There was accumulated corporate surplus unappropriated on December 31, 1919, to the amount of \$11,046.27.

(1) Investment and Valuation -

The fixed capital representing the property of this Company stands on the Company's books (according to the annual

report filed with the Commission for the year ending December 31, 1919,) at \$818,535.95. This sum, it developed at the hearing, does not represent either the valuation figure found by the Company's engineers or the figure found by the Commission's engineers when the consolidation took effect. It represents rather the purchase price agreed upon by the Company at the time of consolidation plus the net additions and betterments since that time.

A valuation was filed by the Company at the hearing in these proceedings as of August 31, 1919, showing a total figure of \$772,289.89. This figure was reached by taking the Commission's Engineering Department's valuation in the consolidation proceedings as of June 30, 1915, (reproduction cost less depreciation) and adding thereto, undepreciated, additions and betterments and then deducting retirements to August 31, 1919. The investment figure in the annual report, as also the valuation figures referred to, includes a certain amount of duplicate property resulting from the consolidation. There is not available a detailed estimate of the amount and the value of such duplication in property. It appears from the record that a portion of this duplicate property has been retired by the Company since the date of consolidation or excluded from the valuation submitted by the Company in this proceeding. It is apparent, however, that the greater portion of the duplicate plant is still in existence and included in the investment and valuation figures.

In order to reach an approximation of what should be considered a normal valuation figure for a plant of this kind, the Commission's Engineering Department's report submitted to the parties to these proceedings and referred to above, contains a valuation estimate on a station basis. On this basis the value

of the reproduction cost of this property undepreciated would come to approximately \$742,000.

The Commission's engineer, Mr. Johns, also estimates that the condition of this property is the equivalent of a 70 per cent condition of its reproduction cost undepreciated on the station basis, which would correspond to a depreciated value of \$520,000.

These estimates permit of an approximation of the amount of duplicate property. This amount would be approximately the difference between the reproduction cost on the station basis and the investment and valuation figures otherwise available in this proceeding.

In this matter of duplicate property the Commission in decision No. 3747 says:

"In passing on the amount of securities which Santa Barbara Company may reasonably be authorized to issue for the properties which it is to acquire, consideration must also be given to the fact that a considerable amount of duplication exists in the properties which are to be acquired, particularly in the matter of poles. While petitioners report that the property of City Company and of County Company which will be rendered inoperative by reason of the consolidation has a structural value of only \$6,554.38, with a net salvage value of \$1,483.46, and that the property of Pacific Company which is not to be sold, exclusive of toll lines, has a "structural value" of only \$15,083.91, the testimony in this proceeding as well as a casual inspection of the existing properties in the city of Santa Barbara shows clearly that there is a much larger amount of duplication in the properties to be acquired by Santa Barbara Company than these figures would indicate. In fact, the total duplication reported by petitioners under the head of poles, would seem to be only an item of \$133.79 in the Carpentaria exchange. Petitioner's own testimony that it expects as soon as possible to remove the duplicate poles from the streets of Santa Barbara and the other towns affected, shows clearly the real situation. In other words, if a single telephone system were being installed to do the work which is now being done by the systems of the three existing telephone companies, a very material saving in the number and cost of poles as well as certain other items of property would unquestionably be made. We cannot agree that in determining the amount of securities which shall be authorized, the amount should be issued against the

"structural value of the combined properties of Pacific Company, City Company and County Company, without reference to existing duplication of property. If losses arise from this situation, they should be borne by the utilities which have created the duplication and not by the public."

The conclusion of the Commission that losses arising from duplication of plant in consolidated properties should not be entirely and permanently borne by the public, appears to me sound. The amortization of such property in a reasonable time out of earnings appears to be the best and most logical way to eliminate duplicate plant and such abnormal operating expenses as result from duplicate plant.

It seems desirable that the amount of duplicate property less its salvage value should be ascertained by applicant and by the Commission's engineers and that the amount so jointly ascertained, amortized over a period of years, should be written off applicant's capital account. Arrangements should be made by applicant to remove within a given time such duplicate plant as increases operating and maintenance expenses.

(2) Revenue and Expenses-

Applicant has submitted to the Commission its revenue and expenses for the past and its estimates for the future covering the period from September 1, 1919, to August 31, 1920. The Commission's engineering department has also made an estimate for the year ending August 31, 1920.

There is a considerable variation between the estimates for 1919-1920 made by applicant and by the Commission's engineering department. The engineering department's estimate of revenue (based on present rates) is about 7 per cent higher than applicant's, while the estimate of expenses is about 16 per cent lower. There is also a large difference in the estimated depreciation allowance, the applicant asking for \$58,000 and the engineering department estimating \$31,000. I am satisfied that the revenue estimates of our engineer are more nearly correct than those submitted by applicant. It would seem, in fact, from the actual revenue figures for the period from September, 1919, to the present date that the engineering department's estimate is conservative.

The Commission's engineering department's expense and depreciation figures are estimated after making proper segregation between capital and operating accounts and making corrections for such abnormal conditions as exist be reason of deferred maintenance and unusual operating expenses resulting from the existence of duplicate property. It cannot be expected that this property within the next year or two will be able to operate with what might be considered a normal maintenance and depreciation expense. If proper provision is made, however, as suggested above, for amortization of duplicate property not needed in the service, operating expenses will then tend to become normal.

The item of depreciation is estimated by the engineering department on the basis of detailed analyses made in connection with other telephone properties in this state. I am accepting this depreciation estimate for the reason, among others, that this depreciation annuity on a 6 per cent sinking fund basis will retire the entire property as estimated on the station basis valuation of \$742,000.00 in 14½ years; on a 5 per cent sinking fund basis in 15½ years.

(3) Depreciation Reserve.

The setting aside annually of an adequate depreciation fund and the proper handling of such a fund is of great import-

ance to this company and to the telephone subscribers on this system. This is especially true in this case because of the abnormally large maintenance expenditures required by reason of the existing duplicate plant and the accumulated deferred maintenance. The applicant, since reorganization, according to the annual reports filed with the Commission, shows charges to depreciation of plant and equipment as follows:

1916.	\$ 600.00
191739 630.06
191821 150.69
191936 277.79
	<u>\$97 658.44</u>

According to the general balance sheet, the reserve for accrued depreciation on December 31, 1919, amounted to \$49,891.92. It appears, therefore, and this is borne out by the annual reports, that during the period of the reorganized company's existence, retirements and other charges to the depreciation fund have amounted to \$47,766.52 (the difference between the total set aside for the years of 1916, 1917, 1918 and 1919 and \$49,189.91), an average of \$15,722.00 per annum.

All other maintenance expenses and replacement costs during that period were charged to maintenance as ordinary operating expenses.

The basis of depreciation charges in applicant's last annual report is given as follows:

"Purely an arbitrary figure. Amount credited to above account during 1919 represents that portion of earnings available after paying operating expenses."

I consider such a policy in the treatment of the depreciation fund unsound. It is the Commission's purpose to fix such rates as will allow this public utility, as all others, adequate operating expenses, a reasonable allowance for depre-

ciation and a fair return, if the conditions are such that a fair return is possible considering the nature of the service. In the rates set up for this utility all three of these items have received proper consideration. It is apparent that operating expenses, including, as they do, compensation for employees and costs of labor and material, are a first charge on all income and must come ahead of all other charges. Next in order are taxes. The setting aside of the depreciation annuity must follow immediately after these two prior items and in the very nature of things must come ahead of fixed charges, dividends and other similar items.

The assumption that depreciation may be taken care of out of surplus and only at such times and to such an extent as, in the opinion of the utility, the surplus may permit of deductions for this purpose, rests upon a fundamental error. It is in violation of a sound public utility policy both from the standpoint of permanent good to the public utility owner and to the public utility consumer, as indicated by the Public Utilities Act, in Section 49 which reads in part as follows:

"..... the Commission may, from time to time, ascertain and determine and by order fix the proper and adequate rates of depreciation of the several classes of property of each public utility. Each public utility shall conform its depreciation accounts to the rates so ascertained, determined and fixed, and shall set aside the money so provided for

"out of earnings and carry the same in a depreciation fund and expend such fund only for such purpose and under such rules and regulations both as to original expenditure and subsequent replacement as the Commission may prescribe. The income from investments of moneys in such fund shall likewise be carried in such fund."

The question is of much importance to the telephone users and rate payers of this utility. I am satisfied that good service cannot be permanently maintained unless an actual depreciation fund is created and properly administered. The main point is not whether the annual payment into the fund as estimated by our engineering department is exactly correct or whether it is too high or too low. As a matter of fact, the amount fixed must be in the nature of an estimate and will be subject to corrections in the future as the facts which should govern are more definitely ascertained. But it is of prime importance that whatever amount is set aside be held strictly for the purposes for which it is intended and be administered in accordance with proper rules under the control of this Commission.

I recommend, therefore, that the applicant set aside, as a trust fund, in monthly installments of \$2,750, a depreciation fund of \$33,000 per annum to be used only for purposes of insuring against depreciation and under rules to be approved by the Commission. The applicant should submit to the Commission such rules governing the depreciation fund as it believes will best meet the requirements, and after these rules have been approved by the Commission, they should go into immediate effect.

(4) Service-

There seems to be agreement on the part of the represen-

tatives of the various communities served by applicant that the matter of the best possible service is of much greater importance with the telephone subscriber than the matter of the lowest possible rates. Mr. C. L. Preisker, representing the City of Santa Maria, put this view in this way:

"The one thing we are particularly interested in is the service. We don't care about the price so much. So in the matter of rules and regulations, the thing we are after is to have those very strictly and carefully drawn and made so that they are almost automatic in that the company must give us service. We will pay the price. We don't object to that. In fact, we recognize that a good price has to be paid in order to enable them to give us service."

And speaking of the rate base, Mr. Preisker continues:

"In other words, if it is a question of a certain figure whether to allow them a little bit more or a little bit less, we would rather you would allow them a little bit more so that we can come at them strong when it comes to service."

The view in these communities does not differ from the view of the telephone users in the rest of the state and I am in agreement that adequate and efficient service is of paramount importance.

The applicant, in connection with this proceeding,

has submitted to the Commission its tentative suggestions for rules and regulations. When these rules have been approved by the Commission, there will be incorporated with them such provisions for good service as it may be possible to formulate. It is the intention of the Commission to give particular attention to service standards in the future and to promulgate rules to that end whenever it seems desirable to do so.

It is apparent that on applicant's system there is discrimination in favor of certain communities where so-called free switching is allowed as against those paying the same rates for similar service where free switching privileges are not given. The objections to this practice are discussed quite fully in this Commission's decision No. 5314, dealing with the consolidation of the telephone properties in Orange County. In that decision the Commission reached the conclusions that between logical exchange areas so-called free switching is a bad practice and should be abolished and that proper logical exchange areas within certain communities (not necessarily confined within political boundaries) should be established. These conclusions should be adhered to in this proceeding.

The fact appears to be established that the community interest between Santa Barbara and Montecito is such that it will be to the greater benefit of the service if these two towns are included in the same logical exchange area.

As regards, Carpinteria, Goleta and Santa Barbara, the conditions are materially different and the community interest between these towns is not such as to require their inclusion in one exchange area. I recommend that local exchange rates be established for Carpinteria and Goleta and proper toll rates be charged for intercommunication between these two communities and between them and Santa Barbara.

(5) Rates-

The rates I am recommending to the Commission are intended to meet the following requirements:

Estimates for 1920-1921

1. Estimated annual operating expenses and taxes (not including depreciation) based on year ending August 31, 1920.	\$170 000	
2. Depreciation annuity	33 000	
3. Work to comply with chapters 499 and 600	4 000	
Total.		\$207 000
4. Estimated gross revenue under proposed rates:		
(a) Exchange and miscellaneous revenue.	\$230 000	
(b) Toll revenue.	60 000	
Total		\$290 000
5. Estimated income		\$ 83 000

Out of this estimated income, applicant is expected to amortize as rapidly as possible all existing duplicate property and also to meet such abnormal operating and maintenance expenses as result from the existence of duplicate property.

Assuming that applicant would amortize the duplicate plant at the rate of \$20,000, as estimated above, and assuming normal operating conditions, it is apparent from the set-up that after the payment of bond interest there will be available a surplus permitting the payment of the preferred stock dividend of 6 per cent on all of the \$350,000 outstanding preferred stock (requiring \$21,000) and that there will then be available for the common stock a balance of \$22,000.

It is true that a portion of the net income will be required for the next few years for the payment of abnormal maintenance and operating expenses. This condition will, however, continue to exist only so long as the duplicate plant remains in existence and the deferred maintenance is not made up. An

amortization of the duplicate plant at the rate of \$20,000 per annum will reduce this abnormal operating expense progressively each year and will do away with it altogether in a comparatively short time (easily within 5 years).

Town	Business				Residence				
	Main Line	Two Party	Suburban	Extensions	Main Line	Two Party	Four Party	Suburban	Extensions
Carpinteria	\$2.50	\$2.00	\$3.00	\$1.00	\$2.00	\$1.75	\$1.50	\$2.50	\$1.00
Coleta	"	"	"	"	"	"	"	"	"
Guadalupe	"	"	"	"	"	"	"	"	"
Los Alamos	"	"	"	"	"	"	"	"	"
Santa Ynez	"	"	"	"	"	"	"	"	"
Gaviota	"	"	"	"	"	"	"	"	"
Los Cruces	"	"	"	"	"	"	"	"	"
Refugio	"	"	"	"	"	"	"	"	"
Lompoc	2.75	2.25	"	"	2.25	2.00	1.75	"	"
Santa Maria	"	"	"	"	"	"	"	"	"
Santa Barbara	3.50	2.75	"	"	2.50	"	"	"	"
Montecito	"	"	"	"	"	"	"	"	"

Note 1: All of the above rates are for wall telephones unless otherwise noted. Desk sets are 25 cents per month extra for all classes of service, except extensions.

Note 2: Rates for private branch exchange and for miscellaneous equipment not included in the above tables are to be filed with the Commission subject to its approval.

In the matter of toll rates, this Applicant, as all other companies in this state, is at this time operating under the rates established by the Federal Government during the period of Federal control. In its General Order 57, this Commission extended these rates until further order and until such time as the state-wide telephone investigation shall be disposed of. I do not recommend, therefore, any change in the toll rates on this system at this time.

By reason of the elimination of so-called free switching service between Carpinteria, Goleta and Santa Barbara, toll rates will become effective for communications between these exchanges. These rates should not exceed the lowest rates for similar service for similar distances now in effect under Order No. 2797 of the Postmaster General as extended by this Commission in General Order No. 57.

Judging the reasonableness and fairness of the proposed rates from the point of view of rates elsewhere in this state for telephone service similar to the service rendered by Applicant in the various communities considered in this opinion, it will be found as a fact that they are strictly comparable and that there is no discrimination in any sense against the subscribers on this system.

(5) Rules and Regulations and Primary Rate Areas.

It is my suggestion to the Commission that the present rules and regulations as continued in effect by the Commission in General Order No. 57 still continue effective until such time as a decision is rendered in the state-wide telephone cases.

Neither do I believe that any change should be made at this time in the primary rate areas as at present established.

I recommend the following form of order:

O R D E R

SANTA BARBARA TELEPHONE COMPANY having applied to the Commission for an order establishing increased rates and asking for approval of its proposed rules and regulations; a hearing having been held, the matter having been submitted and the Commission basing its conclusions on the foregoing opinion and finding as a fact that the rates authorized and the classes of service suggested in this opinion are just and reasonable:

IT IS HEREBY ORDERED, That applicant file with the Commission within thirty days of the date of this order a schedule of rates and services as outlined in the foregoing opinion. Upon approval by the Commission of the schedule so filed, applicant is authorized to put these rates into effect subject to the following conditions:

(1) Adequate and efficient telephone service shall be rendered at all times for all classes of service.

(2) Applicant shall set aside into a depreciation fund the sum of \$33,000 per annum in monthly installments of \$2,750 for the purpose of taking care of such renewals and replacements as shall be covered by the fund. Applicant shall file with the Commission within thirty days of the date of this order its suggestions for rules governing the functions and use of the depreciation fund and these rules shall thereafter go into effect as approved or modified by the Commission.

(3) Applicant shall arrange for the amortization out of net earnings and for the elimination of such duplicate property as is in existence at the time and as should be dis-

passed with to the benefit of the service and shall within thirty days of the date of this order submit to the Commission its suggestions for a plan of bringing about such amortization and elimination within a specified time.

The foregoing opinion and order 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 5th day
of ~~March~~ ^{May}, 1920.

Edwin O. Edgerton
H. J. [unclear]
Frank R. [unclear]
H. W. Brundage

Commissioners