Decision No. 28764

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA.

CITY OF LOS ANGELES, a municipal corporation,

Complainant,

vs.

SOUTHERN CALIFORNIA TELEPHONE COMPANY, a corporation,

Defendant.

Case No. 3800.

ORIGINAL

Ray L. Chesebro, City Attorney, Carl I. Wheat, Public Utilities Counsel, and Milford Springer, Deputy City Attorney, for the City of Los Angeles.
Oscar Lawler, C. E. Fleager, Jack Hardy and Arthur T. George, for the Southern California Telephone Company.
P. A. Young, for the Southern California Hotel Men's Association.
Loren A. Butts, for Down Town Department Stores, Broadway Department Store, Bullock's Inc., J. A. Robinson Company, Barker Brothers and the May Company.
S. M. Haskins and Woodward M. Taylor, for the City of San Marino.
H. P. Huls, Leonard A. Diether and Robert Wanamaker, for the City of Pasadena.
Richard C. Waltz and C. Curtis Smith, for the City of Beverly Hills.
John C. Hayes, for the Communities of the East San Fernando Valley.
O. R. Cline, for the City of Long Beach.
Charles T. Rippy, for the City of Torrance.
E. R. Hurst, for Monte Mar Vista Property Owners Protective Association.
Horace E. Vedder, City Attorney, for the City of South Pasadena.
H. R. Brashear, for Los Angeles Chamber of Commerce.
Albert Launer, City Attorney of Fullerton, appearing as Secretary of the Orange County League of Municipalities.

CARR, COMMISSIONER:

O P I N I O N

On March 9, 1934 the City of Los Angeles filed its complaint against the Southern California Telephone Company alleging that rates in the Los Angeles Exchange (the area of this exchange lies generally within the City of Los Angeles) and between stations in that exchange and stations in exchanges and points exterior thereto were unreasonable and excessive. The Company, on April 9th, answered the complaint. It denied that the rates were unreasonable and sought to tie the rates attacked into the general rate structure of the utility. Reference was made to the decision of the Commission in Re S.C.T.Co., et al., 39 C.R.C. 172, of date January 10, 1934, in which various service changes were ordered. It was alleged that the carrying out of this order would be burdensome to the Company and it was urged that the pending case should be dismissed so that the Company would be unembarrassed in carrying out the provisions of the order. An amended answer was filed on January 23, 1935, in which the original answer was somewhat amplified but in which it was alleged that the system rates of the Company were inadequate as to yield. No authority to increase any rates, however, was sought.

At the initial hearing on February 20, 1935 there was presented in evidence a comprehensive report by Mr. E. F. McNaughton, of the Engineering staff of the Commission (now Director of Research), covering the operations of the defendant Company in its entirety, as well as its operations in various exchanges and departments.[1] This report tended to show that the utility's earnings in its Los Angeles Exchange were at a substantially higher level than in the remainder of its territory. Thereupon the complainant, consent of the Commission having been obtained, amended its complaint to charge that the

(1) Various members of the Commission's Engineering and Accounting staff participated in developing this report. Among these were Messrs. P. E. Dufour, W. B. Wessells, M. M. Barnes, E. P. McAuliffe and Theo. Stein.

rates in the Los Angeles Exchange were not only unreasonable but were unjustly discriminatory. On March 22, 1935 answer was filed to the complaint as thus amended. The new issue of discrimination was controverted. The answer otherwise followed largely along the lines of the first amended answer.

After February 20, 1935 hearings in the case proceeded regularly until October 25th when the evidence was closed. In all, 27 days were occupied in hearings.(2) The transcript of testimony occupies 3,149 pages. There were 144 exhibits presented. The record developed was unusually complete.(3) Since the close of evidence briefs have been filed. The case was submittod on December 16, 1935.

It seems logical to review and consider the evidence in several parts as follows:

I Historical
II Rate Fixing Area
III Separation Studies
IV Property Value
V Operating Revenues and Expenses
VI Accrued Depreciation and Depreciation Expense
VII Future Conditions
VIII Rate Reduction Indicated
IX Spread of Rate Reduction
X Discrimination

(2) Hearings were had on February 20 and 21; on April 2, 3, 5 and 30; on May 1 and 2; on June 18, 19, 20, 21, 25, 26, 27 and 28; on July 2; on August 27, 28, 29 and 30; on September 13, and on October 15, 22, 23, 24 and 25.

(3) Toward the close of the hearings there was presented as having a possible bearing upon the issues, a summary outline of the over-all operating results of the Pacific System in the State of California, segregated as between operations carried on by The Pacific Telephone and Telegraph Company in the northern portion of the State and those carried on by its subsidiary, Southern California Telephone Company.

I

HISTORICAL

On May 1, 1917 the newly organized Southern California Telephone Company took over the property of the old Home Telephone & Telegraph Company of Los Angeles, as well as the Los Angeles portion of the system of The Pacific Telephone and Telegraph Company. (See Re S.C.T.Co., 11 C.R.C. 806.)

On June 1, 1930 the Southern California Telephone Company acquired the remaining properties of The Pacific Telephone and Telegraph Company in Southern California, including the properties of certain subsidiary companies. (Re S.C.T.Co., 34 C.R.C. 584.) Its investment was thereby increased over 60 per cent, and its number of stations some 50 per cent, the larger percentage increase in investment being due to the toll properties taken over.

The Southern California Telephone Company is one of the associated companies of the Bell System. All of its stock is owned by The Pacific Telephone and Telegraph Company, which in turn is controlled by the American Telephone and Telegraph Company.(4)

Rate History.

When the Los Angeles consolidation of duplicate telephone systems was effected in 1917, Southern California Telephone Company agreed that it would not seek an increase in rates for a period of five years ending November 4, 1921. (Re S.C.T.Co., 11 C.R.C. 806, 860; Id. 13 C.R.C. 113.) Shortly after this stipulation was made, the United States entered the World War. Worldwide economic changes occurred. Costs of almost every nature increased. Adherence to the stipulation became burdensome to the Company and an application was

(4) The Pacific Telephone and Telegraph Company operates in California, Oregon, Washington, Nevada and Idaho, either directly or through completely controlled subsidiaries, such as the Southern California Telephone Company.

filed with the Commission, as a result of which increases were authorized by order of date December 14, 1921, effective after the expiration of the five-year period. (Re S.C.T.Co., 20 C.R.C. 981.) On rehearing, some changes were made from the original order, the changes dealing mostly with service matters. (Re S.C.T.Co., 21 C.R.C. 274.)

On January 15, 1922, pursuant to authorization of the Commission, a partial separate exchange in Culver City was established from a portion of the Los Angeles Exchange (Re S.C.T.Co., 20 C.R.C. 568) which was later converted into a complete separate exchange. (Re S.C.T.Co., 24 C.R.C. 958.) Pursuant to the order last mentioned the Montebello territory was similarly, in August, 1924, made into a separate exchange.

The Company, feeling that the increases in its rates authorized by the 1921 decision were inadequate, on December 29, 1923 applied for further increases, urging that they be effected through the introduction of a partial measured service in certain portions of its territory. Increases were approved to be effected February 1, 1925, in part through a limited introduction of measured service. (Re S.C.T.Co., 25 C.R.C. 721.) In 1926 an extension of the measured service plan was authorized. (Re S.C.T.Co., 27 C.R.C. 409.) At this time, also, the message rates were reduced.

By 1929 the Company's earning position had improved to a point somewhat better than that usually deemed reasonable by the Commission. A proceeding was instituted on the Commission's own motion and rate changes were ordered effecting a reduction in the Company's revenue, based on 1929 operations, of $2,300,000 per annum. (Re S.C.T.Co., 33 C.R.C. 812.)[5]

(5) Growth of business was such that the reduction related to 1930 business approximated $2,600,000.

Various complaints, formal and informal, respecting service conditions in the Los Angeles area having reached the Commission, there was instituted in January, 1933 a general investigation into these conditions. After several hearings a decision was made on January 10, 1934 by which the Beverly Hills area was ordered incorporated into a separate exchange and excluded from the Los Angeles Exchange, and by which exchanges adjoining the Los Angeles Exchange were given certain privileges for service between such exchanges and adjoining areas in the Los Angeles Exchange. (<u>Re S.C.T.Co.</u>, 39 C.R.C. 172.) This order also had the effect of adjusting some telephone charges.(6) Rates in the outside exchanges generally have continued on the basis and at the level established in 1919, except as minor alterations have been made from time to time by the utility and except as rates have been authorized for newly established exchanges.

<u>Growth of Company</u>.

The growth of the Company as a corporation, as measured by plant investment, number of stations and operating revenue, is shown in the following Table I:

(6) As the hearings in the instant case proceeded, data became available to measure with substantial accuracy the financial effects upon the Company of this order. Investment was increased about $170,000. Over-all Company annual revenue was decreased about $212,000 a year, the decreases being larger in toll than in exchange revenue. Annual expenses were increased about $84,000.

TABLE I

SOUTHERN CALIFORNIA TELEPHONE COMPANY

INCREASE BY YEARS IN PLANT AS PER BOOKS, REVENUE AND STATIONS

Year	Total Telephone Plant (End of Year)	Annual Telephone Operating Revenues	Total Company Stations (End of Year)
1917	$ 16,671,313	$ 2,982,981	134,657
1918	17,014,140	4,288,605	122,769
1919	17,676,697	4,519,587	137,147
1920	19,153,885	5,262,607	147,978
1921	25,009,677	5,996,653	165,841
1922	36,796,120	8,530,528	189,866
1923	52,168,837	10,079,764	219,294
1924	67,729,607	12,079,150	261,853
1925	79,924,877	16,469,686	282,659
1926	83,624,940	18,917,912	310,023
1927	88,005,178	21,110,390	337,039
1928	91,666,996	23,356,353	361,189
1929	97,965,159	25,856,670	388,269
1930	164,590,454	33,996,856	595,660
1931	166,624,151	39,949,677	592,616
1932	166,227,998	35,939,873	539,989
1933	162,573,362	33,288,014	520,768
1934	163,652,064	33,922,893	529,453

The sharp increase in investment, stations and revenue shown to have occurred in 1930, is attributable largely to the acquisition in that year of the telephone property in Southern California theretofore owned by The Pacific Telephone and Telegraph Company and its subsidiaries.

Earning History.

The earning history of the Company was presented in evidence by the Commission's Staff and is displayed in the following Table II:

TABLE II

SOUTHERN CALIFORNIA TELEPHONE COMPANY

HISTORY OF EARNINGS ON BASIS OF HISTORICAL COST BUT WITH LAND FOR 1933 AND 1934 AT CURRENT VALUES AND WITH SINKING FUND DEPRECIATION EXPENSE

Period	Rate Base	Net Revenue	Rate of Return
1917 (a)	$ 16,376,000	$ 819,000	7.5% (d)
1918	16,843,000	520,000	3.1
1919	17,345,000	344,000	2.0
1920	18,415,000	388,000	2.1
1921	22,082,000	25,000	0.1
1922	31,131,000	(267,000)	(0.9)
1923	44,109,000	(725,000)	(1.6)
1924	58,668,000	211,000	0.4
1925	72,934,000	4,357,000	6.0
1926	82,723,000	6,489,000	7.8
1927	87,161,000	7,810,000	9.0
1928	90,995,000	8,820,000	9.7
1929	94,223,000	9,628,000	10.2
1930 (b)	97,344,000	3,489,000	8.6 (d)
1930 (c)	158,596,000	7,509,000	8.1 (d)
1931	163,892,000	13,309,000	8.1
1932	165,843,000	11,798,000	7.1
1933	164,522,000	10,734,000	6.5
1934	163,895,000	10,346,000	6.3

Average Rate of Return for 18-year period - 6.64%

(a) Last 8 months.
(b) First 5 months.
(c) Last 7 months.
(d) Annual basis.

(Red Figure)

Table III gives the earning history of all of the properties owned or controlled by The Pacific Telephone and Telegraph Company in the State of California for the years 1926 to 1934, inclusive, on the same basis as used in Table II. (Over-all State figures for the period prior to 1926 are not in the record.)

TABLE III

PACIFIC SYSTEM IN CALIFORNIA

HISTORY OF EARNINGS ON BASIS OF HISTORICAL COST WITH LAND IN 1933 AND 1934 AT CURRENT VALUE AND WITH SINKING FUND DEPRECIATION EXPENSE

Year	Rate Base	Net Revenue	Rate of Return
1926	$211,810,000	$16,142,000	7.6%
1927	232,621,000	16,939,000	7.3
1928	252,796,000	19,619,000	7.8
1929	278,601,000	22,261,000	8.0
1930	304,113,000	23,731,000	7.8
1931	317,367,000	25,077,000	7.9
1932	320,817,000	23,530,000	7.3
1933	319,074,000	21,440,000	6.7
1934	319,559,000	21,498,000	6.7

II

RATE FIXING AREA

The Southern California Telephone Company until 1930 served only the Los Angeles Exchange territory and the territory comprised in the Culver City and Montebello Exchanges.(7) The 1921 and 1924 rate cases, initiated by the Company, involved charges to be paid by subscribers in the Los Angeles Exchange. The Company then urged this area as the proper rate fixing unit without consideration of earnings either in Southern California or in the State.(8)

(7) These two exchanges are relatively unimportant, representing, prior to the 1930 consolidation, less than 2 per cent of the Company's investment and contributing less than 1 per cent of its earnings.

(8) See Re S.C.T.Co., 25 C.R.C. 721, 738, where the Company's contention in this respect was referred to.

The present level of rates in the Los Angeles Exchange is the result of two rate increases and one rate decrease, each having been effected in a proceeding involving the rates in the Los Angeles area.

The City urges that the only rates here in issue as unreasonable are the rates applicable to subscribers in the Los Angeles Exchange and with a persuasive historical background and considerable equity advances the claim that the Los Angeles Exchange is the proper rate fixing unit.(9) The Company, however, takes the position that the complaint "challenged the reasonableness of the rates of the entire Company and the case should be decided on the basis of the operations of the entire Company" and, over the objection of the City, adduced evidence both as to Company-wide and Los Angeles Extended Area operations and earnings.

On July 29, 1934 the Los Angeles Extended Area plan(10) became effective. Coincidently the Beverly Hills section, formerly in the Los Angeles Exchange, was established as a separate exchange, and the South Pasadena dual service area was divided between Los Angeles Exchange and Pasadena Exchange.

The status of the Los Angeles Exchange since the occurrence of these changes is a matter of dispute between the Company and the City. The Company urges that it no longer exists except as a rate quotation area. The City contends that it exists as a separate exchange for rate fixing purposes.

Except for the Beverly Hills and South Pasadena modifications, the same subscribers exist in the Los Angeles Exchange as

(9) The assurances by Company counsel in the 1930 consolidation case are convincing that an area smaller than the now Southern California Telephone Company system may properly be viewed as a rate fixing unit.

(10) The Los Angeles Extended Area includes the dominant Los Angeles Exchange and the contiguous exchanges of Alhambra, Glendale, Pasadena, Montebello, Beverly Hills, Compton-Hynes-Cardona, Culver City, North Hollywood, Hawthorne and Inglewood and portions of Burbank and Downey Exchanges.

before the effectiveness of the Extended Area plan except as modified by the station movement ever going on. These subscribers pay the same rates as formerly. Those in the periphery area of the exchange are the beneficiaries of certain service facilities they did not formerly enjoy. The subscribers in the exchanges adjacent to the Los Angeles Exchange also enjoy certain services nottheretofore extended.(11)

Thus it appears that historically the area represented by the present Los Angeles Exchange (except for minor modifications) has been given separate consideration and used as a rate fixing area. The plant costs, revenues and expenses and other data as to this area have been readily ascertained from the books and records of the Company up to July 29, 1934.

The rates clearly under attack are the rates for service in the Los Angeles Exchange. However, the change in operating methods incident to the Extended Area plan makes it difficult now to determine Los Angeles Exchange earnings in a precise manner. As a practical matter, therefore, in determining the issues of value and return for the Los Angeles Exchange, matters respecting the value of the properties and the results of operation may best be analyzed and conclusions and findings reached from a consideration of the figures for the Los Angeles Extended Area, which the Company states is the smallest divisible operating unit.

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(11) Taking subscribers in the adjacent Pasadena Exchange, for example, the Extended Area plan accorded them the option of paying extended service rates (somewhat higher than local rates) for which they could communicate without the former toll charge with subscribers in adjoining fringe areas of the Los Angeles Exchange as well as in the adjoining exchanges of Glendale and Alhambra. Subscribers in the periphery areas of the Los Angeles Exchange were accorded the privilege without added charge of communicating with all subscribers whether Extended Area or local in adjoining exchanges outside of the Los Angeles area. Formerly there was a toll charge for this service.

It will become apparent that the Los Angeles Extended Area, of which the Los Angeles Exchange is the dominant part, is the high earning portion of the Company's system. The amount of reduction in the Los Angeles Exchange rates as a matter of equitable consideration should be tempered by a consideration of the investment structure of the entire Company and other factors so that reasonable over-all earnings will prevail. This represents an equity consideration in favor of the utility and patrons in the less lucrative territory.

III

SEPARATION STUDIES

Included in the Company's revenue are not only payments made by subscribers for exchange service but divisions of revenue on account of interstate and intrastate toll service. Various portions of the plant are used in rendering these several services which contribute to revenue. Hence, in order to determine over-all intrastate earnings, over-all exchange earnings, or earnings by exchanges or groups of exchanges, segregations and allocations must be made as to property, revenue and expense. Two methods or plans have been used for this purpose: the "Board to Board" and the "Station to Station." The former method, long advocated by Bell System companies, was disapproved in Smith v. Ill. Bell Tel. Co., 282 U.S., 133, the latter method being there indicated to be the proper one.

Following the Supreme Court decision last specified, the Company developed a station to station allocation which produced almost identical results as the disapproved board to board plan. These studies were introduced as to intrastate, Los Angeles Exchange and Los Angeles Extended Area.

Mr. McNaughton presented in evidence two separation studies, one based on the Company's board to board definition, and a station to station study in harmony with the views expressed by the United States Supreme Court. These studies are the only separation studies in the record which are complete as to the earnings of the various exchanges.

The results of the Company's operations by exchanges based on the station to station separation study, somewhat condensed for the sake of brevity, are as follows, the figures being on the historical cost-sinking fund depreciation basis for the 12 months ending June 30, 1934:

SOUTHERN CALIFORNIA TELEPHONE COMPANY

Exchange	Rate Base	Net Revenue	Rate of Return	No. of Co. Stations Dec. 31, 1933
Los Angeles Extended Area				
Alhambra	$ 1,823,539	$ 41,726	2.3%	8,840
Beverly Hills	-	-	-	-
Burbank	752,553	6,967	.9	3,191
Compton-Hynes-Gardena	552,377	(13,757)	(2.5)	3,045
Culver City	744,841	37,634	5.1	3,272
Glendale	2,665,872	44,105	1.7	12,639
Hawthorne	110,755	1,012	.9	410
Inglewood	576,572	4,561	.8	2,720
Los Angeles	91,587,661	8,118,712	8.9	351,174
Montebello	343,627	6,579	1.9	1,123
North Hollywood	566,028	7,273	1.3	2,680
Pasadena	7,855,193	290,275	3.7	35,906
Total Los Angeles Extended Area	$107,579,018	$8,545,087	7.9%	425,000
Other Large Exchanges				
Riverside	$ 1,382,727	$ (9,287)	(.7)%	7,247
San Diego	7,570,790	243,499	3.2	36,380
San Pedro-Wilmington	1,708,736	15,534	.9	8,596
Santa Ana	1,353,332	12,916	1.0	6,532
Remaining 65 Exchanges	8,312,058	(68,270)	(.8)	37,013
Total All Company Exchanges	$127,906,661	$8,739,479	6.8%	520,768
Total Toll	35,903,923	1,882,874	5.2	-
Total Company	$163,810,584	$10,622,353	6.5%	520,768

(Red Figure)

None of the various suggested bases of allocation throw serious doubt upon the substantial correctness of the relationship between the earnings of the Los Angeles Exchange and of the various other exchanges indicated by the foregoing table. In other words, the various plans of segregation influence the rates of return by exchanges in substantially the same degree. These relationships are displayed by the following Table IV, showing the results of the studies made both by the Company and the Commission's staff on the various property bases for various operating areas and for the two methods of separation. The Company's showings on investment and fair value are based on the testimony of Mr. C. E. Fleager, First Vice President of the Company.

The station to station separation method employed by the Commission's engineer was basically that used by the Commission in the fixation of Los Angeles Exchange rates in 1924 in Re. S.C.T.Co., 25 C.R.C. 721, the decision which was referred to by the Supreme Court in the Illinois Bell case. In view of the past policy of the Commission, the expressions of the courts and sound reason, the station to station separation on the basis followed by the Commission's Staff should be adhered to as representing the most reasonable procedure for measuring not only interstate and intrastate earnings but exchange and toll earnings.

TABLE NO. IV

SOUTHERN CALIFORNIA TELEPHONE COMPANY

RELATIONSHIPS BETWEEN AREAS

Item	Year Ending June 30, 1934: Company as a Whole	Year Ending June 30, 1934: Exchanges Comprising Present Los Angeles Extended Area	Year Ending June 30, 1934: Los Angeles Exchange	Year 1934: Company as a Whole (Intrastate)	Year 1934: Los Angeles Extended Area Based on last 5 Mos.	Year 1934: Los Angeles Exchange Based on first 7 Mos.	1935 with '36 Taxes Assumed: Company as a Whole (Intrastate) (Exhibit 138)	1935 with '36 Taxes Assumed: Los Angeles Extended Area (Exhibit 138)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
RATE OF RETURN								
McNaughton - (Hist. Cost)								
Station to Station	6.48%	7.94%	8.86%	6.35%	7.65%	8.61%	6.33%	7.21%
Board to Board	6.48	7.33	8.51	6.35	7.38	8.12	6.31	6.94
Company - (Investment)								
Station to Station	-	-	-	4.75	5.62	6.19	-	-
Board to Board	-	-	-	4.75	5.65	6.27	-	-
Company - (Fair Value)								
Station to Station	-	-	-	4.56	5.47	6.04	-	-
Board to Board	-	-	-	4.56	5.51	6.11	-	-
PROPERTY BASE (In Millions of Dollars)								
McNaughton - (Hist. Cost)								
Station to Station	$163.8	$107.6	$91.6	$158.2	$112.5	$89.2	$159.1	$113.4
Board to Board	163.8	111.5	93.4	158.3	114.5	91.9	159.2	115.4
Company - (Investment)								
Station to Station	-	-	-	161.8	115.4	91.6	-	-
Board to Board	-	-	-	162.0	117.5	94.4	-	-
Company - (Fair Value)								
Station to Station	-	-	-	168.7	118.4	93.9	-	-
Board to Board	-	-	-	168.9	120.5	96.9	-	-
GOING CONCERN - (Company)	-	-	-	12.0	8.0	-	-	-

IV

PROPERTY VALUE

The cost of construction of the property, the present cost as compared with the original and all other evidence dealing with the fair value of the properties as a going concern except for the element of accrued depreciation in the properties are considered herein. The accrued depreciation is intimately related to the allowance for depreciation expense, and it seems appropriate to discuss this important subject in a succeeding section.

In considering property values, the objective is the determination of the fair value of the property devoted to the intra-Los Angeles Extended Area operations. However, as much of the evidence was introduced for the entire Company operations, it is convenient to analyze the evidence both as to Company-wide and Los Angeles Extended Area operations. The relationships between these areas are quite consistent.

The Historical Cost of Properties.

The record indicates that the Company's records are complete and accurate, and no substantial disagreement as to the historical cost of the properties developed during the hearings. The telephone plant accounts representing the cost of the properties in service as of December 31, 1934 totaled as follows:

Item	Los Angeles Extended Area	Entire Company
Telephone plant in service	$116,953,000	$162,477,000

It will be noted that the Los Angeles Extended Area bears a relation of 72 per cent to the total Company plant accounts.

With these figures as a base, the Commission's engineers have computed the historical cost rate base, after making certain adjustments, as follows:

Item	Los Angeles Extended Area	Entire Company
Telephone plant in service	$116,953,000	$162,477,000
Adjustments		
Non-operative property	(179,000)	(179,000)
Depreciation on motor vehicles	(687,000)	(890,000)
Adjustment of lands to market value	(650,000)	(650,000)
San Francisco administration building	326,000	386,000
Working cash	944,000	1,321,000
Materials and supplies (12-31-34)	1,331,000	1,629,000
Total	$118,038,000	$164,094,000

(Red Figure)

The Company, on the other hand, starting from the same basic figures for plant arrives at the following total from a cost standpoint:

Item	Los Angeles Extended Area	Entire Company
Telephone plant in service	$116,953,000	$162,477,000
Construction work in progress	297,000	373,000
Cash	472,000	576,000
Working funds	23,000	25,000
Due from customers and agents	1,949,000	2,360,000
Materials and supplies (Average 1934)	1,588,000	2,008,000
San Francisco administration building	326,000	400,000
Total	$121,608,000	$168,219,000

The differences between the studies of the Commission's staff and the Company center to a large extent on the allowance for working cash and materials and supplies, the Company being higher by an amount of $2,019,000. Here, as in the case also of the reproduction cost, the working cash allowance of the Commission's staff is well supported and is in substantial excess of the actual cash on hand. The Company includes in full net amounts due it by subscribers, but fails to deduct average amounts which it currently owes to its employees and other parties. There is no issue on materials and supplies except that the Company's figure is an average for 1934, while the figures shown in the statement of the Commission's staff are as of December 31, 1934, being the more recent experience.

The deduction of the accrued depreciation for motor vehicles is necessary for the reason that part of the depreciation has been charged into plant accounts and the remainder into operating expenses. Without this deduction there is a duplication of charges. However, later figures indicate the amount to be deducted should be $770,000 rather than $890,000.

Construction work in progress includes two different classes of property: (a) actual plant construction under way, and (b) lands held for future telephone use, the money value of the two items being approximately equal. As to the first item, interest during construction is charged until the property is complete and ready for operation. Accordingly, such construction work should not be included in the rate base unless a corresponding interest revenue is included in the operating revenues. Substantially the same result will accrue in either case, and it seems preferable not to include the amount in the property base.

The lands held for future use and the lands and buildings listed as non-operative by the Commission's staff were all acquired in good faith and may be used in the future. It is evident in the particular cases involved that reasonable judgment was employed by the management and that it plans to make use of the property in the future. While the property is not strictly in service, these lands and buildings will be considered in the findings as to property value.(12)

The historical costs above referred to include the amounts actually paid for materials including the amounts paid Western Electric Company, a subsidiary of the American Telephone and Telegraph Company, for telephone equipment of its own manufacture. While no question is raised in this proceeding as to the validity and reasonableness of the costs actually incurred historically through purchase of telephone apparatus from an affiliated manufacturing company, a serious question arises as to the validity of the application of the present prices of the Western Electric Company, which have been raised over 30 per cent since 1929, in considering the issues as to the reproduction cost of the property. This question, however, is discussed later.

The Present Costs Compared with Historical Costs.

The evidence as to the present as compared with the original cost of construction is in the form of three principal sources:

1. An estimate prepared by the Company for the purposes of this case of the cost to reproduce new its present properties, under the assumption that all conditions were identical with those on December 31, 1934 except that the Telephone Company and its telephone plant were not in existence. This estimate was based upon a six-year construction program with spot prices as of December 31, 1934.

2. A study by the City's engineer of the Company's estimated cost of reproduction.

3. The Company's estimate of reproduction cost new prepared for use in arriving at value for taxation purposes.

(12) Mr. Fry, Telephone and Telegraph Engineer of the Commission, testified that the plant of the Company at the end of 1934 was from 9 to 15 per cent larger than necessary to care for its then subscribers. In discussing the reproduction cost this testimony has an important bearing. However, as the trend of business is definitely upward, it seems more reasonable to find a value for the property based upon its ability to serve a greater number of subscribers than it is at present serving.

The Company's Estimate of Reproduction Cost New:

The Company's estimate of reproduction cost new prepared for this proceeding by Messrs. H. W. Hitchcock and D. L. Scoville, engineers of the Company, as of December 31, 1934, is in the following amounts:

Item	Los Angeles Extended Area	Entire Company
Telephone plant in service	$128,116,000	$177,593,000
Construction work in progress	249,000	324,000
Cash	472,000	576,000
Working funds	23,000	25,000
Due customers and agents	1,949,000	2,360,000
Materials and supplies	1,588,000	2,008,000
San Francisco administration building	326,000	400,000
Total	$132,723,000	$183,286,000

Here the Los Angeles Extended Area is 72 per cent of the entire Company.

All of the above items except telephone plant in service are the same as discussed under historical cost, so that with one exception the same conclusions will apply. In the case of construction work in progress, a lesser figure appears in the reproduction cost because of the appraisal of land held for future use.

It is appropriate, therefore, to pass to a detail analysis of the item of "Telephone plant in service." A comparison of these reproduction costs by accounts with the historical costs for the entire Company follows:

Account	Historical Cost	Reproduction Cost New (Rate Case)	Ratio to Book Cost
Organization	$ -	$ 443,000	-
Franchises	4,000	67,000	16.4
Right of way	319,000	366,000	1.1
Land	3,338,000	2,994,000	.9
Buildings	12,954,000	12,987,000	1.0
Central office equipment	47,662,000	53,540,000	1.1
Station equipment	22,941,000	27,017,000	1.2
Outside plant	72,419,000	77,141,000	1.1
Furniture and office equipment	1,540,000	1,372,000	.9
Vehicles and other work equipment	1,300,000	1,448,000	1.1
Miscellaneous interest and taxes during construction	-	218,000	-
Telephone plant in service	$162,477,000	$177,593,000	1.1

In the historical costs, interest and taxes during construction are included in the accounts. The Company's reproduction cost estimate includes some $7,800,000 for these items, and to make proper comparisons, the latter has been spread to accounts except for a minor amount.

The City's Study.

The City of Los Angeles, through Mr. A. V. Cuillou, an engineer for the City of Los Angeles, presented testimony respecting the Company's estimate of cost to reproduce its entire properties. Criticisms of the estimate were grouped into three categories as follows:

1. As a matter of purely hypothetical reproduction, termed visualized reproduction, the following items included in the Company's reproduction cost were urged as being entirely improper:

(a) The inclusion of a theoretical cost of cutting and replacing pavement not historically cut or replaced, which, with an addition for omissions and contingencies and interest during construction on this amounts to........................$3,171,400

(b)	The inclusion of station installations and drop wires which have been abandoned and written out of capital but which may be reused................	$1,033,000
(c)	The inclusion of disconnected stations left in premises........................	1,623,000
(d)	The inclusion of land and buildings held for future use.....................	401,300
(e)	The inclusion of overheads on land.....	317,000
(f)	The inclusion of organization and franchise costs greater than incurred.................................	405,500

2. The use by the Company of spot material prices as of December 31, 1934 was criticized. Had telephone apparatus prices as of the first of 1930 and other prices as of December 31, 1934 been used, the Company's figure would have been reduced $13,000,000. Had average prices of the five years 1930 to 1934 been used, the Company's figure would be reduced by $7,000,000.

3. The Company's unit costs (exclusive of material prices) developed from its recent construction experience were criticized because they were adjusted to represent what was termed difficulty factors. Had actual experience without the adjustments been used, the Company's total figure, according to the City's witness, would be less by $13,700,000.

The City's contention is that from an appraisal of the evidence it believes the Commission would be warranted in a reduction of the Company's estimate of $183,000,000 to approximately $155,000,000.

Reproduction Cost New for Taxation Purposes.

The Company, in connection with the new ad valorem taxation of public utilities, made certain estimates of reproduction cost new as of March 31, 1934. These estimates reflect the result of trending historical costs to the price level of the year 1933. The figures reached were substantially less than those in the reproduction new estimate made for the rate case, being about 91 per cent of the book cost.

In the preparation of such an estimate, the base figures are the historical costs which include all overheads and interest and taxes paid during construction, together with the actual experience of the Company in building its system on a historical construction program.(13)

The reproduction estimate made in this manner shows that price levels prevailing in 1933 were at a substantially lower level than the average costs as reflected on the books of the Company.

Subsequent discussion will indicate that substantial weight may be given the price levels used in this study in viewing the future in this particular case because of the peculiar incidence of prices of Western Electric Company for telephone apparatus of its own manufacture.

This study likewise indicates, as the Supreme Court has recognized in its recent decisions, that price levels since 1929 have dropped to a distinctly lower plateau. (See Atchison T.& S.F.R.Co. v. United States, 284 U.S. 248; Los Angeles G.& E.Corp. v. Railroad Commission, 289 U.S. 287; Central Kentucky Nat.G.Co. v. Railroad Commission, 290 U.S. 264; Clark's Ferry Bridge Co. v. Pub.Serv.Com., 291 U.S. 227.) As said in Great Northern R.Co. v. Weeks, 80 Law Ed. (Ad.Op) 396, decided February 3,1936, "Judicial notice must be taken

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(13) Mr. Blanck, Assistant Vice President, when interrogated as to some of the bases he had used in constructing a valuation for purposes of taxation, testified:

"Mr. Wheat: I also understood you to say that you did not load your figures for so-called difficulty factors in reproduction?
A. That is right, nor any of the general superintendence or developing of plans and all that sort of thing, engineering and all that sort of thing, which would have to go under reproduction cost, which would cost you more than the way we had built the property."

of the fact that late in 1929 there occurred a great collapse of values of all classes of property - railroads, other utilities, commodities and securities, and that the depression then commenced progressively became greater." This collapse, it was said, "resulted in much lower levels of prices and values which at least as early as 1933 were to be regarded not as temporary but as at least relatively permanent."

Lands.

The Company in its reproduction cost estimate for the rate case accepted Mr. McAuliffe's land appraisal for Los Angeles and Pasadena Exchanges, together with book costs for the remaining properties, this being the basis used by the Commission's staff in Exhibit No. 1. In addition the Company added $250 to each parcel for surveying, recording and title insurance. There has also been added taxes during construction in the amount of $55,000 and interest during construction of $255,000, these amounts being superimposed by the Company on the present market value of the lands as appraised.

Buildings.

Of the 89 buildings owned by the Company only 16 were built prior to 1920. The reproduction cost of the buildings before adding interest and taxes during construction was found by the Company to be somewhat less than the actual historical cost. Under the construction program outlined by the Company in its estimate, $168,000 has been added for taxes during construction and $773,000 for interest during construction. For many years the Company has included interest and taxes during construction in its plant costs, yet the actual total amounts of interest during construction were found to be only $64,000 as of January 1, 1933. By such additional interest and tax charges the Company's reproduction cost under a theoretical construction program for buildings is brought to a figure higher than the books.

Central Office Equipment.

Central office equipment presents a much more difficult problem. The prices for central office equipment are not free prices. This equipment is virtually all purchased from the Western Electric Company and the prices have been substantially increased during the depression due to the falling off of Western Electric business.(14) In analyzing this account it is helpful to compare the book cost with the Company's reproduction cost new estimate prepared for this case and with the reproduction cost estimate prepared for tax purposes. This is done in the following table:

Item	Historical Cost	Reproduction Cost New (Rate Case)	Reproduction Cost New (Tax Method)
Manual central office equipment	$ 9,135,000	$ 9,498,000	$ 8,505,000
Long lines equipment	2,880,000	3,315,000	3,005,000
Step by step dial equipment	35,647,000	38,365,000	32,320,000
Interest and taxes during construction	*	2,362,000	*
Total central office equipment	$47,662,000	$53,540,000	$43,830,000

* Interest and taxes during construction included in primary figures.

Station Equipment.

The station equipment group likewise involves to a considerable extent the question of Western Electric prices and added interest during construction. The accompanying table shows the details of the accounts in this group:

(14) The plant investment in Bell companies is some $4,250,000,000. In adjusting this to value, fluctuations in the level of Western Electric prices play an important part. Hence there is necessarily present a powerful self interest which bears upon the level of these prices.

Item	Historical Cost	Reproduction Cost New (Rate Case)	(Tax Method)
Station apparatus	$9,399,000	$9,968,000	$9,870,000
Station installation	5,033,000	5,720,000	4,980,000
Drop and block wires	2,838,000	4,444,000	2,810,000
Private branch exchanges	5,267,000	5,613,000	5,320,000
Booths and special fittings	404,000	372,000	380,000
Interest and taxes during construction	*	900,000	*
Total station equipment	$22,941,000	$27,017,000	$23,360,000

* Interest and taxes during construction included in primary figures.

In connection with station equipment, two additional problems arise. As telephone service is discontinued from time to time by subscribers, a certain portion of the plant is rendered idle, i.e., the drop and block wires, station installation and station apparatus. If the telephone is left in place it becomes a left-in disconnected station and the amounts of capital representing this investment remain in the capital account and therefore in the book cost. If the telephone is removed then the station apparatus, station installation and drop and block wires are written out of the capital accounts on the books. The Company in its reproduction cost for rate case purposes has not only reproduced all of the property shown in the capital accounts, including left-in disconnected stations, but has added to this figure an amount representing the reproduction cost of a portion of the abandoned drop and block wires and station installations which have already been written out of the capital account and charged to operating expenses.

Outside Plant.

The outside plant group includes pole lines, wire, cable and conduit. The cost and reproduction costs of these accounts follow, including interest and taxes during construction in the appropriate accounts in all cases:

Item	Historical Cost	Reproduction Cost New (Rate Case)	Reproduction Cost New (Tax Method)
Pole lines	$11,572,000	$12,726,000	$11,890,000
Aerial wire	4,555,000	3,552,000	3,258,000
Aerial cable	14,442,000	13,586,000	11,765,000
Underground cable	27,460,000	25,209,000	22,590,000
Submarine cable	215,000	198,000	187,000
Underground conduit	14,175,000	21,870,000	13,689,000
Total outside plant	$72,419,000	$77,141,000	$63,379,000

In the case of outside plant, although the material is largely purchased through the Western Electric Company, other suppliers are available and the trend of prices shows practically no change from the 1930 level and stands at about 78 compared with 100 in 1926. Consequently it is not surprising to find that where the historical costs have been trended, as is the case in the reproduction cost new estimate filed with the Board of Equalization, reproduction cost is materially lower than the books. If to this trended reproduction cost additional amounts of interest and taxes during construction and allowances for omissions and contingencies are added because of a hypothetical construction program rather than the actual construction program under which the property was built, it is still found that the reproduction cost is less for most accounts in this group than the historical cost. The price trend for this class of plant has been slightly upward since 1932.

In regard to underground conduit, here again the trended reproduction cost is less than the historical cost, but it will be noted that the reproduction cost rate case method is over 50 per cent higher than the historical cost. This is due somewhat to the inclusion of additional interest and taxes during construction and difficulty factors, but the principal factor accounting for the increase is the cost of paving over conduit which was not actually cut historically. This, according to the City's exhibit, alone accounts for some $3,200,000.

Other Accounts.

Furniture and office equipment under the Company's reproduction cost estimate is $1,372,000, or 89 per cent of the book cost of $1,540,000, whereas motor vehicles are estimated by the Company to cost on a reproduction basis $1,448,000, or 111 per cent of the book cost of $1,300,000.

There is also an item of miscellaneous interest and tax charges during construction of $218,000. This includes such items as interest charges on organization expense, interest on cash and working funds and interest and taxes on materials and supplies, etc.

Price Levels.

In Mr. Guillou's study of price trends, it develops that the spot prices used by the Company December 31, 1934 represent a 33 per cent increase over the Western Electric price levels of Jan. 1, 1930,(15) for telephone apparatus of its own manufacture.

According to the testimony, changes in Western Electric prices are influenced, considerably at least, by the activity or

(15) A 10 per cent increase in Western Electric prices occurring in 1930 and other increases since that time have been the object of general criticism by Commissions and Courts. (Re Southwestern Bell Tel. Co.(Okla.) 9 P.U.R. (N.S.) 113, 122; Louisiana Pub. Serv. Com. v. Southern Bell Tel. & Tel. Co.(La.) 8 P.U.R. (N.S.) 1, 8; Re Southern Bell Tel. & Tel. Co. (N.C.) 7 P.U.R. (N.S.) 21, 26; Re Wisconsin Tel. Co. (Wis.) 6 P.U.R. (N.S.) 389, 420; Re Chesapeake & P. Tel.Co. (Dist.Col.) 4 P.U.R. (N.S.) 346,358; Chesapeake & P.Tel.Co. of Baltimore v. West, 7 F. Supp. 214; Re Ohio Bell Tel.Co.(Ohio) 2 P.U.R. (N.S.) 113,123; Re Chesapeake & P. Tel.Co.(Maryland) 1 P.U.R. (N.S.) 346; Illinois Bell Tel.Co. v. Gilbert, 3 F. Supp. 595,603.

inactivity of the associated Bell companies. With a large volume of business prices tended downward and with a decrease in orders, as has been the case since 1930, prices have been raised substantially. The following table is of interest in connection with the price trends, the first price column indicating largely Western Electric manufactured equipment and the second, material largely purchased through the Western Electric where other suppliers are available.

As of January 1st	Telephone Apparatus	Remainder of Material	Composite All Materials
1935	100	78	89
1934	94	78	85
1933	82	75	78
1932	81	75	78
1931	81	79	80
1930	75	91	84
1929	83	89	86
1928	89	89	89
1927	96	94	95
1926	100	100	100
1925	102	102	102
1924	109	100	105
1923	107	98	102
1922	112	90	100
Average 1930 - 35	85	79	82

Note: "Telephone Apparatus" includes Central Office Equipment, Private Branch Exchanges, and Station Apparatus.

It is of interest to note that while telephone apparatus prices had by January 1, 1935 been raised to the 1926 level, prices for the remainder of the material are still substantially below the level prevailing in that year.

Of the Company's reproduction cost of some $183,000,000, approximately $67,000,000 represents accounts influenced by the Western Electric Company's trend for telephone equipment at prices as of January 1, 1935. If these accounts had been priced on the basis of Western Electric Company's 1930 prices, the total reproduction cost for such accounts would have been $54,000,000, a difference of some $13,000,000. If average Western Electric prices during the period 1930 to 1935 had been employed, the telephone apparatus accounts would have totaled $59,000,000. The remaining property priced at $116,000,000, as of January 1, 1935 would have been priced at $117,000,000, had it been priced at the average 1930 to 1935. If all accounts had been priced at average prices during this period the Company's estimate would have been $176,000,000 instead of $183,000,000, all other elements of the Company's reproduction cost new estimate except material prices being included.

Going Value.

Mr. Fleager expressed the opinion that there is a going value of $12,000,000 existing in the property of the Southern California Company. He premised this upon various statistical data descriptive of the property, its actual cost and estimated reproduction cost, its connection with a larger organization and with other companies and the nature of the territory served.(16) Of the $12,000,000 estimate, he assigned $8,000,000, or 66-2/3 per cent to the Los Angeles Extended Area, a percentage somewhat less than the relationship existing between these two areas as to historical cost and cost of reproduction cost new. Mr. McNaughton testified "that those items which are generally considered as being included in going value have been included in our figures, as they were incurred, either in the capital cost or in the operating expense as recorded - cost of training personnel and cost of developing records and attaching the business." Although he testified that no segregation

(16) These are listed in Exhibit 30 where they are broken down as between the Company and the Extended Area.

had been made, he stated that "I think we have recognized all of the costs which go to the development of those things generally included in going value."

The latest expressions of the Supreme Court are in line with obvious equity in indicating that so far as the cost of creating a going value is in the capital accounts or has been absorbed in the current cost of service it should not be allowed again as an additive sum in developing a property base. (See Dayton P. & L. Co. v. Pub. Util. Com., 292 U.S. 290; Columbus Gas & Fuel Co. v. Pub. Util. Com., 292 U.S. 398.)

The evidence indicates the existence of a substantial going concern value in these properties, and in the findings to follow the fair value of the properties will include their value as a going and operating concern.

Fair Value.

As has been stated, the subject of depreciation has been reserved for later discussion. At this point it is appropriate to consider all of the evidence of value in the record except that relating to accrued depreciation. From a consideration of all the evidence, including the historical costs of the property, and the present costs compared with historical costs and of the value of the property as a going concern, the fair value undepreciated, including an allowance for materials and supplies and working cash for the property existing December 31, 1934 is determined for the entire company to be $166,000,000 and for the Los Angeles Extended Area to be $120,000,000.

The intrastate portion of the entire company property is 96.5 per cent of the total Company.[17] Thus the value of the property of the entire Company assignable to intrastate operations is in round figures $160,000,000.

It is essential to determine the value of the property located in the Los Angeles Extended Area which is assignable to intraarea operations. This may be established by applying a separation percentage of 95.1 to the value of the property located in the Los Angeles Extended Area. The fair value undepreciated of the property existing as of December 31, 1934 assignable to the intra-Los Angeles Extended Area operations is found to be $114,000,000.

V

OPERATING REVENUES AND EXPENSES

The operating revenues and the expenses other than the expense for depreciation present no material issue.[18] The revenues and expenses for the Los Angeles Extended Area for the last five months of 1934 (placed for convenience on an annual basis), together with the separation percentages (which are based on the station to station separation method approved herein) and the amounts applicable to intra-Los Angeles Extended Area operations, follow:

(17) The separation percentages applicable to the property base are not in issue.

(18) The Company assumed the burden of proving the license fee payment of 1-1/2 per cent of gross revenue to the American Telephone and Telegraph Company. Mr. F. N. Rush, the Company's General Manager, testified as to the services rendered his Company by the American Company. The City makes no issue of this payment, and it has been included in the operating expenses. Likewise, the accruals for employees' pensions have been included in operating expenses in full as recorded by the Company.

Item	Book Amount	Separation Per Cent	Intra-Los Angeles Extended Area
Operating Revenue			
Local service revenue	$22,690,662	99.32	$22,536,365
Toll service revenue	2,339,132	74.38	1,739,846
Miscellaneous revenue	631,655	99.64	629,381
Uncollectible revenue	(154,396)	99.46	(153,562)
Total Operating Revenue	$25,507,053	97.04	$24,752,030
Operating Expenses			
Maintenance	5,153,818	96.46	4,971,373
Traffic	1,889,761	95.72	1,808,879
Commercial	2,530,027	89.43	2,262,603
General office - other	1,755,101	93.31	1,637,685
Taxes	2,872,949	97.74	2,808,020
Total Operating Expenses	$14,201,656	94.98	$13,488,560
Net Available for Depreciation and Return	$11,305,397	99.62	$11,263,470

(Red Figure)

The figures for the entire Company for the year 1934, together with the separation percentages and amounts applicable to intrastate operations, follow:

Item	Book Amount	Separation Per Cent	Intra-State Amount
Operating Revenue			
Local service revenue	$25,908,383	99.55	$25,791,795
Toll service revenue	7,559,109	90.41	6,834,190
Miscellaneous revenue	722,401	100.00	722,401
Uncollectible revenue	(267,000)	95.64	(255,359)
Total Operating Revenue	$33,922,893	97.55	$33,093,027
Operating Expenses			
Maintenance	6,885,527	97.24	6,695,486
Traffic	3,570,438	98.92	3,531,877
Commercial	3,014,167	98.23	2,960,816
General office - other	2,376,009	97.79	2,323,499
Operating taxes	3,766,775	97.66	3,678,632
Total Operating Expenses	$19,612,916	97.84	$19,190,310
Net Available for Depreciation and Return	$14,309,977	97.15	$13,902,717

(Red Figure)

VI

ACCRUED DEPRECIATION AND DEPRECIATION EXPENSE

Perhaps the most important and certainly the most intricate issue presented centers about the amount reasonable and necessary as annual operating expense allowance for depreciation and its complement, the amount to be deducted from the property base because of accrued depreciation.

The conflict between estimate and reality adverted to in Lindheimer v. Ill. Bell Tel. Co., 292 U.S. 151, is present here in a no less marked degree than there. Indeed, the record here gives an even more complete picture of fact and reality. While some of the methods of depreciation do not accord with reality but draw in varying degrees upon assumptions, all, if consistently applied to a property like this (19) for the measurement both of annual depreciation expense and accrued depreciation, lead to almost identical results in expressing the earning position of the Company.

The Company claims that it should be allowed as annual depreciation expense (in addition to those charges for that property retired through current maintenance or otherwise) a composite rate of about 4 per cent of the property base. At the same time it insists that because of the high degree of maintenance and the fact that there are currently present no observable or known functional causes for retirement of any consequence, its property with a composite average age in excess of 7 years has suffered an existing depreciation of but 7 per cent, compared with an accrued depreciation of more than 22 per cent if calculated on the basis of the

(19) When a property approaches middle age the provision for depreciation and return under various theories tends to coincide. (See Telephone & Railroad Dep. Charges, 177 I.C.C. 351,411.) Until then, straight line accounting means a somewhat heavier burden upon patrons. As of 1934 the rate of return under the straight line method is about the same as under the sinking fund. The property is now somewhat older.

same rates used by the Company for calculating depreciation expense.

Its claims in this respect are depicted in the following table:

TABLE V

SOUTHERN CALIFORNIA TELEPHONE COMPANY
COMPANY CLAIMS RESPECTING ANNUAL DEPRECIATION EXPENSE AND EXISTING DEPRECIATION IN DEPRECIABLE PROPERTY (AND UPON OTHER PROPERTY NOT SO CLASSIFIED)

Item	Book Cost: Dec. 31, 1934	Annual Depreciation Rates in Per Cent	Company's Estimate of Existing Depreciation
Right of way - Exchange	$ 12,000	2.5%	0.0%
Right of way - Toll	307,000	2.0	0.0
Buildings	12,953,000	2.5	3.0
Central office equipment	47,662,000	4.8	4.0
Station apparatus	9,399,000	7.7	10.0
Private branch exchanges	5,267,000	8.3	5.0
Booths and special fittings	404,000	8.2	10.0
Pole lines - Exchange	8,052,000	5.3	20.0
Pole lines - Toll	3,520,000	4.7	10.0
Cable - Exchange aerial	12,016,000	4.4	10.0
Cable - Toll aerial	2,426,000	3.1	7.0
Cable - Exchange underground	20,785,000	3.3	7.0
Cable - Toll underground	6,675,000	2.4	3.0
Cable - Exchange submarine	36,000	4.0	16.0
Cable - Toll submarine	179,000	4.8	25.0
Aerial wire - Exchange	1,656,000	10.0	17.0
Aerial wire - Toll	2,899,000	3.4	5.0
Underground conduit - Exchange	11,599,000	2.0	6.0
Underground conduit - Toll	2,576,000	1.4	3.0
Furniture and office equipment	1,541,000	7.5	27.0
Vehicles and other work equipment	1,300,000	14.6*	29.0
Station installations	5,033,000	0.0*	10.0
Drop and block wires	2,838,000	0.0*	20.0
Composite Per Cent		4.42	6.99

* Not handled through the regular depreciation expense account.

The most important account is central office equipment. Here, on over $47,000,000 of plant, the Company claims a 4.8 per cent annual depreciation expense allowance; at the same time it insists the total existing depreciation is but 4.0 per cent. The extreme and unequitable results indicated by this table negative the soundness of the Company's position in respect to depreciation.

Results by the Straight Line Method.

The Company for many years has accounted for depreciation expense upon the straight line basis.[20] The result obtained admittedly is not in accord with reality. "The lives of property" as testified to by Mr. Fleager, "do not follow that theory." Under this basis the Company has built up a reserve which at the end of 1934 amounted to nearly three times its estimate of the depreciation existing in the property. On the identical assumptions and prophecies upon which the Company estimates a straight line depreciation expense percentage of 4.42, the past accrued depreciation, the Company estimates, equals an even higher amount than does the reserve.[21]

(20) This has been pursuant to accounting instructions of the Interstate Commerce Commission.

(21) Mr. Fleager testified that if the expense rates claimed by the Company had been approved then the figures represented in his estimate would be those which should appear in column 2 of Schedule 6 of the depreciation report prepared originally in accordance with the requirements of the Interstate Commerce Commission, which column is headed "Estimate of Past Accrued Depreciation." (Ex. 78, pg. 60) He explained how his estimated figure was arrived at as follows:

"*** we have two methods in actually computing this, and we have used in certain accounts one method and in other accounts another method, that is, whichever one of the mechanics was more convenient to get the answer. One was to find, with the prophecy of the future life that you have for a piece of property, how much additional reserve should be accumulated, and knowing the salvage and how much additional reserve should be accumulated, why, you should know what should be in the reserve for it. The other method is to reverse that transaction and begin with the birth of the property and with those rates, with the passage of time, to calculate what reserve should have been accumulated on that property. And, of course, the mathematical conclusions from this gives the total reserve requirement. They really lead to the same answer, only one is a positive way and the other is a negative way of getting that answer."

Mr. Fleager, however, was of the opinion that the present reserve is adequate.(22) If he is correct in this, it necessarily follows that the annual allowance for expense should be less.(23)

The amount in the depreciation reserve as of December 31, 1934 was $29,700,279, while the estimate of existing depreciation for the same accounts was $10,570,894 and for all properties was $11,641,828. The corresponding estimate of the reserve requirement or accrued depreciation on the straight line basis was $40,078,583 and the study presented by the Commission's staff $42,974,667.

From the evidence it appears that the accrued depreciation in the property computed in accordance with the straight line method as of December 31, 1934 was not less than $26,000,000 for the property applicable to the intra-Los Angeles Extended Area and not less than $37,000,000 for the property applicable to intrastate operations.

It is possible, therefore, from the record to set up a table depicting the Company's earning position, were its claim for straight line depreciation expense to be accepted, by applying the resultant net revenue to a rate base reduced by the amount of straight line accrued depreciation estimated on the same basic principles used in computing annual depreciation expense.

The following Table VI depicts the earning position of the Los Angeles Extended Area for the last five months of 1934 (on an annual basis) and for the intrastate operations for the year 1934. The periods were selected by the Company in its presentation and

(22) His testimony was "We have built up a balance in our actual reserve for the Company which, in my judgment, will protect the property. I think it is a proper reserve in view of all the circumstances."

(23) Mr. Barnes testified that if the depreciation reserve requirement merely equalled the reserve then basically the use of longer lives would be proper with a consequently lower annual rate.

for comparative purposes have been used herein. Due to the upward trend of business, the last five months' period of 1934, upon which the Los Angeles Extended Area earnings are based, is on a higher earning level so that the disparity in earnings between the entire Company and the Los Angeles Extended Area is overemphasized in the Company's showing and in Tables VI, VII and VIII herein. Actually, the Los Angeles Extended Area is on an earning basis about 1 per cent higher than the entire Company. The property values as of December 31, 1934 are used as representative of the periods indicated in this and succeeding tables.

TABLE VI

Item	Los Angeles Extended Area	Entire Company Intrastate
Undepreciated rate base	$114,000,000	$160,000,000
Less accrued depreciation	26,000,000	37,000,000
	$88,000,000	$123,000,000
Net revenue before depreciation	11,263,000	13,903,000
Depreciation expense (A)	4,471,000	6,198,000
Net for return	6,792,000	7,705,000
Rate of return	7.72%	6.26%

(A) The separation percentages for depreciation expense are not contested and are as follows: Los Angeles Extended Area 95.70 per cent; entire Company 96.78 per cent.

Observed Depreciation and Retirement Experience.

The existing depreciation in the property, it is claimed by the Company, reflects the fact of depreciation as disclosed by inspection and observation and uninfluenced by any theories and assumptions. It was revealed, however, by the City's cross-examination, and also affirmative testimony by Commission engineers, that actually there were various theories and assumptions underlying the Company's estimate. It was the result of an attempted determination by inspection of a "condition per cent" of the property[24] which in turn was translated into value by the use of the same percentages. Inspectors of the property generally reported its condition by nomenclature, such as "good," "fair" and "poor." To these were assigned percentages.[25] Central office equipment, referred to in the footnote, has, according to the Company, practically zero value as salvage. Hence, under the percentage assumptions or assignments, at or about the time of retirement there occurs what the Company witness characterized as "a comparatively precipitate drop" from a per cent condition of around 83 per cent to zero and which drop, still according to the theory, is translatable to value.[26]

It is obvious that under the definitions and methods upon which the figure under discussion is based, functional causes of depreciation, characterized by the Company's witness Scoville as amongst "the most deadly influences affecting the life of a telephone plant," are almost completely ignored. As expressed by Mr. R. A. Wehe, an engineer of the Commission who has specialized in the subject of depreciation, "to follow a type of service theory of value * * which would find a depreciated cost from 80 to 100 per cent throughout the

(24) Thus, Mr. Ilse, the Company's witness, testified: "We compare that property to a property of exact size, type and kind, similarly located, 100 per cent new. That is the per cent condition."

(25) To central office equipment, the most important item of the Company's property, the percentages assigned ranged from 83 per cent to 99 per cent. Ilse, in response to a question as to what would happen if a unit was to fall as low as 75 per cent, testified it is "inconceivable to me that anything could grade that low because we do not allow central office equipment to get in any such condition - using these percentages as a basis for grade."

(26) The manual central office equipment in the Drexel office in Los Angeles, which office was originally installed in 1911, for some time has been programmed for conversion to dial equipment in 1936. The retirement of such manual equipment and the substitution of dial equipment is dictated by considerations of "over-all economy." Nevertheless, according to the Company's theory the "precipitate drop" in per cent condition, and hence value, is set off by the issuance of an open work order for the conversion.

life of a plant unit, and then indulge in the hypothesis of suffering this final loss during the last stages of service, possibly within a matter of a few months before replacement, is to me so at variance with reason and facts as to cause the collapse of the method by its own inconsistencies."

Satisfactory checks against results reached by elaborate calculations and inspections frequently are not available. In the case of motor vehicles, however, a check was fully displayed. The Company estimated the reproduction cost new of its used automobiles and the lessening in their value because of observed depreciation. Against this was the showing of a most persuasive nature that Southern California is the largest market for used cars in the world, that such property is traded in extensively, and that there exists well known and generally observed current values for the various types of used cars. These prices are public. The discrepancy between the Company's highly theoretical estimate of value and reality as to value as it exists in the market place was striking.

The City presented a study of the Company's claims regarding passenger vehicles, showing that the Company's reproduction cost new less observed depreciation was 40 per cent higher than the full "Blue Book" sales prices and 94 per cent higher than the wholesale prices shown.

The Company's estimate of "existing" depreciation must be substantially modified. However, accepting for the moment the Company's claim, which as indicated disregards almost entirely the functional causes of depreciation, it is of interest to view the actual retirement experience of this Company.

The record shows the actual experience of the Company as to annual property retirements over a period of some 18 years. During this period heavy retirements were occasioned by the almost unprecedented physical consolidation of duplicate systems, by a conversion to automatic equipment and by a phenomenal growth of the territory served, yet the weighted average net retirements over the entire 18 years were but 3.55 per cent of the depreciable capital, compared with the straight line depreciation expense rates which have averaged 5.15 per cent.(27)

The peak of retirements due to the Company's conversion program occurred in 1930 and the completion of this program influenced retirements to some extent in subsequent years.(28) In recent years the rate of retirement has been decreasing steadily. The record discloses a weighted net retirement experience for the last five-year period of only 2.9 per cent. Such actual net retirement experience of the last 5 years is more representative of the Company's reasonable future retirement needs than is the experience of the whole 18 year period.

The Company's reserve at present is more than adequate to cover the existing depreciation in the property, and an allowance of approximately 3 per cent is obviously adequate to care for retirements in view of the experience at this time. This allowance may be viewed as an additional maintenance and replacement allowance as expressed by Mr. Justice Butler in his concurring opinion in

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(27) The percentages of average depreciable plant as charged were: 1918, 6.57; 1919, 6.13; 1920, 6.41; 1921, 6.29; 1922, 6.63; 1923, 5.95; 1924, 5.56; 1925, 5.47; 1926, 5.01; 1927, 5.68; 1928, 5.70; 1929, 5.71; 1930, 5.63; 1931, 5.32; 1932, 4.78; 1933, 4.41; 1934, 4.36.

(28) For the last four years the percentage was 2.59, for the last 3 years 2.34, for the last 2 years 1.66, and in 1935, with the last 3 months estimated, was only 1.52.

(29)
Lindheimer v. Ill. Bell Tel. Co., supra.

The earnings of the Los Angeles Extended Area and the intrastate operations of the entire Company may be stated under these assumptions in the form of a table:

TABLE VII

Item	Los Angeles Extended Area	Entire Company Intrastate
Undepreciated rate base	$114,000,000	$160,000,000
Less observed depreciation	8,000,000	11,000,000
	$106,000,000	$149,000,000
Net revenue before depreciation	11,263,000	13,903,000
Depreciation expense	3,092,000	4,343,000
Net for return	$8,171,000	$9,560,000
Rate of return	7.71%	6.42%

Results of Sinking Fund Method.

As this Commission has frequently pointed out, such conflicts and inconsistencies as have been discussed herein in the treatment of depreciation in rate cases may be avoided by the use of

(29) Thus Mr. Justice Butler said:
"The only legitimate purpose of the reserve is to equalize expenditures for maintenance so as to take from the revenue earned in each year its fair share of the burden. To the extent that the annual charges include amounts that will not be required for that purpose, the account misrepresents the cost of the service." ***** "Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life cannot be accepted as legitimate additions to operating expenses."
As further indicative of the attitude of the Supreme Court, it is worthy of note that in Columbus Gas & Fuel Co. v. Pub. Util. Com., 292 U.S. 398, where accrued depreciation was taken at a figure somewhat less than the reserve, the reduction of the utility's claim for expense of $174,880 to $68,196 was approved.

the sinking fund method. No estimate of the highly controversial issue of accrued depreciation is needed in this method, the undepreciated property value being used as the base. The amounts accrued are in most properties, as in this Company, invested in the property and with a reasonable interest return thereon are sufficient to replace the property at the end of its estimated useful life. The method has been followed for many years by this Commission.(30)

The resultant earning position under the sinking fund method is set forth as follows:

TABLE VIII

Item	Los Angeles Extended Area	Entire Company Intrastate
Undepreciated rate base	$114,000,000	$160,000,000
Net revenue before depreciation	11,263,000	13,903,000
Depreciation expense	2,662,000	3,836,000
Net for return	$8,601,000	$10,067,000
Rate of return	7.54%	6.29%

In the above table the depreciation expense has been computed by the Commission engineer, taking the lives and salvage for the various classes of depreciable property used by the Company.(31)

(30) See Antioch v. P.G.& E. Co., 5 C.R.C. 19; Re So.Cal Ed.Co. 19 C.R.C. 595; Re S.C.T.Co., 20 C.R.C. 981; Re S.J.L.& P.Corp. 21 C.R.C. 545; Re P.G.& E.Co., 22 C.R.C. 744; Re Coast Counties G.& E.Co., 24 C.R.C. 69; Re S.C.T.Co. 25 C.R.C. 721; Re P.T.& T.Co., 33 C.R.C. 737; Re L.A.G.& E.Corp., 35 C.R.C. 442; Re S.D.C.G.& E.Co.,39 C.R.C. 279.

(31) The annuity computed as it is upon the Company's estimates of lives and salvage is perhaps overly liberal if the Company is correct in saying its present reserve on the straight line basis is adequate.

The computation of these depreciation allowances is not questioned.

In Los Angeles G. & E. Corp. v. Railroad Commission, supra, the Commission tested earnings for rate purposes in accordance with its usual practice by making no deduction for accrued depreciation, but with the expense of depreciation taken as a reasonable sinking fund annuity. The Court did not criticize this method of treatment. There was, however, a Commission finding as to the amount of accrued depreciation, but this in fact played no part in the final determination. The same procedure will be followed here. It may be concluded that such accrued depreciation was not less than $13,500,000 for the intra-Los Angeles Extended Area property and not less than $19,000,000 for the intrastate property. If it is desired to consider accrued depreciation in conjunction with sinking fund depreciation, then the results shown by Table VIII, in which the indicated return is for the dual purpose of providing a return on the property base and interest on an appropriate fund representative of accrued depreciation, may be used. The deduction for accrued depreciation may be in any reasonable amount, and interest thereon may be added to the amount of the annuity included in operating expense.

It may be of interest to note that the combined allowances for maintenance and depreciation are substantial in all of the three methods as shown by the following summary. In each of the three methods there is included in operating expense for current maintenance for the intra-Los Angeles Extended Area the sum of $4,971,000. This amount when combined with the respective provisions made for depreciation expense is shown in tabular form as the total provision thus made for the protection of the plant in its relation both to property base and to gross revenue. In expressing the relationship of the provision in Table VIII the annuity has been augmented by interest on the accrued depreciation found herein.

TABLE IX

	Total of Maintenance and Depreciation (1)	Per Cent of Column (1) to Property Base Undepreciated (2)	Per Cent of Column (1) to Revenue (3)
Table VI	$9,442,000	8.3%	38.1%
Table VII	8,063,000	7.1	32.6
Table VIII	8,443.000	7.4	34.1

Because of the long use of the sinking fund method in this State with satisfactory results, and because it more closely approximates reality than does the straight line theory, it will be employed here as a test of earnings for the purpose of establishing rates, although it is clear that the same conclusions are reached by consideration of any of the three methods.

VII

FUTURE CONDITIONS

It now becomes necessary to look ahead and to determine what, if any, modifications should be made in the 1934 earning position in order to visualize and appraise the probable earnings of the Los Angeles Extended Area and the Entire Company under present rates in the near future. Looking ahead there are three outstanding factors to be evaluated: First, increased taxes already beginning to be felt and the full incidence of which will come in 1936 (except for the increasing payroll tax under Social Security legislation, which becomes heavier in subsequent years); Second, a rapid pickup in stations with an increased revenue, together with a mounting toll business, and some increase in expense and in capital, as shown by the experience of the first nine months of 1935; and Third, the fact that the Company's plant is still a considerable distance from the degree of utilization realized during the early part of 1931.(32)

Taxes in 1936 (unless affected by litigation) will be over $1,000,000 higher than in 1934. Most of this increase is to be ascribed to the change in the State tax system effective for the fiscal year 1935-36. Unemployment insurance taxes become effective in 1936. The Company estimates its increased tax requirements as follows:

State and local taxes..................	$1,018,000
Federal taxes (assuming a 3 per cent payroll tax)................	354,000
Total	$1,372,000

(32) On March 1, 1931 there were 596,194 stations in use. This peak declined rapidly until August 1, 1933, when the number was only 511,911. Since then there has been a steady increase, the growth being most noticeable in 1935. On September 30, 1935, the total stations were 549,361. During all of this time there has been in addition a large number of disconnected stations averaging around 50,000. Mr. Fry was of the opinion that at the end of 1934 the Company's plant was from 9 to 15 per cent larger than necessary to care for its then subscribers.

The factor of excess plant capacity mentioned naturally tends towards keeping the increase in both capital and expense (other than taxes) at a lesser rate than the increase in gross revenue.

This result is very clearly shown by the 1935 figures which are available.(33)

The actual experience of the Company for the 12 months' period ending September 30, 1935, including actual added tax accruals in July, August and September, indicates an earning at the rate of 6.8 per cent with the property base and depreciation allowance herein found reasonable as contrasted with the 6.3 per cent for the calendar year 1934. Indeed, as Mr. McNaughtoh showed, the increased earnings of the first nine months of 1935 were sufficient to cover the increased taxes expected in 1936 and still leave the Company in as good an earning position as in 1934.

The improvement in gross and net revenue of recent months may be illustrated by the monthly figures as reported by the Company for cost of plant, gross revenue, and expense, and net revenue before depreciation, as well as of stations, which are summarized in the following Table X. This table also indicates percentage increasesand the increase in revenue per station consequent upon upgrading in service and increased message and toll usage:

(33) The Company presented general testimony respecting probable increases in expenses over the 1934 level. Experience for nine months of 1935 has given weight to the effect of such increases.

TABLE NO. X

SOUTHERN CALIFORNIA TELEPHONE COMPANY
PLANT, GROSS REVENUE, OPERATING EXPENSE,
NET BEFORE DEPRECIATION AND TAXES, STATIONS,
AND GROSS REVENUE PER STATION,
ALL AS REPORTED BY THE COMPANY

Month	Gross Revenue (Thousands of Dollars)			Expense Before Depreciation and Taxes (Thousands of Dollars)			Net Before Depreciation and Taxes (Thousands of Dollars)		
	1934	1935	Per Cent Increase	1934	1935	Per Cent Increase	1934	1935	Per Cent Increase
Jan.	$2,870	$2,966	3.34%	$1,264	$1,355	7.20%	$1,606	$1,611	0.31%
Feb.	2,717	2,867	5.52	1,228	1,307	6.43	1,489	1,560	4.77
Mar.	2,886	3,014	4.44	1,299	1,389	6.93	1,587	1,625	2.39
Apr.	2,811	3,047	8.40	1,292	1,420	9.91	1,519	1,627	7.11
May	2,847	3,067	7.73	1,381	1,449	4.92	1,466	1,618	10.37
June	2,807	3,042	8.37	1,372	1,432	4.37	1,435	1,610	12.20
July	2,782	3,091	11.11	1,388	1,476	6.34	1,394	1,615	15.85
Aug.	2,827	3,121	10.40	1,363	1,431	4.99	1,464	1,690	15.44
Sept.	2,745	3,047	11.00	1,322	1,392	5.29	1,423	1,655	16.30
Oct.	2,870	-	-	1,379	-	-	1,491	-	-
Nov.	2,823	-	-	1,276	-	-	1,547	-	-
Dec.	2,936	-	-	1,282	-	-	1,654	-	-

Month	Telephone Plant (Thousands of Dollars)			Stations			Gross Revenue Per Station		
	1934	1935	Per Cent Increase	1934	1935	Per Cent Increase	1934	1935	Per Cent Increase
Jan.	$161,379	$162,575	0.74%	521,566	532,404	2.08%	$5.50	$5.57	1.27%
Feb.	161,435	162,743	0.81	521,626	534,978	2.56	5.21	5.36	2.88
Mar.	161,322	163,024	1.06	522,095	537,276	2.91	5.53	5.61	1.45
Apr.	161,528	163,110	0.98	521,546	538,828	3.31	5.39	5.65	4.82
May	161,643	163,239	0.99	520,087	540,529	3.93	5.47	5.67	3.66
June	161,698	163,364	1.03	517,591	540,900	4.50	5.42	5.62	3.69
July	161,747	163,392	1.02	515,926	541,918	5.04	5.39	5.70	5.75
Aug.	161,757	163,514	1.09	516,821	544,367	5.33	5.47	5.73	4.75
Sept.	162,025	163,782	1.08	520,987	549,361	5.45	5.27	5.55	5.31
Oct.	162,184	-	-	523,990	-	-	5.48	-	-
Nov.	162,331	-	-	526,784	-	-	5.36	-	-
Dec.	162,477	-	-	529,453	-	-	5.55	-	-

The importance of the present and reasonably to be anticipated earnings of the Extended Area has already been indicated in the preceding Table IV, which displays various relationships as between the Los Angeles Exchange, the Los Angeles Extended Area and the Company as a whole for various periods. The following Table XI gives monthly figures for stations and other items for the 13 months since the Los Angeles Extended Area was established in conjunction with corresponding Company-wide figures for the same items. Percentages are inserted to indicate relationships. The consistency of relationship between entire Company and Extended Area is significant.

TABLE NO. XI

SOUTHERN CALIFORNIA TELEPHONE COMPANY
RELATIONSHIPS BETWEEN ENTIRE COMPANY AND LOS ANGELES EXTENDED AREA
BASED ON MONTHLY COMPANY FIGURES
AUGUST, 1934 TO AUGUST, 1935

Month	Gross Operating Revenues (Thousands of Dollars)			Expense Before Depreciation and Taxes (Thousands of Dollars)			Net Before Depreciation and Taxes (Thousands of Dollars)		
	Entire Company	Extended Area	Per Cent Relationship	Entire Company	Extended Area	Per Cent Relationship	Entire Company	Extended Area	Per Cent Relationship
Aug.	$2,827	$2,097	74.18%	$1,363	$ 975	71.53%	$1,464	$1,122	76.64%
Sept.	2,745	2,074	75.56	1,322	943	71.33	1,423	1,131	79.48
Oct.	2,870	2,148	74.84	1,379	993	72.01	1,491	1,155	77.46
Nov.	2,823	2,131	75.49	1,276	909	71.24	1,547	1,222	78.99
Dec.	2,936	2,177	74.15	1,282	900	70.20	1,654	1,277	77.21
Jan.	2,966	2,231	75.22	1,355	966	71.29	1,611	1,265	78.52
Feb.	2,867	2,163	73.44	1,307	936	71.61	1,560	1,227	78.65
Mar.	3,014	2,229	73.95	1,389	995	71.63	1,625	1,234	75.94
Apr.	3,047	2,291	75.19	1,420	1,026	72.25	1,627	1,265	77.75
May	3,067	2,264	73.82	1,449	1,042	71.91	1,618	1,222	75.53
June	3,042	2,239	73.60	1,432	1,031	72.00	1,610	1,208	75.03
July	3,091	2,265	73.28	1,476	1,049	71.07	1,615	1,216	75.29
Aug.	3,121	2,297	73.60	1,431	1,007	70.37	1,690	1,290	76.33

Month	Telephone Plant (In Thousand Dollars End of Month)			Stations (End of Month)			Local Service Revenue Per Station		
	Entire Company	Extended Area	Per Cent	Entire Company	Extended Area	Per Cent	Entire Company	Extended Area	Per Cent
Aug.	$161,757	$116,426	71.98%	516,821	422,993	81.85%	$4.11	$4.41	107.30%
Sept.	162,025	116,631	71.98	520,987	426,261	81.82	4.06	4.34	106.90
Oct.	162,183	116,773	72.00	523,990	428,586	81.79	4.18	4.48	107.18
Nov.	162,331	116,865	71.99	526,784	430,422	81.71	4.11	4.40	107.06
Dec.	162,477	116,953	71.98	529,453	432,676	81.72	4.16	4.45	106.97
Jan.	162,575	117,054	72.00	532,404	434,930	81.69	4.21	4.52	107.36
Feb.	162,743	117,202	72.02	534,978	436,987	81.68	4.09	4.37	106.85
Mar.	163,024	117,470	72.06	537,276	438,887	81.69	4.20	4.50	107.14
Apr.	163,110	117,551	72.07	538,828	439,786	81.62	4.25	4.57	107.53
May	163,239	117,635	72.06	540,529	440,408	81.48	4.22	4.53	107.35
June	163,363	117,703	72.05	540,900	440,237	81.39	4.20	4.49	106.90
July	163,391	117,711	72.04	541,918	440,994	81.33	4.22	4.53	107.35
Aug.	163,514	117,829	72.06	544,367	442,964	81.37	4.24	4.56	107.55

As in the case of Company earnings, the record points irresistibly to the conclusion of better earnings in 1936 in the Los Angeles Extended Area. Stations and gross and net revenue mounted steadily and consistently in 1935. The actual experience of the Extended Area for the 12 months' period ending on August 31, 1935, including added tax accruals in July and August, indicates an earning at the rate of 7.9 per cent.

It is impossible to view the facts of record without being impelled to the conclusion that the earning position of the Los Angeles Extended Area and the entire Company in the future will be distinctly better than it was in 1934. The year 1934 departed from normality in various respects. The change-over to the Extended Area plan of service resulted in certain non-recurring expense. The record plainly indicates that this year together with 1933 was at the bottom of the depression as to the telephone business.

The extent of the improvement ahead must be approximated in order to establish just and reasonable rates for the future. It would be absurd to take into account probable added taxes, both State and Federal, (which of course are subject to judicial attack) and close the eyes to rapidly and consistently increasing stations and mounting gross and net revenue during 1935.

A careful evaluation of the facts of record in this case leads irresistibly to the conclusion that in 1936 the intra-Los Angeles Extended Area earnings will probably be over 8.0 per cent and certainly not less than 7.7 per cent on an undepreciated fair value rate base of $116,000,000. And it is equally clear that in 1936 the intrastate earnings of the entire Company will probably be over 7 per cent and certainly not less than 6.7 per cent upon an undepreciated fair value rate base of $163,000,000.

VIII

RATE REDUCTION INDICATED

What constitutes a reasonable rate of return, usually an important issue in a rate case, is here not a matter requiring extended treatment. In the fixing of reasonable rates for the Los Angeles Exchange alone, the consideration of other factors relative to Company-wide results serves to minimize the rate reduction which otherwise might reasonably be made. The net return available from the Los Angeles Exchange at the rates here to be prescribed will yield in excess of a fair return upon the value of the property in that exchange.

The Commission is compelled to recognize the great changes occurring during the period of depression through which the Nation has been passing, those "profound changes" to which the Supreme Court has referred, not only in property values but in "reasonable return on invested capital." (Central Kentucky Nat. Gas Co. v. Railroad Commission, supra.) Neither may the Commission fail to observe the sharp decline which has occurred in the cost of capital funds to public utilities, as disclosed in its own decisions authorizing the issuance of securities.(34)

(34) Major refinancing authorizations by the Commission since Jan. 1, 1935 follow:
1. Pacific Gas & Elec. (Dec. 27837, Mar. 22, 1935) $45,000,000. 4% bonds due 1964 offered at 100, yielding 4.00%
2. Sou. Cal. Edison (Dec. 27856, Mar. 27, 1935) $73,000,000. 3-3/4% bonds due 1960, offered at 98-1/2, yielding 3.85%.
3. San Diego Cons. G.& E. (Dec. 27968, May 20, 1935) $15,500,000. 4% bonds due 1965, offered at 101, yielding 3.95%.
4. Pacific Gas & Elec. (Dec. 28053, June 19, 1935) $30,000,000. 4% bonds due 1964, offered at 104, yielding 3.77%.
5. Sou. Cal. Edison (Dec. 28035, June 12, 1935) $35,000,000. 3-3/4% bonds, due 1960, offered at 98-1/2, yielding 3.85%.
6. Assoc. Tel. Co. (Dec. 28055, June 24, 1935) $8,500,000. 4% bonds due 1965, offered at 99, yielding 4.05%.
7. Sou. Cal. Gas. (Dec. 28077, June 27, 1935) $15,000,000. 4% bonds due 1965, offered at 101-1/2, yielding 3.92%.
8. Coast Cos. G. & E. (Dec. 28177, Aug. 19, 1935) $3,000,000. 4% bonds due 1965, offered at 103-1/2, yielding 3.80%.
9. Sou. Cal. Edison (Dec. 28220, Sept. 12, 1935) $27,500,000. Serial debentures offered to yield .875% to 3.75%.
10. Sou. Cal. Edison (Dec. 28221, Sept. 12, 1935) $30,000,000. 4% bonds due 1960, offered at 102, yielding 3.85%.
11. Pacific Gas & Elec. (Dec. 28231, Sept. 17, 1935) $20,000,000. 4% bonds due 1964, offered at 102, yielding 3.88%.

The City has contended in this case that a return of 6 per cent is the maximum rate of return which may reasonably be accorded. It presented evidence indicating the yield which might be obtained by an investor in representative national and California portfolios of bonds and stocks, the current yield being shown less than 4 per cent on their current average market cost.

The capital which the Company has invested in the enterprise consists largely of common stock issued to its parent Company, The Pacific Telephone and Telegraph Company. For some time this stock has been on a 6 per cent dividend basis. Approximately 5 per cent of its capital is derived from bonds and from advances by the parent Company, and about 20 per cent consists of reserve funds built up from earnings for depreciation and employees' pensions, which reserves are invested in the plant. Mr. W.C.Fankhauser, of the Commission's staff, testified that the carrying cost of the Company's borrowed money for 1934 was approximately 5.25 per cent.

The extent to which the Company's record of earnings may justify a reduction of its rates in the Los Angeles Exchange may not, as above stated, rightly be measured by the results of operations in that exchange alone. Based upon the fair value here

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(34) Cont'd.
12. Los Angeles Gas & Elec. (Dec. 28298, Oct. 24,1935) $40,000,000. 4% due 1970, offered at 102, yielding 3.90%.
13. Cal. Water & Tel. (Dec. 28276, Oct.14, 1935) $5,000,000, of 5% bonds due 1965, offered at 101, yielding 4.93%.
14. Pacific Tel. & Tel. (Dec. 28567, Feb. 10,1936 as later modified) $30,000,000. 3-1/4% bonds due 1966 offered at 101-1/2, yielding 3.17%.
15. Pacific Gas & Elec. (Dec. 28626, March 16,1936) $90,000,000. 3-3/4% bonds due 1961 offered at 102-1/2, yielding 3.60%.
16. Cal. Ore. Power (Dec. 28633, March 16, 1936) $13,500,000. 4% bonds due 1966, offered at 97-1/2 yielding 4.15%.
17. Santa Barbara Tel. (Dec. 28696, Apr. 6, 1936) $1,460,000. of 3-1/2% bonds due 1966, offered at 102-1/2, yielding 3.36%.

found for the property applicable to the whole Los Angeles Extended Area, a reduction in annual gross revenue of over $2,000,000 might be effected and not reduce the earnings for that area below 6 per cent. And it is clear that the earnings in the Los Angeles Exchange are distinctly higher than in the other exchanges of the Company's system.

The Commission is not, however, disposed to reduce the Company's rates to the extent that it might under these circumstances. Rather it seeks a result which as a matter of equity gives some consideration to the investment structure of the entire property and to the earnings thereon in the low earning territory outside the Los Angeles Extended Area and not involved in this proceeding.

It is the conclusion of the Commission, in view of all the evidence presented by the record in this case, that a reduction of $1,250,000 in the gross revenues of the Company should be made in the rates applicable to the Los Angeles Exchange. Because of the incidence of taxes and certain operating charges which are proportioned to gross and net revenue, a reduction in gross revenue affects net revenue to a lesser degree.(35) The result of this reduction in net revenue will amount to about $975,000. It will leave the Los Angeles Extended Area with an earning of not less than 6.8 per cent upon the fair value of that property as here found.(36)

(35) A lesser gross revenue affects the amount of license and franchise payments and uncollectibles, and a reduction in net reflects itself in the State and Federal taxes proportioned against net income. To effect a reduction in net revenue of $100, a reduction in gross revenue of not less than $128 must be made.

(36) Although the rates of the whole Los Angeles Extended Area are not here involved, it is evident that because of the relatively high earnings in the Los Angeles Exchange compared with those of the other exchanges in the Extended Area, such rate reduction would in any event properly be applicable to the Los Angeles Exchange alone.

IX

SPREAD OF RATE REDUCTION

While the Commission was considering the record of the case, it addressed a communication to the City and to the Company to the effect that it would be pleased to receive any suggestions or recommendations from the parties respecting rate changes in the Los Angeles Exchange. The request was based on assumed gross reductions ranging from $250,000 to $1,500,000. The letter made it clear that answers to such request would in no way prejudice the position of either party. A copy of the letter was sent to all appearances.

The City and the Company replied to the communication by making various suggestions appropriate to the several amounts of assumed reductions. Since the receipt of the replies, the parties have submitted a map displaying the changes in the base rate area of the Los Angeles Exchange to conform to their common suggestion. With these very helpful suggestions the delicate and oftentimes difficult task of spreading a reduction in rates is greatly simplified.

The following summary lists the suggestions in tabular form, the monetary effect being indicated, and the order of importance or priority of each as expressed by the parties being shown by numerals as nearly as they may be deduced from the replies:

	COMPANY Order	Amount	CITY Order	Amount
Eliminate monthly charge on long cords and modify installation charge	(1)	$ 33,000	(1)	$ 35,000
Reduce hand set rate 10 cents a month	(2)	226,000 (a)	(2)	146,000
Reduce one-party residence flat 25 cents a month	(3)	76,000	(4)	76,000
Reduce two-party residence flat 25 cents a month	(4)	249,000	(5)	249,000
Reduce one-party residence flat additional 25 cents a month	(5)	76,000	(9)	76,000
Reduce one-party business measured service 50 cents a month and decrease message allowance by 10	(6)	170,000	(6)	170,000
Reduce semi-public service guarantee by 10 per cent	(7)	45,000	(7)	45,000
Revise base rate area	(8)	25,000	(3)	25,000
Reduce hotel P.B.X. message rate to 4 cents	(9)	45,000	(14)	45,000
Reduce business and semi-public extensions 25 cents a month	(10)	55,000	(10)	55,000
Reduce commercial P.B.X. stations 25 cents a month	(11)	177,000	(11)	177,000
Reduce commercial P.B.X. trunks $1.00 for first two a month	(12)	34,000	(13)	34,000
Reduce hotel P.B.X. non-guest stations 25 cents a month	(13)	8,000	(12)	8,000
Reduce two-party measured residence 25 cents a month			(8)	220,000
Reduce business main P.B.X. rate to 3 cents per message over 350 per line per month			(15)	140,000
		$1,219,000		$1,501,000

(a) Applies to all exchanges in Southern California.

The record also contains a comparison of telephone rates of the Southern California Telephone Company and comparable rates prevailing in other sections of the United States.[37] Rates in Los Angeles were compared with those prevailing in fourteen other large cities, and the general conclusion drawn that the charges for business telephone service in Los Angeles are slightly above the average, while the charges for residence service are below the average of rates in other large cities. It was found also that for the business service, the rates of the small user are comparatively high in Los Angeles, while charges for the larger business user fall close to the average.

A careful consideration of these suggestions, of the various rate schedules of the Company and of comparative rates in other cities has led to conclusions which may be expressed briefly as follows:

1. Consideration should first be given to charges for business service and particularly the minimum charges for individual business service. Certain miscellaneous charges which seem to be out of line should be adjusted.

2. Existing relationships in the various grades of residence service should be disturbed as little as possible.

3. With the other conclusions reached herein, charges for hand set stations are reduced 25 cents to 50 cents a month in common with reductions in the desk and wall set rates.

4. The equity of the large department stores is recognized by the general reductions applicable to private branch exchange station rates made herein.

(37) This study was prepared jointly by Mr. Fry, Mr. Guillou and Mr. T. J. Harris, Commercial Engineer for the Company.

The following tabulation expresses the conclusions reached by the Commission respecting the several and separate reductions in charges which should be made for the Los Angeles Exchange, their order of priority being appropriately indicated by numerals:

	General and Miscellaneous		
(1)	Eliminate monthly charge on long cords and modify installation charge	$33,000	
(2)	Revise the base rate area	25,000	
	Sub-total		$ 58,000
	Business		
(3)	Reduce one-party business measured service by 50 cents a month but with no reduction of message allowance	$240,000	
(4)	Reduce semi-public service guarantee by 10 per cent	45,000	
(5)	Reduce business and semi-public extensions by 25 cents a month	72,000	
(6)	Reduce commercial P.B.X. stations by 25 cents a month	177,000	
(7)	Reduce commercial P.B.X. trunks by $1 for first two a month	34,000	
(8)	Reduce hotel P.B.X. non-guest stations by 25 cents a month	8,000	
	Sub-total		576,000
	Residence		
(9)	Reduce two-party residence flat by 25 cents a month	249,000	
(10)	Reduce two-party measured residence by 25 cents a month	220,000	
(11)	Reduce one-party residence flat by 25 cents a month	76,000	
	Sub-total		545,000
	Total all reductions		$1,179,000

The monetary effects of these reductions as expressed in the tabulation are the results of the estimates of the parties checked against the "Classification of Lines and Stations" filed in this case. As they are based upon telephones in service in November, 1935, they do not reflect the effect of increased stations in 1936. Allowance for this should be made.

With such an allowance being made, the effect of the reductions specified upon the Company's gross revenue will be approximately $1,250,000, and the effect on its net will be approximately $975,000. While a larger reduction could be justified, certain changes in the extended service rates in contiguous exchanges while not necessitated by the reductions ordered, may prove desirable to maintain relationships, and the Commission does not desire to discourage the making of these changes.

X

DISCRIMINATION

Sharp differences in the lucrativeness of various exchanges furnished the background for the charge of discrimination by the City and for extensive and interesting arguments by counsel as to whether this afforded a basis for a finding of discrimination and if so the form of order which might be made.

With the conclusion heretofore reached and with the orders consequent thereon it is unnecessary to consider this issue at any length. Cost is not the sole criterion of the spreading of rates. It is impossible to bring about a situation where every class of service and every area contributes ratably to the earnings of a large utility. Consideration has been given here to earning relationships and with the disposition of the case these relationships will not be so out of line as to justify entering upon the field of correcting maladjustments by orders against discrimination.

I propose the following form of findings and orders:

FINDINGS AND ORDERS

Public hearings having been had in the above entitled case and the case having been submitted for decision, the Railroad Commission of the State of California, after giving full and careful consideration to the record before it and the arguments of the parties, concludes and finds as follows:

1. The fair value (before deduction for accrued depreciation) of the property of Southern California Telephone Company, devoted to service within the Los Angeles Extended Area as a going property with business attached:

For the 12 months' period ending on August 31, 1935 was......................	$114,000,000
And for the year 1936 will be............	116,000,000

2. In view of the character of the property and the occurrence of depreciation, it is reasonable to measure the present and probable future earning position, under rates now in effect and under rates herein prescribed, without deduction from the figures expressed in finding No. 1 for accrued depreciation but with depreciation expense (Account 608) measured by the amount of an appropriate sinking fund annuity; and the succeeding finding No. 3 includes depreciation expense on such basis.

3. Under rates now in effect, the net revenue available for return and interest upon a reasonable depreciation reserve:

For the 12 months' period ending on August 31, 1935 was......................	$8,950,000
And the reasonably to be anticipated net for the year 1936 is not less than..................................	8,900,000

And under the rates herein fixed:

The reasonably to be anticipated net revenue for the year 1936 (had the reduction been in effect during the entire year) would not be less than.........................$7,925,000

4. Under the rates herein prescribed the utility will earn a return on the fair value of the Los Angeles Extended Area (including the Los Angeles Exchange) which considered by itself is higher than a reasonable return, and will earn a return on its entire investment as high or higher than capital in the vicinity can obtain in other investments comparable as to security and risk and will be able to earn all of its fixed charges and reasonable depreciation requirements and dividends upon the equity in the property represented by common stock and attract such, if any, new capital as may be needed for the improvement and extension of the system.

5. The present rates and practices of the utility in the Los Angeles Exchange (which is the dominant factor in the Los Angeles Extended Area) are and each of them is unreasonable to the extent they differ from the rates and practices herein prescribed, which are, and each of them is, found to be just and reasonable rates and practices for the future.

Based upon the findings contained herein and in the opinion preceding and the facts shown by the record,

IT IS HEREBY ORDERED, that effective on all bills issued subscribers in the Los Angeles Exchange, according to the presently practiced rotation in billing, on and after the 1st day of June, 1936, Southern California Telephone Company shall charge, collect and observe the rates and practices prescribed in its several schedules, rules and regulations affecting subscribers in the Los Angeles

Exchange, as the same are required to be modified and altered by the following numerically designated and separable orders:

Order No. 1. So far as "Exchange Service Schedule No. A-28" affects the Los Angeles Exchange, substitute for

	Installation Charge	Rate Per Month
"Desk and hand set cords, over 6 feet, but not exceeding 25 feet in length..............	1.00	.10 "

the following

	Installation Charge	Rate Per Month
"Desk and hand set cords, over 6 feet, but not exceeding 25 feet in length:		
Not exceeding 13 feet in length	1.00	-
Over 13 feet, but not exceeding 25 feet in length	2.50	- "

Order No. 2. Revise the boundary of Los Angeles base rate area to conform to boundary indicated upon map filed herein on the 11th day of February, 1936.

Order No. 3. In "Exchange Service Schedule No. A-1" for Los Angeles Exchange, change "$5.50" to"$5.00"; in "Exchange Service Schedule No. A-6" for Los Angeles Exchange, change "5.50" to "5.00"; and in "Exchange Service Schedule No. A-35" for Los Angeles Exchange, in Section (8) change "5.50"to "5.00."

Order No. 4. In "Exchange Service Schedule No. A-3" for Los Angeles Exchange, change ".25"to ".22½"; and in "Exchange Service Schedule No. A-4" for Los Angeles Exchange, change ".25" to ".22½."

Order No. 5. In "Exchange Service Schedule No. A-1" for Los Angeles Exchange, change "1.00" to ".75"; in "Exchange Service Schedule No.A-3" for the Los Angeles Exchange, reduce each monthly rate specified by twenty-five cents; and in "Exchange Service Schedule No. A-4" for Los Angeles Exchange, reduce each monthly rate specified by twenty-five cents.

Order No. 6. In "Exchange Service Schedule No. A-5" for Los Angeles Exchange, in Section (5) change "1.00" to ".75"; in "Exchange Service Schedule No. A-32" for Los Angeles Exchange, in Section (4) reduce each monthly rate specified by twenty-five cents; in "Exchange Service Schedule No. A-9" for Los Angeles Exchange, in Section (2) reduce each monthly rate specified by twenty-five cents; in "Exchange Service Schedule No. A-6" for Los Angeles Exchange, in Section (2) (f) change "1.00" to ".75"; and in "Exchange Service Schedule No. A-35" for Los Angeles Exchange, in Section (7) change "1.00" to ".75."

Order No. 7. In "Exchange Service Schedule No. A-5" for Los Angeles Exchange, in Section (3) change "$6.00" to "$5.00"; in "Exchange Service Schedule No. A-32" for Los Angeles Exchange, in Section (5) change "6.00" to "5.00"; in "Exchange Service Schedule No. A-9" for Los Angeles Exchange, in Section (3) change "6.00" to "5.00"; and in "Exchange Service Schedule No. A-6" for Los Angeles Exchange, in Section (2)(g) change "6.00" to "5.00."

Order No. 8. In "Exchange Service Schedule No. A-7" for Los Angeles Exchange, in Section (5) change "$1.00" to "$.75."

Order No. 9. In "Exchange Service Schedule No. A-1" for Los Angeles Exchange, in Section (2) change "3.50" to "3.25."

Order No. 10. In "Exchange Service Schedule No. A-1" for Los Angeles Exchange, in Section (3) change "$2.75" to "$2.50."

Order No. 11. In "Exchange Service Schedule No. A-1" for Los Angeles Exchange, in Section (2) change "$4.50" to "$4.25."

Except as otherwise prescribed herein, the effective date of this order shall be twenty (20) days from the date hereof.

The foregoing opinion, findings and orders are hereby approved and ordered filed as the opinion, findings and orders of the Railroad Commission of the State of California.

Dated at San Francisco, California, this 27th day of April, 1936.

M. B. Harris
Leon O. Whitsell
Wallace Ware
Frank R. Devlin
Commissioners.

In joining in the foregoing opinion, findings and orders (which I do), it is appropriate to state my understanding of the basis of the opinion which has been revised and amplified in the endeavor to attain an expression in which all the members of the Commission could join in support of an order as to which at no time has there been any disagreement.

The Los Angeles Exchange is the high earning and dominant portion not only of the Los Angeles Extended Area but of the entire system. It is the rates in this exchange that are assailed. It is the rate fixing area in issue. Two limitations, one purely equitable and the other legal, spell out the amount of the reduction ordered in this exchange:

(a) The reduction has been limited to an amount which will not reduce the earnings of the Company as a whole below approximately 6 per cent on its investment, with depreciation expense on a sinking fund basis. This limitation does not represent a matter of legal right of the utility but rather an equity in favor of the outside low earning exchanges.

(b) Unusual care has been taken to insure against rates fixed for the Los Angeles Exchange falling short of yielding a reasonable return on the fair value of the property devoted to the service in that exchange and thus impinging upon the legal rights of the utility. To this end is the long discussion of value and the consideration of the earnings of the Los Angeles Extended Area which the utility claims is the smallest divisible operating unit which includes the Los Angeles Exchange. These earnings and evidence showing the Los Angeles Exchange to be the highest earning exchange in the Extended Area indicate that the rates fixed leave the Los Angeles Exchange on a very liberal earning basis. It would still be on a liberal earning basis even were the earnings computed upon the utility's own claims as to value, value being the least important of the various issues present. Indeed, even if all the claims of the utility were accepted <u>in toto</u>, it is doubtful if the rates fixed for this exchange could be said to be unreasonable and to violate any legal rights of the utility.

In a word, this is peculiarly an "equity" case in which the important and controlling consideration has been the adoption of a reasonable limitation upon the amount of the reduction - a limitation which under all the circumstances is fair as between the high earning metropolitan area and the outside low yielding exchanges.

W. J. Carr
Commissioner.