

Decision No. 9864**ORIGINAL****BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA**

In the matter of the application of SOUTHERN CALIFORNIA TELEPHONE COMPANY for an order fixing just and reasonable rates for telephone service, authorizing the filing of same with the Commission, fixing a date when such just and reasonable rates shall become effective, and defining exchanges and exchange boundaries for the administration and application of said just and reasonable rates, together with rules and regulations appertaining thereto.

Application No. 6285.

Arthur Wright, H. D. Pillsbury and James T. Shaw,
Pillsbury, Madison and Sutro of counsel,
for the applicant.
J. E. Stephens and H. Z. Osborne, Jr., for the
City of Los Angeles.
Kemp, Mitchell & Silberberg, by John W. Kemp
and Carlos S. Hardy, for Chamber of Com-
merce of Los Angeles.
Hartley Shaw, for City of Glendale.
Wm. Hazlett, for City of South Pasadena.
John F. Inel, for Culver City.
Mott & Cross, for Goldwyn Producing Corporation.
C. W. Loucks, in propria persona.
O. E. Winburn, for City of Watts.
Bon W. Utter, for the County of Los Angeles.

BRUNDIGE AND ROWELL, COMMISSIONERS:**O P I N I O N**

In this application the Southern California Telephone Company (hereinafter referred to as the Company) asks for an order fixing just and reasonable telephone rates in the territory served by the Company in the City of Los Angeles and

adjacent thereto. The Commission is also asked to determine proper exchange areas for the service rendered by applicant with inter^{ex}change rates comparable with those existing in the state at large. The amount of increased annual revenue required by the Company is stated to be approximately \$2,000,000.00 and a schedule of proposed rates, designed to produce this additional revenue, is attached to the application.

In support of its application the Company makes reference to this Commission's Decision No. 3845 in Application No. 2227 (Opinions and Orders of the Railroad Commission of California, Vol. 11, page 806) and asks that the entire record upon which that decision of November 4, 1916, is based be considered as a part of the present application. The Company directs particular attention to page 860 of the decision referred to, being condition 1 (a) and reading as follows:

"That during the period of five years subsequent to the date of this order, Southern California Telephone Company will not make application to the Railroad Commission or any other public authority for any increase in the telephone rates now in effect in the territory in which the company is to operate, except in such minor matters as may be necessary to remove discriminations."

The Company states that this stipulation was made and accepted by it without any realization of the imminence of the entry of the United States into the world war and the experience of world-wide changes in economic conditions that have followed. These economic consequences of the war, the Company avers, had to be met by the applicant in common with business everywhere, but because of this stipulation the relief open to others through increased rates and revenue was denied to applicant. It would have been impossible, according to applicant, to carry forward its business except through the credit and the resources of the

Pacific Telephone and Telegraph Company (hereinafter referred to as the Pacific Company). The condition quoted above has now expired and in its application the Company points out that after this expiration it will not be able to rely further upon the credit and resources of the Pacific Company but will be dependent absolutely upon its own credit resources to meet operating expenses and to secure capital for extensions of plant, and that, without immediate assurance of effective relief through increased revenue from rates, its credit and resources will be nil, extensions in progress must stop, and further extensions to care for unprecedented demands in 1921 and subsequent years must halt. The point is further made by the Company that, in spite of its difficulties, it has taken care of the heaviest growth ever recorded in the telephone history of the territory served and that there was a waiting list of applicants (at the time of the filing of the application early in November, 1920) in excess of 9,000, with the list growing daily, and that the ability to take care of these demands, and to meet the demands for service, is absolutely dependent upon securing adequate relief in increased revenue concurrently with the expiration of the stipulation.

Under a literal interpretation of condition 1 (a) referred to, the Company stipulated that it would "not make application" to this Commission or any other public authority for an increase in the telephone rates until November 4, 1921. The filing of the application on November 9, 1920, one year ahead of the stipulated time, might have been construed, therefore, as a technical violation of the stipulation. The Commission took this matter up with the Los Angeles city authorities and it was agreed that it would be fair to the Company, and not unfair to the telephone users, to commence with the consider-

ation of this application,--since of necessity a considerable period, probably not less than a year, must elapse before a proceeding of such magnitude could be concluded. The facts have substantiated that conclusion and this matter is only now ready for a decision.

An unusually large number of complaints regarding the telephone service rendered by the Company, and particularly with reference to delayed installations, were received by this Commission during the last two years and the number of such complaints grew subsequent to the filing of this application. It became apparent that the matter of service would be a factor of paramount importance in this case and that an adequate consideration of that factor might unduly delay and interfere with the rate proceeding. The Commission, therefore, on January 27, 1921, commenced on its own motion a proceeding, in Case No. 1531, instituting an investigation into the reasonableness and adequacy of the service rendered by the Company, for the following purposes

"to determine whether the rules, regulations, practices, equipment, appliances, facilities or service of said Company are unjust, unreasonable, improper, inadequate or insufficient in any particular and, if so, to determine the just, reasonable, proper, adequate or sufficient rules, regulations, practices, equipment, appliances, facilities, service or methods to be observed, furnished, constructed, enforced or employed, and to fix the same by order, rule or regulation; to determine whether or not any additions, extensions, repairs or improvements to or changes in the existing plant, equipment, apparatus, facilities or other physical property of said Company ought reasonably to be made, or whether any new structure or structures should be erected to promote the convenience of the public, or in any other way to secure adequate service or facilities, and to make any such order in regard thereto as the Commission may determine to be in the interest of public convenience and necessity, directing that such conditions, extensions, repairs, improvements, or changes be made, or that structure or structures be erected in the manner and within the time to be specified in said order."

The proceeding in that case is not yet concluded.

To the extent that the record in Case No. 1531 throws light on the matter of service, it will be taken into consideration in this present decision.

Hearings were held in the present application in Los Angeles on March 15th and 16th, May 17th and 18th, September 20th and on November 7th, 1921. Exhibits were put in evidence by the Company, the City of Los Angeles, and the Commission's engineering department, and the list of these exhibits is, for reference, attached to this decision as Supplement "A." In the hearing on September 20, 1921, it developed that a lengthy cross-examination of witnesses would be inevitable if the matter was proceeded with by formal trial by reason, mainly, of the wide divergence of opinion and statements and interpretation of facts as between the Company's witnesses, on the one hand, and the City's, on the other. It was agreed that it would not be in the public interest to unduly protract this proceeding. As the result of a conference between the representatives of the City and of the Company with the presiding Commissioners, it was decided that there should be appointed a joint engineering conference to be composed of the engineers of the Commission, engineers to be appointed by the City and engineers to be appointed by the Company, who were to organize immediately under instructions to be issued by the Commission. These instructions would direct this conference to go into all of the exhibits and reports submitted by the Company and by the City, and to report back to the Commission, at a later hearing, those matters on which there was agreement and all matters on which there was disagreement. The Commission, accordingly, instructed its chief engineer to take charge of this conference and to arrange for the immediate meeting of the engineers and for the assignment of the

work. Under the Commission's letter of instructions the engineering conference was to deal with the following matters:

- (a) Investment, valuation and rate base.
- (b) Duplication of property.
- (c) Analysis of operating expenses, including the question of depreciation.
- (d) Past and present revenues and estimated revenues under proposed rate structures.
- (e) Rate areas.
- (f) Relation between exchange revenues and expenses and toll revenues and expenses.
- (g) Relation between Southern California Telephone Company, The Pacific Telephone & Telegraph Company, American Telephone & Telegraph Company and Western Electric Company.
- (h) Service.

The conference undertook this work and, on November 7th, filed its report dealing with all of the matters assigned to it. This report is one of the exhibits in this proceeding. There were filed subsequent to the report of the conference statements by the City and by the Company (Exhibit "B" and Exhibit No. 30 of the City and Company respectively and reply memorandum of the City to Company's Exhibit No. 30), and the matter is now submitted.

After a careful consideration of the entire record we have reached certain conclusions as hereunder discussed under different headings.

1. Consolidation of prior companies and conditions growing out of consolidation.

Great stress is laid by the Company, both in its application and in subsequent hearings, upon the alleged fact that the present applicant came into being as a result of this Commission's Decision No. 3845, in Application No. 2227, above

referred to. It is said (in the application) that applicant's corporate existence has its foundation in the conditions culminating in that decision and order. And again, referring to the consolidation proceeding before this Commission, according to counsel for the Company, there was no idea as strongly in the minds of the Commission as that, once and for all, they were officiating at the birth of a public utility (Tr. p. 355). It will be useful, therefore, to refer briefly to the consolidation proceeding and to the decision of the Commission in that case, and to consider the consequences of the consolidation.

The Pacific Company and its predecessor, the Sunset Company, have operated in Los Angeles since 1891, when a twenty-five (25) year franchise was granted to the Sunset Company. Until 1902 the Sunset Company enjoyed a monopoly of the telephone business, but in that year the City granted a fifty (50) year telephone franchise to M. A. King and this franchise was subsequently transferred to the Home Telephone and Telegraph Company (hereinafter referred to as the Home Company). Since 1903, therefore, the Pacific Company and the Home Company were in competition with one another and the record shows that in the period 1910 to 1916 the business of the two companies as measured by the number of telephone stations was approximately equal, the Pacific Company exceeding by approximately 10% the number of stations of the Home Company. From the earning standpoint, the operations of the two competing systems were not successful. Home Company's exhibits introduced in Application 2227, and checked by the Commission's engineers, show that from 1903 to 1915 the Home Company's net earnings averaged considerably below what may be taken as a normal fair return although the financial showing of the Home

Company, especially during the years 1911 to 1915, inclusive, was much better than the showing of the Pacific Company in its Los Angeles operations. The Pacific Company's net revenue (assuming the accuracy of the Pacific Company's claim for depreciation) was sufficient, apparently, since 1911, to pay 6% interest on the following amounts: in 1911 on \$880,000; in 1912 on \$2,430,000; in 1913 on \$563,000; in 1914 on \$1,775,000 and in 1915 on \$1,090,000. Compared with these figures, the Pacific Company claimed as of December 31, 1915, "actual performance value" of the same date of \$7,554,000. It is apparent, therefore, that the Pacific Company's Los Angeles operations for a number of years prior to consolidation were not financially satisfactory. From 1911 to 1915, inclusive, the Pacific Company in no year earned in excess of 2% on its claimed "structural value" as of December 31, 1915, while in 1913 the Company earned less than one-half of one per cent on its claimed "structural value". There can be no doubt, therefore, that consolidation on any terms likely to result in a lessening of financial losses was of advantage to the Pacific Company, even if consolidation did not result in actual profits over and above the cost of operation and the cost of money.

Another factor possibly of greater importance than immediate financial considerations, operated in favor of consolidation. It appears that the franchise granted by the City to the Sunset Company on November 16, 1891, would have expired on the same date in 1916. The people of Los Angeles for a considerable time had been dissatisfied with duplicate telephone service, and the difficulties attending the renewal of a franchise under conditions favorable to the Pacific Company, together with the unfavorable financial outlook towards the past as well as

towards the future, conspired to make consolidation a thing devoutly to be wished for from the standpoint of the Pacific Company.

In Decision 3845 the Commission makes abundantly clear why permission to consolidate was granted. It was granted because (Opinions and Orders of the Railroad Commission of the State of California. Vol. 11, page 856)

"the facts clearly show that under a condition of consolidation, by reason of a smaller return to be paid on capital invested, a smaller depreciation annuity to be set aside, year by year, and a smaller amount necessary to meet maintenance and operating expenses, the Southern Company will be able to give to the people of Los Angeles and vicinity a unified telephone service at rates lower than those which would be necessary under a condition of interchange, and that under a condition of consolidation the Southern Company will be able to give to the people of Los Angeles good telephone service without increasing the present rates."

And further, in answer to the suggestion that competition had proved the best incentive to good service and that with consolidation such competition would be eliminated, the Commission said (page 858):

"In the present instance, the evidence shows that if the consolidation is effected, the people of Los Angeles and vicinity will immediately save the sum of \$483,000.00 per year from the elimination of duplicate telephone stations. They will be relieved from the nuisance of a dual telephone system. Their rates will not exceed those which they have heretofore enjoyed under a condition of competition. The consolidated telephone company, receiving the entire gross revenue from telephone service within the area affected without corresponding increase in maintenance and operating expenses, will be a stronger company financially than either of the existing companies in so far as their operations within this area are concerned, and ought to be better able to borrow new moneys on favorable terms, to accord reasonable rates to its customers, and to make such extensions of service as the interests of the public may require.

"In view of these immediate, substantial benefits to accrue to the public from the consolidation, we do not feel warranted in denying these benefits to the public merely because hereafter the consolidated company may possibly become remiss in its duty to the public. We prefer to believe that under the present supervision and regulation of telephone companies by the state, the state will be strong enough to secure good service, even from a telephone monopoly, in case

such monopoly should, blind to its own interest, revert to the conditions of the past."

The Commission granted the petition for consolidation subject to certain conditions. Capital stock and bonds not exceeding a par value of \$14,000,000.00 (as compared with \$16,098,500.00 applied for) were authorized to be issued by the Company and of this amount the bonds were not to exceed in par value the sum of \$9,330,000.00 (as compared with \$9,927,000.00 applied for). The condition requiring a stipulation that no increase in rates should be asked for for a period of five (5) years has already been referred to. Permission was made conditional upon absolute impartiality as between automatic and manual stations, according to the wish of the subscriber; similarly, the choice of the subscriber was to control as to the use of the toll lines of the various long distance lines; that the Company would retain its principal office in the City of Los Angeles; that no franchise value should ever be claimed in any proceeding before this Commission, in court, or other public authority, in excess of the sum actually paid for such franchises; and certain other conditions insuring good service.

It would appear in the light of events subsequent to 1916 that the consolidation was of great benefit to the telephone users of Los Angeles and to the Pacific Company and we believe this to be true, as far as the Company is concerned, notwithstanding the fact that the war and conditions resulting from the war have laid financial burdens on this Company which, in some respects, have been more onerous than other telephone companies have had to contend with.

2. Investment, Valuation, Rate Base.

We do not believe, in view of the facts in the case, that the matter of a rate base is a controlling factor in the fixing of the rates of this utility at this time. If, with reasonable rates from the standpoint of the service rendered and compared with rates for reasonably similar service in other cities, this applicant can earn a fair return after operating expenses upon a reasonable rate base for its property used and useful in the public service, we should not hesitate to fix such rates. On the other hand, if, in order to secure a theoretically fair return on a theoretical rate base an unreasonable charge in the form of abnormally high telephone rates had to be laid on the Los Angeles telephone users, we are of the opinion that such a procedure would result in unjust and unreasonable rates and in a burden the subscribers should not be asked to bear. We must remember, as indicated above, that the competitive conditions of the past made impossible a profitable operation of the Pacific Company's Los Angeles business. At the time of consolidation in 1916, there were over 60,000 telephone stations on the Home Company's plant and over 68,000 on the Pacific Company's plant, and a large proportion of these were duplicate stations. The great majority of these duplicate stations disappeared with the progress of consolidation. This meant an inevitable loss in revenue. There was also some decrease in operating expenses, but not proportionate to the decrease in gross income. There was a considerable amount of duplicate plant other than duplicate subscribers' equipment and it is in the record that the extraordinary expenses incident to consolidation were large

and have extended to the present day, with the end not yet. These conditions clearly were and are the aftermath of the period of competition and it would be unreasonable to place these costs and losses entirely upon the present subscribers. This would be the more unjustifiable since another unavoidable consequence of past competitive systems and thoroughgoing unification is unsatisfactory service during the period of transition. Such unsatisfactory service the City of Los Angeles has had to bear and is still bearing.

While, therefore, in our opinion, a rate base is not an essential factor in this proceeding, we shall, nevertheless, briefly review the evidence on that item and indicate our conclusions.

There is not available to the Commission an exact inventory of the operative physical property of the Company as of the present time, but it was agreed by the Engineering Conference that the delay and expense incident to the making of such an inventory is not warranted for the purposes of this proceeding and that the valuations made in the consolidation proceeding could be brought to date and used in this case.

The following valuation estimates are in evidence:

By the Company (as of October 31, 1921):

(a) Reproduction cost new of property at September 30, 1920, prices, plus net additions,	\$47,720,000.
(b) Reproduction cost new of property (Exhibit No. 24),	39,278,100.
(c) Reproduction cost new of property less depreciation (Exhibit No. 24),	36,089,000.
(d) Fair value of property plus net additions,	30,700,000.
(e) Actual performance appraisal of plant and working assets (Exhibit No. 25),	24,050,256.

By the City:

- (f) "Maximum rate base" 1920 (page 27 Exhibit "A" Engineering Conference). \$15,071,684.
- (g) "Rate base for end of 1921" (Board of Public Utilities City of Los Angeles, Exhibit "B"). 17,250,032.

By the Commission's Engineering Department:

- (h) Rate base as of March 31, 1921 (Exhibit "A" Engineering Conference, page 45). 16,520,000.

The Engineering Conference points out that the rate base figures as of March 31, 1921, should be brought to a later date and that there should be added materials and supplies, employees' working funds, and other working capital to the extent that current cash receipts do not take care of current cash expenditures. We shall deal with the question to what extent expenditures not yet made shall be considered in fixing present rates under another heading in this opinion.

- (i) Engineering Department's rate base, 1922, on basis of 170,300 stations (19,600 additional stations over March 31, 1921), including materials and supplies, employees' working funds and additional capital required. 23,800,000.

It is apparent that these valuation figures differ within very wide limits. The difference is in part accounted for by the fact that differing dates are used for the estimates. The important reasons for the wide discrepancies, however, are to be found in the differing methods of valuations and in the variety of facts and principles used by the several witnesses. It should also be stated that the figure under (i) is based, in point of time, on the year 1922 and that to bring the preceding figures from (a) to (h), inclusive, to the same base, all of them would have to be increased by a large amount (Exhibit "A" Engineering Conference, page 70).

The Company does not claim, however, that its figures under (a), (b) and (c) should be taken by the Commission as a proper rate base. They are given merely as indicative of certain measures of value and of results obtained with certain valuation methods. The fourth valuation figure, (d), is stated by the Company (Exhibit No. 26) to be "the minimum fair value or present worth", while the fifth figure, (e), is termed "an actual performance appraisal" by the Company and it is argued that a lower figure cannot be given consideration by the Commission in a rate case.

It may here be noted that all of the valuation figures shown above (and others in addition) were thoroughly analyzed by the engineers of the Company, the City, and the Commission, in the Engineering Conference above referred to and in Exhibit "A", the report of that Conference to the Commission. The Commission is thoroughly aware, therefore, of the significance of these various figures from the standpoints of the several interests. It is pointed out by the Commission's chief engineer in Conference Exhibit "A" (page 36) that figure (d) includes all intangibles such as the value of the business, prospective earnings under assumed rates, etc., and that the figure, on the face of it, is not intended to be a rate base but rather an estimate of what this property as a going concern would be worth under rates giving an adequate return upon this estimated "present worth". It is further pointed out that since it is the rates which are at issue in this proceeding, this figure can have no direct relation to a rate base.

With reference to figure (e) - ("actual performance value"), the chief engineer points out that this figure, as that term is used by the Pacific Company, is a reproduction

cost estimate of existing property on the basis of labor and material costs incurred over a limited period of time on a portion of the property under operating conditions. And he states that this method of valuation does not provide for a check of the reasonableness or unreasonableness of costs and accepts whatever costs were actually incurred by the Company, regardless of whether they be normal, too high, or too low. This statement appears on page 37 of Conference Exhibit "A":

"The engineering department (of the Commission) has never been able to agree that a so-called actual performance appraisal, depreciated or undepreciated, is a reliable index either to a rate base or to 'value'. It is our contention that, in order to determine the reasonableness of so-called actual performance figures, it is necessary to test them against investment or historical reproduction cost incurred not under operating conditions but under construction conditions during a reasonable construction period."

Since the Company, as also the Pacific Company, appears to put great weight upon this particular method of valuation for purposes of rate proceedings, it is pertinent to say that, in our opinion, the objections in the preceding quotation appear valid and that we should be unwilling to rely on such a valuation estimate to the exclusion of any other. We make this statement in this place because the so-called

actual performance figures were passed upon, in a measure, by this Commission in the decision in the consolidation case heretofore referred to. The Commission did not then approve the so-called actual performance method of valuation and we see no reason for a different conclusion.

The City, in its Exhibit "A", objects to all of the Company's valuation figures. Its principal objections may be summarized as follows: the reproduction estimates are based on an improbable reproduction scheme; no account is taken of duplication; the condition per cent given is not satisfactory; intangible values are excessive; cost of additions is based on non-competitive tabulation of probable current costs; no account is taken of actual per cent condition of property; performance value is based on at least one valuation not approved by Commission in the consolidation proceeding; no deduction is made for depreciation in performance estimate. The City asks for a re-check of all quantities and the application of new unit costs approximating historical costs. It also requests a re-determination of condition per cent. The principal point of objection by the City to both the Company's and the Commission's engineering department's valuation estimates is with reference to the treatment of the depreciation reserve in the valuation and in the rate base. The City insists that the depreciation reserve accumulated by the Company is too high and that that portion which has been invested in plant should be deducted from the rate base. This matter will be discussed under another heading and it is sufficient to state here that in the City's figures above, both under (f) and under (g), there is deducted from the otherwise "maximum rate base" the sum of \$4,181,327.00, this being the

amount of the depreciation reserve invested in plant. The City's figures are based on the valuations made by the Commission's engineers in the consolidation case, after making allowance for duplicate plant and with net additions between December 31, 1915; and March 31, 1921. In item (g) the net additions have been estimated to the end of the year 1921.

The engineering department's figure under (h) is reached after an analysis of the valuation figures, and of the portion dealing with the securities to be issued, in Decision 3845 above referred to. It is concluded that the Commission, when consolidation was permitted, took as the best measure of value the historical reproduction cost depreciated and that this amount should, therefore, be taken as the figure representing most nearly the rate base on the day consolidation occurred. The correctness of this figure as a theoretical rate base is suggested because the new Company, on consolidation, took over all of the assets and liabilities of the two old companies, including the reserve for accrued depreciation. To this December 31, 1915 figure the engineering department has added the net additions, undepreciated, to March 31, 1921, and this is the figure shown under (h) and designated as the theoretical rate base.

The term theoretical rate base is used by the Commission's chief engineer because it is pointed out that the figures shown under (h) and (i) do not reflect the "value", as the term is ordinarily used, of this property. This is because of the effect of the factor of earning power. This factor is discussed in the engineering department's memorandum (Conference Exhibit "A", page 46) as follows:

Earning Power:

"The figure of \$16,520,000 does not in any sense indicate the present day "value" of this property in the sense that the term value is used in the estimate of the company's president, for instance. It is acknowledged that the value of public utility property is made up of two principal elements: first, the plant necessary to produce the service; second, the earning power of the plant. When measured by this universally recognized standard, then the present value of this property is very much less than the figure shown above. This is true because it is now earning, and has been earning, since its existence under consolidation, a very low return, and a return which is below the cost of money. Furthermore, the profits from the business have become smaller and, in 1920, according to the company's annual report, there was a profit, after operating expense, depreciation, taxes and rents, of only \$108,406.00 (this sum was available for the payment of interest, sinking funds, amortization and surplus. The interest charges, accrued for that year, amounted to approximately \$429,000.00). For each year since January 1, 1917, the gross income was as follows (gross income is the amount available for interest, other fixed charges, dividends and surplus, after the payment of operating expenses, including depreciation and taxes):

Year ending December 31, 1917,	\$656,674.00
Year ending December 31, 1918,	266,922.00
Year ending December 31, 1919,	101,696.00
Year ending December 31, 1920,	131,460.00

(NOTE: These figures are subject to some modification because of intervening federal control.)

If, therefore, the past and present earning power of the property were taken as one factor of "value" and of "rate base", as appears to be urged by the Company, then it is apparent that to whatever extent that factor is taken into consideration, it must operate as reducing the figure found for the plant alone.

The present instance affords a perfect example of the unavoidable reasoning in a circle, if it is claimed that rates must be based on "value" and that "value" must reflect both plant and earning power. Under such a theory it is apparent in this case that with the existing rates the value, and, therefore, the rate base, of this property is much lower than any investment or valuation figure, and to whatever extent the Commission increases the rates, it would, of a necessity, increase the earning power and, therefore, the "value" and, therefore, the "rate base".

Neither can it be said that the factor of earning power had a different influence prior to consolidation. It is in the record in Application 2227, heretofore referred to, that both predecessors of the present Com-

pany carried on an unprofitable business for a number of years prior to 1916 and probably since the year 1903, when competitive telephone service developed in Los Angeles. It is equally true that, under competitive conditions, these losses would have continued if consolidation had not been brought about and permitted by this Commission.

The Engineering Conference is agreed that the factor of past, present, and prospective earning power is a negative quantity in this property and would result in a further reduction of the figure of \$16,520,000.00 found above. It is also agreed that a capitalization of a prospective rate increase by the Commission would be unsound and unreasonable and that such capitalization should not be permitted in any degree to affect the rate base to be found in this proceeding."

A careful consideration of the facts dealt with under this heading justifies, we believe, the designation "theoretical rate base" to any rate base figure that has been estimated by the Company's, the City's, or the Commission's engineers. We believe a distinction must be made between a rate base on which it has been possible to earn a fair return in the past, under rates fair to the public, and a rate base on which a full fair return has not been and cannot at the present time be earned under such rates. Considering the earning possibilities of this property during the time prior to the consolidation and to the five years subsequent thereto, it is not possible to speak of any but a theoretical rate base.

We shall indicate under a later heading what rate of return this applicant may be expected to earn on one or several capital figures, under rates fair and reasonable alike to the Company and to the subscribers, after operating expenses and reasonable allowance for depreciation and proper allowances for taxes and other items have been provided for.

3. Duplication of Property.

The City maintains that the Company's present telephone plant is still burdened with a considerable amount of duplicated property, resulting from the consolidation of

two competing systems and that the amount of such duplicated cost should be eliminated both as it affects the rate base and operating expenses. It is suggested by the City that the only accurate way of determining such duplication is by means of a careful field study. The Company, on the other hand, points out that the chief item of duplication was in the two telephones that many people had been under the necessity of installing prior to consolidation. All these duplications were subsequently removed, with the result that facilities were made available for additional business. It is also pointed out by the Company that the additions to the plant made since the date of consolidation (May 1, 1917) represent a very large proportion of the existing plant and cannot be considered, in any sense, as having duplication included. In the Company's opinion there is no duplication existing in the operative property at this time.

We are satisfied that the effects of the existence, five years ago, of two separate telephone plants of practically equal importance are still present to some extent. The Commission's engineers point out that there still, of necessity, exists duplication in the matter of poles, right of way, easements, cable, conduit trenches, and central offices, and other items. This duplication must have its effect on the cost of the plant as well as on the cost of operation. We are not persuaded, however, that the loss resulting from this condition should be borne by the Company in its entirety. The public has benefited, to some extent at least, by the existence of this duplication. The spare plant made available by the disconnecting of 15,000 duplicate stations made possible the taking care of a considerable number of new telephone applications under the abnormal material and financial conditions prevailing in 1918 and 1919. It is also a fact that the combined service of the

two former systems has been delivered to all subscribers at the rates in effect when the business was divided between two competing concerns. We reach the conclusion that, from the standpoint of the rate base, the duplication reflected in the engineering department's figures under (h) and (i) in the preceding heading is fair and reasonable to the Company and to the public alike, and we shall not make a further deduction on that account under operating expenses.

4. Operating costs and other expenses and charges, and estimated revenue.

It is our purpose to fix rates in this proceeding which will allow the Company reasonable operating expenses, including a proper allowance for depreciation and taxes, reasonable compensation to affiliated companies for service rendered or value received and, in addition, a reasonable fair return having in mind the essential conditions surrounding this utility.

A careful estimate of operating expenses necessary to the Company was worked up by the Engineering Conference. On a number of such expense items there is agreement; on other items the differences of opinion and the reasons therefor have been presented to us by the several engineers. We shall summarize the agreed items and then briefly discuss the items in dispute. The estimate of operating expenses for the year 1922, based on current expenses plus estimated increases and figured as average unit costs per station, and taking the average number of stations for the year 1922 as 170,310, is as follows:

	<u>Unit per station per month</u>	<u>Total per Year</u>
1. Ordinary repairs,	.860	\$ 1,757,599
2. Station removals and changes,	.140	286,121
3. Traffic expenses,	1.200	2,452,464
4. Commercial expenses,	.475	970,767
5. General expenses,	.085	173,716
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Sub-total,	2.760	\$ 5,640,667
	say -	\$5,641,000

	<u>Unit per Station per Month</u>	<u>Total per Year</u>
Brought forward -	2.760	\$ 5,641,000
6. Rent deductions,		30,000
7. Amortization of landed capital		2,500
8. Taxes		<u>480,000</u>
Sub-total,		\$ 6,153,000

The amounts shown opposite items 1 to 8 above are reasonable estimates of the actual amount of expenses that will have to be met during the year 1922, regardless of whether these amounts may be considered as normal or abnormal. It is the City's position, however, that operating conditions, and therefore operating expenses, cannot be considered as normal at the present time, nor in 1922. The City urges the use of average figures over a number of years, properly adjusted to allow for unusual conditions obtaining by reason of existing duplication, delayed installations and the present period of unusually heavy construction. Because of these considerations, the City contends for a general reduction of operating expense items and particularly for a 10% reduction in items 1 and 2.

We have already stated our views with reference to duplication. With reference to abnormal construction conditions, and the situation resulting from delayed installations, we believe that, as to the former item, the actual operating costs should be allowed unless there is evidence that with more efficient management and operation such costs can be reduced. No evidence to that effect is before the Commission in this proceeding. The matter of delayed installations will have attention in the consideration of the quality of the service rendered by the Company and its effect upon the rates. We can also not be unmindful of the fact that the unprecedented growth of the City of Los Angeles, in building activity and

population, and in expansion of all sorts of business enterprises, has created an equally unprecedented demand for telephones. We see no indications justifying a belief that this growth will be retarded or come to a pause in the future. On the contrary, in our judgment, the indications are that this remarkable development will continue and the conditions which have been designated as abnormal in this proceeding may, for some considerable time to come, prove the normal condition of Los Angeles. Holding to this conclusion, we see no justification for a percentage reduction in the operating expenses shown above on account of their being abnormally high.

On other expense items there are material differences and it will be necessary to analyze the most important ones in some detail.

Depreciation

We consider the matter of depreciation of great importance. The Company for the year 1922 claims a depreciation allowance under operating expenses of \$1,428,000. The allowance estimated by the Commission's engineering department for the same year is \$730,000 and the City urges as a sufficient allowance the sum of \$610,000. It will be well to state the bases for these three figures. The Company figures its depreciation allowance for plant and equipment on the so-called straight line method and on the book amount of depreciable property for the average of the year 1922 (\$23,800,000). To the cost shown on the Company's books on September 30, 1921, there is added the estimated net additions for the balance of 1921 and half of 1922. An exhaustive statement has been filed with the Commission by the Company showing its position on the matter of depreciation. It is difficult to summarize this extensive presentation. It may be stated, however, that, on the whole, it is based principally on accounting con-

siderations and on the classification of accounts prescribed by the Interstate Commerce Commission and by this Commission. The Company maintains that in maintenance expenses it is entitled to a depreciation allowance for all losses suffered through the current lessening in value of tangible property from wear and tear not covered by current repairs. This includes obsolescence and inadequacy resulting from age, physical change, or supersession by reason of new inventions and discoveries, changes in popular demand, or public requirements, and losses suffered through destruction of property by extraordinary casualties. Under this accounting definition the experience, over a number of years, of the associated Bell telephone companies throughout the United States with particular reference, perhaps, to the experience of the Pacific Company, is used and the percentages thus obtained for the various classes of property are applied to the property of the applicant. An inspection of applicant's annual reports filed with this Commission shows, however, that the depreciation rates have changed from time to time and that, during the period of federal control, the provisions of the federal control superseded the Company's practices. The Company and the Pacific Company both recognize the fact that, of necessity, and in the nature of things, any depreciation allowance must partake of the speculative and that the amount in the reserve cannot, at any time, measure the actual physical depreciation and, conversely, the physical depreciation, at a given time, cannot measure the amount which should be in the reserve. This must be so because the present physical condition of any property is a physical fact. The amount which must go into the reserve is necessarily, to a certain extent, based on hypothesis, because this reserve must provide for facts and contingencies which have not yet occurred and which lie in the future.

The Company takes the position that under the accounting rules it is compelled to set aside its depreciation reserve in equal periodical installments on the straight line method and that to use a sinking fund depreciation annuity would be unlawful. It maintains that the rates fixed by it, the amounts proposed to be set aside in this proceeding and the methods adopted by it for the accumulation and use of the reserve must not be interfered with and that at least the sum of \$1,428,000 is required to enable it to render efficient service. It may be stated that the method used by the Company results in a rate very closely approximating 6% per annum on the total depreciable property.

The City's estimate of an adequate depreciation allowance is in radical disagreement with the Company's method. The City contends that the rate of approximately 6% is entirely too great for the reason, mainly, that the life of the various components of the property, as submitted by the Company, is entirely too short. In the City's opinion the Company has, with regard to life, to obsolescence, to inadequacy and to salvage, made assumptions as impracticable and unsound as the theory of reproduction cost now submitted by the Company.

According to the City's contention the \$610,000 per annum, estimated by it as a depreciation annuity, is the maximum and set aside on a sinking fund basis at a 7% rate of interest in monthly installments will amply take care of the retirement of all of the depreciable property at the end of its life.

The theory on which the City bases its argument can best be indicated by a quotation from the statement of the chief engineer of the Board of Public Utilities (Conference Exhibit A, Page 99):

"The City is of the opinion that the purpose of a reserve fund is for the replacement of worn out plant and is a guarantee that the original investment will be maintained. It takes the position also that the money set aside for this purpose should be placed in a separate fund as provided for in California Statute, Section 49, Public Utilities Act. The interest on this separate fund should be calculated at the prevailing rate and set aside and made a part of the fund. This the Company does not do at the present time. The City contends that while the reserve fund for replacement belongs to the property, it is for just one purpose, namely, the replacement of worn-out property, and it was taken out of the rates paid by the subscribers for that purpose only.

As conditions are at the present time, the subscribers have absolutely no protection against the neglect on the part of the Company to replace old and worn out inadequate equipment; they have no protection against the lack of service resulting from a failure to replace inefficient equipment. In other words, the condition per cent of the Southern California Telephone Company is an unknown quantity. We do not admit for one moment that the condition per cent of the property has nothing to do with the service rendered by the Company, or with the matter of rates.

We cannot agree that the reserve fund may be used by the Company for any purpose whatever which the Company may find convenient. It would seem to us that the only guarantee of good faith in the expenditure of the money set aside for a particular purpose and included in the rates for that purpose, is that the Commission should have charge both of the debits and credits to the depreciation reserve fund.

We contend that the Commission should be the judge of obsolescence whenever a radical change is proposed. We do not contend that either obsolescence or inadequacy should be borne entirely by the rate payer.

The statement that the Government allowed the Company 5.72% for the depreciation fund is absolutely immaterial. It is extremely doubtful whether any estimate was ever made during war times on what the rate of depreciation should be. We would need to be shown that the Government was not influenced by engineers of the American Telephone & Telegraph Company in arriving at this rate of 5.72%.

The City contends that no one can prophesy the exact amount necessary for the replacement of property or keeping intact the original investment. We contend that a reasonable amount over and above the actual current replacements to take care of emergency withdrawals should be set aside annually and placed in a separate fund together with the interest thereon

and the fund put under the supervision of the California Railroad Commission, and used for the only purpose for which it was ever taken out of the rates -- namely, the replacement of worn out plant, and keeping the original investment intact.. Should it become necessary at any time, in the opinion of the Commission, to increase the annual allowances for depreciation or should the fund accumulate too rapidly to take care of current replacements, then the Commission can increase or reduce the annual payments. By this method there will be no tendency to neglect replacements and use the money for some other purpose."

It is also the position of the City, as indicated under a previous heading, that on the portion of the depreciation reserve invested in plant the Company is not entitled to a return and that the amount so invested should be deducted from the rate base.

The Commission's engineering department has also made a report on this item and its estimate is contained in Conference Exhibit A (Page 103).

It is the conclusion of the department that the depreciation allowance included in operating expenses by the Company in the past and estimated for the future, is too high and that the estimate for this item as submitted by the Company in this proceeding should be materially reduced. Our engineers report that neither they, nor the Company's engineers, nor the City's engineers have made the detailed analysis necessary to determine an accurate depreciation allowance for this particular property. Such an analysis would require a

1 list of property inventory items in the various accounts, a determination of lives and salvage value, a distinction between depreciable and non-depreciable property and between such items as should be renewed through ordinary maintenance expense and such as should be replaced out of a depreciation fund. It is the department's conclusion, however, that an approximate figure sufficiently accurate and fair for the purposes of this case can be found on the basis indicated in the Conference report for the estimated figure of \$730,000. This allowance, according to our engineers, should be subject to further modification by reason of the excessive reserves set aside in the past and by reason of the fact that the earnings of the depreciation fund have not been added to the fund but re-invested in plant, the ownership of which is now in the Company and included in the department's rate base. According to our engineers' figures the reserve estimated by the Company for 1921 is from 43 to 48% too high, depending upon whether the 6 or 7% sinking fund rate is used and the same percentage approximately applies to the depreciation allowances set aside by the Company since consolidation.

It appears that the total amount set aside by the Company between May 1, 1917 and June 30, 1921, is \$4,129,474. and it is estimated that in this period there has been going into the depreciation reserve an excess amount of \$1,651,790.

In Applicant's Exhibit No. 30 (which is the reply memorandum to Exhibit B of the City of Los Angeles) counsel for the Company reviews the position of the City, and to some extent the statements of the Commission's engineering department on this matter, and calls attention to certain errors in computation and to certain other matters that are not conceded to be errors by the City and by our engineers.

The Company in its Exhibit 30 re-states its position and relies for the soundness of its conclusions principally upon the prescribed accounting classifications. It suggests that the matter of depreciation is outside the jurisdiction of this Commission and that there is nothing for us to do but to accept the Company's methods and practices and to allow the amount they claim under this item. This view is taken because the Company contends that the Interstate Commerce Commission has sole control of this matter.

We are of a different opinion and the question of jurisdiction we do not believe to be at issue. The amount to take care of depreciation is one of the largest, if not the largest, single item in the total sum that must be provided for the Company in rates. We believe that this Commission, being the rate-making body, has not only the right but the duty to scrutinize this expense item most carefully and to include it in the total sum of money to be provided for in an amount reasonable alike to the subscribers and to the Company. The Public Utilities Act clearly places this function upon the Commission and Section 49 of the act 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."

From all the evidence on this point we conclude that the sum to be allowed as an operating expense for a depreciation annuity should be \$780,000. per year. Set aside in monthly installments of \$65,000. in a sinking fund, with provision that the earnings accruing are added to the fund, this amount will retire, compounded at the ordinary interest rate of 6%, the total depreciable property within a reasonable life expectancy. There can be no question, in our opinion, about the adequacy of an allowance that will accomplish this end.

Our view of this matter does not go to the mere accounting considerations and is much more far reaching. This Commission has constantly held to the view that a proper depreciation annuity is an operating expense and must be allowed for the same reasons that proper maintenance expenses must be contributed by the rate-payers. We make such a depreciation allowance not merely in the interest of the public utility and in order to enable it to keep up its plant, but, more important, in order to assure the public of the permanency of good service. The depreciation allowance, therefore, is a contribution the public is making to the utility in order to insure a continuation of service through the renewal of plant worn out in the service to the public.

If the Company concludes to include more than \$780,000. in operating expenses for depreciation, the excess must come out of the allowance for a fair return. In our opinion the amount claimed by the Company is excessive and the amount allowed by us, determined as it is for this particular plant at this particular time, is reasonable in view of all circumstances.

We are aware of the fact that the Interstate Commerce

Commission is now engaged in an investigation of the subject of depreciation as it relates to interstate telephone utilities and understand that there is a likelihood of that Commission establishing depreciation percentages for the various items of property. Whether such percentage rates, if any are to be fixed, will be intended to apply to all interstate telephone systems throughout the United States or whether percentages will be determined according to the facts and necessities in a particular territory, and of a particular company, we do not know. The Pacific Company, which is particularly interested in this matter, by reason of its stock ownership in the Southern Company, is an interstate company, while the latter company is engaged in a purely intrastate business. In view of the present status of the matter, we prefer not to direct a change in the percentages employed by the Company in setting up on its books the depreciation accruing in each class of its depreciable property. We shall not allow in operating expenses for depreciation any sum larger than the amount above indicated. We hold to the view that the proper amount to be set aside for a particular property cannot be determined by rule of thumb, or by the use of general percentages applying over a territory as large as the United States, and under conditions as varied as they are found in the large number of separate telephone utilities. Each property, we believe, must be governed by its own particular circumstances and requirements, and the local rate-making body seems to be in the best position to consider and determine the amounts which properly should be set aside for depreciation.

Payments to the American Telephone & Telegraph Company.

In its estimate of expenses the Company claims for this item under the designation "licensee revenue" the annual amount of \$217,000.00. The City's and the Commission's engineering department's allowance is smaller and amounts to \$120,000.00 a year. The engineering department's figure is based on the conclusion that, regardless of the method of computation, this amount is a reasonable payment for services rendered by the American Company to the Southern Company in view of all circumstances surrounding the plant at this time and that will surround it in the next few years. The Company's figure is based on an agreement now in existence between the Pacific Company and the Southern Company, and particularly on Section 6 of that agreement regarding license contract payments on a gross earning basis. This item, therefore, goes to the matter of the relation between this Company, the Pacific Company, the American Company, and other affiliated or subsidiary corporations. An inquiry into this relation was one of the subjects assigned to the Engineering Conference. The Conference has exhaustively reported on this point and there are before the Commission the views of applicant and of the Pacific Company, as also the views of the City and of our engineers. We shall briefly deal with this matter under another heading. It is sufficient to say at this point that, after a careful consideration of the entire record, we are satisfied that the inclusion of \$120,000.00 in the expense estimate is a reasonable amount for the services rendered by the American Company to applicant.

Uncollectible Revenue.

The amount for revenue which the Company will be unable to collect and which, therefore, must be a charge upon the general business, is estimated by the Engineering Conference at one-half of one per cent of the estimated gross revenue. We are willing to accept this estimate and are making an allowance for this item of \$41,000.

Summarizing the foregoing items, we have a total expense estimated for 1922, exclusive of fair return, as follows:

Operating expense items 1 to 8, inclusive, (as enumerated above),	\$6,153,500.
9. Annual amount to be put into depreciation fund,	780,000.
10. Payment to American Telephone and Tele- graph Company,	120,000.
11. Uncollectible Revenue,	<u>41,000.</u>
Total, -	\$7,094,500.

The rate schedule we are proposing is estimated by the engineers to produce a gross revenue in 1922 of \$8,300,000. We wish to call attention to the percentage growth in the Company's revenues during the last three years. It appears that the 1920 revenues showed an increase over the year 1919 of approximately 16% and the 1921

revenues over those for 1920, in spite of delayed installations, are likely to show an increase of at least 14%. The estimate of the Commission's telephone engineer for the year 1922 (under present rates) shows an increase, however, of only about 9%. The gross revenue estimate derived from the rate schedule suggested in this decision is based on the same approximate percentage increase in business as is the estimate assuming a continuance of the present rates. We are inclined to believe that the business of the Company in 1922 will show an increase closely proportionate to the one of the preceding year. If this view is correct, there is an underestimate in the engineers' revenue figure for 1922 rather than an overestimate.

The rate base we have in mind is the sum of \$23,800,000. This sum includes the estimated capital expenditures necessary to take care of the 1922 business and these new capital expenditures (partly made and partly not yet made) amount to \$6,738,000. We are aware that, to a considerable extent, the rebuilding of the Los Angeles plant is now going on and has been going on for some time. Unquestionably a portion of the capital expended is not only useful for the stations to be immediately attached to the present system, but will be useful for additional future business. Good telephone engineering demands the design and construction of the plant in such manner.

The Engineering Conference agreed that there should go into the rate base such cost of new construction as is required for the needs of the estimated number of stations plus a reasonable margin for spare facilities and Company maintains that the full amount of \$6,738,000. does not provide for anything in excess of such needs.

With an estimated revenue of \$8,300,000., and total estimated expenses of \$7,094,000., there remains a net return of \$1,206,000. This is approximately 5.1% on the estimated rate base and falls short by \$222,000. of a 6% return. In our opinion the Company will earn a 6% return on this rate base since we are satisfied that the estimates of earnings are unduly conservative. We consider such a return as reasonable and entirely fair to the Company in view of all the circumstances in this case.

While this Commission has repeatedly pointed out that the volume and the classes of outstanding securities cannot be controlling in the determination of a just and reasonable rate, we wish to point out that the fair return as estimated above will be sufficient to provide for all of this Company's inter-

est on outstanding bonds, allow for interest payments for all borrowed money and for additional money that will have to be borrowed in order to carry out the 1922 program, and in addition leave a substantial surplus. This, it appears to us, must be considered a gratifying financial situation as compared with the condition prior to consolidation and as it would have been had consolidation not been permitted.

Reference should be made in this connection to the matter of the apportionment of toll revenues and expenses between the exchange company and the toll company. The City contends that the present 30% revenue apportionment to the Company is insufficient and that at least 40% of the toll revenue should be credited to the Los Angeles exchange. If an increase were made, the gross revenue of the Company would, of course, be increased, the net revenues would be increased in the same amount and the percentage of fair return would increase accordingly.

We have given careful consideration to this matter. It may be that upon a close analysis the applicant may be entitled to receive a larger proportion of the toll revenue than it receives at present, but no data is before the Commission at this time that would permit of a fair determination of the question. A reapportionment of toll revenue, it is also apparent, would take this revenue away from one branch of the Pacific Company's business and give it to another, and in this manner would have an effect on other telephone rate structures which are not now at issue. In our opinion it seems desirable

to let this matter rest until a statewide determination can be made.

5. Rate Area.

The Company submitted exhibits showing a proposed primary rate area. This proposal was objected to by the City and the item was one of the matters referred to the engineering conference. It appears that the primary rate area is substantially agreed upon by the conference with one material exception. As recommended by the Commission's telephone engineer and accepted by the conference, the Company's proposal is modified by the exclusion from the area of a small neck of territory along Verdugo Road, east of Tropic, and the extension of the area to include a district in the southern part of the City, bounded by Florence Avenue on the north, Mountain View Avenue on the east, Manchester Avenue on the south and Central Avenue on the west. We believe the Company should adopt this rate area and the exchange rates fixed in this decision should apply within this territory.

It is the City's contention that the so-called Palms-Culver district should be included within the primary rate area. The Commission has decided this matter in Decision No. 9516 and the only point left open at this time is the location of the Los Angeles primary rate area boundary closer to the Palms-Culver city boundary, or further away from that boundary, compared with the present location. The rate area here suggested extends the present boundary; that is to say, a larger territory will be available to the Los Angeles exchange rates than is at present the case. A reversal of Decision No. 9516 does not appear justified.

6. Rates.

The rate structure proposed by the Company in this application compares with the present rate structure as follows:

Class of Service	Present Rates		Proposed Rates	
	Wall	Desk	Wall	Desk
1-Party Business Flat	\$6.25	\$6.75	\$12.00	\$12.25
1-Party Business Meas	5.50	6.00	--	--
*1-Party Bus. Prepayment	5.50	6.00	6.00	6.25
2-Party Bus. Flat	4.75	5.25	9.00	9.25
Business Extensions	1.00	1.00	1.00	1.00
Business Suburban	3.00	3.00	3.50	3.75
1-Party Residence	2.50	2.75	4.25	4.50
2-Party Residence Flat	2.25	2.50	3.50	3.75
4-Party Residence Flat	1.75	2.00	2.75	3.00
Residence Extensions	1.00	1.00	1.00	1.00
Business P.B.X. Flat				
Switchboards				
Cordless	3.00	--	5.00	--
Com'l Cord	3.00	--	--	--
Non-Multiple	--	--	5.00	(Up to 80 lines)
Multiple	--	--	10.00	" " " "
Hotel Flat	2.00	--	--	--
Non-Multiple	--	--	5.00	(Up to 80 lines)
Multiple	--	--	10.00	" " " "
Stations				
Commercial	1.00	--	1.00	--
Hotel				
Not in Guest Room	1.00	--	1.00	--
In Guest Room	0.35	--	0.50	0.75
Intercommunicating	1.00	--	1.00	--
Switching Keys 10lines	0.25	--	0.50	--
" " 20 "	0.50	--	0.75	--
" " 30 "	0.75	--	1.00	--
Trunks 1st B.W.	8.00	--	--	--
" Add'l B.W.	7.00	--	--	--
" Outgoing	6.00	--	18.00	--
" Incoming	5.00	--	6.00	--

*Under present rates appears under Section 3 of tariff.

We are satisfied that the proposed rates are too high and would be unfair and unreasonable to the subscribers. We suggest the following rate structure and believe that with these suggested rates in effect there will be produced the gross revenue previously estimated and that this income will enable the Company to give good and adequate service and to take care of the future telephone requirements of Los Angeles.

Proposed Rate Structure

Business Service

	Rate per Wall Set	Month Desk Set
Individual Line, Unlimited Service	\$ 9.00	\$ 9.25
2-Party Line " "	7.00	7.25
Suburban, 10-Party Line, Unlimited Service	3.50	3.75
Individual Line, Coin Box Service, Guarantee - 20¢ per day, Each Exchange Message - 5¢		
Extension - with or without Bell	1.00	1.00

Residence Service

Individual Line, Unlimited Service	\$3.75	\$ 4.00
2-Party Line " "	3.00	3.25
4-Party Line " "	2.25	2.50
Suburban, 10-Party Line, Unlimited Service	3.00	3.25
Extension, with or without bell	1.00	1.00

Private Branch Exchange Service

Business Commercial, Unlimited Service, Switchboard, with battery power ring- ing circuit, and switchboard telephone for each position,		
Cordless, each position	\$5.00	per month
Cord, non-multiple, each position	5.00	" "
Cord, multiple, each position,	10.00	" "
Each station, primary or extension, wall or desk set	1.00	" "
First bothway trunk line	11.00	" "
Each additional bothway trunk line	8.25	" "
Each outgoing trunk line	9.00	" "
Each incoming " "	6.00	" "
Each two position order table equipped with two complete telephone sets	4.00	" "
Each line from the order table to the private branch exchange switchboard	1.00	" "

Hotel, Private Branch Exchange - Unlimited Service

Switchboard, with battery power, ringing circuit and switchboard telephone for each position,		
Cord, non-multiple, each position,	\$5.00	per month
Cord, multiple, each position,	10.00	" "

Each station, primary or extension, wall or desk set not in guest rooms	\$1.00 per month		
Each station, primary or extension in guest rooms			
Wall Set.	0.50	"	"
Desk "	0.75	"	"
First bothway trunk line	11.00	"	"
Each additional bothway trunk line	8.25	"	"
Each outgoing trunk line	9.00	"	"
Each incoming " "	6.00	"	"

Intercommunicating systems, Business Unlimited Service

Each Station, wall or desk set, with switching device, same premises as primary station,			
10 line switching device	\$ 1.50 per month		
20 " " "	1.75	"	"
30 " " "	2.00	"	"
Each station, wall or desk set, with switching device, outside premises on which primary station is located but not exceeding 300 feet from pri- mary station,			
10 line switching device	\$ 2.25 per month		
20 " " "	2.50	"	"
30 " " "	2.75	"	"
First bothway trunk line	11.00	"	"
Each additional bothway trunk line	8.25	"	"
Each outgoing trunk line	9.00	"	"
Each incoming " "	6.00	"	"

Intercommunicating Systems, Residence Unlimited Service

Each station, wall or desk set, with switching device on same premises as primary station,			
12 button switching device	\$ 1.50 per month		
24 " " "	1.75	"	"
36 " " "	2.00	"	"
Each station, wall or desk set, with switching device, outside premises on which primary station is located, but not exceeding 300 feet from pri- mary station,			
12 button switching device	\$ 2.25 per month		
24 " " "	2.50	"	"
36 " " "	2.75	"	"
Each bothway trunk line	3.75	"	"

Apartment House System

Apartment telephone, connected with its vestibule and janitor set, wall set	\$ 0.25 per month		
Vestibule set, including telephone	0.50	"	"
Janitor set, " "	1.00	"	"

Primary Rate Area

The foregoing rates are for service within the primary rate area as outlined in this decision.

Other Rates and Rules and Regulations Affecting Rates

Rates other than those herein suggested, and rules and regulations governing all rates should until or unless otherwise authorized by the Commission remain as at present and schedules providing therefor should be filed by the Company, subject to the approval of the Commission.

In the rate schedule submitted by the Company the so-called P. B. X. both-way trunk service and the rates now quoted for such service were eliminated. No reasons for this particular elimination were presented by the Company. It appears, however, that the great bulk of private branch exchange trunk service in Los Angeles is over both-way trunks and that about 90 per cent of private branch exchanges would be affected by this change. This class of service, therefore, should be continued unless the Company can show that the public interest is better served by an elimination. If the Company desires to make such a showing, this may be done in a supplemental proceeding.

7. The Relation between Southern California Telephone Company, The Pacific Telephone and Telegraph Company, American Telephone and Telegraph Company, Western Electric Company, and Other Affiliated Companies.

The City, generally speaking, takes the position that, by reason of the relationship existing between the Company and the corporations with which it is affiliated, the cost of telephone service to the Los Angeles subscribers is unduly increased and a financial showing much less favorable than the actual showing, and less favorable than need be, is produced on applicant's books. This result is brought about, in the City's view, because of unreasonably high payments to the American Company for services rendered, also by means of a division of joint revenue and expenses (referring to toll business) between affiliated companies resulting to the disadvantage of applicant and further, by reason of excessive material and supply costs for plant and equipment manufactured and furnished by the affiliated companies.

The Company, on the contrary, insists that its affiliations with other Bell telephone companies and enterprises result in distinct benefits to the public and lower rather than increased cost of service. Western Electric Company material prices and charges for service are not too high in the opinion of the Company and payments made for services to the American Company and divisions of joint revenues and expenses are fair.

We have already dealt with the so-called licensee revenue payment and allowed in our expense estimate the sum of \$120,000.00 per annum as a reasonable and fair compensation for the service rendered by the American Company, through the Pacific Company, to applicant under the terms of the agreement of May 31, 1917 (Company's Exhibit No. 29). We believe no sum larger than \$120,000.00 for this purpose should be charged to operation and that whatever additional amount this applicant

elects to pay to the Pacific Company, or to the American Company, under the terms of this contract, should be a deduction from net income. On the expiration of the present contract at the end of next year the reasonableness of its terms will be before the Commission. We have also stated our view on the matter of apportionment of toll revenue and are of the opinion that this matter cannot be properly decided in this case.

Applicant is controlled by the Pacific Company through ownership of all the outstanding stock, except ^{a few} qualifying directors' shares (60,869 shares of a par value of \$6,086,900). No dividends have been paid on this stock. The Pacific Company owns none of the applicant's outstanding bonds and receives, therefore, no bond interest. The Pacific Company, however, has loaned to applicant considerable amounts for construction and on these loans interest is paid at the rate of 6%. For labor and material delivered to applicant by the Pacific Company, or vice versa, the actual cost is charged and paid. The Pacific Company also collects from applicant the so-called licensee revenue and turns it over, without deduction, to the American Company.

Applicant is indirectly controlled by the American Company through the latter's ownership of the majority of the stock of the Pacific Company (73.3 per cent on December 31, 1920). The American Company owns none of applicant's bonds or notes. Indirectly it receives the licensee payment paid the Pacific Company and such interest and dividends as it may earn through ownership of the securities of the Pacific Company and of the Western Electric Company.

The licensee payment agreement referred to above provides for a payment of $4\frac{1}{2}$ per cent on gross revenue, the computation to be made as follows:

"The same proportion of the gross earnings of the Southern Company as the proportion of the instruments not furnished by the American Company bears to the total number of instruments used in the service of the Southern Company. This plan to be effective until January 1, 1923, provided, however, that the proportion of the gross earnings so excluded shall, at no time, be more than at the beginning of business by the Southern Company."

The question of equitable contract terms will arise, therefore, after January 1, 1923.

The matter of the 4½ per cent payment by its subsidiaries to the American Company has had the attention of this Commission repeatedly and particular reference is here made to Decision No. 1254 (San Jose Telephone Rate Case, Vol. 4, page 150, Opinion and Orders of the California Railroad Commission). We believe that a payment on a mere percentage basis, regardless of the kind and quality of the service rendered, is not a fair measure of such services. A truer measure can be had, we believe, by estimating as accurately as possible what the value of such service amounts to in each particular case and this method we have applied in this instance.

With reference to this applicant's relations to other affiliated companies, we have reached no definite conclusions. A decision on that point we do not consider essential to a determination of this case. This matter should be reserved for a more thorough analysis in the pending statewide telephone rate case.

8. Service.

We have given particular attention in this proceeding to the matter of service. Reference has already been made to the service investigation instituted by the Commission in Case 1531. That proceeding will be kept open and further careful attention will be given by the Commission to this matter. Counsel for the Company has urged that the service now rendered by appli-

cant in Los Angeles is excellent. This statement is not borne out by the facts before the Commission.

Service conditions must be improved and means must be found to meet more promptly and more satisfactorily than in the past the demand for new telephones that is bound to continue at a rapid rate in Los Angeles. The rates fixed in this decision will make it possible for applicant to render a high class telephone service.

The Commission's telephone engineers, in conjunction with the engineers of the Board of Public Utilities of the City of Los Angeles, made an analysis of the Company's records of service observations and of trouble records. In addition, an independent service test was conducted by these engineers. The analysis of the Company's own records led to the conclusion that the management is making satisfactory efforts to give good service, but that the number of troubles reported is excessive, that the actual trouble is not cleared with sufficient promptness and that the investigation of a considerable portion of the troubles is not carried far enough to determine and eliminate the condition occasioning the report. The independent service tests led to the conclusion that the plant and equipment is not being maintained in such condition as to provide good service and that a larger number of better trained employees is required for the proper maintenance of the plant.

Since these conclusions were reached, the Company has made arrangements, upon the Commission's suggestion, to increase its maintenance and construction forces and we believe an improved service may confidently be expected.

The following form of order is suggested:

O R D E R

Southern California Telephone Company having applied to the Commission for an order fixing just and reasonable rates for telephone service, for the fixing of an effective date and for the definition of exchanges and exchange boundaries, together with rules and regulations; hearings having been held 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, together with the exchange area and boundaries defined, are just and reasonable;

IT IS HEREBY ORDERED, that applicant file with the Commission within fifteen (15) days of the date of this order a schedule of rates and services as outlined in the preceding opinion. Upon approval by the Commission of the schedule so filed, applicant is authorized to make these rates effective as of January 1st, 1922, such authorization to be 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 file with the Commission within fifteen (15) days of this order, for the approval of the Commission, a map showing the Los Angeles primary rate area as outlined in the foregoing opinion.

3. Applicant shall submit to the Commission, within fifteen (15) days from the date of this order, its proposed rules and regulations to conform to the rate structure outlined in the foregoing opinion and to the prescribed rate area.

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 14 day of December, 1921.

H. B. Prudigg

H. D. Loveland

Livingston Martin

Chester H. Russell

J. P. Smith

Commissioners.

SUPPLEMENT "A"

(Accompanying Decision No. 9864)

List of Exhibits Filed

In Application No. 6285.

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I - Filed by the Company.

- A. Financial statement.
- B. Monthly rates for principal classes of service.
 1. Statement of delayed orders held for material or equipment.
 2. Narrative report of construction.
 3. Increased annual expense due to wage increases only.
 4. Gross revenues, expenses and net income 8 months 1917, years 1918-19-20 and January 1921.
 5. Income statement-1917.
 6. Income statement-1918.
 7. Income statement-1919.
 8. Income statement-1920.
 9. Income statement 1921.
 10. Classification of stations by classes of service and by rates- February 28, 1921.
 11. Estimated revenues and expenses year 1921 under present rates.
 12. Proposed rates covering the principal classes of service together with map showing proposed primary rate area.
 - 12a. Proposed exchange rates.
 13. Estimated revenues and expenses year 1921 under proposed rates.
 - 13a. Proposed exchange rates, year 1921.
 14. Map showing present rate areas.
 15. Map showing present rate areas.
 16. Map showing proposed primary rate area.
 17. Area assigned to the Southern California Telephone Company under decision 3845.

18. Map showing area assigned to Southern California Telephone Company under decision 3845.
19. Map showing annexations to the City of Los Angeles and also area assigned to the Southern California Telephone Company.
20. Inventory of property of Southern California Telephone Company September 30, 1920.
21. Estimated cost of reproduction of property of Southern California Telephone Company, September 30, 1920.
22. Report in connection with estimated cost of reproduction Southern California Telephone Company, September 30, 1920.
23. Estimated cost of reproduction less depreciation of property Southern California Telephone Company, September 30, 1920.
24. Estimated cost of reproduction and estimated cost of reproduction, less depreciation Southern California Telephone Company brought down to March 31, 1921 and October 31, 1921.
25. Southern California Telephone Company actual performance appraisal.
26. Summary of appraisals and fair value.
27. Standard Supply contracts and supplements thereto between Southern California Telephone Company and Western Electric Company.
28. Comparison cost of telephone materials to Home Telephone and Telegraph Company of Los Angeles and Home Telephone and Telegraph Company of Portland Oregon vs. cost of equivalent items to Southern California Telephone Company under contract with Western Electric Company.
29. Copy of Agreement with The American Telephone and Telegraph Company.
Copy of Agreement with The Pacific Telephone and Telegraph Company.
30. Reply memorandum in answer to Exhibit "B" of the Board of Public Utilities of the City of Los Angeles.

II - Filed by the City.

- A. Report entitled, "Board of Public Utilities, Southern California Telephone Company, Increase of Rates - Before California Railroad Commission - H. Z. Osborne, Jr., Chief Engineer.
- B. Income Statements for the years succeeding consolidation May 1, 1917 to September 30, 1921.
- C. Reply memorandum in answer to Exhibit 30 of Southern California Telephone Company.

III - Filed by Engineering Conference.

- A. Report of Engineering Conference in Southern California Telephone Company Rate Case - November 7, 1921.