SD

Decision No. 61915

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the reasonableness and propriety of tariff sheets filed by THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY relating to internal service items required by the Air Defense Semi-Automatic Ground Environment System.	Case No. 6950

Pillsbury, Madison & Sutro, by Francis N. Marshall and James B. Atkins, for The Pacific Telephone and Telegraph Company, respondent.
Neal C. Hasbrook, for California Independent Telephone Association; and Thomas J. O'Reilly, for General Services Administration, on behalf of the Air Force, as a consumer; interested parties.
Paul Popenoe, Jr., for the Commission staff.

OPINION

Purpose of Investigation

By an investigation order filed on September 13, 1960, the Commission initiated the above-entitled proceeding for the purpose of determining if the tariff sheets[1/] filed by The Pacific Telephone and Telegraph Company on July 25, 1960, with its Advice Letter No. 7718, or any of them, are unreasonable, unjust, improper, or discriminatory in any respect, and if so, to establish just, reasonable, proper, and nondiscriminatory rates and charges for the

1/ The following specific tariff sheets of The Pacific Telephone and Telegraph Company are involved in this proceeding:

Schedule Cal. P.U.C. No. 22-T	Schedule Cal. P.U.C. No. 83-T
4th Revised Title Sheet	138th Revised Sheet 1
39th Revised Sheet 1	4th Revised Sheet 15
1st Revised Sheet 37	
Original Sheets 40 through 50, both inclusive	

service covered by said tariff sheets. The tariff sheets in question relate to key equipment systems and associated services furnished to the Air Force in connection with internal service items of the Semi-Automatic Ground Environment System (SAGES). Such tariffs became effective on August 25, 1960, on regular statutory notice.

The General Services Administration (GSA), on behalf of the Air Defense Command had requested suspension and investigation of the rates and charges set forth on said tariff sheets. This investigation was instituted in order to afford the GSA an opportunity to present evidence concerning the reasonableness and propriety of said tariff sheets.

Public Hearing

After due notice, public hearing was held on this investigation before Examiner William W. Dunlop on December 7 and 8, 1960, in San Francisco. The Pacific Telephone and Telegraph Company (Pacific) presented one exhibit and testimony through two witnesses in support of the reasonableness of the rates and charges under investigation.

The General Services Administration presented eight exhibits and testimony through one witness suggesting that the presently effective monthly rates in question be reduced by approximately 39 percent. The Commission staff confined its participation to the cross-examination of witnesses.

At the conclusion of the hearing on December 8, 1960, the matter was taken under submission subject to the receipt of one exhibit and briefs. Such exhibit and briefs having been filed,[2/] the matter now is ready for decision.

2/ Exhibit No. 10 was filed on December 15, 1960, and the last brief was filed on January 16, 1961.

Motion to Strike Exhibits

Respondent moved to strike exhibits 2 through 9, inclusive, presented by the General Services Administration primarily on the ground that they were incompetent and immaterial and irrelevant to any issue in the proceeding. The General Services Administration opposed respondent's motion. Upon a consideration of this matter, respondent's motion is denied.

Air Defense SAGE System

Witness for Pacific testified that from a communications point of view the Air Defense SAGE System is a complex arrangement of switching equipment, special designed terminal equipment and private line facilities which system is designed to operate independent of Pacific's common switching system. According to this witness, the SAGE system is directly connected to Pacific's toll system by only two toll terminals to be used by direction of the Air Force only in case of an emergency when there has been an interruption or destruction of the Air Force's private line facilities.

The services under inquiry in this proceeding are a part of the SAGE System. In California Pacific provides internal services for that part of the Air Defense SAGE System known as San Francisco Air Defense Sector in accordance with the specifications furnished by the Air Force. It appears that the San Francisco Air Defense Sector service became operational on December 7, 1960, although some of the equipment had been installed and under test as early as June, 1960.

Rates and Charges

Rates and charges applied to Pacific's California SAGE System service, according to the testimony, fall into three categories as follows:

(1) Items of service that for some time have been generally offered in California at regularly filed tariff rates. These items are being furnished to the Air Force at these filed rates.

(2) Items of regular tariff services but with modifications required to meet the particular requirements of the Air Force. These items are being furnished to the Air Force at the previous regularly filed tariff rate plus an increment based on the estimated cost of making the modification required by the Air Force.

(3) Items of service not previously furnished to any other customer in California. Rates and charges for these items were developed by Pacific based on estimated costs.

Pacific's witness testified that the rates and charges under investigation herein had been developed using the same method as has been used by Pacific in developing all of its rates and charges for special services in California not previously covered by existing tariffs. A form numbered GE-100, entitled, "Computation of Charge and Rate on Basis of Cost", was prepared according to Pacific's witness for each of the items of service, the rate of which was developed based on cost. A total of 40 GE-100 forms were prepared which collectively constitute Exhibit No. 1 herein.

There are a total of 47 monthly rates for service specified in the tariff sheets under investigation herein in addition to 16 installation charges, 28 basic termination charges and 3 references to rates and charges in other of Pacific's tariffs. Six of these monthly rates and three of the installation charges, in addition to the three reference rates, are identical with rates and charges for the identical items of service contained in other presently effective tariffs of Pacific. No specific suggested changes in these rates and charges were proposed by GSA. However, for the remaining 41 monthly rates,[3] 13 installation charges and 28 basic termination charges, GSA urged that a reduction be made.

A comparison of present rates and charges with those suggested by the witness for GSA for a few typical service items follows:

Service Item	No. of Units in Service Oct. 1960	Presently Effective Basic Termination Charge	Presently Effective Monthly Rate	GSA Suggested Basic Termination Charge	GSA Suggested Monthly Rate
Each initial 6-line key unit	153	$1,200	$ 42.50	$1,125	$ 26.00
Each additional 6-line key unit	143	515	18.75	495	11.50
Line equipment for each PBX station line terminating on system	249	90	3.25	85	2.00
Foot switch including jack and plug	58	45	1.60	40	1.00
Each recorder and auxiliary equipment	17	2,700	100.00	2,560	60.00
Recorder patch and monitoring panel	1	5,800	210.00	5,575	130.00
Manual conference arrangement, 6-jack	2	2,500	79.00	2,385	55.50
Mounting arrangement for terminating PBX station line in console without key units	26	265	9.75	255	6.00
Training activating equipment	1	1,100	39.00	1,030	24.00

GSA Suggested Adjustments

Witness for GSA testified that in his opinion there were at least four major items of cost reflected by Pacific in its form GE-100 (Exhibit No. 1) which require adjustments as follows:

(1) The total cost of material shown on line 2a on each of the 40 forms should be reduced by 8.17 percent to reflect an adjustment which, according to the GSA witness, was for excess profit including

3/ Rates (2)(b) 4.a. and (2)(b) 6.b. of Schedule 22-T are identical rates and appear to relate to sheet 9 of Exhibit 1.

income taxes on material sales to Pacific from an affiliated company, Western Electric.

(2) The total investment shown on line 7 on each of the GE-100 forms should be reduced by 15 percent to reflect an allocation of total investment to state and to interstate toll operations.

(3) Annual maintenance expenses shown on line 9 on each of the forms should be reduced by 50 percent to reflect a more appropriate maintenance to plant ratio.

(4) The factor for equated cost of money and income taxes shown on line 12 on each of the forms should be reduced by 45 percent to reflect an interest cost of 3.677 percent, a 45 percent depreciation reserve ratio, and a 6.75 percent rate of return.[4/]

Exhibits 2 through 7 show the development of the four adjustment factors suggested by the witness for the GSA, while Exhibits 8 and 9 are a recomputation of Pacific's Exhibit 1 reflecting the adjustments suggested by the GSA. The GSA also questioned the reasonableness of Pacific's estimates for removal costs, salvage, service lives, and Western Electric installation and engineering costs, but it made no specific adjustments in Exhibits 8 and 9 for these latter items.

Comparison of Cost Estimates

Based on the quantities of equipment items in service in October, 1960, as revealed by Exhibit No. 10, there is set forth in the tabulation following a comparison between the estimates prepared

4/ This Commission in its Decision No. 56652, dated May 6, 1958 (56 CPUC 277) found a 6.75 percent rate of return to be fair and reasonable as to Pacific's over-all California intrastate operations.

by Pacific and by GSA summarizing the investment costs, annual charges, and rate treatment. It is significant that GSA's estimate of total investment assigned exchange is $66,890, or 18.8 percent, lower than Pacific's estimate and that GSA's estimate of total annual charges is $64,210, or 38.6 percent lower than Pacific's estimate.

COMPARISON OF COMPANY AND GSA ESTIMATES
OF FIRST COSTS, ANNUAL CHARGES AND RATE TREATMENT
FOR SAGES EQUIPMENT ITEMS CONTAINED IN EXHIBITS NOS.
1 AND 9 AND QUANTITIES IN SERVICE IN OCTOBER 1960
AS LISTED IN EXHIBIT NO. 10.

Item	Company Estimates Present Rates Ex 1 and 10	GSA Estimates GSA Rates Ex 9 and 10	GSA Lower Than Company	
			Amount	Percent
Estimated First Costs				
Total Material	$187,460	$172,140	$15,320	8.17%
Non-Reusable Material	187,460	172,140	15,320	8.17
Total Labor and Engineering	168,080	168,080	-	-
Cost of Removal	32,000	30,620	1,380	4.31
Salvage	5,480	4,990	490	8.94
Total Investment	355,540	340,220	15,320	4.31
Total Non-Recoverable Costs	382,060	365,850	16,210	4.24
Total Investment Assigned Exchange	355,540	288,650	66,890	18.81
Estimated Annual Charges				
Maintenance Expense	$ 53,570	$ 21,690	$31,880	59.51%
Depreciation	38,210	36,580	1,630	4.27
Administration	20,970	17,070	3,900	18.60
Equated Cost of Money and Taxes on Income	45,510	20,240	25,270	55.53
Other Taxes	8,180	6,650	1,530	18.70
Total Annual Charges	$166,440	$102,230	$64,210	38.58%
Rate Treatment				
Basic Termination Charge	$375,340	$355,170	$20,170	5.37%
Installation Charge	5,130	4,930	200	3.90
Annual Revenue (Monthly Rate x 12 Months)	164,980	101,140	63,840	38.70

Material Costs

GSA claims that the rates reflected in Schedule 22-T are based solely on estimated costs; that major material items represent approximately 50 percent of Pacific's estimated first costs; that the major material items were purchased by Pacific from Western Electric Company; and that this Commission for 30 years has given full and proper consideration to the relationship between Pacific and Western and has, in rate proceedings, made adjustments to Pacific's rate base on the principle that Western is entitled to no greater return on its sales to Pacific than Pacific is entitled to as against its ratepayers.[5/]

In Exhibit 2 the GSA witness developed a material cost adjustment factor of 8.17 percent which GSA claims is simply an application of this Commission's long established principle respecting purchases by Pacific from Western to the cost development underlying the rates in issue in this proceeding. GSA developed the 8.17 percent adjustment factor from data for the year 1959 prepared by Western at the request of the joint NARUC-FCC subcommittee. GSA adjusted Western's reported gross income from its sales of total station apparatus for 1959 in the amount of \$139,096,600 by \$11,352,500, or to \$127,744,100, thereby reducing Western's reported net profit on its net investment of \$89,638,000 in station apparatus from 13.1 percent to a rate of return of 6.75 percent as last found reasonable for Pacific's over-all California intrastate operations by this Commission. The 8.17 percent adjustment factor was obtained by dividing the \$11,352,500 amount by \$139,096,600.

5/ Decision No. 42530 (48 CPUC 487).

Pacific urges that a "disallowance" of any part of the Western Electric costs in this proceeding would be most improper, impractical and unfortunate from a regulatory standpoint. It claims there is nothing in the record to show that Western made any profit on the equipment in question citing the testimony of the GSA witness at page 121 of the transcript: "I agree I do not have specific knowledge of the rate of profit earned by Western on the specific SAGES internal equipments". Pacific further states that the installation labor, roughly half of the installed cost, was without any profit to Western; that this Commission has never made a disallowance of Western Electric costs in determining, with the assistance of GE-100 forms, special tariff rates for special assemblies of equipment; that the rates in question are not wedded so tightly to cost determinations that judgment may not be used as to what a fair and reasonable rate for these services should be in the light of Pacific's public undertaking generally; and that, while this Commission in some past general rate cases has disallowed part of the Western Electric costs in determining the over-all rate of return which Pacific is afforded the opportunity to earn, for this Commission also to make a disallowance of Western Electric costs in connection with particular rates would either result in doubling the disallowance, or in intolerably complicating and burdening the rate making process in general rate proceedings.

A staff engineer in a closing memorandum states that an adjustment for Western's profits is a sound rate-making adjustment; that heretofore the staff has made such adjustment only on Pacific's over-all rate base in connection with major rate proceedings; and that the method of adjustment used by GSA appears to be in harmony with methods previously used by the staff. The staff, however, did not submit a witness to present its position.

We are not impressed with the argument that a rate-fixing adjustment should not be made merely because it has not been made in the past. Pacific itself continually emphasizes its search for new and better approaches to problems. Neither are we impressed with the argument as to the regulatory difficulties involved in making an appropriate adjustment to protect the public interest. However, in this proceeding we find a singular lack of competent evidence to show that Western in fact earned an excessive profit on sales of SAGES equipment to Pacific in California. Because Western earned a return of 13.1 percent on its net investment in station apparatus in 1959 it does not follow, as GSA suggested, that Western earned 13.1 percent on SAGES equipment purchased by Pacific.

We find no basis in the record in this proceeding for the material cost adjustment urged by GSA at this time.

Allocation to State and to Interstate Toll Operations

Witness for GSA took the position that 15 percent of the total investment in the facilities, the rates and charges for which are under investigation should be assigned to state and to interstate toll operations. The 15 percent factor was a judgment figure based on certain data contained in Exhibit No. 87 of Application No. 39309 of Pacific. It was the view of the GSA witness that Pacific in its normal separation process would assign the investment in these facilities to Category A exchange plant, a portion of which would then be separated to state and interstate toll operations on the basis of the relative minutes of use. Such portion of the investment and related expenses that would be thus assigned to toll operations, according to this witness, should not be recovered in exchange rates. He acknowledged, however, that if the facilities were not used for message toll telephone service and the investment therein were directly assigned 100 percent to exchange operations in Pacific's separation process, then the revenue requirements would have to be met out of exchange service.

The GSA witness acknowledged he had not seen the particular facilities in service in California, he did not know what the actual usage of the facilities was; nor did he know whether or not Pacific was actually classifying the investment in these facilities as Category A exchange plant and separating a portion of the costs to state and to interstate toll operations. He did testify that there are very extensive private line voice circuits connecting the direction center with adjacent direction centers, with combat centers, with radio and radar sites, and with gap fillers.

Pacific's witness testified that the facilities in question are designed to operate independent of its common switching system or its toll network; that the facilities are connected to Pacific's toll system by two toll terminals which, under normal operation, would be completely unused; that the particular facilities will be identified by a number so that the investment and related expenses and revenues could be assigned 100 percent to exchange consistent with the principles expressed in paragraphs 25.123 and 25.22 of the October 1957 Separations Manual. Pacific further asserts that the service in question is provided to one customer, the Air Force; that it is a highly specialized service furnished at considerable cost by Pacific;

that Pacific should get all of its compensation for rendering the service from the sole customer; and that if a portion of the cost were to be assigned to toll, Pacific would have to recover such costs in its toll rates. This would have the effect, according to Pacific, of spreading the burden of the service to the Air Force to other customers.

Pacific proposes to directly assign the cost of the SAGE facilities to exchange operations. The only direct assignment of station equipment among the operations provided for in the Separations Manual is that furnished under private line service tariffs.[6] Hence, Pacific proposes a departure from the Separations Manual for SAGES equipment.

A staff engineer, in a closing memorandum, urged that the rates for SAGES facilities here in question be reclassified from Pacific's exchange tariffs to its private line tariffs. It was the position of the staff engineer that such reclassification would obviate the need for an adjustment proposed by GSA in Exhibit No. 3 and also would eliminate the need for non-standard separation procedures as suggested by Pacific.

We find there is merit to the staff's suggestion particularly since this record clearly shows the SAGES facilities in question are designed to operate independent of Pacific's exchange and toll switching system and are connected to extensive private line circuits. The order herein will require Pacific to refile the rates under investigation herein under its private line tariffs and delete them from exchange tariffs.

6/ See paragraphs 25.12 and 25.22 of the Separations Manual.

Maintenance Expenses

Based on Exhibits 4 and 5, the GSA witness suggested a 50 percent reduction in Pacific's estimate of maintenance expenses. In Exhibit 4 the GSA witness used a maintenance force consisting of one foreman, two exchange repairmen, one central office repairman and two plant clerical personnel at cost rates based on a 40-hour week. Witness for Pacific, however, stated the maintenance force at Camp Beal consists of one foreman, five maintenance men plus a part-time clerk, under cost rates figured on a 44-hour week, plus two men on nights and Sundays.

A comparison of the pertinent figures as developed by GSA in Exhibit 4 with modifications as testified to by Pacific's witness is as follows:

	GSA Ex. 4	As Modified by Pacific
Total Direct Maintenance Labor	$ 34,986	$ 52,937
Loading for Overtime and Materials	23,324	22,349
Estimated Annual Maintenance Expense	$ 58,310	$ 75,286
Investment in SAGES Equipment	840,049	355,262
Investment in Standard Items	69,341	211,356
Total Plant Investment	$909,390	$566,618
Maintenance to Plant Ratio	6.41%	13.3%

According to Pacific's witness its $75,286 maintenance figure excludes the cost of two men on nights and Sundays.

In Exhibit 5 the GSA witness showed the ratio of maintenance expense for PBX and for circuit equipment-exchange to related plant investment for Pacific's Southern California area for the years 1958 and 1959 as follows:

	PBX	Circuit Equipment-Exchange
1958	7.19%	8.29%
1959	5.20	7.57

From his calculations on Exhibits 4 and 5 the GSA witness concluded that a maintenance to plant investment ratio for SAGES equipment of 7.5 percent was reasonable. He did, however, state that maintenance expenses during the initial cut-over phase may well run 50 percent to 200 percent higher than normal maintenance expenses.

Witness for Pacific stated that its maintenance estimate is based on estimated costs for each specific item of equipment prepared by experienced engineers and maintenance personnel estimating the amount of time required to maintain the equipment.

The staff engineer in his closing memorandum noted that both Pacific's and GSA's maintenance figures are, at best, estimates, and that this matter can be better determined after a review of several years' operations. The staff engineer suggested that provision be made for periodic reviews of the costs of furnishing this service, at which time appropriate adjustments in rates could be made to reflect actual rate base, maintenance and other expense results.

We find the figures submitted by GSA on Exhibit 4 so at variance from the facts at Camp Beal that no weight can be accorded to them. Likewise, the evidence is not convincing that because in 1958 or 1959 the maintenance to plant investment ratio in Southern California area for PBX equipment ranged from 5.20 percent to 7.19 percent and, for circuit equipment-exchange, ranged from 7.57 percent to 8.29 percent, that a 7.5 percent ratio is appropriate at this time for the SAGES equipment rates here under investigation.

We find that the staff's suggestion of periodic reviews of costs of furnishing SAGES equipment is appropriate and the order herein will so require.

Equated Cost of Money and Taxes on Income

GSA suggested a 7.0 percent cost of money and income tax factor rather than Pacific's 12.8 percent factor which reflects an interest cost of 3 percent for income tax purposes, a depreciation reserve ratio of 18 percent and a rate of return of 8 percent. GSA developed its 7.0 percent factor in Exhibits 6 and 7 using an interest cost of 3.677 percent, a depreciation reserve ratio of 45 percent and a rate of return of 6.75 percent.

The record is unchallenged that Pacific's average interest cost of debt outstanding as of November, 1960, was 3.677 percent and that the interest cost on more recent debenture issues has ranged up to 5.1 percent. Pacific takes the position that as the cost of its debt goes up, all other things remaining equal, the charges for its services must also go up, or its net income will fall away. Interest costs affect income taxes as well as return. We are of the view that Pacific's average interest cost should be used in computing income taxes rather than some arbitrary amount such as 3 percent as used by Pacific, but such income tax saving as would result is small as compared with the over-all costs.

GSA claims that it is not appropriate to use Pacific's average depreciation reserve ratio for its entire California operations of approximately 18 percent because the SAGES equipment will be static plant. Pacific points to the fact that if rates are to be fixed on the basis of a reserve actually attributable to this equipment at this time, the reserve ratio would be practically zero and the rates correspondingly higher. According to Pacific, it uses the average reserve position in its rate proposals in order to treat all customers fairly and alike.

We cannot say that rates fixed on the basis of a depreciation reserve ratio of 18 percent, when the actual reserve ratio attributable to this equipment is materially below that level results in unreasonably high rates at this time.

With respect to rate of return, GSA urges that the 6.75 percent rate of return found by this Commission in 1958 to be reasonable for Pacific's over-all California intrastate operations is appropriate for the SAGES service. GSA claims Pacific's risks and hazards associated with the SAGES service are reduced to a minimum if not completely eliminated by termination charge provisions of the tariff. Under the termination charge provisions, if the Air Force does not retain the service for ten years it must pay Pacific the applicable termination charge which reduces 1/120 for each full month the equipment is retained in service at the same premises.

Pacific's witness testified that in his opinion an 8 percent rate of return is a minimum amount for this specialty type of service with a basic termination charge and without such termination charge the return should be higher. In the last several years Pacific has used a rate of return of 8 percent in developing cost support for rates applicable to specialty type service in California.

There is no showing in this record as to the actual rate of return now being realized by Pacific on the SAGES facilities under investigation. The estimates submitted by Pacific and by GSA may or may not materialize. As previously indicated we will require Pacific to submit periodic cost reviews. Our action herein should not be construed as passing at this time on the reasonableness of an 8 percent rate of return for SAGES facilities.

Other Questioned Costs

While GSA made no specific adjustments in Exhibits 8 and 9 for removal costs, salvage, service lives, and Western Electric installation and engineering costs, it questioned the reasonableness of Pacific's estimates relating to these items. We have carefully reviewed the record and do not find therein a basis for finding Pacific's estimate of these items unreasonable at this time.

Over-all Conclusion

The Commission has carefully weighed all of the evidence of record and has considered the statements of the parties with equal care. We find no basis in this record to conclude that the rates under investigation herein and presently in effect for the SAGES facilities yield an unreasonably high rate of return or are discriminatory, or unjust at this time. We do find however that such rates should be refiled as part of Pacific's private line tariff schedules. We further find that Pacific should periodically review the costs associated with the provision of California intrastate SAGES service and file with this Commission the results of such reviews showing the actually realized revenues, operating expenses, depreciation, taxes, net revenue, investment in plant and depreciation reserve attributable to such intrastate service.

O R D E R

Investigation as above-entitled having been heard and submitted for decision, the Commission having been informed thereon, and based upon the evidence and the conclusions and findings contained in the foregoing opinion, IT IS ORDERED as follows:

1. Within thirty days after the effective date of this order The Pacific Telephone and Telegraph Company shall refile the rates, charges and conditions filed under Advice Letter No. 7718 as part of its private line tariff schedules and concurrently cancel such rates, charges and conditions from its Schedules Nos. 22-T and 83-T. Such refiled rates, charges and conditions shall become effective on five days' notice to the public and to this Commission after filing as indicated above.

2. The Pacific Telephone and Telegraph Company shall review the costs associated with the provision of California intrastate SAGES service for the year 1961 and file with this Commission by April 30, 1962 the results of its review showing the actually realized revenues, operating expenses, depreciation, taxes, net revenue, investment in plant and depreciation reserve attributable to such intrastate service. Thereafter, periodic cost reviews shall be undertaken by The Pacific Telephone and Telegraph Company for such service at three-year intervals, the results similarly to be filed with the Commission until further order.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 1st day of May, 1961.

Everett C. McKeage
President

C. Lyn Fox
George G. Grover
Frederick B. Holoboff
Commissioners