ORIGINAL

Decision No. 42529

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation (inclusive of its wholly-owned subsidiary, Southern California Telephone Company, a corporation), for authority to increase certain intrastate rates and charges applicable to service furnished within the State of California.	Application No. 28211

(Appearances are shown on sheet attached to this decision.)

O P I N I O N

This proceeding upon the order to show cause herein arose out of the situation created by the failure of the respondent The Pacific Telephone and Telegraph Company (hereafter referred to generally as "respondent") to comply satisfactorily with an order contained in Decision No. 41416 rendered by this Commission on April 6, 1948, in the above-captioned rate proceeding. Said Decision No. 41416 partially granted to respondent requested rate increases. In granting, in part, such rate increases, this Commission, in its said Decision No. 41416, ordered respondent to comply with certain terms, conditions and requirements embodied therein, among which was the following:

> "3. Applicant" /respondent in this proceeding/ "shall submit not later than July 1, 1948 a plan for a new arrangement with American Telephone and Telegraph Company in respect to payments for services rendered to Applicant by Bell Telephone Laboratories, Inc. and for services rendered to Applicant by the operation and engineering and other departments of the American Telephone and Telegraph Company to the

extent recognized herein as proper costs chargeable to Applicant."

Pursuant to the foregoing quoted order, respondent filed a written response with the Commission on July 1, 1948, which response reads as follows:

"By Item 3 of the Order the Company was directed to submit 'a plan for a new arrangement with American Telephone and Telegraph Company in respect to payments for services rendered to Applicant * * * to the extent recognized herein as proper costs chargeable to Applicant'. In its Opinion the Commission also stated that the Company had a responsibility to take immediate steps to negotiate with the American Company for a restatement of the license fee so as not to exceed a charge of $1,850,000.

"Notwithstanding that the Company has always considered the license contract a fair contract under which the Company has had full value received for every payment made, the Company, immediately following the issuance of the Commission's Opinion and Order, negotiated with American Company as to the possibility of obtaining modification of the present arrangement as suggested by the Commission.

"The American Company has advised that in view of its costs incurred, which exceed the amount paid by the Pacific Company for services received, it cannot assent to a reduction of the current payments to $1,850,000 or enter into a new arrangement for determining the annual payment on the basis on which the $1,850,000 was computed.

"The license contract, as modified from time to time, has been in effect since 1880. The present organization of the Bell System as to the division of work between the central organization and the operating companies, provided for by the license contract, results in better service at lower cost than any other method. The services which have been rendered under this contract are of great value and in the opinion of the management are indispensable. Over the years it has been and it now is the judgment of the officers and the Board of Directors of the Company that the contract is in the best interests of the Company and its service to the public; also that it would be very detrimental to the Company and to the public if the services under the license contract were to be terminated.

"The Company is advised by its counsel that

the Commission's Order of April 6th does not require this Company to revise the contract and that the Commission is without jurisdiction to make such an order. Counsel advised that while the Commission in rate cases may properly pass upon the reasonableness of claimed operating expenses and in so doing may disallow a part of a payment under a contract, assuming, of course, there is warrant for such action in the testimony before it, it has no jurisdiction to make an order operating directly on the contract.

"In the opinion of the Company, the method of measuring payment for the services in question is not the primary issue--the important matter is the amount paid for the services received. While the Company cannot in the existing state of affairs effect the particular changes in the present arrangement which are suggested by the Commission and while the Company most respectfully submits that the Commission erred in disallowing any part of the contract payments for rate purposes, the Company does emphasize its desire to find a common ground with the Commission, if possible, and to that end will be glad to work with the Commission either informally or in a formal proceeding.

"In this connection, the Company has just been advised by the American Company that it has agreed again to discuss with the NARUC* the license contract and cost of furnishing services thereunder. In view of this situation, we request this Commission to defer, for the time being, its further consideration of the matter in question.

"We also wish to make reference to certain statements made in the Opinion of the Commission; namely, that the American Company 'dominates and controls Applicant'; that 'Applicant, in carrying out the terms of this so-called license agreement, exercises no independent judgment'; that the 'so-called license contract or agreement is, in fact and in law, not a contract or agreement but is in essence a directive or requirement imposed upon Applicant by the American Company'; and that in some undefined sense, there has been an 'abuse of intercorporate relations'.

"We most respectfully submit that these statements have no bearing on the point under consideration. Regardless of alleged 'domination', the Commission in the exercise of its rate-making functions may, when justified by the evidence, disal-

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* National Association of Railroad and Utilities Commissioners.

low a part of a payment as an operating expense, and the jurisdiction of the Commission in this regard is not dependent upon a finding of domination. The recent rate case involved no issue of domination; in the hearing thereof no issue was raised as to any possible abuse of intercorporate relations and no evidence whatever of such abuse was before the Commission. The fact is there is no dictation or domination by the American Company in the affairs of the Pacific Company."

In effect and substance, the response of respondent was, first, that this Commission has no jurisdiction or power to interfere with the license contract arrangement existing between it and its corporate holding company, the American Telephone and Telegraph Company (hereafter generally referred to as "American Company"); second, that, should respondent be so disposed, the American Company would not consent to a revision of said arrangement; and, third, that, in any event, this Commission should not interfere with such arrangement, alleging the same to be justified. Respondent stated its willingness to work with the Commission, either formally or informally, looking toward an adjustment of the matter satisfactory to all parties.

The Commission was of the opinion that respondent, by its action embodied in said response, had not complied satisfactorily with the aforementioned order and, being of such opinion, on August 24, 1948, issued the herein order to show cause, which order is hereby annexed to this decision, marked Exhibit "A," and by reference is hereby incorporated herein for all intents and purposes. Hearing on said order to show cause was set for September 30 and October 1, 1948. After the issuance of this order to show cause, the American Company reduced the license fee from 1½ per cent of respondent's gross revenues, with minor exclusions, to one per cent of a slightly higher revenue base, effective as of October 1, 1948, until fur-

ther notice. The contemplated reduction was reported by the American Company to the N.A.R.U.C. Telephone Committee at its meeting in September 1948. Respondent requested and was granted a continuance of the hearing of this proceeding to October 27, 1948.

At the opening of the hearing of this matter on said date, respondent seasonably filed its response and answer to said order to show cause, which response and answer are hereby annexed to this decision, marked Exhibit "B," and by reference are hereby incorporated herein for all intents and purposes. At the same time, respondent duly moved to dismiss the proceeding and discharge the order to show cause on the ground that the Commission did not have jurisdiction to proceed with the same or to prescribe the rule or regulation envisioned by said order to show cause. Also, respondent contended that, assuming that power did reside in the Commission to prescribe such proposed rule or regulation, it should not do so, all the facts and the law being considered. Respondent also contended that the prescription of such a rule or regulation would deprive it of allegedly valuable services received by it pursuant to said license contract. This motion was taken under advisement with the understanding that it would be ruled upon at the close of the proceeding and after the same had been submitted for decision. For the reasons hereafter in this decision stated, respondent's motion to dismiss is hereby denied.

A number of the municipalities and other interested parties participating in this proceeding, at the outset thereof, objected to the introduction of any evidence by respondent for the reason that the subject matter of the proceeding was res judicata and that respondent was in contempt of the Commission for not having complied with the order contained in Decision No. 41416. Said objec-

tion was overruled with the right to move to strike the evidence at the close of the proceeding, which motion to strike was duly made. This motion was withdrawn by the parties at the date of submission of this proceeding.

The herein proceeding went to hearing and continued intermittently until its final submission for decision on February 2, 1949. These hearings consumed 15 days, were recorded in 1675 pages of transcript and 77 exhibits were received in evidence. Oral argument was had before the Commission in bank and memorandums of points and authorities were filed.

The order to show cause proposed the possibility of the Commission's requiring the respondent to show cause why it should not be ordered and directed to do the following things:

> "1) Refrain and desist from making further or any payments, directly or indirectly, or under any color or guise, or by any device, to the American Telephone and Telegraph Company, or any of its subsidiaries or affiliates, pursuant to the provisions of said so-called license contract;
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> "2) Requisition, in writing, any and all services said respondent company reasonably requires performed for it by the American Telephone and Telegraph Company, its subsidiaries or affiliates, said requisition to be made in advance of and prior to the rendition of any service thereby requisitioned;
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> "3) Require the American Telephone and Telegraph Company, its subsidiaries or affiliates, to render bills or invoices to said respondent company for any services rendered by them, or either or any of them, to said respondent company, and said respondent company to pay only the reasonable cost of services reasonably required by and rendered to it, but not in excess of the reasonable value of such service, or not in excess of the cost to said respondent company, if said services were performed by its own personnel;
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> "4) File with this Commission monthly, not later than the 5th day of each and every month, a verified statement setting out in full

> for the immediately preceding month all requisitions for services made by said respondent company upon the American Telephone and Telegraph Company, its subsidiaries or affiliates, during said period; also all charges made during said period against respondent company for services rendered to it by the American Telephone and Telegraph Company, its subsidiaries or affiliates, and also showing, for the immediately preceding month, all payments made during said period by respondent company, in money or other consideration, directly or indirectly, or under any color or guise, or by any device, to the American Telephone and Telegraph Company, its subsidiaries or affiliates, for any services rendered to respondent company by the American Telephone and Telegraph Company, its subsidiaries or affiliates."

All pertinent history and evidence concerning this license contract were introduced into this record. The Commission is now fully, completely and extensively advised as to the genesis, operation and effect of this license fee arrangement, which exists between respondent and the American Company, denominated by them as "license contract" or "license agreement." In Application No. 28211, the Commission fully considered this license contract in connection with respondent's request for an increase of its telephone rates and, in rejecting the principle underlying this license fee arrangement based upon a percentage of gross revenues of the respondent and invoking the principle of allocated costs, we had occasion to express the following view thereof in said Decision No. 41416, as follows:

> "The Bell System operating companies have for many years paid to the American Company and charged to operating expense a 'license fee' [4] comprising a percentage of their gross revenues."

"[4] The license agreement between the Pacific and American companies specifies a fee of 2½% of 'total gross earnings' (total revenues excluding certain minor accounts). However, the fee has been fixed at 1½% since 1929 by a letter of modification which provides also that the American Company can increase the fee to 2½% upon four months' written notice."

The fee is intended to compensate the American Company for advice, assistance and services which it furnishes to its associated operating companies under the 'license contract.' The license fee applicable to total California operations increased from $1,245,000 in 1937 to $2,821,000 in 1946. The amount applicable to California intrastate operations for Test Period B, after adjusting for the effect of the three interim rate increases, was $3,344,000.

"As justification for the license fee, Applicant introduced evidence both as to the value of the advice and assistance and as to the American Company's costs and an allocation thereof to the Pacific Company system and the State of California.

"The fixed-percentage-of-revenue basis for the license fee was attacked as unsound by both witnesses and counsel. They pointed out that the amount of services received bore no direct relation to revenues. The fallacy of such a basis of payment is obvious when it is realized that the three interim rate increases which this Commission has granted have served to increase the license fee by approximately $330,000 per year, with no appreciable resultant increase in the services rendered. Applicant's over-all request for rate increases, if granted, would increase the license fee by more than $600,000 per year. The record contains testimony by a Commission staff witness that the American Company has agreed, as to principle, that services should be paid for on the basis of allocated costs rather than as a percentage of gross revenue.

"It is Applicant's position, as testified to by Mr. H. C. Gretz, an assistant comptroller of the American Company, that all expenses and taxes incurred by the American Company's General Department are properly allocable to the operating companies and the Long Lines Department, except for minor amounts (about 3% of the total) deducted as 'non-license,' and that the American Company is likewise entitled to a return of 6½ to 7% for the year 1946 on about $173,000,000 of 'capital employed in rendering services under license contracts.' Included in this amount were $28,000,000 of working capital and $127,000,000 of 'funds held available during year to meet cash requirements of licensees and Long Lines.' Based on this philosophy, Mr. Gretz concluded that American Company costs allocable to the Pacific Company's total California operations for the year 1946 amounted to more than $4,000,000. He testified that all such costs would be proper charges

to operating expenses of the Pacific Company.

"Mr. E. A. Hosmer, a witness for a number of cities in the Los Angeles area, contended there should be no charge to Pacific Company operating expenses in respect to the license contract, and that the Bell Laboratories costs should be charged to Western Electric Company and reflected in the prices of Western Electric products. He showed in an exhibit the estimated effect of this approach on the California operating results for Test Period A.

"Mr. Mors, the Commission's research engineer, made a determination of allocated service costs which he considered properly includible in Applicant's operating expenses for both total California operations and California intrastate operations. He recognized that the American Company furnishes various services of value to the Pacific Company, but took the position that the Pacific Company's subscribers should not be required to pay costs which the American Company incurs as an investor in the operating companies. In the absence of records showing the amount of the investor expenses, he estimated their magnitude by applying to the American Company's investment holdings a factor based on the relationship of expenses to investment holdings in a number of utility holding companies whose subsidiaries are served by service organizations separate from the holding company. In determining the factor, Mr. Mors made allowance for the greater magnitude of the American Company's holdings. As to taxes, the staff witness included those taxes which would be incurred by a non-profit service company without an investment interest in the companies serviced. He included also a 6% return on the American Company's net investment in facilities employed in furnishing services to the operating companies.

"Mr. Mors concluded that the American Company's investors are not required to advance working cash capital with which to carry on that company's service functions, since an analysis made by him showed that the American Company receives the license fee payments almost four weeks in advance of the average time it must meet its expenses. He did not make a study of the amount of American Company funds 'held available' for the Pacific Company or the cost thereof, it being his position that such cost would not be a proper charge to Pacific Company operating expenses. The Commission staff's estimate of total allocated service costs properly chargeable to California operating expenses for both intrastate and interstate operations was $2,395,000 for the year 1946 and

$2,393,000 for Test Period B, and for intrastate operations alone, $1,816,000 for Test Period A and $1,843,000 for Test Period B.

"The difference between Applicant's and the Commission staff's figures results almost entirely from different views as to the function of the American Company's General Department. Applicant's position is that the General Department holds its vast investments in the Bell System operating companies solely as a service to those companies and in the interest of an efficient nation-wide communication service, and that therefore all costs incurred by the General Department should be passed on to the licensee companies and the Long Lines Department, except for minor amounts not related to the operating companies. The Commission staff witness agreed that the licensee companies should pay the cost of bona fide services which are of benefit to them, but contended they should not be required to pay also the costs which the American Company incurs as an investor in their securities. We are inclined to the latter view. While we realize that the amount of investor costs cannot be determined precisely, the staff's estimate appears reasonable. With respect to American Company taxes, the Pacific Company's subscribers should not be required to pay income and other taxes which result from the American Company's earnings on its investments.

"Mr. Gretz' rebuttal criticism of the staff presentation, implying inconsistent treatment in allowing the return component of the American Company's investment in physical facilities devoted to this service and not including the cost of 'funds held available,' indicates a possible misunderstanding of proper regulatory procedure. It is well established that, in considering affiliated relationships, the cost of properties devoted to service should be included, irrespective of corporate lines. Mr. Mors has accomplished this by allowing a return on such properties.

"As to the 'funds held available' by the American Company, such moneys clearly have no place in a rate base, and we do not believe the cost of such funds is a proper charge to operating expense, being rather a financial cost to be met out of the net return to the extent that an independent company might find it necessary to do so. It would appear that ample compensation for any such costs is included in the interest charge of 2-3/4% on 'temporary advances,' which is in excess of competitive costs for temporary financing.

"The foregoing treatment accorded this so-called license agreement is based upon well recognized principles of law. It is an elementary rule of regulatory law, generally speaking, that a utility must bear the burden of showing by satisfactory evidence that all charges to operating expense are reasonable and have been reasonably incurred. (Smyth v. Ames, 169 U.S. 466, 547; 42 L. ed. 819, 849. Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 150, 169; 78 L. ed. 1182, 1194.)

"This rule applies with special emphasis where the charge to operating expense is a charge made against the utility by an affiliate or by a holding company, which dominates and controls the utility. (Dayton Power & Light Co. v. Public Utilities Commission of Ohio, 292 U.S. 290, 295, 298, 307-308; 78 L. ed. 1267, 1273, 1274, 1279. Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U.S. 398, 400-401; 78 L. ed. 1327, 1329. Western Distributing Co. v. Public Service Commission of Kansas, 285 U.S. 119, 124; 76 L. ed. 655, 658. Smith v. Illinois Bell Telephone Company, 282 U.S. 133, 152-153; 75 L. ed. 255, 265-266. San Diego v. San Diego etc. Co., 39 C.R.C. 261, 274.)

"In such circumstances, transactions between a utility and an affiliate are not binding upon a regulatory body or the rate payers of such utility, and contracts existing between a utility and an affiliate have no validity in a rate proceeding unless the terms thereof are within the bounds of reason. (Dayton Power & Light Co. v. Public Utilities Commission of Ohio, supra, at p. 295 of U.S. report and p. 1273 of L. ed. report.)

"The evidence in this proceeding clearly demonstrates that the American Company dominates and controls Applicant. Not only does the American Company have the opportunity for such domination and control resulting from its ownership of an overwhelming majority of Applicant's stock, but the evidence shows that the former does actually dominate and control the latter. The testimony of Mr. Gretz demonstrates this to be the fact. Also, the evidence of the relationship between these two corporations, as carried out in actual practive, lends support to this view. Therefore, we find as a fact that Applicant, in carrying out the terms of this so-called license agreement, exercises no independent judgment or will and the same is true concerning any action which the American Company directs Applicant to carry out. It follows that the so-called license contract or agree-

ment but is in essence a directive or requirement imposed upon Applicant by the American Company. We further find that the payment required to be made by Applicant to the American Company pursuant to this so-called license agreement is arbitrary, unreasonable and unjust and bears no rational relationship to the reasonable cost of the services actually rendered to Applicant by the American Company and its affiliates. Unlike the situation in Smith v. Illinois Bell Telephone Company, supra, at p. 152 of U.S. report and p. 265 L. ed. report, we do have here directly in issue the abuse of intercorporate relations.

"In this connection, we point out that the Congress did not subject the American Company to the provisions of the Public Utility Holding Company Act of 1935.

"For the foregoing reasons, we have disregarded this so-called license agreement in arriving at a reasonable charge to operating expense for the services furnished to Applicant by the American Company. We hereby adopt the amounts of allocated costs recommended by the Commission staff. We may add that Applicant has not borne the burden of proving that any greater allowance for such charge to operating expense should be recognized by this Commission."

What we there said, we reaffirm here. Nothing has come into this record, which changes in any way our view of this subject as expressed in Decision No. 41416. The factual situation concerning this license contract is substantially the same today as it was when Decision No. 41416 was issued. The major difference is that the percentage payment has been reduced from 1½ per cent to one per cent. The evidence of record in this proceeding all the more convinces us that what we said upon this subject in that decision was and is correct and was and is fully substantiated by both law and fact. We find as a fact from the evidence of record in this order to show cause proceeding that the American Company dominates, controls and directs respondent in its operations and administration; that respondent exercises no real, untrammeled and independent judgment in its negotiations, dealings and relationships with the

American Company and, in arriving at understandings and agreements between respondent and said American Company, arms-length bargaining is not, in fact, engaged in, although an attempt, in some instances, is made by said parties to simulate the same; that, in effect, said American Company, when dealing with respondent, is merely dealing with itself for the reason that respondent and all wholly-controlled operating subsidiaries of said American Company are treated as departments of one large nation-wide enterprise with operating and directing centralized control exercised by the American Company as the head or home office. The license contract, in and of itself, is evidence of domination of respondent by the American Company. The entire factual situation on this issue compels the conclusion and finding, and we do so hereby find, that the American Company does actually dominate and control respondent. A contrary holding would be entirely unrealistic. Domination, usually, must be proven by circumstantial evidence, for the reason that witnesses, rarely ever, will admit categorically that domination exists as a fact.

Decision No. 41416 has long since become final and is binding upon the respondent. The order to show cause procedure was employed in connection with this subject to give respondent every opportunity to show, if it could, any possible justification for continuing to be a party to the license contract. That this Commission had and has jurisdiction and authority to regulate, in the public interest, respondent's participation in this license fee arrangement existing between it and the American Company, we entertain no doubt. The question was and is: Should this Commission exercise its lawful regulatory authority in the circumstances? We are of the opinion that this question must be answered in the

affirmative.

This license fee arrangement came into existence in the Bell System in the year 1880. It was changed to a percentage of gross revenues payment in 1902, the percentage being then established at 4½ per cent. Over the years, this percentage payment has been gradually reduced to the present one per cent of gross revenues as a result of criticism and pressure brought to bear upon the American Company and its operating subsidiaries by regulatory bodies and courts. This license contract is in evidence in this proceeding as Exhibit No. 4. An examination of this document, together with explanatory history, demonstrates that it is not an agreement reached by the process of arms-length bargaining and negotiation. It is clearly a one-sided arrangement in favor of the American Company and prejudicial to the respondent and its rate-payers. We find said contract to be arbitrary, unreasonable and unjust and, in law and in fact, not a contract but merely a requirement imposed upon respondent by the American Company. It is here pointed out that, under the express term of the contract as it now reads, the American Company, on four months' notice, may increase the percentage payment to 2½ per cent, without obtaining the consent of respondent. This contract works to the definite prejudice of the minority stockholders of respondent and to the unjust enrichment of the American Company, which owns 87.93 per cent of the capital stock of respondent, by its receipt not only of dividends as such majority stockholder but by the receipt of the percentage payments of gross revenues under this license arrangement. We shall advert to this phase of the situation later on in this decision.

The evidence in this record demonstrates that the principle of allocated costs is the desirable principle to adopt in fixing rates

for this respondent, so far as the charges made against it by the American Company for services are concerned. This principle is realistic and is followed by the American Company in its financial dealings with its own Long Lines Department. If this principle is correct as applied to the Long Lines Department of the American Company, what rational argument can be offered to demonstrate that the same principle is improper as applied to the respondent and other operating subsidiaries? There is evidence in this record that officials of the American Company generally admit the correctness of the principle underlying the allocated costs basis. Witnesses for the respondent, under cross-examination, conceded the validity of the allocated costs basis. Furthermore, this treatment is generally accorded the operating subsidiaries of the Bell System by courts and regulatory bodies in rate cases. Witnesses for respondent testified that the services rendered to respondent pursuant to said license contract were of a value in excess of the payments made by respondent thereunder. We find that such contention is not supported by the evidence.

Whether or not the amounts of money actually paid by respondent to the American Company for services rendered to the former by the latter under this license contract, by coincidence, may approximate the correct charge to be made by the American Company, is wholly beside the point. It is the device employed that we are here concerned with, the proper regulatory rule to promulgate, the proper principle to adopt, which will give correct results in all situations and not in accidental situations. The percentage of gross revenues device is totally unrealistic and bears no rational relationship to the reasonable cost of services rendered, reflects no causal or proximate connection or relationship between payments

made thereunder and reasonable value of the service rendered and is neither supported by law, logic nor elementary common sense. The principle involved in the license contract, we find to be erroneous; the device employed, the percentage payment, we find to be a false measuring rod. Therefore, such device should not be permitted to stand as a continuing burden upon the minority stockholders of respondent and as a constant threat to the interests of the rate-payers and as a constant temptation to respondent, under the direction of the American Company, to use the payment of these excessive amounts as expenses as a constant argument in support of pleas for rate increases.

Rate-making is that process whereby past experience is projected into the future as a basis for prescribing rates to be charged by a public utility. If the past experience used is false or contains any element of falsity, to that extent will the forecasts for the future be false. It is our opinion that this false quantity resulting from the operation of this license contract should not be allowed to continue to confound rate proceedings in the future.

It is conceded by all that this Commission may disallow, for the purpose of rate-fixing, any improper amounts paid by respondent under this license fee contract. It, therefore, follows that this Commission may take all reasonable measures to prevent the occurrence of that which it has the power to reject.

It is elementary that a regulatory body may take all reasonable and necessary action to reach a permissible end and that in reaching such end or objective it may fashion tools and instrumentalities best calculated to achieve that lawful end. There is a presumption of the existence of a state of facts sufficient to sustain such end, if any such state of facts reasonably can be con-

ceived. (Pacific States Box and Basket Co. v. White, 296 U.S. 176, 185-186; 80 L. ed. 138, 146. Thompson v. Consolidated Gas Utilities Corporation, 300 U.S. 55, 69; 81 L. ed. 510, 518.)

We are here prescribing a statute, so to speak, in the Commission's legislative capacity, not unlike a statute or rule prescribing an accounting requirement or regulation in aid of regulatory jurisdiction. It is not the question of the existence of power that we are concerned with but rather with a possible abuse of power. All power may be abused but that is no argument against its existence. However, we see here no possible abuse of power.

Under the broad regulatory power granted to this Commission over the fixing of rates, the issuance of securities and the general regulation and supervision of public utilities as prescribed by the State Constitution and the Public Utilities Act enacted pursuant to such Constitution (bearing in mind that the Legislature has conferred upon this Commission power to regulate and supervise public utilities unlimited by any provision of the State Constitution), it is our opinion that the authority of this Commission to prescribe the rule and regulation envisioned by the order to show cause herein is quite obvious. The proposed rule and regulation lawfully could be promulgated by this Commission as a necessary incident to its power to fix rates, and to abate unreasonable, unjust and improper practices. (Sec. 35, Public Utilities Act. American Tel. & Tel. Co. v. U.S., 299 U.S. 232, 246; 81 L. ed. 142, 153.)

Such rule and regulation lawfully could be prescribed by the Commission under its authority to control the issuance of securities. It is clear that a rule and regulation of this nature is absolutely necessary to protect minority stockholders of this respondent because of the fact that the majority stockholder (the

American Company) of respondent receives not only dividends on the 87.93 per cent of the capital stock of the respondent, which the American Company holds, but also receives the percentage of gross revenue payments under the license contract. Any excessive payment under the license contract diminishes to that extent income that might be devoted to dividends and that is exactly what happens as regards the minority stockholders of respondent. However, the American Company is concerned not at all with this situation because of the fact that the diminution of income by payments made under the license contract goes into the treasury of the American Company. It is a public duty of this Commission to protect these minority stockholders and the prescription of the rule and regulation envisioned by this order to show cause is best calculated to afford that protection. Furthermore, the excessive payments made to the American Company by this respondent under the provisions of the license contract are charged to operating expenses of this utility and the accounting records of the respondent reflect these excessive payments. Thus, the financial picture that respondent presents to this Commission is one reflecting these excessive charges to operating expenses. This financial picture, the respondent uses in its argument to this Commission in support of its requests for rate increases.

In our opinion, this Commission has plenary power and authority to prevent this respondent from continuing to present a financial picture that contains this false quantity. The authority to remove an evil carries with it a concomitant authority to take the necessary measures to prevent that evil from occurring or continuing. Under the Commission's plenary authority to prescribe accounting practices for public utilities, such a rule and regulation could

and should be issued. The uniform interpretation announced by the courts with regard to the authority of regulatory bodies to prescribe uniform systems of accounts leaves no possible doubt that the prescription of this type of rule or regulation would well come within the power of this Commission. We will refer more specifically to this particular subject later on in this decision.

It is a familiar rule of law that matters normally not subject to regulation by a particular governmental authority may become subject to such regulation where it becomes necessary to regulate them in aid and protection of the power to regulate matters admittedly subject to regulation by the particular governmental authority. For instance, federal regulatory bodies may regulate intrastate matters - otherwise prohibited by the Federal Constitution -, where it becomes necessary to regulate such intrastate matters in aid and protection of the admitted power of such agencies to regulate interstate matters. Likewise, the Supreme Court of the United States has held that the Federal Power Commission may value purely intrastate property, wholly exempt from its general regulatory jurisdiction, as an incident and an aid to its general regulatory power over interstate public utilities. (Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581, 597-605; 89 L. ed. 1206, 1220-1224. Panhandle Eastern Pipeline Co. v. Federal Power Commission, 324 U.S. 635, 639-649; 89 L. ed. 1241, 1246-1251.)

The evidence in this proceeding indicates that requisitioning of services may be a desirable procedure. Should actual experience, under the regulation we will prescribe herein, demonstrate that requisitioning is necessary, we shall further address ourselves to such subject at that time.

A requirement that respondent pay no more for services than the

reasonable cost to the American Company of performing them or the reasonable value of such services, whichever is lesser, requires no more than the law itself requires and good regulatory practice demands. (American Tel. & Tel. Co. v. U.S., 299 U.S. 232, 246; 81 L. ed. 142, 152-153. U.S. v. New York Tel. Co., 326 U.S. 638, 654; 90 L. ed. 371, 381.) In the New York Telephone Company case, the Supreme Court points out that a holding company is not entitled to profit at the expense of its subsidiary. (P. 654 U.S. Report.) If it can be said that the intercorporate relationships existing between the American Company and the respondent are so commingled and interwoven that such relationships would render it difficult for the respondent to comply with the rule and regulation herein promulgated, the ready answer is that such situation is of the respondent's own making and that of the American Company. It lies within the power of the American Company to simplify these relationships. Having not seen fit to do so, respondent and the American Company must bear any brunt that results from these relationships, when subjected to lawful regulation.

The contention by the respondent that such a rule and regulation would invade the domain of management is the contention that utilities have always made when faced with threatened regulation. Of course, all regulation, to some degree, invades the domain of management and such regulation became necessary because management had not performed its function properly. Section 31 of the Public Utilities Act provides as follows:

> "The railroad commission" /now the Public Utilities Commission/ "is hereby vested with power and jurisdiction to supervise and regulate every public utility in the state and to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

Were this provision not embodied in the Public Utilities Act, under the well-recognized principle of necessary and incidental powers, it would be implied.

We perceive no conflict with the Federal power in issuing herein the regulation, which we will prescribe, for the reason that its application will involve, as to rate regulation and accounting practices, only intrastate operations. As to regulation of securities issues of this respondent, this Commission's authority is not questioned because of the fact that the Federal power has not occupied this field, thus leaving this area of regulation to the several States.

All contracts, no matter how lawful or valid, and property rights, no matter how long vested, are subject to impairment and even destruction by the lawful exertion of the police power of the State. The contract clause of the Federal Constitution affords no protection. This rule is elementary. The regulatory power exercised by this Commission is a branch of the police power.

The contention made by the respondent that requiring the respondent to abandon the license contract and to pay no more than the reasonable cost of the services furnished to it by the American Company would confiscate the property of the American Company overlooks entirely the presence of the police power. Obviously, any action taken by this Commission that would remove any financial burden from the shoulders of the Pacific Company would not confiscate the property or property rights of the Pacific Company or prejudice it in any way. Conversely, the American Company could not gain a vested right in any unlawful or improper conduct it might engage in with its subsidiary, the Pacific Company. It must be borne in mind that special rules of law apply to the relationships existing be-

tween a dominating holding company and its subsidiaries and affiliates. What might be proper for two corporations to do, when dealing at arms-length, might be highly improper for two corporations to do sustaining the same relationship one to the other as is the case with the American Company and this respondent. So, assuming for the purpose of argument only that the license contract is a valid one even as applied to the special relationship existing between the respondent and the American Company, it does not follow that this Commission has not plenary authority and power to compel action on the part of the respondent that, in effect, would destroy entirely the relationship based upon this contract. Furthermore, we here point out that the relationship existing between this dominating holding company (owning, as it does, 87.93 per cent of the capital stock of respondent) and its subsidiary is a particularly appropriate subject for the operation of the police power because of the evils so often inhering in such a relationship. (American Tel. & Tel. Co. v. U.S., 299 U.S. 232, 246; 81 L. ed. 142, 152-153.)

Additionally, it is here pointed out that the prescription of the type of rule and regulation, as is envisioned by the order to show cause, would be analogous to an accounting regulation or procedure. The uniform systems of accounts imposed upon public utilities by such agencies as the Federal Power Commission, Federal Communications Commission, Interstate Commerce Commission and many of the State commissions (including this Commission) require public utilities to write off hundreds of millions of dollars worth of alleged assets and the courts have held uniformly that such requirement is perfectly valid. The utilities have generally contended that the imposition of such systems of accounts confiscates their property and denies them due process of law and the equal protec-

tion of the law. These are the contentions made by the respondent in the present proceeding. Any rights which this respondent or the American Company may claim under this alleged license contract are no more sacred than the rights claimed by the utilities to carry in their property accounts hundreds of millions of dollars worth of claimed assets, which the courts have uniformly held may be required to be written off under uniform accounting regulations. The Supreme Court of the United States has held that an accounting regulation will be upheld by that Court unless such regulation be so entirely at odds with fundamental principles of correct accounting as to be the expression of a whim rather than an exercise of judgment. (U.S. v. New York Tel. Co. (1946), 326 U.S. 638, 655; 90 L. ed. 371, 382. American Tel. & Tel. Co. v. U.S. (1936), 299 U.S. 232, 246; 81 L. ed. 142, 152.) The foregoing two cases decided by the Supreme Court of the United States are especially appropriate to be considered in this proceeding for the reason that those cases involved the same corporate combine which is involved in this proceeding.

Based upon the evidence in this record, the Commission finds as follows:

1. That it is contrary to the public interest, the interest of respondent and its minority stockholders and constitutes a continuing prejudicial threat to the interest of the rate-payers for respondent, directly or indirectly or under any color or guise or by any device whatsoever, to continue to make percentage of gross revenues payments to the American Company pursuant to the provisions of said license contract.

2. That it is in the public interest to order and direct respondent forthwith to discontinue such payments to the American Company pursuant to the provisions of said license contract.

3. That it is in the public interest for this Commission to promulgate and to order and direct respondent to comply with the rule and regula-

tion, which will be prescribed in the order following this opinion.

We are definitely of the opinion that this Commission should exercise its jurisdiction and authority in the premises to regulate in the public interest the respondent's participation in this license fee arrangement. The following order will provide for such regulation, which we hereby find to be in the public interest, the interest of respondent and the interest of the minority stockholders of respondent. Said regulation we hereby find not to be adverse or contrary to the legitimate and lawful interests of the American Company or any of its subsidiaries or affiliates.

The evidence in this record shows that, as applied to its California intrastate operations, $2,250,000 is a proper amount for respondent to charge, at this time, to operating expenses, on an annual basis, for services rendered to it pursuant to said license contract and we hereby find said amount to be the reasonable value of said services and the reasonable cost for performing the same. The order contained in this decision will prescribe such requirement as a part of the regulation, which will be promulgated in said order. Any increase of the amount of $2,250,000 must receive the prior approval of the Commission before respondent may pay such increase. Of course, if said services should fall either in reasonable value or in reasonable cost below the amount of $2,250,000, respondent will be required to conform its payments to such facts and reduce said amount accordingly.

O R D E R

The within order to show cause having been duly issued and hearings having been duly held thereon and said matter having been

submitted for the decision of this Commission, and the Commission being fully advised in the premises,

IT IS HEREBY ORDERED that, as applied to its California intrastate operations, respondent, The Pacific Telephone and Telegraph Company, hereafter, shall pay to the American Telephone and Telegraph Company, for services rendered by it or any of its affiliates to respondent, no more than the reasonable cost incurred in the rendition of such services or the reasonable value of said services, whichever is the lesser. That in determining the reasonable value of any service rendered, consideration shall be given, among other things, to what it would reasonably cost respondent to perform such service with its own organization. Services rendered to respondent, which, in the judgment of the Commission, are not reasonably required by respondent shall not be paid for by respondent. Neither respondent nor any officer, agent or servant of respondent, by any device whatsoever or under any pretense or guise, directly or indirectly, shall commit any act or engage in any conduct which shall be calculated to circumvent or evade the intent of this order.

IT IS HEREBY FURTHER ORDERED that respondent shall file with this Commission, bi-monthly, a verified report showing for the immediately preceding two-calendar-month period all payments made by respondent to the American Telephone and Telegraph Company for services rendered to respondent by said American Telephone and Telegraph Company and/or any of its affiliates, together with an itemization of said services and the amount paid by respondent for each type of service rendered, such report to be filed not later than 40 days after the close of the period, which it covers. Said verified report shall show, for each type of service rendered, the total cost incurred by the American Telephone and Telegraph Company or

its affiliates in the rendition of said service to respondent, and the payment therefor by respondent on an allocated basis, segregated as to company-wide, total California and California intrastate operations. The first report shall be for the months of January and February 1949 and shall be filed on or before April 9, 1949.

IT IS HEREBY FURTHER ORDERED that, as applied to its California intrastate operations, the amount of $2,250,000, on an annual basis, shall be adopted by respondent as the base and starting point for the program and procedure prescribed by this order and respondent shall be entitled to pay, on an annual basis, to American Telephone and Telegraph Company said amount for services rendered to respondent by American Telephone and Telegraph Company and/or its affiliates pursuant to said license contract. Provided, however, that said amount shall be adjusted to a lesser or greater amount as the facts and circumstances may warrant, but, in no event, shall respondent pay more than $2,250,000, on an annual basis, without first seeking and receiving the authority of this Commission so to do.

This decision shall become effective after the expiration of twenty (20) days from and after the date hereof.

Dated, San Francisco, California, this 23rd day of February, 1949.

Commissioners

Application No. 28211
Order to Show Cause

I concur in that part of the majority order reading: "as applied to its California intrastate operations, respondent, The Pacific Telephone and Telegraph Company, hereafter, shall pay to the American Telephone and Telegraph Company, for services rendered by it or any of its affiliates to respondent, no more than the reasonable cost incurred in the rendition of such services or the reasonable value of said services, whichever is the lesser. That in determining the reasonable value of any service rendered, consideration shall be given, among other things, to what it would reasonably cost respondent to perform such service with its own organization" and "as applied to its California intrastate operations, the amount of $2,250,000, on an annual basis, shall be adopted by respondent as the base and starting point for the program and procedure prescribed by this order and respondent shall be entitled to pay, on an annual basis, to American Telephone and Telegraph Company said amount for services rendered to respondent by American Telephone and Telegraph Company and/or its affiliates pursuant to said [redacted] license contract. Provided, however, that said amount shall be adjusted to a lesser or greater amount as the facts and circumstances may warrant."

This procedure, though the record may not definitely establish the actual result, is a reasonable and wholly proper course to pursue in a rate proceeding. The difference in the charges under the present license contract provision and the maximum base and starting point proposed by the order is approximately $250,000 before income taxes. A test of the proposed method as set forth in the order will readily establish its actual cost and the extent to which savings can be made.

Justus F. Craemer

JUSTUS F. CRAEMER
Commissioner

Application No. 28211

I dissent from the foregoing Opinion and Order.

Ira H. Rowell.

IRA H. ROWELL, Commissioner.

JA
A-28211 C.S.C.

A P P E A R A N C E S

Arthur T. George, Eugene M. Prince, Fletcher Rockwood, and Eugene D. Bennett, for respondent; Roger Arnebergh and T. M. Chubb for the City of Los Angeles; John J. O'Toole, Dion R. Holm, and Paul L. Beck, for the City and County of San Francisco; Emuel J. Forman, for the Cities of Alhambra, Beverly Hills, Burbank, Culver City, El Monte, El Segundo, Glendale, Hawthorne, Inglewood, Pasadena, South Pasadena, Arcadia, and South Gate; J. J. Deuel and Edson Abel, for the California Farm Bureau Federation; Reginald L. Vaughan and John G. Lyons, for the Cities of Bakersfield, Sacramento, Fresno, Stockton, and San Jose; C. M. Ozias, for the City of Fresno; Everett M. Glenn, for the City of Sacramento; Frederick J. Lordan, for the Department of Public Utilities of the State of Washington; John W. Collier, Archer Bowden, and Loren W. East, for the City of Oakland.

EXHIBIT "A"

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation (inclusive of its wholly-owned subsidiary, Southern California Telephone Company, a corporation), for authority to increase certain intrastate rates and charges applicable to service furnished within the State of California.	Application No.28211

O R D E R

WHEREAS, in Decision No. 41416, rendered on the 6th day of April, 1948, in the above captioned proceeding, this Commission found that the payments required to be made by Pacific Telephone and Telegraph Company (hereinafter referred to as "respondent company"), applicant above named, pursuant to the so-called license contract existing between said respondent company and the American Telephone and Telegraph Company, were and are arbitrary, unreasonable, and unjust, as applied to said respondent company, and that such payments bear no rational relationship to the reasonable cost of the services actually rendered to said respondent company by the American Telephone and Telegraph Company and its affiliates, and further found that said so-called license contract is, in fact and in law, not a contract or agreement but is in essence a directive or requirement imposed upon said respondent company by the American Telephone and Telegraph Company, which said Decision No. 41416 is by reference hereby incorporated in this order to show cause as if set out in full herein; and

WHEREAS, in and by said decision said respondent company was directed by this Commission to submit, not later than July 1, 1948, a plan for a new arrangement with the American Telephone and Telegraph Company in respect to payments for services rendered to

said respondent company by Bell Telephone Laboratories, Inc., an affiliate of the American Telephone and Telegraph Company, and for services rendered to said respondent company by the operation and engineering and other departments of the American Telephone and Telegraph Company to the extent recognized in said decision as proper costs chargeable to said respondent company; and

WHEREAS, said decision became final on the 26th day of April, 1948; and

WHEREAS, said respondent company, pursuant to the direction and order contained in said decision, did file with this Commission, on July 1, 1948, a report, which, in effect, informed the Commission that said respondent company was unable to change or revise the terms and provisions of said so-called license contract and questioned the jurisdiction of this Commission to require respondent company to do so and offered to work with the Commission either informally or in a formal proceeding looking towards a solution of the matter, which said report is by reference hereby incorporated in this order to show cause as if set out in full herein;

NOW, THEREFORE, said PACIFIC TELEPHONE AND TELEGRAPH COMPANY, its responsible officers and members of its board of directors, hereinafter named respondents herein, are, and each of them is, hereby ordered and directed to appear before Commissioner Huls, to whom this proceeding is hereby assigned, or such Examiner as may be designated to take evidence on his behalf in this proceeding, on Thursday and Friday, the 30th day of September, and the first day of October, 1948, at the hour of 10:00 o'clock a.m. of said day, in the Commission's Court Room, Room 540 State Building, 350 McAllister Street, San Francisco, California, and show cause, if any they may have, why they should not be ordered and directed to do the following:

1) Refrain and desist from making further or any payments,

directly or indirectly, or under any color or guise, or by any device, to the American Telephone and Telegraph Company, or any of its subsidiaries or affiliates, pursuant to the provisions of said so-called license contract;

2) Requisition, in writing, any and all services said respondent company reasonably requires performed for it by the American Telephone and Telegraph Company, its subsidiaries or affiliates, said requisition to be made in advance of and prior to the rendition of any service thereby requisitioned;

3) Require the American Telephone and Telegraph Company, its subsidiaries or affiliates, to render bills or invoices to said respondent company for any services rendered by them, or either or any of them, to said respondent company, and said respondent company to pay only the reasonable cost of services reasonably required by and rendered to it, but not in excess of the reasonable value of such services, or not in excess of the cost to said respondent company, if said services were performed by its own personnel;

4) File with this Commission monthly, not later than the 5th day of each and every month, a verified statement setting out in full for the immediately preceding month all requisitions for services made by said respondent company upon the American Telephone and Telegraph Company, its subsidiaries or affiliates, during said period; also all charges made during said period against respondent company for services rendered to it by the American Telephone and Telegraph Company, its subsidiaries or affiliates, and also showing, for the immediately preceding month, all payments made during said period by respondent company, in money or other consideration, directly or indirectly, or under any color or guise, or by any device, to the American Telephone and Telegraph Company, its subsidiaries or affiliates, for any services rendered to respondent company

by the American Telephone and Telegraph Company, its subsidiaries or affiliates.

Said PACIFIC TELEPHONE AND TELEGRAPH COMPANY, its responsible officers and members of its board of directors and the successors in office of any such officers or directors, are hereby made respondents to this order to show cause and they may appear in said proceeding in person or by counsel.

The Secretary is hereby directed to cause a certified copy of this order to show cause to be served, by registered mail, on said PACIFIC TELEPHONE AND TELEGRAPH COMPANY at least ten days prior to the date set for the hearing on the within order to show cause.

Dated at San Francisco, California, this 24th day of August, 1948.

R. E. MITTELSTAEDT
JUSTUS F. CRAEMER
IRA H. ROWELL
HAROLD P. HULS
KENNETH POTTER
Commissioners

CERTIFIED AS A TRUE COPY
R. J. Pajalich

Secretary
Public Utilities Commission
State of California

SEAL

EXHIBIT "B"

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation (inclusive of its wholly-owned subsidiary, Southern California Telephone Company, a corporation), for authority to increase certain intrastate rates and charges applicable to service furnished within the State of California.	Application No.28211

RETURN TO ORDER TO SHOW CAUSE

DATED AUGUST 24, 1948

The respondents herein, The Pacific Telephone and Telegraph Company, a corporation, M. R. Sullivan, its President, F. J. Reagan, Glen Ireland, S. W. Campbell, R. E. Hambrook, R. J. Hadden, G. H. Jess, F. A. Dresslar, E. D. Wise, F. D. Tellwright, F. N. Rush and John M. Black, its Vice Presidents, G. L. Harding, its Secretary and Treasurer, and the members of its Board of Directors, namely: N. R. Powley, Chairman, Allen L. Chickering, C. F. Craig, William W. Crocker, John E. Cushing, Preston Hotchkis, G. H. Jess, Frank B. King, Atholl McBean, C. K. McIntosh, N. Loyall McLaren, Henry D. Nichols, F. J. Reagan, V. H. Rossetti, E. C. Sammons, William S. Street and M. R. Sullivan make this Return to the Order to Show Cause issued herein under date of August 24, 1948 by the Public Utilities Commission of the State of California (hereinafter called the "Commission").

Respondents respectfully represent that the Commission should not order them to do any of the things mentioned in the paragraphs numbered 1 to 4, inclusive, of said order dated August 24, 1948, for the following reasons severally and collectively:

1. The paragraph numbered 1 in said order directs respondents to show cause why they should not be directed to desist from further payments under, or further performance of the so-called license contract between respondent The Pacific Telephone and Telegraph Company, hereinafter called "Pacific", and American Telephone and Telegraph Company, hereinafter called "American". Concerning said contract and said paragraph 1 of said order to show cause, respondents respectfully represent:

(a) Said contract is now and for many years has been a valid contract in full force and operation between Pacific and American. By it, and in consideration of the contract payments to American, Pacific is now entitled to and has had for many years the rights, privileges, benefits, licenses and services provided in said contract (sometimes collectively referred to herein as the "services"). Said services include (without limitation) research and development in scientific, engineering and operating fields; they include operating assistance; patent licenses and patent protection; financial assistance; and assistance in the manufacture and procurement of necessary equipment, supplies and material.

(b) Said services are necessary to the efficient operation of Pacific and to the rendition of efficient public service, and their value to Pacific substantially exceeds the payments being made by Pacific under said contract.

(c) For the most part said services cannot be obtained otherwise than through American, and to the extent that they could either be supplied by Pacific, itself, or obtained elsewhere, they would be so suppliable or obtainable only at a substantially higher cost than the payment under said license contract and in a substantially less efficient manner than under said license contract.

(d) The cost of rendering said services substantially exceeds the payments being made by Pacific under said contract.

(e) The amounts currently being paid by Pacific under said contract, and the amounts which will be paid thereunder in the reasonably foreseeable future, if said contract continues in effect, are reasonable from the viewpoint of Pacific.

(f) If Pacific were required to cease making the payments provided by said contract, Pacific would incur all liabilities incident to breach thereof, including liability to a termination of said contract by American. Such termination would be detrimental to the best interests of the public served by Pacific and of Pacific and its stockholders.

(g) The Commission has no jurisdiction or authority to make any order forbidding further payments under or further performance of said contract. The authority and jurisdiction of the Commission respecting said contract (whatever it may be for rate-making purposes) does not extend to ordering non-performance thereof, or to the making of any order impairing or operating directly upon the obligation of said contract.

(h) Any order forbidding further payments under or further performance of said contract would be beyond the authority and jurisdiction of the Commission in that it would invade and be an assumption of the rights and privileges of the management of Pacific.

(i) Any order of the Commission forbidding further payments under or further performance of said contract, or in any manner, directly or indirectly, depriving Pacific of said contract, or the benefits thereof, whether by directing Pacific to commit a breach thereof or otherwise, would be invalid under the Constitution of California in that

I. It would be a taking of Pacific's property without due process of law contrary to Section 13 of Article I of said Constitution;

II. It would impair the obligation of said contract contrary to Section 16 of Article I of said Constitution.

(j) Any order of the Commission forbidding further payments under or further performance of said contract, or in any manner, directly or indirectly, depriving Pacific of said contract or the benefits thereof, whether by directing Pacific to commit a breach thereof or otherwise, would be invalid under the Constitution of the United States in that

I. It would be a taking of Pacific's property without due process of law and would deny respondents the equal protection of the laws contrary to Section One of the Fourteenth Amendment to said Constitution;

II. It would impair the obligation of said contract contrary to Section Ten of Article One of said Constitution;

III. It would unreasonably burden interstate commerce, and the interstate business and service of Pacific contrary to Section Eight of Article One of said Constitution. Pacific is engaged in an interstate as well as intrastate telephone business; the services provided by said license contract are essential to the interstate as well as intrastate service of Pacific; their continuance is in the best interest of said interstate service for all the reasons stated above; a breach of said contract by Pacific would entail liability for the termination of said contract in its entirety.

2. The paragraphs in said order to show cause numbered 2 to 4, inclusive, direct respondents to show cause why Pacific should not requisition services from American in advance, payment to be made on

the basis of cost to American, as more particularly set out in said order to show cause. The basis set out in said order is sometimes referred to herein as "a requisition basis." Concerning said paragraphs 2 to 4 of said order to show cause, respondents respectfully represent

(a) Said paragraphs presuppose the breach or termination of the license contract, which for all reasons herein set forth would be beyond the jurisdiction or authority of the Commission to direct, and contrary to the best interests of the public served by Pacific and of Pacific and its stockholders.

(b) The major part of said services could not by their nature be obtained by requisition; such (for example, and without limitation) as inventions and ideas for scientific, engineering and operating improvements. The license contract gives Pacific, among other benefits, the continuous flow of all improvements in the telephone art developed by American and its affiliates.

(c) As to those services which could be obtained by Pacific upon a requisition basis, they could only be so obtained later, and at greater cost and with less efficiency than under the license contract.

(d) The payments being made by Pacific under said contract are less than the value to Pacific of all of said services and are less than the total cost to American of performing them.

(e) The major part of the services necessary to Pacific and now being rendered under the license contract are services beneficial not only to Pacific but also to other operating companies in the Bell System. Payments for such services should be apportioned among and made by all benefited and should not be made by Pacific alone.

(f) The method of apportioning payments for benefits among

recipients thereof on the basis of a percentage of gross revenues, as now and for many years provided in said license contract, is a reasonable method. The requisition basis set out in said order to show cause is not a reasonable or efficient method for providing payment for said services.

(g) Any order requiring Pacific to adopt said requisition basis would be beyond the authority and jurisdiction of the Commission in that it would invade and be an assumption of the rights and privileges of the management of Pacific.

(h) Any order of the Commission requiring Pacific to adopt said requisition basis in place of the basis for obtaining said services provided in said contract would be invalid under the constitution of California in that

I. It would deprive respondents of the freedom of contract and be a taking of Pacific's property without due process of law contrary to Section 13 of Article I of said Constitution;

II. It would impair the obligation of said contract contrary to Section 16 of Article I of said Constitution.

(i) Any order of the Commission requiring Pacific to adopt said requisition basis in place of the basis for obtaining said services provided in said contract would be invalid under the Constitution of the United States in that

I. It would deprive respondents of the freedom of contract and be a taking of Pacific's property without due process of law and would deny respondents the equal protection of the laws contrary to Section One of the Fourteenth Amendment to said Constitution;

II. It would impair the obligation of said contract contrary to Section Ten of Article One of said Constitution.

III. It would unreasonably hinder interstate commerce and the interstate business and service of Pacific contrary to Section Eight of Article One of said Constitution.

3. Concerning the recitals of said order to show cause, and concerning matters contained therein in addition to said paragraphs numbered 1 to 4, inclusive, respondents respectfully represent:

(a) The payments made and being made by Pacific under the license contract are not arbitrary, unreasonable or unjust as applied to Pacific.

(b) Said payments are not unrelated to the reasonable cost of said services rendered by American to Pacific, or in excess thereof, but, on the contrary, the amount thereof is less than the reasonable cost of performing said services.

(c) Said license contract is not a directive or requirement imposed upon Pacific by American, but a fair and valid contract under which Pacific has obtained and is obtaining necessary services and benefits at a price which is reasonable from the viewpoint of Pacific.

(d) The findings of the Commission in Decision No. 41,416, which are recited in said order to show cause, are not conclusive or binding upon respondents in the present proceeding.

(e) Respondents had no way of obtaining any judicial hearing or review of said recited findings, and said findings were not subject to any judicial hearing or review, and if said findings, or any thereof, were held conclusive or binding upon respondents in this proceeding, respondents would thereby be bound without due process of law in violation of Section 13 of Article I of the Constitution of the State of California.

(f) Any order of the Commission based upon a holding that said findings or any thereof are conclusive or binding upon respondents in

this proceeding, would be invalid in that respondents would thereby be bound without due process of law and would be denied the equal protection of the laws in violation of Section One of the Fourteenth Amendment to the Constitution of the United States.

(g) The Commission has no authority or jurisdiction to accord to said findings any conclusive or binding effect in this proceeding.

(h) Pacific, as set forth in its report to the Commission dated July 1, 1948, negotiated with American for a modification of the then arrangements for payment by Pacific for services rendered by American, but was unable at that time to obtain a modification thereof. The payments under the license contract were later reduced effective October 1, 1948.

Pacific respectfully represents that the plan set forth in said order to show cause would not be practicable or efficient, and that the enforcement thereof would be contrary to the best interests of Pacific, its stockholders and the public, and in excess of the authority and jurisdiction of the Commission.

On consideration by the Commission of this return and of the oral and written evidence to be given on behalf of respondents in further response to said order to show cause, respondents respectfully pray that said order to show cause be discharged.

Dated, San Francisco, California,
October 27, 1948.

ARTHUR T. GEORGE
EUGENE M. PRINCE
FLETCHER ROCKWOOD

Attorneys for Respondents

PILLSBURY, MADISON & SUTRO
Of Counsel.