EP*

ORIGINAL

Decision No. 67369

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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|---|---|
| Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, practices, contracts, service and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY. | Case No. 7409 (Filed July 26, 1962) |

(Appearances are set forth in Appendix B)

# O P I N I O N

## Purpose of Investigation

The above-entitled investigation was instituted by the Commission on July 26, 1962, for the purpose of determining the reasonableness of the rates, tolls, rules, charges, operations, practices, and contracts and the adequacy of the service and facilities of The Pacific Telephone and Telegraph Company, respondent.[1/]

## Hearing

After due notice, 49 days of public hearing were held on this investigation before Commissioner Holoboff and/or Examiner Dunlop during the period January 23 to October 2, 1963, in either San Francisco or Los Angeles. On March 15, 1963, the eleventh day of public hearing, counsel for the City of Los Angeles and counsel for the City and County of San Francisco moved that the Commission issue an interim order immediately reducing the gross rates and charges of respondent in the amount of approximately $15,363,000 on an annual basis. This motion was renewed at the close of the twenty-eighth day of hearing, on May 3, 1963, and denied by the Commission on July 9, 1963 (Decision No. 65702). Respondent's direct presentation commenced

1/ Sometimes hereinafter referred to as Pacific Telephone.

on June 12 and concluded on September 27, 1963. On August 30, 1963, Pacific Telephone filed Application No. 45726 requesting increases in rates to produce additional annual gross revenues of not less than $43,953,000 and further requesting that said Application No. 45726 be consolidated with Case No. 7409 for hearing and decision.

At the forty-fifth day of hearing in the investigation, namely, on September 20, 1963, counsel for respondent moved that Application No. 45726 be consolidated with Case No. 7409 for hearing or, in the alternative, that the Commission increase respondent's rates within the framework of Case No. 7409 in the amounts and in the details shown in the application and exhibits thereto.

On September 27, 1963, the forty-eighth day of hearing, the Commission's staff moved that the Commission forthwith enter its interim order reducing respondent's California intrastate revenues by the amount of approximately $31,200,000.

At the conclusion of the hearing on October 2, 1963, Case No. 7409 was taken under partial submission for a final determination of respondent's reasonable test year intrastate revenues, expenses and rate base as well as a determination as to what is a fair rate of return for respondent's intrastate operations. Also taken under submission was respondent's motion for rate relief, except those parts of the motion which related to the proposed manner of spreading such increased rates. The extent of the submission is more particularly set forth at transcript pages 7132-7134 as follows:

> "This submission embraces what is commonly referred to as test year results of operation and revenue requirements, together with the effect thereof upon reasonableness of rates.
>
> "The issues which the Commission now undertakes to finally determine include those covered by the following exhibits and testimony relative thereto, together with all

testimony relating to issue of fair rate of return. These exhibits are the following: Staff Exhibits numbered 1, 2, 3, 4, 5, 21, 22, 23, 43, 47, 112, 113, 117, 118; the Respondent's Exhibits numbered 49 Revised, 50 Revised, 51 Revised, 52 through and including 96, 106, 107, 108, 109, 114, 115, 116, 119, 122, 123 and 124; General Services Administration Exhibit 111; Los Angeles, San Francisco and San Diego Exhibits numbered 28, 120, 121, 122 and late-filed Exhibit No. 125.

"This submission contemplates that if, based upon a resolution of the foregoing issues, the Commission finds that rate decreases are warranted, the Commission will at that time fix rates on an interim basis pending further hearing and determination in Case No. 7409, including hearing and determination of issues relating to rate spread and others.

"This submission also contemplates that if, based upon a resolution of the issues hereby taken under submission, the Commission finds that no rate decreases are warranted, or that rate increases are warranted, the Commission will proceed to hear and determine all other issues in Case No. 7409, including the issues of rate spread, all in order that a final order with respect to rates and other matters contemplated in Case 7409 can expeditiously issue.

"This submission shall be subject to concurrent briefs upon the issues heretofore mentioned by not later than November 12, 1963.

"The submission shall also be subject to oral argument on the same issues on November 20 and/or November 21, 1963."

Concurrent briefs upon the issues taken under submission were filed on November 12, 1963. Oral argument on the same issues was heard on November 20 and 21, 1963, and these issues are now ready for decision. Certain of respondent's monthly and annual reports filed with this Commission were made part of the record by reference.

History of Rate Proceedings

During the period 1948 to 1958, respondent seven times requested intrastate rate increases in California totaling on an annual basis, $234,692,000. During this period the Commission granted rate increases of $114,887,000 on an annual basis considering business volumes at the time of grant, or approximately 48.9 percent of the requested amounts. In each rate proceeding during the period 1948 to 1958 respondent requested a rate of return in every instance of 6.75 percent or greater. Between 1948 and 1954 the authorized rate of return was 5.6 percent. In 1954 it became 6.25 percent, and in 1958 it became 6.75 percent; the rates fixed in 1958 included an additional allowance of one-tenth of one percent attributable to attrition.

Investigation in this proceeding (Case No. 7409) commenced on July 26, 1962. During the course of the investigation, on August 30, 1963, respondent filed its Application No. 45726 seeking increases in intrastate rates in the total amount of $43,953,000 (based on the test year ending September 30, 1962) and further seeking a rate of return of 6.89 percent on its claimed intrastate rate base of $2,054,278,000. Thereafter, on March 9, 1964, respondent filed its amendment to said Application No. 45726 reducing the amount of its requested increase to approximately $34,400,000 (based on the test year ending September 30, 1962) to reflect certain tax changes, but still seeking the same 6.89 percent intrastate rate

of return on its claimed intrastate rate base. As previously indicated, respondent's reasonable results of operations and revenue requirements are being determined herein.

Relationships with American Telephone and Telegraph Company and Other Companies

American Telephone and Telegraph Company (American) holds 89.62 percent voting control of Pacific Telephone through ownership of 90.25 percent of the latter's common stock and 78.17 percent of its preferred stock. The number of minority common stockholders of Pacific Telephone increased by 2,796, or by over 7 percent, during the year 1962, from 39,145 to 41,941, and further increased to 43,140 at the end of 1963.

Pacific Telephone is one of 20 principal telephone operating subsidiaries of American. These 20 operating subsidiaries, together with two operating companies in the United States in which American owns less than a majority interest are termed "Associated Companies". American also owns Western Electric Company, Inc. (Western Electric), which in addition to being the manufacturing branch of the Bell System also acts in the capacity of purchasing agent and supply department, storekeeper, developer, installer, repairer, and salvager for the Associated Companies and Long Lines Department of American. American and Western Electric each own 50 percent of the outstanding capital stock of Bell Telephone Laboratories, Inc., which is the research and development branch of the Bell System. The Associated Companies, Western Electric Company, Inc., and Bell Telephone Laboratories, Inc., together with American form the Bell System.

Under the terms of an agreement commonly referred to as the "license contract", American carries on research and development work (through its subsidiary, Bell Telephone Laboratories, Inc.);

furnishes to the Associated Companies through its General Department advice, assistance and services on a wide variety of matters pertaining to the conduct of their business; and arranges for the manufacture of telephones and other telephonic devices and apparatus (by its subsidiary, Western Electric Company, Inc.).

Employees are frequently transferred between the American or other Bell System companies and Pacific Telephone. In case of transfer, the employee retains full pension credit for prior service.

The several Associated Companies, including Pacific Telephone, have an arrangement under which they obtain from American temporary advances of funds to meet their requirements for construction and other purposes, borrowing and repaying frequently as funds are needed or become available to them. From time to time the Associated Companies issue their own securities to repay or reduce the amount owed to American. When the Associated Companies issue stock, American subscribes for its pro rata shares, thus maintaining its financial interest in them.

Pacific Telephone has one subsidiary, the wholly owned Bell Telephone Company of Nevada, which renders telephone service only within the State of Nevada. Until June 30, 1961, respondent operated in California, Washington, Oregon, Idaho and, through its subsidiary, in Nevada. Since that date respondent has operated only in California and Nevada, its properties in Washington, Oregon and Idaho having been sold to Pacific Northwest Bell Telephone Company. Under the terms of the sale Pacific Telephone received 30,450,000 shares of the $11 par value common stock of Pacific Northwest of the aggregate par value of $334,950,000, and a 4½ percent demand note in the principal amount of $200,000,000. The program for the sale of the properties, as announced at the time, contemplated that within

three years Pacific Telephone, from time to time, would offer the 30,450,000 shares to its own stockholders and that Pacific Northwest, from time to time, would sell its own debentures and redeem the $200,000,000 note.

A new "license contract" agreement (Exhibit 86) was entered into between American (Licensor) and Pacific Telephone (Licensee) effective July 1, 1961, which, among other things, reflected the change in the territory of the Licensee.

Respondent's toll telephone network is interconnected with other Bell System toll facilities, the major portion of which is owned by American and operated by its Long Lines Department. Revenues from interstate message toll telephone business are divided among participating Bell System companies under a "division of revenues" contract which is designed to yield a uniform rate of return upon each company's net investment devoted to such interstate business.

Respondent also interconnects with facilities of a number of independent telephone companies, not affiliated with the Bell System, pursuant to contracts negotiated from time to time between the parties. Among other things, such contracts specify the basis upon which divisions of costs and revenues are made.

Issue on Partial Submission

Pacific Telephone opposed partial submission of the proceeding if such submission would lead to an interim rate reduction order. It claimed that while the Commission may grant an interim increase ex parte, a rate reduction can be ordered only with the consent of the utility or after a full hearing of all material issues. According to Pacific Telephone the issues of rate spread and of independent company settlements which were excluded from partial

submission cannot fairly be divorced from any interim rate reduction order and at this juncture of the proceeding any interim reduction necessarily would be made on an incomplete record on these issues and without evidence on which the Commission could make findings of all material issues. Accordingly, it was the conclusion of respondent that on the record now made the Commission should grant its motion for rate increases in the amount of $43,953,000 forthwith; that partial submission of the proceeding should be set aside; and that the Commission should proceed to hear and determine all other issues in Case No. 7409, including the issues of rate spread and independent company settlements so that a final order with respect to rates and the other matters contemplated in the proceeding could expeditiously be issued.

The California Independent Telephone Association and various independent telephone companies, including California Water & Telephone Company, General Telephone Company of California and California Interstate Telephone Company supported respondent's opposition to partial submission. They generally took the position that the issues of settlements for toll and exchange traffic, rate spread and rate disparities could not be disassociated from the revenue requirements of Pacific Telephone. The independents urged that the partial submission either be set aside and hearings be resumed to complete evidence on all issues or, in the alternative, that the Commission adopt and accept for all purposes the settlement recommendations advocated in the proceeding by them. While the independent companies are urging the Commission to fix settlements differing from those currently effective, the record discloses that the independent companies are operating under voluntarily negotiated effective settlement contracts.

The Commission staff urged partial submission and prompt determination by the Commission of the full extent and magnitude of the revenue excesses during the test year and recommended that such interim rate reductions as are found to be justified, pending completion of hearings to fix final rates, be given in the Los Angeles extended area and San Francisco-East Bay extended area and in message toll service because of the relatively higher earning levels realized by Pacific Telephone on these services in comparison with other areas and services. The staff maintained that the subject of settlements was a matter of contract between Pacific Telephone and the respective independents; that if the independents claim the contracts are unreasonable, they may seek to renegotiate or terminate them; that it knows of no action taken by the parties to terminate the contracts or any other basis of settlement Pacific Telephone has offered to the independent companies; and that if, as and when settlement arrangements are in fact changed by the parties to those settlement contracts, the revenue effect, if any, on Pacific Telephone can be the subject of consideration by the Commission in an appropriate proceeding.

The City and County of San Francisco, the Cities of Los Angeles, San Diego and National City, the United States General Services Administration and the Utility User's League supported partial submission of the proceeding and interim rate reductions pending completion of the hearings.

A representative of the California Farm Bureau Federation opposed partial submission of the proceeding in its present posture and further opposed interim reductions if confined to the Los Angeles and San Francisco-East Bay extended areas, the areas in the State in which the earning levels of Pacific Telephone are shown to be the highest. However, he stated that he would be satisfied if an interim reduction in rates were found to be justified by the Commission provided such reduction were spread equally throughout the State to all

customers, with the same rate structure that currently prevails in the State, pending completion of further hearings on the issue of final rate spread.

Upon consideration of this issue the Commission finds that:

1. Respondent and the Commission staff in their respective results of operations showings included the effects on Pacific Telephone of settlements to independent companies on the basis of voluntarily negotiated contracts currently effective and on file with this Commission. The issues relating to final rate spread and settlements do not preclude a determination of the issues herein taken under submission.

2. Pacific Telephone has not offered to pay additional settlements over and above the amounts called for by the terms of the voluntarily negotiated existing settlement contracts.

3. All parties have been given a full hearing on the material issues on the cost of service and revenue requirements phase of the proceeding.

4. The constitutional requirement of due process on the issues embraced by the partial submission of this proceeding has been abundantly satisfied and a decision on those issues now under submission should be issued.

5. Unless this proceeding is decided under the interim procedure herein adopted, respondent will be permitted to continue to collect from customers the excessive revenues found by the order herein until such time as further hearings are concluded on all issues not taken under submission and an order thereafter issued. It would be contrary to the public interest to permit respondent to continue to collect these excessive revenues from customers during such period.

6. The rate reductions provided by the order herein are in essence across-the-board reductions which are equitable on an interim basis pending the final rate spread herein.

Growth Since 1957

California intrastate rates of respondent were last fixed by this Commission, with minor exceptions, pursuant to Decision No. 56652, dated May 6, 1958, in Application No. 39309 (56 CPUC 277). The test year used in that proceeding was the first six months of 1957, adjusted and annualized. Respondent's growth in its total California operations from 1957 to 1963 is indicated by the tabulation following. The year 1959 was the first full year in which the rates authorized by Decision No. 56652 were effective, and for that reason 1959 is used as 100 in the index.

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
STATE OF CALIFORNIA
Growth 1957 - 1963

| Year | Operating Revenues | | Operating Expenses Excluding Depreciation and Taxes - Per Books | | Operating Expenses Including Depreciation and Taxes - Per Books | |
|---|---|---|---|---|---|---|
| | Amount | Index | Amount | Index | Amount | Index |
| 1957 | $ 671,786,147 | 81.8 | $375,240,354 | 96.4 | $582,264,594 | 85.0 |
| 1958 | 735,258,931 | 89.6 | 379,115,189 | 97.4 | 626,400,730 | 91.4 |
| 1959 | 820,791,019 | 100.0 | 389,380,198 | 100.0 | 685,214,417 | 100.0 |
| 1960 | 898,557,940 | 109.5 | 428,420,951 | 110.0 | 756,774,190 | 110.4 |
| 1961 | 967,066,033 | 117.8 | 446,555,940 | 114.7 | 812,053,572 | 118.5 |
| 1962 | 1,055,166,757 | 128.6 | 483,298,609 | 124.1 | 884,717,931 | 129.1 |
| 1963 | 1,146,352,253 | 139.7 | 530,105,608 | 136.1 | 961,006,985 | 140.2 |

| Year | Net Operating Income - Per Books | | Telephone Plant in Service-Ac. 100.1 End of Year | | Depreciation and Amortization Exps. Per Books | |
|---|---|---|---|---|---|---|
| | Amount | Index | Amount | Index | Amount | Index |
| 1957 | $ 89,521,554 | 66.0 | $2,021,054,696 | 83.3 | $ 83,235,331 | 78.1 |
| 1958 | 108,858,202 | 80.3 | 2,236,488,697 | 92.2 | 97,422,895 | 91.4 |
| 1959 | 135,576,603 | 100.0 | 2,425,889,179 | 100.0 | 106,606,956 | 100.0 |
| 1960 | 141,783,751 | 104.6 | 2,649,044,587 | 109.2 | 115,618,877 | 108.5 |
| 1961 | 155,012,462 | 114.3 | 2,862,035,170 | 118.0 | 130,671,455 | 122.6 |
| 1962 | 170,448,826 | 125.7 | 3,091,085,092 | 127.4 | 142,100,654 | 133.3 |
| 1963 | 185,345,268 | 136.7 | 3,365,689,648 | 138.7 | 154,565,050 | 145.0 |

| Year | Total Company Telephone Stations End of Year | | Total Employees End of Year | | Total Wage Payments (Operations and Construction) | |
|---|---|---|---|---|---|---|
| | Number | Index | Number | Index | Amount | Index |
| 1957 | 5,244,578 | 88.0 | 73,804 | 113.5 | $352,268,822 | 99.2 |
| 1958 | 5,527,697 | 92.7 | 66,905 | 102.9 | 347,509,346 | 97.9 |
| 1959 | 5,960,618 | 100.0 | 65,025 | 100.0 | 355,083,204 | 100.0 |
| 1960 | 6,321,785 | 106.1 | 67,045 | 103.1 | 381,610,650 | 107.5 |
| 1961 | 6,695,663 | 112.3 | 65,344 | 100.5 | 392,837,586 | 110.6 |
| 1962 | 7,117,647 | 119.4 | 67,871 | 104.4 | 425,777,087 | 119.9 |
| 1963 | 7,479,848 | 125.5 | 71,843 | 110.5 | 458,930,297 | 129.2 |

SOURCE: Exhibit 1, Annual Reports and Monthly Reports.

The growth in average telephone plant in service less depreciation reserve, gross revenues and net operating income for the years 1957 through 1963 and for the test year as reported by respondent for total California operations is compared in the tabulation following. Since 1959 there has been little variation in the ratio of gross revenues to average net plant in service or in the ratio of net operating income to average net plant in service. While respondent through its adjustments has reduced the net operating income per $100 of average net plant in service for the test year ending September 30, 1962, downward from $6.72 to $6.10, the corresponding figures actually reported by respondent for the years 1962 and 1963 were $6.96 and $6.95, respectively.

| Year | Avg. Tel. Plant in Service Less Depr. Reserve | Gross Revenues | Net Operating Income | Gross Revenues Per $100 of Avg. Plant in Service Less Depr. Reserve | Net Operating Income Per $100 of Avg. Plant in Service Less Depr. Reserve |
|---|---|---|---|---|---|
| 1957 | $1,515,149,000 | $ 671,786,000 | $ 89,522,000 | $44.34 | $5.91 |
| 1958 | 1,737,708,000 | 735,259,000 | 108,858,000 | 42.31 | 6.26 |
| 1959 | 1,905,787,000 | 820,791,000 | 135,577,000 | 43.07 | 7.11 |
| 1960 | 2,070,938,000 | 898,558,000 | 141,784,000 | 43.39 | 6.85 |
| 1961 | 2,261,611,000 | 967,066,000 | 155,012,000 | 42.76 | 6.85 |
| 1962 | 2,450,559,000 | 1,055,167,000 | 170,449,000 | 43.06 | 6.96 |
| 1963 | 2,668,434,000 | 1,146,352,000 | 185,345,000 | 42.96 | 6.95 |
| Test Year | | | | | |
| Unadjusted | 2,401,210,000 | 1,035,061,000 | 161,401,000 | 43.11 | 6.72 |
| Adjusted By: | | | | | |
| CPUC Staff | 2,340,952,000 | 1,033,145,000 | 175,770,000 | 44.13 | 7.51 |
| Respondent | 2,398,788,000 | 1,028,469,000 | 146,273,000 | 42.87 | 6.10 |

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Evidence Respecting Results of Operations

The Commission staff and respondent presented complete showings with respect to results of operations for the test period, 12 months ending September 30, 1962. The General Services Administration presented evidence on a limited portion of respondent's operations dealing with executive salary expense which will be discussed later herein. The tabulation following summarizes the exhibits introduced by the Commission staff and respondent, reflecting respondent's earning position for total California operations and for California intrastate operations under present rates during the test year.

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
Comparison of Results of Total California and
California Intrastate Operations
Twelve Months Ending September 30, 1962

| Item | Respondent Unadjusted Ex. 114&115 | Respondent Adjusted Ex. 114&115 | CPUC Staff Adjusted Ex. 43&47 | Respondent Adjusted Exceeds Respondent Unadjusted | CPUC Staff Adjusted Exceeds Respondent Unadjusted |
|---|---|---|---|---|---|
| | | | Total California Operations | | |
| Operating Revenues | $1,035,061,000 | $1,028,469,000 | $1,033,145,000 | $( 6,592,000) | $(1,916,000) |
| Operating Expenses | 472,999,000 | 504,826,000 | 468,923,000 | 31,827,000 | (4,076,000) |
| Depreciation | 143,177,000 | 139,072,000 | 135,896,000 | (4,105,000) | (7,281,000) |
| Taxes | | | | | |
| Payroll | 13,325,000 | 15,426,000 | 12,470,000 | 2,101,000 | (855,000) |
| Income | | | | | |
| Federal | 133,014,000 | 113,682,000 | 130,201,000 | (19,332,000) | (2,813,000) |
| California | 17,341,000 | ( | 15.538,000 | ( | (1,803,000) |
| Other | 93,804,000 | (109,190,000 | 94,347,000 | ( (1,955,000) | 543,000 |
| Total Taxes | 257,484,000 | 238,298,000 | 252,556,000 | (19,186,000) | (4,928,000) |
| Total Expenses & Taxes | 873,660,000 | 882,196,000 | 857,375,000 | 8,536,000 | (16,285,000) |
| Net Revenue | 161,401,000 | 146,273,000 | 175,770,000 | (15,128,000) | 14,369,000 |
| Rate Base | 2,423,636,000 | 2,421,214,000 | 2,333,919,000 | ( 2,422,000) | (89,717,000) |
| Rate of Return | 6.66% | 6.04% | 7.53% | (.62%) | .87% |

(Red Figure)

| Item | Respondent Unadjusted Ex. 114&115 | Respondent Adjusted Ex. 114&115 | CPUC Staff Adjusted Ex. 43&47 | Respondent Adjusted Exceeds Respondent Unadjusted | CPUC Staff Adjusted Exceeds Respondent Unadjusted |
|---|---|---|---|---|---|
| | | | California Intrastate Operations | | |
| Operating Revenues | $ 870,057,000 | $ 863,605,000 | $ 867,785,000 | $( 6,452,000) | $(2,272,000) |
| Operating Expenses | 396,144,000 | 421,268,000 | 388,936,000 | 25,124,000 | (7,208,000) |
| Depreciation | 125,687,000 | 122,125,000 | 119,045,000 | (3,562,000) | (6,642,000) |
| Taxes | | | | | |
| Payroll | 10,984,000 | 12,681,000 | 10,184,000 | 1,697,000 | (800,000) |
| Income | | | | | |
| Federal | 109,160,000 | 93,382,000 | 109,357,000 | (15,778,000) | 197,000 |
| California | ( | ( | 13,055,000 | ( | ( |
| Other | ( 93,942,000 | ( 92,345,000 | 79,766,000 | ( (1,597,000) | ((1,121,000) |
| Total Taxes | 214,086,000 | 198,408,000 | 212,362,000 | (15,678,000) | (1,724,000) |
| Total Expenses & Taxes | 735,917,000 | 741,801,000 | 720,343,000 | 5,884,000 | (15,574,000) |
| Net Revenue | 134,140,000 | 121,804,000 | 147,442,000 | (12,336,000) | 13,302,000 |
| Rate Base | 2,056,691,000 | 2,054,278,000 | 1,975,690,000 | (2,413,000) | (81,001,000) |
| Rate of Return | 6.52% | 5.93% | 7.46% | (.59%) | .94% |

(Red Figure)

The Commission staff and respondent also presented adjusted results of intrastate operations for the test year segregated by exchange and toll operations. These results are summarized below:

| Category | Rate of Return | |
|---|---|---|
| | CPUC Staff Adjusted Ex. 43 | Respondent Adjusted Ex. 115 |
| Exchange Operations | | |
| San Francisco-East Bay Extended Area | 8.83% | 7.33% |
| Other No. Calif. Exchanges | 3.72 | 2.66 |
| Total Northern California Exchanges | 6.57 | 5.26 |
| Los Angeles Extended Area | 8.43 | 6.83 |
| San Diego Extended Area | 5.33 | 4.02 |
| Other Southern California Exchanges | 5.55 | 4.41 |
| Total Southern California Exchanges | 7.67 | 6.17 |
| Total Exchange Operations | 7.15 | 5.74 |
| Intrastate Toll Operations | | |
| Message Toll | 8.93 | * |
| Private Line | 6.71 | * |
| Total Intrastate Toll | 8.76 | 6.72 |
| Total Intrastate | 7.46 | 5.93 |

* Not shown separately

A more detailed comparison of the respective adjusted results of intrastate operations for the test year is shown in the following tabulation.

ADJUSTED RESULTS OF INTRASTATE OPERATIONS
FOR TEST YEAR ENDING SEPTEMBER 30, 1962
AT PRESENT RATES AND 52% FEDERAL INCOME TAX RATE

| Item | CPUC Staff Exhibits Nos. 43 &47 | Respondent Exhibit No. 115 | CPUC Staff Exceeds Respondent |
|---|---|---|---|
| Operating Revenues | | | |
| Local Service | $595,973,000 | $595,815,000 | $ 158,000 |
| Toll Service | 221,208,000 | 217,319,000 | 3,889,000 |
| Miscellaneous | 55,096,000 | 55,096,000 | - |
| Less: Uncollectibles | 4,492,000 | 4,625,000 | (133,000) |
| Total Operating Revenues | 867,725,000 | 863,605,000 | 4,180,000 |
| Operating Expenses & Taxes | | | |
| Maintenance | 144,892,000 | 155,907,000 | (11,015,000) |
| Traffic | 76,352,000 | 81,899,000 | ( 5,547,000) |
| Commercial | 86,164,000 | 90,084,000 | ( 3,920,000) |
| General Office Salaries & Expenses | 48,172,000 | 50,343,000 | ( 2,171,000) |
| Other Operating Expenses | 33,356,000 | 43,035,000 | ( 9,679,000) |
| Subtotal | 388,936,000 | 421,268,000 | (32,332,000) |
| Depreciation | 119,045,000 | 122,125,000 | ( 3,080,000) |
| Taxes | | | |
| Payroll | 10,184,000 | 12,681,000 | ( 2,497,000) |
| Income | | | |
| Federal | 109,357,000 | 93,382,000 | 15,975,000 |
| California | 13,055,000 | { | { |
| Other | 79,766,000 | { 92,345,000 | { 476,000 |
| Total Taxes | 212,362,000 | 198,408,000 | 13,954,000 |
| Total Operating Expenses & Taxes | 720,343,000 | 741,801,000 | (21,458,000) |
| Net Revenue | 147,442,000 | 121,804,000 | 25,638,000 |
| Rate Base, Depreciated | 1,975,690,000 | 2,054,278,000 | (78,588,000) |
| Rate of Return | 7.46% | 5.93% | 1.53% |

(Respondent Exceeds CPUC Staff)

Adjustments

Both the staff and respondent made adjustments to test year recorded results of operations to reflect various changes they considered appropriate for rate-fixing purposes. Basically, these proposed test year adjustments fall into two categories. First, those proposed adjustments for so-called "level" or "period" changes; for example, those for changes in telephone rates, settlements, postage rates, wage and benefit rates, payroll tax rates and separations. Second, those proposed adjustments reflecting basic rate-making policy; for example, adjustments for purchases from Western Electric, treatment of the investment tax credit, depreciation, license fee, dues, donations, legislative advocacy, working cash allowance and others.

While the staff made some adjustments to test year results for so-called level or period changes, most of its adjustments were of the second category generally following Commission rate-fixing policy findings in prior decisions involving respondent. On the other hand, most of respondent's adjustments were for so-called level or period changes, with its adjustments for wage and fringe benefit changes accounting for most of the dollar effect. Basically it was the staff's position that it would be improper to include effects of future wages in a past test period without at the same time including the effect of increasing revenue and future cost savings. However, with respect to those adjustments made by the staff for so-called level or period changes, it did not reflect back into the test year the effect of increasing revenue or future cost savings. Respondent's basic position with respect to so-called level or period changes is that it cannot absorb such changes without increasing its telephone rates and that the test year results must be adjusted as respondent proposes without at the same time reflecting the effect of increasing revenue and future cost savings. For example, by its method

of adjusting for so-called level or period changes respondent reaches the conclusion that its "going-level" test year California net operating income per $100 of average net plant in service is $6.10 and its "going-level" test year consolidated earnings per share of common stock is $1.24 (reflecting normalization of the investment tax credit) while the actual trend in these items before, during and since the test year are:

| Year | Net Operating Income Per $100 of Average Net Plant in Service | Per Share Earnings of Common Stock |
|---|---|---|
| 1959 | $7.11 | $1.47 |
| 1960 | 6.85 | 1.39 |
| 1961 | 6.85 | 1.43 |
| Test Year Unadjusted | 6.72 | 1.39* |
| 1962 | 6.96 | 1.42* |
| 1963 | 6.95 | 1.45* |

* Reflects normalization of investment tax credit. On a flow-through basis the 1962 and 1963 amounts are $1.47 and $1.52.

Changes in revenues, expenses and plant occur daily. It goes without saying that the effect on respondent's operations of changes in telephone rates, settlements, wages and fringe benefits and similar level or period changes, must be given due and reasonable consideration in fixing respondent's rates. However, it is so easy to distort past test year results by adjusting on a selective basis for level or period changes and ignoring the many day-by-day changes taking place in the operations that reduce cost per unit of revenue or increase revenue per unit of cost. The methods of adjusting the test year results for level or period changes used by respondent as well as the staff are incomplete. While the changes in rates and wages were made effective on various dates both during and subsequent to the test year and operated only in the future from their effective date, the proposed adjustments are estimated amounts reflected

retroactively to the beginning of the test year without at the same time folding back prospective revenues and cost savings. Thus, respondent in its showing relates expenses excluding depreciation and taxes of $504,826,000 ($31,827,000 more than in the test year) with revenues of $1,028,469,000 ($6,592,000 less than in the test year). But, by the time respondent's actual expense level reached $504,826,000 its actual revenues far exceeded $1,028,469,000. Respondent's revenues increased by $111,291,000 between the test year and the year 1963 while its expenses, excluding depreciation and taxes, increased by only $57,107,000 in the same period.

Bearing in mind the trends and relationships in revenues, expenses and net plant before, during and since the test year, we find it reasonable to test respondent's rate of return and revenue requirements by use of the test year recorded results without incorporating either respondent's or the staff's proposed adjustments for so-called level or period changes but adjusted only to the extent and in the amount for those so-called basic policy rate-fixing adjustments which we hereinafter find to be fair, reasonable and necessary in the public interest.

Issue on Separation Between Interstate and Intrastate Operations

Respondent's telephone equipment is used, generally speaking, for intrastate toll and exchange operations and for interstate communications. Because this Commission has jurisdiction only over intrastate toll and exchange operations, it is necessary to apply some method for separating the revenues, expenses and property of the jointly used plant. Respondent and the staff agree that the separations between intrastate and

interstate operations should be accomplished in accordance with the procedures set forth in the April 1963 Separations Manual, a copy of which is included in this record as Exhibit 53.

The Separations Manual has never been formally prescribed by this Commission or by the Federal Communications Commission (FCC), although the FCC has from time to time approved, on an interim basis, various modifications made in the manual. There have been numerous changes made over the years in separations procedures as related in the foreword to the manual (Exhibit 53). At best, the April 1963 edition, and prior editions, for that matter, represent compromises of various conflicting interests.

A change in separations procedures[2/] was put into effect by the Bell System, including Pacific Telephone, on April 1, 1962, which is the mid-point of the test period in this proceeding. While plant and expense in the second six months of the test year actually were separated on the basis of the new procedures, those for the first six months of the test period actually were separated using procedures in effect prior to the April 1, 1962, change. Adjustments were made by the respondent and by the Commission staff for the purpose of reflecting the April 1, 1962, separations changes as though effective for the full test year. The staff and respondent disagree as to the amount of the adjustment. Respondent maintained that application of the new procedure resulted in a transfer of $1,454,000 of plant and $2,327,000 of annual expense from intra to interstate operations. The Commission staff estimated that $5,300,000 of plant and $4,600,000 of annual expense had been shifted to interstate operations.

2/ The April 1963 Separations Manual reflects these April 1, 1962 separations procedure changes.

We view this proposed adjustment in this proceeding as falling within the category of adjustment for level or period changes heretofore discussed. Basically it is one of many changes that have occurred from time to time either during or subsequent to the test year that affect respondent's operations, including its separated results. For reasons heretofore given, we find it reasonable not to adjust test year results for this item. We specifically reserve the right, however, to review the reasonableness of any of the procedures set forth in the Separations Manual or to consider any other factors when necessary to provide equitable results between intrastate and interstate rates should they become issues in any proceeding.

RATE OF RETURN

In General

Testimony and exhibits with respect to rate of return were submitted by the Commission staff, the City and County of San Francisco, the Cities of Los Angeles and San Diego, and respondent. The staff and the cities each produced one witness while respondent presented 15 witnesses on this subject.

Basically, the Commission staff witness recommended an 8.25 percent return on common equity and then developed an amount of $158,418,000 as being required to sustain and support respondent's adjusted test year average total California debt, stock and surplus capital of $2,481,141,000 (Exhibit 5, Table 25). He converted the $158,418,000 amount into a cost of capital rate of 6.38 percent related to his adjusted test year total capital and into a rate of return of 6.76 percent related to a total California rate base of $2,334,829,000 as developed by the engineering staff in Exhibit 2. The intervening cities, using an 8.25 percent return on common equity, recommended in Exhibit 28 a rate of return of 6.24 percent related to a California intrastate rate base of $1,976,407,000 as developed by the engineering staff in Exhibit 4. Respondent concluded that it required a return on common equity in the range of 9.53 percent to 10.31 percent and a rate of return of not less than 7.5 percent on its claimed total capital of $2,794,034,000 composed of debt, preferred stock and common equity (Exhibit 57). However, according to respondent, its requested rate increases will produce a rate of return of only 6.39 percent on its claimed intrastate rate base of $2,054,278,000.

C. 7409 ds /ypo

The Staff's Evidence

The staff witness reached his conclusions by first considering the following test year average capitalization for respondent:

| | Amount | Percent |
|---|---|---|
| Long-Term Debt | $ 902,000,000 | 32.29 |
| Advances from American Company | 26,000,000 | .93 |
| Preferred Stock | 82,000,000 | 2.94 |
| Common Stock Equity | 1,782,931,000 | 63.84 |
| Total | 2,792,931,000 | 100.00 |

He then excluded $101,644,000 of long-term debt, $9,229,000 of preferred stock and $200,917,000 of common stock equity (a total of $311,790,000) representing investments other than those applicable to total California operations. Next, the staff witness adjusted the resulting $2,481,141,000 capitalization to reflect a 60 percent common equity ratio with a corresponding increase in the debt ratio to eliminate the effects of respondent's sale of its properties in Oregon, Washington and Idaho to Pacific Northwest Bell Telephone Company and to reflect an equity ratio more in harmony with respondent's average equity ratio in recent years.3/ To this resulting adjusted test year total California capitalization, the staff witness applied various costs of capital ratios he considered reasonable in developing his total annual charges of $161,551,000. He then deducted $3,133,000 for interest during

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3/ Respondent's equity ratio over the 27-year period 1935-1961 averaged 55.1 percent. It was 58.7 percent in 1957, 61.6 percent in 1958, 58.6 percent in 1959, 60.2 percent in 1960 and 64.4 percent in 1961, and averaged 60.7 percent for the period 1957-1961.

construction in reaching the amount of $158,418,000 which he considered necessary to support his resulting $2,481,141,000 of total California capital. This development is set forth below:

Total California Operations

| | Staff Adjusted Capitalization Ratio | Staff Adjusted Capitalization Amount | Cost of Capital | Annual Charges |
|---|---|---|---|---|
| Long-Term Debt | 36.02% | $ 893,685,000 | 3.67% | $ 32,798,000 |
| Advances from American Co. | 1.05 | 26,000,000 | 4.50 | 1,170,000 |
| Preferred Stock | 2.93 | 72,771,000 | 6.55 | 4,766,000 |
| Common Stock Equity | 60.00 | 1,488,685,000 | 8.25 | 122,816,000 |
| Total | 100.00 | 2,481,141,000 | | 161,551,000 |
| Less Interest During Construction | | | | 3,133,000 |
| Balance - Net Annual Charges | | | | 158,418,000 |
| Ratio to Adjusted Capitalization | | | | 6.38% |

The 8.25 percent equity allowance recommended by the staff witness was a judgment determination using a comparative earnings approach from data included in Exhibit 5. The witness gave weight to the theory that the rate of return on equity should decrease as the equity ratio of total capitalization is increased. In this connection he analyzed data for the years 1957-1961 separately for 52 telephone utilities, 19 Bell System companies, 15 General Telephone subsidiaries, 18 independent telephone utilities, 28 electric utilities, 16 combination electric and gas companies, 11 gas distributors, 11 gas wholesalers, and 17 class 1 railroads.

The staff witness presented no evidence as to what part of his total California capital of $2,481,141,000 should be allocable to respondent's California intrastate operations. Nor did the staff

witness make a recommendation as to what would constitute a fair and reasonable rate of return applicable to respondent's California intrastate operations.[4/] However, on cross-examination, the witness testified that he had made calculations as to what the intrastate rate of return would be, based upon certain assumptions. Thus, using a 7.7 percent rate of return on interstate operations and varying earning ratios on common equity, he testified that the results would be as follows:

| Earnings on Common Equity | Intrastate Rate of Return |
|---|---|
| 8.1% | 6.49% |
| 8.2 | 6.56 |
| 8.25 | 6.59 |
| 8.3 | 6.63 |
| 8.4 | 6.71 |
| 8.5 | 6.78 |

The staff witness, however, made no study of what would constitute the fair rate of return for respondent's interstate business, nor did he present any support for the use of his assumed 7.7 percent figure or state the intrastate rate base to which his calculated intrastate rate of return figures would apply. Moreover, he made no adjustment to capital for rate base adjustments urged by other staff witnesses, for example, for Western Electric purchases. In net effect the staff's witness on rate of return would make up in the rate of return allowance that which had been excluded from rate base by other staff witnesses.

4/ At transcript page 3077 the staff witness stated: "Well, as I stated before, I have been interested in the total money requirements of the Company as a whole and I didn't find it necessary to include on Table 25 here any calculation of the intrastate return."

The Cities' Evidence

The intervening cities contend that the rate of return allowed to respondent should in no case exceed 6.24 percent on rate base applicable to California intrastate operations. They accepted the engineering staff's rate base and other adjustments to test year recorded figures and the 60 percent average equity ratio utilized by the staff. They maintained that, unlike the rate of return evidence of the staff and respondent, their Exhibit 28 makes meaningful the disallowances to booked utility plant figures which this Commission has repeatedly held to be appropriate for rate-making purposes (48 CPUC 487; 56 CPUC 277). The cities used an allowance of 8.25 percent for common equity and reached their intrastate rate of return figure after application of a 7.25 percent rate of return to the interstate portion of the total California rate base.[5/]

5/ The 7.25 percent figure is the rate of return which the Federal Communications Commission, on January 29, 1963, found reasonable in adjusting private line telephone and telegraph rates of American Telephone and Telegraph Company. This percentage was applied to $358,422,000 representing that portion of the engineering staff's total California rate base allocable to California interstate operations.

The development of the California intrastate rate of return recommended by the cities follows:

| | Average Capitalization | | | Cost of Capital | Annual Charges |
|---|---|---|---|---|---|
| | | Adjusted to Rate Base | | | |
| | Total Calif. | Ratio | Amount | | |
| Long-Term Debt | | | | | |
| Outstanding | $ 800,356,000 | 34.28% | $ 800,356,000 | 3.67% | $ 29,373,000 |
| Additional | - | 1.74 | 40,629,000 | 4.30 | 1,747,000 |
| Subtotal | 800,356,000 | 36.02 | 840,985,000 | | 31,120,000 |
| Advances from American | 26,000,000 | 1.05 | 24,467,000 | 4.50 | 1,101,000 |
| Total Debt | 826,356,000 | 37.07 | 865,452,000 | | 32,221,000 |
| Preferred Stock | 72,771,000 | 2.93 | 68,480,000 | 6.55 | 4,485,000 |
| Common Equity | 1,582,014,000 | 60.00 | 1,400,897,000 | 8.25 | 115,574,000 |
| Total | 2,481,141,000 | 100.00 | 2,334,829,000 | | 152,280,000 |
| Less Interest during construction ........ | | | | | 2,948,000 |
| Balance - Total California Operations ........ | | | | | 149,332,000 |
| Less 7.25% on interstate rate base of $358,422,000 ........ | | | | | 25,986,000 |
| Balance California Intrastate Operations ........ | | | | | 123,346,000 |
| California intrastate rate base ........ | | | | | 1,976,407,000 |
| Intrastate Rate of Return | | | | | 6.24% |

The cities claimed that the 8.25 percent allowance for common equity was at the higher limit of the range of reasonableness for telephone utilities such as respondent. Based on an analysis of 11 state regulatory commission decisions since 1957 wherein the cost of equity capital of Bell System operating affiliates was explicitly determined in fixing a fair rate of return, the cities in Exhibit 28 developed a range in cost of equity from a low of 6.95 percent to a high of 9.98 percent. This study indicated a median return on equity of 7.75 percent applicable to a 55 percent median equity ratio for the companies included. According to the cities, return on equity varies inversely with the equity ratio and at 60 percent equity the return on equity should be something less than 7.75 percent. On cross-examination respondent sought to demonstrate the non-comparability between these decisions and the treatment accorded respondent by this Commission with respect to rate base, revenues and expenses.

Moreover, the cities contended that all rate of return evidence presented by parties other than themselves fails to exclude the less stable, more risky interstate toll operations from consideration in arriving at a basis for judgment as to intrastate rate of return.

Respondent's Evidence

Respondent's position is that its earnings are too low in comparison with other investments; that the standing of its common stock as an investment is relatively poor and growing poorer; that a compulsory reduction of its earnings would be damaging to the economy of the State; that in a rapidly expanding economy, higher rather than lower returns are required to best serve the public interest; that improved earnings are vitally necessary to enable it to meet the demands for new and expanding service in the immediate future; and that even the increases in rates it seeks will still produce a return far below that which it should earn in relation to other utilities and industries.

Respondent presented financial evidence through seven bankers, two institutional investors, two investment counselors, and one economist, in addition to its own officials. The testimony of its outside financial witnesses, although varying in detail, generally centered around the proposition that the minority interests in respondent establish the market price of its stock; that respondent's present earnings are not excessive and should be higher; that respondent's common stock is not an attractive investment either for their own portfolios or for trust accounts under

their directions;[6] that respondent plays an important role in the economic growth of California; and that under respondent's present earnings it would be difficult to dispose of debentures at favorable rates and, should the Commission establish a lower rate of return, respondent would be put in the position of having to dispose of its debentures at very high rates, if, indeed, it could find interested buyers in the market place.

In viewing the evidence presented by respondent's outside witnesses, we acknowledge that it was presented by persons, who, individually and collectively, hold reputations for integrity and high standing in their professional and social communities. We must also note that without exception these witnesses expressed the investor viewpoint as it relates to respondent's earnings and to the extent that the Commission must, in determining rate of return, equate the interests of respondent's ratepayers with those of its investors, these witnesses have contributed towards informing the Commission of the interests of respondent's investors. The common thread running throughout all of these witnesses' testimony is the urging that respondent should be allowed either higher earnings or that its rates should not be reduced. We can accept as self-evident that the investor interests lie in the

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6/ For example, one witness testified he would not recommend any telephone company stock as investment because he considered telephony a less stable service than electric and gas service (Tr. 3970). Another testified he does not recommend any California utility stock because he considers the "regulatory climate" unfavorable (Tr. 3998,4000). A third witness testified he would not recommend respondent's stock regardless of its earnings "because there is only around 10 percent of it outstanding", the balance being held by the parent, American Company (Tr. 4455).

direction of higher earnings and it certainly is respondent's prerogative to advance such interests through the urgings of these witnesses. However, the public interest goes beyond merely satisfying the investors' interest in higher earnings even though from the viewpoint of the investor such higher earnings are variously characterized as reasonable or "optimal".

We can also accept as self-evident the generalizations of these witnesses to the effect that the rapidly expanding California economy requires financially healthy utilities which will be able to finance acquisitions of the plant that such growth demands. But it must also be accepted that financial health of California utilities depends not alone upon the rates of return this Commission allows--it depends as much upon the determination of a price for the utility services which will create demand for the service. If it be true, as respondent claims, that it is one of the legitimate purposes of this Commission to insure a healthy California economy, then we conceive the function of determining utility rates low enough to continue to attract persons, industry and commerce to California as important as that of allowing earnings as high as those advocated by respondent.

A review of respondent's outside testimony also indicates a general tendency to base respondent's rate of return requirements upon its total capital, that is, debt, stock and surplus, without a full appreciation of the fact that this Commission's rate-making jurisdiction is delineated by respondent's intrastate operations.

The conclusion of these outside financial witnesses that respondent's earnings will not attract investors unless there is some foreseeable increase in future earnings is not supported by the evidence. The number of respondent's minority stockholders increased from 39,145 at the end of 1961 to 41,941 at the end of 1962, an increase of 7.1 percent. Additionally, it must not be overlooked that 90 percent of respondent's common equity is held by its parent, American, which has consistently made large advances to its subsidiary, respondent. Moreover, respondent's present stockholders have, in past offerings, had pre-emptive rights at par which at present is in the neighborhood of $14-2/7, compared with a market price of over $30 per share. We cannot ignore the fact that respondent's debentures are generally rated Triple A and its stock is generally rated A and that its own witnesses could not enumerate any instance over the last five years where respondent's financing efforts have been impeded in the slightest by its actual earnings.

Respondent's most extensive showing of documentary evidence on the subject of rate of return was presented in Exhibits 57 and 61 and the testimony relating thereto. The earnings requirements developed by respondent in Exhibit 57, page 13 and Exhibit 61, page 5 are summarized in the following tabulation.

C. 7409 ds/ypo

## THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Test Year Amounts
(Source: Exhibit 57, Page 13)

| | Average Capital Obligations and Surplus | Earnings | Return |
|---|---|---|---|
| **Actual** | | | |
| Debt | $ 928,364,000 | $ 34,618,000 | 3.73% |
| Preferred Stock | 82,000,000 | 4,920,000 | 6.00 |
| Common Equity | 1,783,670,000 | 145,477,000 | 8.16 |
| Total | 2,794,034,000 | 185,015,000 | 6.62 |
| **Required for 7½% Return on Total Capital** | | | |
| Debt | $ 928,364,000 | $ 34,618,000 | 3.73% |
| Preferred Stock | 82,000,000 | 4,920,000 | 6.00 |
| Common Equity | 1,783,670,000 | 170,015,000 | 9.53 |
| Total | 2,794,034,000 | 209,553,000 | 7.50 |
| **Required for 8% Return on Total Capital** | | | |
| Debt | $ 928,364,000 | $ 34,618,000 | 3.73% |
| Preferred Stock | 82,000,000 | 4,920,000 | 6.00 |
| Common Equity | 1,783,670,000 | 183,985,000 | 10.31 |
| Total | 2,794,034,000 | 223,523,000 | 8.00 |

## THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Required Return on Average Total Capital
Test Year Amounts
(Source: Exhibit 61, page 5)

| | Amount of Average Capital | % of Capital | % Return | Composite Return |
|---|---|---|---|---|
| **9.50% Return on Common Equity** | | | | |
| Debt | $ 928,363,887 | 33.23% | 3.73% | 1.24% |
| Preferred Stock | 82,000,000 | 2.93 | 6.00 | .18 |
| Common Equity | 1,783,670,201 | 63.84 | 9.50 | 6.06 |
| Total | 2,794,034,088 | 100.00 | | 7.48 |
| **10.50% Return on Common Equity** | | | | |
| Debt | $ 928,363,887 | 33.23% | 3.73% | 1.24% |
| Preferred Stock | 82,000,000 | 2.93 | 6.00 | .18 |
| Common Equity | 1,783,670,201 | 63.84 | 10.50 | 6.70 |
| Total | 2,794,034,088 | 100.00 | | 8.12 |

In its development of rate of return, respondent has given no effect to interest during construction. Moreover, the $2,794,034,000 of average capital used by respondent in its exhibits includes $311,790,131 of average capitalization representing its investment in Pacific Northwest and Bell of Nevada and, of course, the $2,794,034,000 is not adjusted to reflect the portion of respondent's total California operations representing its California interstate operations. Respondent's procedure would render meaningless any adjustments to rate base for property which is not used or useful in serving the public or for expenditures, if any, made outside the bounds of prudence.

Respondent's suggested 9.53 percent return on common equity results in earnings of $170,015,000, or $44,307,000 (35 percent) more than dividend requirements of $125,708,000 at the current rate of $1.20 per share on 104,756,943 shares outstanding. This Commission does not fix the rate of return to be allowed a utility on the basis of outstanding shares of common stock and the annual dividends paid on such stock. The number of issued and outstanding shares of stock and the annual dividends paid reflect the exercise by respondent of its managerial judgment. This judgment is not to be substituted for the Commission's judgment when the Commission is called upon to fix rates for service. The Commission does, however, carefully weigh the evidence of such facts as may pertain to security issues and earnings thereon. In any rate proceeding the Commission considers a utility's past financing success, its future prospects, and many other elements as well.

Fundamental to respondent's position on rate of return is its contention that the telephone industry is more risky than either the gas or electric utilities. Respondent endeavors in Exhibit 57 to establish higher risks in the telephone industry by a method which relies upon the measurement of the fluctuation in earnings in various industries over a selective period of time (in this case 1946 through 1961) as the true test of risk. It grouped separately the 50 largest operating companies in the electric, gas, telephone, banking and industrial industries. Next, it listed the percent of return on average total capital for each of the companies for each of the years 1946 through 1961. It then calculated the average percent of return on average total capital of each group for each year. It then reduced the averages for each industrial group to three different ratios purporting to equate risk to fluctuations of earnings (Exhibit 57, page 10). Without relying upon equally relevant data such as earnings price ratios, capital ratios and the like, respondent concluded from Exhibit 57 that in the telephone industry there exists a greater fluctuation of earnings than that which exists in the electric or gas industries and hence the risks in the telephone industry lie between those of electric and gas industries, on the one hand, and banking and industrial enterprises, on the other hand.

Of the elements that demand attention in the determination of a reasonable rate of return, the factor of risk is most open to error. Respondent's study deals with industry-wide averages and not with specific companies, thereby ignoring great diversity among separate companies. It ignores respondent's size and affiliation with American. Results of the study vary depending

upon the period and companies selected. Respondent's study produces contradictory results (Exhibit 121), absurd conclusions (Tr. p.6727) and results which are at odds with the consensus of universally recognized investment services (Exhibit 122). For example, a company that consistently had earnings of one percent for the period selected would, under respondent's method, be less risky than a company that had earnings that varied between six and seven percent. Furthermore, respondent's method would lead to the conclusion that a company that had uniformly decreasing earnings over the selected period would have the same risk as a company that had uniformly increasing earnings so long as the earnings fluctuations either down or up were the same. Comparability between respondent and the various selected companies has not been shown.

We specifically reject respondent's theory of risk measurement. This theory has been rejected by both state and federal regulatory commissions. (Washington Public Service Commission v. The Pacific Telephone and Telegraph Company, 25 PUR 3rd 18,41; Federal Communications Commission v. Western Union Telegraph Company, 25 PUR 3rd 385,463.)

Respondent further contends that it does not enjoy sufficient earnings per share on its common stock. In support of this contention, respondent relies heavily upon a comparison of the earnings of its common stock in relation to the earnings of Moody's 24 utility common stocks. Moody's 24 utilities are all electric operating companies, none being owned by a parent. Respondent has not shown any comparability between itself and Moody's 24 utilities with respect to capital structure, method of new financing, size, risks, or any other factors necessary to draw sound conclusions on a comparability test.

In Exhibit 61 respondent compared, among other things, for the period 1946-1961 its earnings on common equity and on total capital with earnings of 15 electric operating companies, 15 retail gas companies, 15 telephone utilities, 15 oil companies and 15 other industrial companies and concluded therefrom that its earnings in relation thereto were low. Here again respondent has failed to show meaningful comparability between it and the selected companies. For the entire period 1946-1961 the ratio of average common equity to average total capital varied markedly among the individual companies and as between the industry groups. This variation in capital structure is indicated by the following tabulation:

% Average Common Equity of Average Total Capital

| | 1946 - 1961 | | | 1958 - 1961 | | |
|---|---|---|---|---|---|---|
| | | Range Individual Companies | | | Range Individual Companies | |
| | Average | High | Low | Average | High | Low |
| Respondent | 53.1% | -% | -% | 60.6% | -% | -% |
| 15 Telephone | 68.9 | 98.3 | 31.6 | 70.1 | 97.5 | 37.7 |
| 15 Electric | 35.6 | 57.1 | 23.1 | 38.4 | 45.6 | 31.7 |
| 15 Retail Gas | 48.0 | 71.3 | 30.7 | 43.6 | 56.2 | 28.1 |
| 15 Oil Companies | 80.1 | 94.4 | 48.3 | 79.4 | 94.6 | 53.1 |
| 15 Other Industrials | 79.4 | 97.0 | 54.3 | 79.0 | 90.9 | 56.4 |

The return on common equity shown by Exhibit 61 and summarized below for the several industry groups must be viewed in the light of the wide range in the proportion of equity capital among the companies with due regard to the method used to effect new financing by these companies. It is significant that while respondent showed an improvement in return on common equity in the

1958-1961 period compared with the 1946-1961 period, all the other groups, with the exception of the Retail Gas and Telephone groups showed a decline.

% Return on Common Equity

| | 1946 - 1961 | | | | 1958 - 1961 | | | |
|---|---|---|---|---|---|---|---|---|
| | | Range Individual Companies | | | | Range Individual Companies | | |
| | Average | High | Low | Range | Average | High | Low | Range |
| Respondent | 7.48% | -% | -% | -% | 8.64% | -% | -% | -% |
| 15 Telephone | 7.58 | 10.41 | 6.54 | 3.87 | 8.93 | 10.33 | 8.15 | 2.18 |
| 15 Electric | 11.74 | 16.89 | 8.23 | 8.66 | 10.73 | 13.07 | 8.81 | 4.26 |
| 15 Retail Gas | 9.54 | 15.94 | 6.80 | 9.14 | 10.13 | 13.54 | 7.18 | 6.36 |
| 15 Oil Companies | 12.56 | 16.58 | 8.99 | 7.59 | 8.92 | 14.64 | 4.84 | 9.80 |
| 15 Other Industrials | 14.43 | 23.65 | 6.58 | 17.07 | 10.77 | 18.79 | .17 | 18.62 |

For all of the reasons discussed, we are not persuaded that Exhibit 61 supports respondent's claim that its earnings are unreasonably low in relation to the industry groups considered therein.

Respondent also contends that the telephone industry is more sensitive to cyclical fluctuations of the economy than are other groups of utilities. In effect, the contention is that the use of the telephone is more a luxury than a modern day necessity. However, this contention is not supported by any documentary evidence on this record and, moreover, is refuted by the comparisons of revenue and income trends set forth in Exhibit 1 and Exhibit 120.

While some of respondent's witnesses criticized what they termed "regulatory climate" in California and deplored the increase in common stock prices of certain local electric utilities by only 233-250 percent between 1952 and 1961 as shown in Exhibit 59, we note that, at the rates which have been fixed, California ratepayers are using more electricity, gas, telephone service and water than

ever before; and California utilities have attracted sufficient capital upon terms not generally less favorable to support the unprecedented plant expansion made necessary by the public demand for service.

One of respondent's own witnesses acknowledged that in the case of a nonregulated enterprise which has a public market for its securities, attempt is made to issue new capital at as close to the price on the market as it possibly can (Tr. p.4625). Leading California utilities such as Pacific Gas and Electric Company and Southern California Edison Company have financed new stock issues by taking full advantage of existing market prices in obtaining increasing amounts of money in comparison to the number of shares issued. Respondent, on the other hand, issues all of its common stock to existing shareholders at par regardless of market price, thereby diluting per share earnings. At no time has it endeavored to seek equity capital at the lowest possible cost in recognition of a favorable market price at the time of issuance of the new shares. No doubt American, as an investor, owning approximately 90 percent of respondent's common stock, finds it desirable to obtain respondent's new stock at a cost of par. The return to American based on par cost of $14-2/7 per share, produces a present ratio of earnings to cost of 10 percent and a present yield ratio, based upon dividends to cost, of more than 3 percent.

Respondent would have the Commission ignore the relationship between respondent and American and fix a rate of return as if respondent were an independent utility. At the same time respondent would have the Commission ignore the differences between respondent's method of equity financing (which disregards market price) and

the method of leading independent utilities in California. Thus, while respondent advocates the need for higher per share earnings, it has maintained its equity ratio at about 60 percent and has issued its stock at par. It is apparent that the necessary result of such a financing policy is to dilute per share earnings. Furthermore, while respondent complains about its claimed low earnings per share, it resists taking the investment tax credit on a flow-through basis and does not avail itself of liberalized depreciation for income tax purposes. Nevertheless, respondent chooses to compare its per share earning performance with the per share earning performance of Pacific Gas and Electric Company and Southern California Edison Company, each of which maintains debt ratios of 50 percent or more, takes advantage of market price in new offerings and uses liberalized depreciation for income tax purposes.

In viewing the matter of relative risk between major California electric and gas utilities and respondent, we observe that they all operate in California under virtually the same physical environment and "regulatory climate" insofar as State regulation is concerned; respondent serves more customers and its operations are somewhat larger and more diverse with respect to service area than any single California gas or electric utility; while the gas and electric utilities have had certain of their properties taken over in eminent domain proceedings, respondent has not; competition, in the form of alternative fuels is present with respect to the gas and electric utilities; respondent receives and relies on advice and assistance from its parent on management and other problems; the gas and electric utilities as well as

respondent must raise substantial amounts of capital from time to time; and the services of the gas and electric utilities as well as of respondent are essential in the economic development of California.

Finally, one other contention of respondent requires comment. It contends that its common stock is not attractive to investors. In this connection it bears noting that several of respondent's outside financial witnesses testified that while they would not purchase or recommend purchase of respondent's common stock, they have recommended or would recommend purchase of American's stock. This suggests to us that if respondent's common stock is not attractive to investors, it is because approximately 90 percent of it is held by American. Thus, an investor other than American, who purchases respondent's common stock necessarily acquires only a minority interest in respondent. To whatever extent such minority interest impairs a stockholder from having an effective voice in respondent's affairs, to that extent respondent's stock is necessarily less attractive than that of its parent. For example, one basis for such relative unattractiveness can lie in the fact that respondent's minority stockholders have no voice at all in any determination by the parent to increase by 2½ times respondent's payments due under the license contract. Similar disabilities may exist with respect to the determination by the parent of dividend policy and policy on purchase of plant, equipment and services through subsidiaries of the parent. By reason

of the relationship alone between respondent and American there have been created risks to the minority stockholder which explain, if such be the fact, why respondent's common stock is unattractive as an investment.

Summary

With the wide range in the claims now before us and with the opposing opinions of witnesses, our final determination of rate of return to be accorded respondent's intrastate operations represents the exercise of judgment on our part, having in mind the lawful interests of the ratepayer and the utility.

We find a rate of return of 6.30 percent to be fair and reasonable when applied to the test year intrastate rate base of $1,996,533,000, adopted herein as reasonable.

# RATE BASE

## Comparisons

The difference of $78,588,000 between the respective California intrastate rate bases developed by the Commission staff and by respondent for the test year ending September 30, 1962 arises from a number of items compared in the tabulation following.

WEIGHTED AVERAGE DEPRECIATED RATE BASE
CALIFORNIA INTRASTATE OPERATIONS
TEST YEAR ENDING SEPTEMBER 30, 1962

| Item | CPUC Staff Ex.47 | Respondent Ex.50 Rev. & Ex.115 | Respondent Exceeds CPUC Staff |
|---|---|---|---|
| Plant | $2,469,899,000 | $2,475,489,000 | $ 5,590,000 |
| Investment Tax Credit | - | (1,718,000) | (1,718,000) |
| Net | $2,469,899,000 | $2,473,771,000 | 3,872,000 |
| Property Held For Future Use | 2,555,000 | 2,558,000 | 3,000 |
| Adjustment - 3-Year Rule | (102,000) | - | 102,000 |
| Adjustment - Transfer to AC.100.3 | (171,000) | - | 171,000 |
| Net | 2,282,000 | 2,558,000 | 276,000 |
| Telephone Plant Acquisition Adjustment | - | 93,000 | 93,000 |
| Western Electric Adjustment to Plant | (27,603,000) | - | 27,603,000 |
| Credit Received From Western | (21,140,000) | - | 21,140,000 |
| Working Cash Allowance | (15,473,000) | 8,803,000 | 24,276,000 |
| Materials and Supplies (M&S) | 7,834,000 | 7,839,000 | 5,000 |
| Western Electric Adjustment to M&S | (88,000) | - | 88,000 |
| Net | 7,746,000 | 7,839,000 | 93,000 |
| Deduction For Depreciation | 444,479,000 | 438,826,000 | (5,653,000) |
| Adjustment - Mobile Communication | 552,000 | - | (552,000) |
| Investment Tax Credit | - | (40,000) | (40,000) |
| Western Electric Adjustment | (5,010,000) | - | 5,010,000 |
| Net | 440,021,000 | 438,786,000 | (1,235,000) |
| Weighted Average Depreciated Rate Base | 1,975,690,000 | 2,054,278,000 | 78,588,000 |

(Red Figure)

Respondent presented Exhibit 84 entitled "Determination of the Current Value of Telephone Plant as of December 31, 1961", and Exhibit 85 entitled "Price Level Depreciation". In closing argument counsel for respondent stated:

> "By the way, I will take one second to mention current value, to clear up any misconception.
>
> "We have not advocated departing from the traditional net plant and working capital rate base. We put in current value testimony as a measure of the effects of inflation. The effects of inflation are a current condition which faces the Company as well as the Commission and this measure is something which is brought to the attention of the Commission for its consideration, but what the Commission does with and how it uses it is another thing again. We suggest that, as in past cases, there should be an allowance in the rate of return to make up for it and that is the use of the current value testimony besides showing the inadequacies of depreciation accruals on strictly an original cost basis."

We find no justification in departing from the Commission's long-established principle of original cost as the proper basis for determining rate base for rate-fixing purposes. We specifically reject current value as presented in Exhibit 84 and price level depreciation as presented in Exhibit 85 as being without substantial probative value.

Plant

The difference of $5,590,000 shown for the item "Plant" results from differences in separations between intrastate and interstate operations previously discussed.

Neither the Commission staff nor respondent included telephone plant under construction in rate base because respondent accrues interest on projects during construction. This is in accord with past Commission practice which we find is reasonable.

Investment Tax Credit

The Revenue Act of 1962 provided for a credit to Federal income taxes equal to 3 percent of a public utility's investment in

tangible depreciable property, except buildings, having an estimated life of eight years or longer. Utility plant with an estimated life of less than eight years but longer than six years qualifies to the extent of 2 percent credit while plant with a life of less than six years but more than four years qualifies for a 1 percent credit. The 1962 Act did not allow, for Federal income tax purposes, tax depreciation on the investment credit. This provision has since been changed to allow tax depreciation on the investment credit.

The Commission staff urged that the Federal investment credit be treated on the "flow-through" basis such that Federal taxes based on income shall be accounted for at the accruable actual liability therefor. The staff's results of operations exhibits reflect the "flow-through" treatment. Respondent maintained that the investment tax credit should be deducted from the cost of plant that gives rise to the credit, stating that the effect of its treatment of the investment tax credit in its exhibits is that of a Federal "contribution in aid of construction".

A comparison of the different treatment accorded the Federal investment tax credit by the staff and by respondent for the test year intrastate operating results follows:

| Item | CPUC Staff | Respondent |
|---|---|---|
| Investment Tax Credit | $5,383,000 | $4,581,000 |
| Revenues | - | - |
| Expenses Other Than Depreciation and Taxes | - | (5,000) |
| Depreciation | - | (98,000) |
| Taxes Other Than Federal Income | - | - |
| Federal Income Taxes | (4,985,000) | 53,000 |
| Total Expenses and Taxes | (4,985,000) | (50,000) |
| Net Revenue | 4,985,000 | 50,000 |
| Average Plant in Service | - | (1,718,000) |
| Average Depreciation Reserve | - | (40,000) |
| Rate Base | - | (1,678,000) |

(Decrease)

The investment credit became effective on January 1, 1962 and was actually in effect for only the last nine months of the test period. The staff's estimated investment credit of $5,383,000 for the test year (12 months ended September 30, 1962) assumed that the Revenue Act of 1962 had been in effect the three previous years and that the credit applied to all qualified investment placed in service during the test year. Respondent's investment tax credit figure of $4,581,000 reflects the credit for the nine months January - September, 1962, rather than a full 12-month effect, and respondent deducted from rate base 37.5 percent of the credit on the assumption that the credit was booked equally each month from January to September, 1962.

The staff maintained that respondent's treatment of this item substantially overstates current tax expense with the inclusion of phantom taxes and is contrary to the Commission's letter of direction to all utilities and carriers dated December 18, 1962 and to Decision No. 65205 decided by this Commission on April 9, 1963 in Case No. 7305 and Applications Nos. 43659 and 43685, Park Water Company. Respondent, on the other hand, urged that its method, which it denominated "service life flow-through", was in harmony with the statutory purpose of the investment credit; was not a means of retaining any of the benefits of the investment credit for its investors; and would actually flow through more dollars over the life of the property.

The Cities of Los Angeles and San Diego and the City and County of San Francisco urged that for intrastate rate-making purposes, this Commission should not allow a public utility to charge to its operating expense for income taxes any amount in

excess of the amount of income taxes lawfully assessed by the taxing authority and paid by said public utility. The Administrator of General Services took the position that the investment tax credit constitutes a true reduction in operating taxes and should "flow through" in accordance with the staff position.

We find that respondent's method of deducting the investment tax credit from rate base substantially overstates current year tax expense and substantially understates current year net revenues. Further, we find that respondent's method should be rejected for intrastate rate-fixing purposes and that the staff's flow-through method is reasonable, is consistent with the treatment accorded the investment tax credit by this Commission in the fixing of rates of other utilities in this State, and should be followed for intrastate rate fixing of respondent's service. Consistent, however, with our treatment of other so-called level changes, we find it reasonable to reflect in the test year the investment tax credit commencing January 1, 1962. Thus, the intrastate test year amount we find reasonable for this item as a deduction from Federal income tax is $4,581,000 offset by $340,000 for depreciation.

Property Held For Future Telephone Use

The amount included by the Commission staff in the test year intrastate rate base for Account 100.3, Property Held For Future Telephone Use, is $2,282,000 which is $276,000 less than respondent's claim of $2,558,000. Some $3,000 of this difference results from differences in separations between intrastate and interstate operations previously discussed. The remaining $273,000 results from two staff deductions: (1) $171,000 representing the average investment in property transferred from Account 100.3 to

Account 103 (Miscellaneous Physical Property) during the test year, and (2) $102,000 representing property scheduled for telephone use more than three years in the future from 1962 (the test year) or to be abandoned.

The staff requested and obtained from respondent for the many items of property in this account a schedule showing the type of property concerned, the location of the property, the purpose for which the property was on the books of respondent and the anticipated date of telephone use for each item. It was upon this information that the staff evaluated the account and developed the portion it considered reasonable for inclusion in the test year intrastate rate base. Properties are held in this account by respondent for varying lengths of time before being either put to telephone use or transferred out of Account 100.3 to the miscellaneous physical property account (Account 103).

Respondent does not urge that the miscellaneous physical property account (Account 103) should be included in rate base. Respondent does maintain, however, that all of the investment included by respondent in Account 100.3 should be included in rate base regardless of the length of time items of property are held in the account prior to being put to telephone use or abandoned. Respondent takes the position that the decision to acquire the property at the time of acquisition was prudent and the best way of meeting telephone requirements. Respondent pointed to the need to purchase microwave sites in advance, hold lands adjacent to existing central office buildings for future expansion and construct underground conduit in advance of freeway or airport construction, urging that

the land might not be obtainable or obtainable only at excessive cost at the time needed for expansion and that underground construction if delayed would be more expensive. While the staff recognized the needs of respondent for future expansion, its position is that respondent's long-term plans are subject to change and future use may never materialize at a particular location; that even if the property is used in the future, the costs associated with carrying such lands for periods longer than three years in the future might well exceed the possible increase in market price; that respondent should not be allowed to speculate in real estate at the ratepayers' expense; and that the three-year rule applied by the staff is reasonable for rate-fixing purposes.

Rather wide changes have occurred in the weighted average balance in this account (Account 100.3) for respondent's total California operations during the years 1957 through 1961 and for the test year ending September 30, 1962, as shown in the tabulation ollowing:

| Year | Amount |
|---|---|
| 1957 | $1,570,048 |
| 1958 | 1,253,222 |
| 1959 | 882,200 |
| 1960 | 1,808,778 |
| 1961 | 2,102,884 |
| Test Year Ending Sept. 30, 1962 | 2,956,000 |

As long ago as 1954 the Commission set forth the principle owed for testing the reasonableness of including in rate ntrastate rate-fixing purposes, property held for e in telephone service under a definite plan". The

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principle included a three-year rule looking into the future from the test year, with a five-year limit for any item residing in Account 100.3. (Decision No. 50258, dated July 6, 1954 in Application No. 33935.) This rule was followed in respondent's rate proceedings decided in 1954 and in 1958 and used by the staff in this proceeding.

The Commission has previously stated that in acquiring property for future use an unreasonable burden must not be imposed upon the ratepayer, nor should the utility be penalized if it exercised reasonable judgment. However, there are certain "risks of the business" which a utility must bear and which may not be transferred to the ratepayer. The situation here presented we find is illustrative of one such risk of the business.

We find that the staff's allowance, increased by $3,000 for separations, or a total of $2,285,000 for this item in the test year intrastate rate base is reasonable and is consistent with past Commission practice, which we find to be reasonable.

Plant Acquisition Adjustment

Consistent with past findings of this Commission, the Commission staff did not include the telephone plant acquisition adjustment account in the rate base because that account reflects the difference between the purchase price and the original cost of certain lands principally acquired many years ago (some dating to 1904) as well as a few parcels acquired more recently from predecessor companies. The intrastate amount for this item included by respondent in rate base is $93,000. A witness for respondent maintained that such amount is properly a part of rate base, urging that it represents dollars actually expended to obtain the property in an arms-length transaction.

We find that the amounts included in the telephone plant acquisition adjustment account do not represent original cost of plant in service and should not be included as a component of respondent's intrastate rate base. We further find that the question of the exclusion of this account from respondent's intrastate rate base has been before this Commission in a number of respondent's prior rate proceedings, including the last one decided in 1958, and each time the account has been, we think, properly excluded.

Adjustments For Purchases From Western Electric

Western Electric Company, Inc. and respondent are arms of the same corporate combine in the Bell System. American Telephone and Telegraph Company controls both respondent and Western through 89.62 percent and 99.82 percent stock ownership, respectively. Western, in addition to being the manufacturing branch of the Bell System, also acts in the capacity of purchasing agent and supply department and as developer, storekeeper, installer, repairer and salvager. Western has several wholly owned subsidiaries, including Nassau Smelting and Refining Company, Inc., Teletypewriter Corporation, and Weco Corporation. Bell Telephone Laboratories, Inc., is owned 50 percent by Western and 50 percent by American. Western is by far the largest manufacturer, installer, and procurer of telephone equipment in the United States, accounting for 80 percent or more of the total business. Respondent, like other Bell System companies, makes most of its purchases from or through Western under a standard supply contract (Exhibit 78). The prices under this contract are fixed by Western.

Because of the close affiliation of Western and respondent, the Commission staff made an investigation of Western's accounting procedures and of its profits and earnings on net investment over the 46-year period 1916-1961 and for the first nine months of 1962. The staff also reviewed Western's pricing policies, inspected several of Western's principal manufacturing plants, conferred with executives of Western and American in New York and elsewhere, studied reports on the operating results of Western, reviewed the proposed report of the telephone investigation made by the Federal Communications Commission in 1938 and also reviewed the anti-trust action brought by the United States government against Western and American commencing in 1949 and culminating in a consent decree in 1956. In addition, the staff considered prior decisions of this Commission and underlying exhibits as related to respondent's purchases from Western.

The staff in its presentation followed the previous decisions of this Commission in considering Western a manufacturing and construction department controlled by an affiliated company and entitled to no greater return on its sales to respondent than respondent is entitled to as against its ratepayers. The staff maintained that the books of account of respondent do not accurately reflect the costs to the utility and its owners for expenses incurred in operation and investment in rate base components with respect to purchases from and through its affiliate, Western; that with respect to such purchases respondent's books of account reflect prices that are fixed by respondent's owners and to be paid to respondent's owners; that such prices include cost plus return; that the rate of return actually enjoyed by respondent's owners on the

inter-affiliate business at the prices fixed by respondent's owners during the 46-year period, 1916-1961 was a composite 9.1 percent; that during this 46-year period Western realized earnings of $340,746,000 more than the returns found fair by this Commission for respondent, a composite of 6.5 percent over the entire 46-year period; and that in the test year there remains in respondent's intrastate rate base $22,681,000 more than the cost to the owners plus a reasonable return on investment and that respondent's intrastate maintenance and depreciation expenses include $3,131,000 more than is reasonable under the affiliated relationship. The staff's specific adjustments to rate base and to expenses for purchases by respondent from and through its affiliate, Western, are developed in Exhibits 3, 43 and 47 and are summarized in the tabulation following.

CPUC Staff Adjustments for Purchases
From Western Electric Company
Test Year Ending September 30, 1962

| Adjustment to: | Total California Operations | California Intrastate Operations |
|---|---|---|
| Rate Base | | |
| Average Plant | $(32,651,000) | $(27,603,000) |
| Materials and Supplies | (101,000) | (88,000) |
| Less: Depreciation Reserve | (5,952,000) | (5,010,000) |
| Rate Base | (26,800,000) | (22,681,000) |
| Expenses | | |
| Current Maintenance | (2,100,000) | (1,720,000) |
| Depreciation Expense | (1,611,000) | (1,411,000) |
| Total | (3,711,000) | (3,131,000) |

(Red Figure)

Respondent took the position that Western's prices are and have been reasonable; that Western's earnings have not been excessive; that cost reduction programs carried out by Western have redounded to the benefit of respondent's ratepayers; and that the

Commission, in establishing respondent's rates, must recognize in full the amounts which it paid to Western.

Respondent presented evidence to the effect that a manufacturing division of a nationwide telephone utility could do a better job of manufacturing with resultant lower unit cost than one of the operating units of the same utility. In the field of installation, respondent presented evidence to the effect that a trained installation organization working in close coordination with the manufacturing division, possessing specialized experience and working with a nationwide market can do a better job of installing telephone equipment than an organization without these advantages. Respondent also presented evidence to the effect that purchasing and distributing in great volume yields lower unit cost than purchasing and distributing in lesser volume.

Having established the inherent advantages of a single large market supplied by a single large supplier of telephone material and services, respondent proceeded to compare in Exhibit 69 Western's prices with the prices of the much smaller non-Bell market of more than 90 manufacturers and suppliers for some similar equipment. Comparability of manufacturers and suppliers was not established and the reasonableness of other company prices, even assuming comparability, was not demonstrated. Moreover, the massive and unique market enjoyed by the nonoperating segments of American in the purchases by operating segments provides an advantage so great in volume alone in each of the fields of manufacturing, installation, purchasing and distribution that competition is effectively eliminated. Western has a stable, assured and captive market. Were American's manufacturing, supply

and installation unit not more efficient than outside suppliers who do not possess the manifold advantages enjoyed by Western, the very existence of Western under American's control would be subject to great question. We find that little, if any, weight can be accorded such price comparisons in judging the reasonableness of Western's prices. It is the cost to Western that is significant.

Respondent attempted to justify the earnings of Western that resulted from the prices for telephone material that the Bell System determined that the Bell System should pay, by a comparison in Exhibit 75 of various financial ratios over the years 1946-1961 for Western and for 47 selected utility suppliers (15 gas, 15 electric and 17 telephone). Based on these financial ratios respondent concluded that: (1) the risk of Western's manufacturing operations was greater than that of the 15 gas and the 17 telephone utility suppliers but less than that of the 15 electric utility suppliers; (2) the risk of Western's operations, other than manufacturing, was greater than that of the 15 electric, 15 gas and 17 telephone utility suppliers; (3) Western's earnings over the period 1946 to 1961 have been less than could be justified using its comparable earnings test; and (4) Western had not profited unreasonably on its manufactures for or sales of other services to Bell companies. Respondent's showing in this respect completely disregards the affiliation of Western with the Bell System and the unique conditions under which Western operates, is devoid of valid comparisons, and, even assuming comparability, does not demonstrate the reasonableness of earnings of the other companies. The advantage that the Bell System has in its integrated position of being researcher, designer, engineer, manufacturer, distributor,

installer, repairer, junker and, of course, operator of 80 percent of the telephone business in the entire continental United States makes it impossible to compare one phase of its operations, that of Western Electric, with outside companies who have none of the same spread of operations and control either in utility business or with respect to any business within which the outside companies operate. Western, in its relationship to respondent and other operating subsidiaries of the Bell System, is not at all comparable to an independent manufacturing concern.

As a matter of policy respondent over the years has required that it provide the equipment and instrumentalities used in its services. The result of such a policy has been effectively to prohibit entry of any competitive instruments into the telephone market in respondent's territory. Accordingly, practically all items of communication equipment on customer premises served by respondent are manufactured by Western. In those few instances where Western is not the manufacturer, the instruments are subject to prior approval and acceptance by Western. Moreover, because of the close affiliated relationship between respondent and Western, respondent's policy results in a substantial reduction in risk

since both respondent and Western have the opportunity for complete control of what instruments will be offered for public use and the degree of obsolescence that they assign to the instruments that are now in respondent's operating plant.

Basically, the adjustments recommended by the staff for purchases by respondent from and through Western bring up to date similar adjustments developed by the staff and adopted by the Commission in prior rate proceedings involving respondent, the latest being Decision No. 56652, dated May 6, 1958 in Application No. 39309.

Starting with the earning results of Western's Bell business as reported and adjusted by Western for the 46-year period 1916-1961 and for the first nine months of 1962, the staff in Exhibit 3 made additional adjustments designed to place Western's net investment and net income on a proper basis for rate-fixing purposes. Having arrived at a revised net investment and net income for each year by means of these adjustments, the staff then determined the amount by which each year's revised net income would have to be increased or decreased to yield Western the same level of rate of return as this Commission had found reasonable for

respondent. These indicated increases or decreases in Western's net income from Bell business were then converted to corresponding increases or decreases in Western's gross revenues by applying net-to-gross tax factors to allow for the effect on income tax. The staff then applied, for each year, a set of factors designed to allocate the indicated adjustment of Western's total revenue from Bell business, either decrease or increase, to that portion of the plant purchased from Western by respondent in the particular year which remained in respondent's California plant in the test year.

The staff adjusted respondent's expenses as well as the rate base, first because approximately 23 and 21 percent, respectively, of its California purchases were charged to expense in 1961 and in the first nine months of 1962, and second, because the adjustments to plant necessitate adjustments to depreciation expense. The staff made no adjustment to ad valorem tax as a result of its adjustment to respondent's California purchases from Western which have been capitalized, because the State Board of Equalization recognized on a percentage of net plant basis the purchases adjustment adopted by this Commission in Decision No. 50258 (53 CPUC 275, 296) in determining one of the factors entering into the judgment ad valorem tax base, namely, the depreciated historical cost of respondent's California plant beginning in 1956.

The adjustments made by the staff to Western's Bell net investment and net income had the effect of increasing the rate of

return on Western's Bell business for the 46-year period (1916-1961) from 8.72 percent as adjusted by Western to 9.08 percent as adjusted by the Commission staff and of increasing by $193,521,000 and by $64,996,000, respectively, Western's Bell net investment and net income over the 46-year period. These staff adjustments are explained in Exhibit 3 and summarized below.

| | Total for 46-Year Period 1916-1961 |
|---|---|
| **A. Western's Bell Net Investment** | |
| As Adjusted by Western | $12,956,772,000 |
| CPUC Staff Adjustments: | |
| New York Office land sold in 1957 | (12,905,000) |
| Cash and Marketable Securities reduced to 4% of total costs | (601,882,000) |
| Depreciation Reserve, remaining life method in lieu of total life | 176,006,000 |
| Reserve for Equalization of Development, adjusted to allow in full only actually incurred expenses for research and development | 519,362,000 |
| Deferred Assets for Prepaid Taxes on special reserves not allowable under Federal income tax regulations | 112,940,000 |
| Total CPUC Staff Adjustments | 193,521,000 |
| CPUC Staff Adjusted Western's Bell Net Investment | 13,150,293,000 |
| **B. Western's Bell Net Income** | |
| As Adjusted by Western | 1,129,209,000 |
| CPUC Staff Adjustments: | |
| Interest income on excluded cash and marketable securities | (10,130,000) |
| Depreciation expense, remaining life basis | 33,538,000 |
| Pension expense, 3½% interest rate and amortization of unfunded reserve on the remaining cost principle | 1,295,000 |
| Subtotal | 24,703,000 |
| Income tax effect of subtotal | (2,013,000) |
| Accrual to reserve for equalization of development after income tax | 21,276,000 |
| Prepaid tax effect on special reserves after income tax | 21,030,000 |
| Total CPUC Staff Adjustments | 64,996,000 |
| CPUC Staff Adjusted Western's Bell Net Income | 1,194,205,000 |

(Red Figure)

Because Western does not maintain a monthly record of its Bell net investment and net income it was necessary for the staff in its Exhibit 3 to make certain estimates respecting the test year ending September 30, 1962. Respondent urged that the staff's estimated figure of $4,200,000, shown on line 17 of Table 9, Exhibit 3, page 20, as "Pacific California purchases adjustment, first nine months 1962" should be reduced to $3,555,000 to reflect the effect of the 1962 return on investment realized by Western on its Bell business. Respondent also pointed out that the staff's calculations were inconsistent in that the staff had excluded from Western's net investment certain cost for a parcel of land in New York City which was acquired by Western in 1948 for an office site and sold in April 1957, but that the staff had not excluded from Western's 1957 net income $550,000 realized from the sale of this land.

While respondent took exception to a number of the other staff adjustments to Western's Bell net investment and net income, the Cities of Los Angeles and San Diego and the City and County of San Francisco characterized these staff adjustments as "soft" in that the staff had not reduced Western's costs for the investment tax credit taken by Western, the staff had accepted Western's standard costs without audit or verification and the staff had inflated Western's costs by an assumed profit going to Bell Laboratories. The record does not contain sufficient information to evaluate the effect of the investment tax credit taken by Western starting in 1962. In our opinion the effects of the investment tax credit and use of liberalized depreciation on Western's operations will deserve further consideration in the future.

We find that the staff's adjustments to Western's Bell net investment and net income adjusted to reflect the exclusion of $550,000 from Western's 1957 net income realized from the sale of certain land and further adjusted to reflect the effect of the 1962 return on investment realized by Western on Bell business, follow the methods and principle heretofore adopted by this Commission and produce a fair and reasonable result.

In determining the amount by which each year's revised net income would have to be increased or decreased to yield Western the same level of rate of return as this Commission had found reasonable for respondent, the staff used a rate of return of 7 percent for all years prior to 1936, 6.8 percent for 1936-1943, inclusive, 5.95 percent for 1944-1947, inclusive, 5.6 percent for 1948-1953, inclusive, 6.25 percent for 1954-1956, inclusive, and 6.75 percent for 1957 and subsequent years. The rates of return used by the staff prior to 1957 were the same as those used by the staff in developing a similar adjustment adopted by this Commission in respondent's last rate proceeding. The 6.75 percent rate of return used by the staff for 1957 and subsequent years is the rate of return last found reasonable by this Commission for respondent in its last rate proceeding.

While respondent has again challenged the use of these rates of return applied to Western's sales to respondent, we find nothing in this record which would warrant a change in the Commission's holding that Western is entitled to no greater return on its sales to respondent than respondent is entitled to earn on its operations. American should not be permitted, through the

corporate instrument of Western, to subject respondent's ratepayers to the burden of providing an unreasonable return. We find that the rates of return used by the staff in developing its adjustment for purchases from Western to be those found fair for respondent for the years involved and that they produce a fair and reasonable result, except that for the test year the rate of return should be that accorded respondent herein, namely, 6.3 percent.

To assure that respondent's ratepayers will not be unduly burdened, we find that Western's profits on sales to respondent, for rate-making purposes, should be adjusted so as to be no greater than that allowed respondent. The adjustments for purchases from Western applicable to respondent's intrastate operations which we hereby find to be reasonable and adopt for purposes of this decision are:

| | |
|---|---|
| Rate Base Adjustments: | |
| Average Plant | $(27,692,000) |
| Materials and Supplies | (88,000) |
| Less: Depreciation Reserve | (5,021,000) |
| Rate Base, Depreciated | (22,759,000) |
| Expense Adjustments: | |
| Maintenance | (1,696,000) |
| Expenses from Clearing Accounts | (57,000) |
| Depreciation Expense | (1,332,000) |
| Total | (3,085,000) |

(Red Figure)

Credit Received from Western Electric Company

In developing the intrastate rate base the staff deducted $21,140,000, which the staff maintained represented the average amount of credit received by respondent from Western Electric Company during the test year on all billings other than charged operating expense but modified to reflect the effect of the staff recommended Western purchase adjustment. The staff urged that in the development of its Western purchase adjustment, it had included as part of Western's net investment (rate base) an amount representing accounts receivable from respondent for purchases of plant items and that in order to avoid these items being considered twice, the credits extended by Western must be deducted in determining respondent's rate base.

Respondent's position is that no part of the $21,140,000 amount is legally deductible from its rate base and that even under the staff's theory the amount of the deduction calculated by the staff contains two errors aggregating $14,914,000 for total California operations (approximately $12,615,000 intrastate). Respondent maintained that it owned the property represented by the credit received from Western and to the extent such property is included in Account 100.1 (Telephone Plant in Service), it is devoted to and used in furnishing telephone service and must be allowed in rate base.

The question of allowing in respondent's rate base credit from Western Electric Company is not a new issue before this Commission. In deciding respondent's Application No. 33935 requesting rate increases, the Commission in its Decision No. 50258, decided July 6, 1954, stated:

"An item of $1,627,000 in the computation of the staff's allowance for working cash represents the average amount of credit extended to applicant by Western Electric Company on purchases used for operation and maintenance. In addition, there is an average amount of $8,940,000 representing credit extended to applicant by Western Electric Company on purchases used for construction that has not been included in the staff's working cash computation but has been included in Western Electric Company's net investment (rate base) as accounts receivable.

"The staff, after adjusting the $8,940,000 figure down to $8,696,000 because of the purchase adjustment on Western Electric Company, deducted the latter amount from applicant's materials and supplies on the assumption that the rate base should not include plant and materials and supplies for which applicant has not yet paid. The applicant's position on this point was that there should be included in rate base the full book account of materials and supplies which it has purchased. In our opinion applicant's position is reasonable and these materials and supplies represent plant devoted to the public service which should be included in rate base.

"By having a credit of $8,696,000 available from Western, however, the applicant's need for working cash is correspondingly reduced. If this amount is not shown as an adjustment to materials and supplies it follows that it should be deducted from the applicant's working cash as computed by the staff. In applicant's summary of position for oral argument, page 46, it states that telephone plant under construction has not been included in rate base and that the portion of the $8,696,000 attributable to purchases in construction work in progress has, in effect, been disallowed twice by the staff. Such contention disregards the fact that applicant is capitalizing interest during construction on part of these purchases prior to paying for them and is receiving a rate of return on the parts that reside in the accounts of plant in service and materials and supplies.

"Our conclusion on working cash is that $7,941,000 (the intrastate portion of the $8,696,000), should be deducted from the staff's allowance of $8,969,000."

We find that it would be unreasonable to include the average amount of credit from Western in respondent's rate base and at the same time allow in Western Electric Company's net investment (rate base) amounts representing accounts receivable from respondent, because such action would require respondent's ratepayers to pay earnings on the credit twice. Respondent's position on this item

completely disregards its affiliated relationship with Western and produces an unreasonable result. We find the treatment that should be accorded this item for the purpose of this proceeding should be no different in effect from that previously accorded, except that this adjustment more appropriately should be reflected as a separate deduction in determining rate base.

We turn now to a discussion of the two alleged errors which respondent maintained were in the staff's calculated deduction. First, respondent urged that 39.6 percent, or $9,900,000 of the property represented by the credit received from Western Electric Company for total California operations is in Account 100.2 (Telephone Plant under Construction) until after it is paid for; that Account 100.2 is not included in respondent's rate base; and that the staff's calculation accordingly is overstated by $9,900,000 for total California operations for this item. The staff maintained that plant in Account 100.2 will be in rate base in the future with amounts added thereto for interest during construction; that this interest is considered by respondent as income and is so shown in its income statement; and that failure to deduct the entire amount of the Western credit charged to respondent's plant accounts would result in respondent earning on the credit twice, once in accruing interest during construction and a second time in Western's net investment. We find that no part of the amount of the Western credit charged to respondent's plant accounts should be included in respondent's rate base and that respondent's assertion of a $9,900,000 error in staff calculations is invalid.

Next, respondent maintained that the average amount of "plant credits" not received by respondent during the test period applicable to its total California operations was $7,257,000 of which $5,014,000 related to Account 100.1 (Telephone Plant in Service) and

$2,243,000 related to Account 100.2 and that the staff's calculation resulted in a double deduction of the $5,014,000 amount. Upon consideration, we find that the staff's calculation of the adjustment for credit received from Western should be reduced by the average amount of "plant credits" not received by respondent during the test period applicable to intrastate operations ($6,138,000) and also revised to reflect the effect of the Western Electric Company purchase adjustment adopted herein. Accordingly, we find that the average amount of credit received by respondent from Western on all billings other than charged operating expense that reasonably should not be included in respondent's test year intrastate rate base is $15,000,000.

Working Cash Allowance

The purpose of including an allowance for working cash in rate base previously has been stated by this Commission (48 Cal. P.U.C. 22):

> "The purpose of including a working cash allowance in rate base is to compensate investors for capital which they have supplied to enable the company to operate efficiently and economically and for which they would not otherwise be compensated. If, through the availability and use of tax accruals, monies or other funds supplied by the subscribers, the investors are required to supply a smaller sum, their compensation should be proportionately less."

In developing its allowance in rate base for working cash, the staff started with a gross requirement indicated by the average balances for the test year in Account 113, Cash, and Account 115, Working Funds, as supplied to the staff by respondent in the aggregate amount of $8,957,000 for total California operations. From this gross requirement, the staff deducted $27,597,000 representing amounts which the staff determined were not supplied by investors,

leaving a net allowance for working cash of minus $18,640,000 (minus $15,473,000 for intrastate operations). Thus, the staff deducted from rate base the average amount of working cash it determined respondent had on hand not supplied by investors. The staff's working cash study is set forth in detail in Exhibit 43, Table 15-B, the results of which are summarized below. It generally follows the same methods and principles heretofore adopted and is similar to other staff studies presented in rate proceedings.

| | State of California | Intrastate |
|---|---|---|
| Gross Working Cash Requirement Indicated by Certain Balance Sheet Accounts: | | |
| Cash ........................... | $ 8,586,000 | $ |
| Working Funds .................. | 371,000 | |
| Total Gross Requirement | 8,957,000 | |
| Deductions From Gross Requirements of Amounts Not Supplied by Investors: | | |
| Average amount available as a result of collecting revenues in advance of paying expenses, taxes and depreciation ........ | 15,184,000 | |
| Debenture Interest ............ | 5,111,000 | |
| Taxes Withheld from Employees . | 7,302,000 | |
| Total Deduction From Gross Requirement ............... | 27,597,000 | |
| Working Cash Allowance ............ | (18,640,000) | (15,473,000) |

Subsequent to the time the staff had presented its studies, respondent discovered that the gross working cash requirement figure of $8,957,000 which it had earlier supplied to the staff was in error and that the correct figure was $10,392,000. Respondent included in its exhibits an allowance of $10,392,000

for working cash in rate base for total California operations and $8,303,000 for intrastate operations. Respondent's figure is simply the average of the actual cash balances with no consideration given to the sources of these funds so as to permit a determination of the average amount supplied by investors for the efficient and economical operation of the business for which investors are not otherwise compensated. In this proceeding respondent abandoned its traditional 1/12[7] formula which it had advocated in a number of its prior rate proceedings, including the last one.

Respondent maintained that the working cash allowance included in its exhibits is minimal; that no deductions from the average cash balances are warranted or lawfully may be made; and that the staff's lag-and-lead study on which the deduction from gross requirements is primarily based is totally theroetical and replete with error, as are other staff calculations.

Respondent further contends that under the net-plant- and working-capital rate base method followed by this Commission, the devotion of property to public service, and not the source of funds with which it is purchased, is determinative of the entitlement to an opportunity to earn a fair return. This contention is inconsistent with respondent's own vigorously recommended treatment of the investment tax credit as a deduction from rate base because it constituted, in respondent's own view, a Federal "contribution in aid of construction". Where, as in this case, the funds supplied to

7/ Respondent has traditionally claimed working cash in the amount of 1/12 of annual operating expenses exclusive of depreciation and taxes.

respondent by others than investors are greater than the amount required by respondent for working cash, and the excess amount is not deducted from rate base, customers would be unreasonably required to pay a return on funds supplied by them to defray reasonable expenses and taxes and to provide a reasonable return on invested funds.

Respondent contended that the staff's negative working cash allowance was a theoretical approach. However, respondent's own balance sheets reveal that approximately $11,900,000 as of December 31, 1961 and $22,400,000 as of December 31, 1962 of plant and investments had been furnished by employees, ratepayers and suppliers.[8/] These same balance sheets also reveal that when the accounting definition of working capital, namely, current assets less current liabilities, is considered, respondent's working capital amounted to a negative $51,300,000 as of December 31, 1961 and to a negative $59,300,000 as of December 31, 1962.[9/]

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8/

| | December 31 | |
|---|---|---|
| | 1961 | 1962 |
| Net Telephone Plant | $2,420,909,887 | $2,638,249,553 |
| Investments and Other Funds | 358,483,155 | 313,208,307 |
| Total Net Plant and Investment | 2,779,393,042 | 2,951,457,860 |
| Capital Stock and Surplus | 1,858,789,162 | 1,880,599,674 |
| Long-Term Debt | 902,000,000 | 902,000,000 |
| Advances from Affiliated Companies | - | 140,000,000 |
| AC.135, Discount on Long-Term Debt | (832,622) | (795,779) |
| AC.168, Premium on Long-Term Debt | 7,523,366 | 7,199,283 |
| Total Capitalization | 2,767,479,906 | 2,929,003,178 |
| Excess of Plant & Other Investments over Capitalization ............... | 11,913,136 | 22,454,682 |

9/

| | | |
|---|---|---|
| Current Assets | $ 170,371,937 | $ 154,810,708 |
| Current Liabilities | 221,686,205 | 214,156,295 |
| Difference | (51,314,268) | (59,345,587) |

The Commission heretofore has decided not to include in rate base the average amount of working cash a utility has on hand not supplied by stockholders. (59 Cal. P.U.C. 610, 625).

Respondent contends that the staff's cost method ignores the lag in the portion of revenues over and above expenses and taxes, which represents profit, and suggests the staff should have used the retail method. As long ago as November 24, 1930 the Commission considered and rejected the retail method and adopted the cost method (35 CRC 443, 453). It is not the common practice to earn a return on amounts accrued but not received. For example, an employee does not earn interest on wages earned but not received. A bank depositor loses interest entirely if he draws his money out between interest dates. We specifically reject the retail method because it would unreasonably require the customer to pay interest on funds he is supplying to pay a return.

Similar to its contention that respondent should earn a return on the return furnished by the ratepayers, is respondent's position that it should earn on funds provided by the ratepayers to pay debenture interest. The customers have provided the funds to be used to pay debenture interest. Respondent holds these funds and pays them to debenture holders at semiannual intervals. Ratepayers should not be required to pay a return on funds which they have already supplied and which respondent is merely holding to pay out to debenture holders.

Respondent maintained that it is able to operate with minimum cash balances because it is able to receive advances from its parent, American. Since under the Uniform System of Accounts,

advances from affiliated companies are to be repaid by the issuance of capital stock or funded debt, and since the Public Utilities Code prohibits the issuance of securities to pay expenses, it follows that advances from American are limited to expenditures for capital purposes. This Commission repeatedly has held that needed construction cash capital is not includible in rate base as an item of working cash but is an element of the cost of capital. (49 Cal. P.U.C. 107,117).

Respondent urged that if certain pending legislation before Congress involving the acceleration of the collection of corporate Federal income taxes were to become law, an additional positive working cash requirement of about $50,000,000 ultimately would be indicated under the staff's lag-and-lead approach.

We have considered all of the various contentions of respondent respecting the allowance in rate base for working cash. We find that the staff's computation of the allowance for working cash is in all respects reasonable and proper, except that the staff's computation should be modified to reflect: (1) the corrected figure of $10,392,000 for the gross California requirement and (2) the revenues, expenses, and rate of return herein found reasonable for the test year. Accordingly, we find the average intrastate amount of working cash respondent has on hand not supplied by stockholders to be $6,800,000, which amount we find reasonably should be deducted in arriving at intrastate rate base in this proceeding at the rates ordered herein.

Materials and Supplies

The staff included in the test year intrastate rate base $7,746,000 for materials and supplies. Respondent's figure for

this item is $7,839,000 or $93,000 higher than the staff's figure. This difference results from two items: separations $5,000 and Western purchase adjustment $88,000, both of which we have previously discussed. We find respondent's amount reduced by $88,000 for the Western Electric Company adjustment, or $7,751,000, reasonable for intrastate materials and supplies in the test year.

Deduction for Depreciation Reserve

The staff's test year intrastate deduction for depreciation is $440,021,000, or $1,235,000 greater than respondent's figure of $438,786,000. The staff's figure reflects the use of straight-line remaining life depreciation deduction, an increase of $552,000 for private mobile transactions and a decrease of $5,010,000 for the effect of the staff's Western purchase adjustment. Respondent's figure reflects straight-line total life depreciation deductions and a decrease of $40,000 for its treatment of the investment tax credit.

Consistent with our findings elsewhere set forth respecting depreciation expense and private mobile transactions, and our findings on the investment tax credit and on the Western purchase adjustment, we find $440,227,000 is the fair and reasonable test year intrastate deduction for depreciation for rate-fixing purposes.

Summary

Based on the evidence, the Commission finds a depreciated intrastate rate base of $1,996,533,000 to be fair and reasonable for the test year before the Commission in this proceeding. This figure is derived as follows:

| | Intrastate Test Year |
|---|---|
| Average Plant in Service | $2,476,216,000 |
| Property Held for Future Use | 2,285,000 |
| Adjustment for Western Electric Purchases | (27,692,000) |
| Adjustment for Credit Received from Western Electric | (15,000,000) |
| Materials and Supplies | 7,751,000 |
| Working Cash Allowance | (6,800,000) |
| Subtotal | 2,436,760,000 |
| Deduction for Depreciation | 440,227,000 |
| Weighted Average Depreciated Rate Base | 1,996,533,000 |

(Red Figure)

## OPERATING REVENUES

### Revenue Comparisons

Respondent's revenues from California operations since 1959, the first full year at the rates last fixed by the Commission, have shown significant increases both in total amount and per average company telephone. These trends together with the test year revenues urged by the Commission staff and by the respondent are shown below:

### REVENUE TRENDS

| Year | Total California Operations | | California Intrastate Operations | |
|---|---|---|---|---|
| | Amount | Amount Per Average Co. Telephone | Amount | Amount Per Average Co. Telephone |
| 1959 | $ 820,791,000 | $143.13 | $ | $ |
| 1960 | 898,558,000 | 146.41 | | |
| 1961 | 967,066,000 | 149.08 | | |
| 1962 | 1,055,167,000 | 152.97 | | |
| 12 Mo. Ended 7/31/63 | 1,106,806,000 | 155.19 | 924,507,000 | 129.63 |
| 1963 | 1,146,352,000 | 157.33 | | |
| Test Year Ended 9/30/62: | | | | |
| Unadjusted | 1,035,061,000 | 152.41 | 870,057,000 | 128.11 |
| Adjusted By: | | | | |
| CPUC Staff | 1,033,145,000 | 152.12 | 867,785,000 | 127.78 |
| Respondent | 1,028,469,000 | 151.44 | 863,605,000 | 127.16 |

While the Commission staff and respondent adjusted test year intrastate revenues downward by $2,272,000 and $6,452,000, respectively, respondent's actual revenues subsequent to the test period have continued to increase.

Test year intrastate operating revenues presented by the staff exceed by $4,180,000 or by about one-half of one percent, the estimate made by respondent. In developing their respective estimates, both the staff and the respondent started with the test

year total California operating revenues to which allocations and various adjustments were made. The details of the respective revenue estimates are compared in the following tabulation.

| Item | CPUC Staff Exhibits 2, 43 & 47 | Respondent Exhibits 49 Rev., 50 Rev., 51 Rev., 114 and 115 | CPUC Staff Exceeds Respondent |
|---|---|---|---|
| Unadjusted Test Year Total California Oper. Revenues (Rounded) | $1,035,061,000 | $1,035,061,000 | $ - |
| Allocated to Other Than Intrastate | 165,005,000 | 165,004,000 | 1,000 |
| Unadjusted Test Year Intrastate Oper. Rev. | 870,056,000 | 870,057,000 | (1,000) |
| Adjustments: | | | |
| Retroactive Multi-Message Unit Settlements | (227,000) | (191,000) | (36,000) |
| Retroactive Toll Settlements | 512,000 | (412,000) | 924,000 |
| Settlement Change-Digit Absorption | - | (223,000) | 223,000 |
| Base Rate Area Changes | - | (97,000) | 97,000 |
| April 1, 1962 Message Toll Rate Reduction | (1,322,000) | (1,322,000) | - |
| May 7, 1962 Private Line Rate Reduction | (1,367,000) | (1,367,000) | - |
| May 6, 1963 Message Toll Rate Reduction | - | (2,840,000) | 2,840,000 |
| Uncollectibles on Written-Off Basis | 133,000 | - | 133,000 |
| Total Intrastate Rev. Adjustments | (2,271,000) | (6,452,000) | 4,181,000 |
| Adjusted Test Year Intrastate Operating Revenue | 867,785,000 | 863,605,000 | 4,180,000 |

(Red Figure)

Allocation to Intrastate

Except for a difference in rounding of $1,000, both the Commission staff and respondent agree on the amount of $870,057,000 for the unadjusted test year intrastate operating revenues.

Adjustments for Retroactive Settlements

The Commission staff conceded that respondent's adjustments for retroactive multi-message unit settlements and retroactive toll settlements are more accurate since respondent relied on later information than that available when the staff made its presentations.

Adjustment for New Settlements - Digit Absorption

New independent company settlement schedules and contracts were negotiated which became effective June 1, 1962, providing for additional allowances to independent companies for the incremental cost of digit absorbing selectors and for other changes. No part of the effect of these new settlements was paid or booked by respondent in the test year. Respondent reduced test year intrastate revenues by $223,000 to give effect to these new settlement arrangements. The staff made no adjustment for this item. In support of the $223,000 adjustment, Exhibit 117, respondent used the Novato office costs of $2.23 per station for all independent company offices, except those of General Telephone Company, even though the Novato office is nontypical of the other offices in that it is a combined crossbar and step-by-step office which would give higher costs. Furthermore, three separate amounts were rounded upward by $20,000 each, for a total of $60,000, on a judgment basis without any attempt being made on the part of respondent's witness to check what amount, if any, respondent was actually paying in settlements for this item.

Base Rate Area Expansion

Respondent reduced test year intrastate revenues by $97,000 for base rate area expansions made not only during the test year but through April 1963, as well. No revenue adjustments were made by the Commission staff for normal month-by-month changes such as for base rate area changes and directory advertising rate increases. While respondent reduced test year revenues for periodic tariff changes involving base rate area expansions, it did not increase test year revenues for periodic tariff changes involving increases in directory advertising rates, for example. Such directory advertising rate increases made effective during the test year but not reflected in test year intrastate revenues amounted to $310,680. This amount of increase would have been even greater had the directory advertising rate changes been considered through April 1963 as was done by respondent for base rate area expansions.

April 1, 1962, Message Toll Rate Reduction

Respondent filed revised tariffs under its Advice Letter 8174 on March 26, 1962, reducing its intrastate rates for message toll telephone service, such tariffs becoming effective on less than statutory notice, namely, on April 1, 1962, pursuant to Commission Resolution T-4915. Said Advice Letter indicated that respondent estimated the reduced rates would have the effect of reducing its intrastate revenues by approximately $2,600,000 annually after settlements with independent companies. Further, said Advice Letter indicated that these reduced rates were filed to reflect certain changes in separations procedures and practices which respondent estimated would have the effect of reducing California intrastate

annual revenue requirements by some $2,500,000. This estimate was made by respondent prior to such separations changes becoming effective. The reduced rates were effective during a portion of the test year, namely, from April 1, 1962, through September 30, 1962. Both the Commission staff and the respondent made a downward adjustment of $1,322,000 to the intrastate test year revenues for the stated purpose of reflecting the effect of these reduced rates for the entire twelve months of the test year. However, the estimate of the amount of these reductions merely represents a mathematical repricing of the traffic sometime prior to the rate change and neither the Commission staff nor the respondent presented any evidence showing that respondent's revenues actually had declined as a result of this rate change subsequent to its becoming effective.

May 7, 1962, Private Line Rate Reduction

Reduced intrastate private line rates voluntarily were filed on April 6, 1962, by respondent under Advice Letter 8184 which became effective on May 7, 1962, under Commission Resolution No. T-4940. Under this tariff filing respondent made a new offering of TELPAK channels and service, reduced the interdistrict area channel mileage rates, established channel terminal rates in lieu of station and local channel charges, and eliminated drop service and conference service charges. Such Advice Letter also indicates that respondent estimated, prior to such reduced rates becoming effective, its annual intrastate revenues would be decreased by $2,300,000 as a result of these rate changes. These reduced rates were effective during a portion of the test year, namely, from May 7, 1962, through September 30, 1962. Both the Commission

staff and the respondent made a downward adjustment of $1,367,000 to the intrastate test year revenues for the stated purpose of reflecting the effect of these reduced rates for the entire test year. However, this reduction merely represents an estimate made sometime prior to the effective date of the rate reduction and neither the Commission staff nor the respondent presented evidence showing the extent, if any, that respondent's revenues actually had declined as a result of this rate change subsequent to its becoming effective.

May 6, 1963, "After 9" Message Toll Rate Reduction

On April 17, 1963, respondent voluntarily filed revised tariffs under its Advice Letter 8461 reducing its intrastate message toll telephone rates over certain distances for station service between the hours after 9 p.m. and before 4:30 a.m. Such tariffs became effective on less than statutory notice, namely, on May 6, 1963, pursuant to Commission Resolution T-5182. This was about seven months after the end of the test year. Sometime prior to April 17, 1963, respondent estimated that its intrastate test year revenues would be reduced by $2,840,000 as a result of this change. Respondent's estimate assumed no stimulation in usage resulting from the off-peak reduced rates although the apparent purpose of the reduction was to achieve greater use of off-peak facilities. Furthermore, the estimate assumed that there would be a 20 percent shift of person traffic to "after 9" station traffic and a substantial shift of 6 p.m. to 9 p.m. station traffic to "after 9" traffic. Respondent did not adjust traffic expenses downward to reflect its assumed shift of person traffic to station traffic. The estimate is a mere mathematical

calculation based on assumptions which are not supported by experience subsequent to the time the rates became effective. There is no evidence showing that respondent's revenues actually have declined as a result of this rate change subsequent to its becoming effective.

Uncollectibles

Respondent claimed $4,625,000 for intrastate uncollectibles in the test year. The Commission staff urged $4,492,000 for this item, a difference of $133,000. Respondent's figure represents the intrastate allocation of the accrual to the reserve for uncollectibles during the test period without adjustment. The staff's figure represents the intrastate allocation of actual uncollectible writeoffs during the test period reduced by $13,000 to give effect to the reduction in message toll rates which became effective on April 1, 1962. While respondent reduced test period intrastate revenues by $6,452,000, it did not reduce uncollectibles by any amount. The balance in the reserve for uncollectibles has increased year by year from $653,711 at the end of 1957 to $1,173,809 at the end of 1961 and to $1,537,765 at the end of 1962. This indicates that the accruals have consistently exceeded the actual net losses.

TWX Burden on Other Users

The teletypewriter exchange (TWX) operating results of respondent in the test year are included with its message toll operations. The most recent results of TWX operations are set forth in Exhibit 2 for the year 1960 as follows:

TWX Operations for Year 1960

| | |
|---|---|
| Operating Revenue | $2,349,533 |
| Operating Expenses and Taxes | 2,481,400 |
| Balance Net Revenue | (131,867) |
| Average Net Plant and Working Capital | 10,024,607 |
| Rate of Return | (1.32)% |

(Red Figure)

In Decision No. 56652, dated May 6, 1958 (56 CPUC 277) issued in respondent's last rate proceeding, the Commission found a toll schedule designed to produce a 7.7% rate of return to be fair and reasonable. Additional TWX operating revenues of approximately $2,000,000 would be required to increase the negative 1.32% return to a positive 7.7% return for 1960 TWX operations. Despite several requests by the Commission staff during the course of these proceedings respondent did not make available later information, than the 1960 results, on the earning level of its TWX operations. The 1960 TWX earning results are the best information available in this record. While the Commission staff did not make an upward adjustment of $2,000,000 in its test year results of operations exhibits presented in this proceeding because of the anticipation that more current TWX earning figures could finally be obtained from respondent, the Commission staff in its brief and argument urged that the message toll revenues of respondent shown in Exhibit 43 be adjusted upward by $2,000,000 prior to the setting of message toll rates. The Commission staff urged that unless this adjustment is made, TWX operations will continue to be an unfair and unreasonable burden on the ordinary user of message toll service in California.

Respondent's TWX service is a specialized service used by relatively few customers. It is competitive with services offered by Western Union Telegraph Company. Respondent in its motion requesting rate increases of $43,953,000 has not requested general increases in rates for TWX service for reasons best known to itself.

Deficient Private Line Earnings

Effective May 7, 1962, respondent voluntarily reduced its intrastate toll private line rates by $2,343,000 with the introduction of TELPAK service (Exhibit 51 Revised, page 12). The Commission staff and the respondent each made an identical downward adjustment to test year intrastate revenues to reflect this rate reduction for the full test year. The staff in Exhibit 43, page 6, shows a resulting rate of return of 6.71 percent for respondent's test year intrastate toll private line operations. The staff maintained that additional private line revenues of approximately $640,000 would be required to increase private line earnings from 6.71 percent, as developed by the staff, to 7.7 percent so that the private line service would not be a burden on users of regular message toll telephone service.

Respondent's private line services are developed for specialized users and are competitive with services of Western Union Telegraph Company and others.

Summary

We find that the staff's and the respondent's proposed adjustments to test year revenues relate to the category of so-called level or period changes with the exception of the staff's proposed adjustment to uncollectibles to reflect actual uncollectible writeoffs during the test year. For the reasons heretofore given, we find that adjustments to test year revenues for settlements and rate changes have not been justified. We further find that an allowance of $4,625,000 for intrastate test year uncollectibles is reasonable.

We find that the issues raised with respect to teletypewriter exchange and private line rates should be left for determination in connection with the phase of this proceeding involved with the final rate spread or in such other manner as may be deemed to be appropriate.

Based on the evidence, the Commission finds that the amount of $870,057,000 represents a fair and reasonable estimate of respondent's test year California intrastate gross revenues, after reasonable allowance for uncollectibles, under present rates and charges.

## OPERATING EXPENSES

### Expense Comparisons

Respondent's reported expenses, excluding depreciation and taxes, for its total California operations have increased by approximately $140,726,000, or by 36.1 percent between 1959 and 1963. Revenues during this same period have increased by about $325,561,000, or by 39.7 percent. Comparisons of the trend in expenses from 1957 through 1963 applicable to total California operations with test year amounts urged by the Commission staff and by respondent and with related revenues are set forth in the following tabulation. Test year total California operating expenses, excluding depreciation and taxes, urged by respondent for rate fixing purposes are $31,827,000, or 6.7 percent higher than its reported actual expenses for the same period, and $35,902,000 higher than such expenses urged by the staff.

| Year | Operating Revenues | Operating Expenses Excluding Depreciation and Taxes | Net Revenue Before Depreciation and Taxes | * Expenses Per $100 of Revenue | Amount Per Average Company Telephone | | |
|---|---|---|---|---|---|---|---|
| | | | | | Revenues | * Expenses | Net Revenue Before Depreciation and Taxes |
| **Total California Operations** | | | | | | | |
| 1957 | $ 671,786,000 | $375,240,000 | $296,546,000 | $55.86 | $132.10 | $73.78 | $58.32 |
| 1958 | 735,259,000 | 379,115,000 | 356,144,000 | 51.56 | 137.10 | 70.69 | 66.41 |
| 1959 | 820,791,000 | 389,380,000 | 431,411,000 | 47.44 | 143.13 | 67.90 | 75.23 |
| 1960 | 898,558,000 | 428,421,000 | 470,137,000 | 47.68 | 146.41 | 69.81 | 76.60 |
| 1961 | 967,066,000 | 446,556,000 | 520,510,000 | 46.18 | 149.08 | 68.84 | 80.24 |
| 1962 | 1,055,167,000 | 483,299,000 | 571,868,000 | 45.80 | 152.97 | 70.06 | 82.91 |
| 1963 | 1,146,352,000 | 530,106,000 | 616,246,000 | 46.24 | 157.33 | 72.75 | 84.58 |
| Test Year Unadjusted | 1,035,061,000 | 472,999,000 | 562,062,000 | 45.70 | 152.41 | 69.65 | 82.76 |
| Adjusted by: | | | | | | | |
| CPUC Staff | 1,033,145,000 | 468,923,000 | 564,222,000 | 45.39 | 152.12 | 69.05 | 83.07 |
| Respondent | 1,028,469,000 | 504,826,000 | 523,643,000 | 49.09 | 151.44 | 74.33 | 77.11 |
| **California Intrastate Operations** | | | | | | | |
| Test Year Unadjusted | 870,057,000 | 396,144,000 | 473,913,000 | 45.53 | 128.11 | 58.33 | 69.78 |
| Adjusted by: | | | | | | | |
| CPUC Staff | 867,785,000 | 388,936,000 | 478,849,000 | 44.82 | 127.78 | 57.27 | 70.51 |
| Respondent | 863,605,000 | 421,268,000 | 442,337,000 | 48.78 | 127.16 | 62.03 | 65.13 |

* Excluding depreciation and taxes.

Respondent's reported net revenues before depreciation and taxes per average company telephone have increased from $75.23 in 1959 to $84.58 for the year 1963. While there have been year-by-year increases in respondent's wage rates, respondent's reported expenses before depreciation and taxes per average company telephone declined from $73.78 in 1957 to a low of $67.90 in 1959 and were $72.75 for the year 1963. Respondent's revenues per average company telephone have continued an upward trend from $143.13 for 1959 to $157.33 for 1963. Respondent's downward adjustments to test year revenues and upward adjustments to test year expenses had the effect of reducing the reported test year net revenues before taxes and depreciation by $5.65 per average company telephone, from the reported $82.76 figure to $77.11. This compares with the reported figures for 1962 of $82.91 and for 1963 of $84.58.

Test year intrastate operating expenses, excluding depreciation and taxes, presented by respondent are $32,332,000, or 8.3 percent, higher than the amount urged by the staff. In developing their respective estimates, both the staff and respondent started with the test year total California operating expenses as reported by respondent, to which allocations and adjustments for rate fixing purposes were made. The major differences between the presentations result from the difference in treatment accorded increases in wage rates, pensions and other

fringe benefits awarded from time to time during the test year and subsequent to the end of the test year. Differences in the respective expense estimates are compared below:

OPERATING EXPENSES, EXCLUDING TAXES AND DEPRECIATION

| Item | CPUC Staff Exhibits 2, 43 & 47 | Respondent Exhibits 49 Rev., 50 Rev., 51 Rev., 114, 115, 116 and 124 | CPUC Staff Exceeds Respondent |
|---|---|---|---|
| Unadjusted Test Year Total Calif. Operating Expenses, Excluding Depreciation and Taxes | $472,999,000 | $472,999,000 | $ - |
| Separated to Other than Intrastate | 80,394,000 | 77,921,000 | 2,473,000 |
| Subtotal | 392,605,000 | 395,078,000 | (2,473,000) |
| Intrastate Adjustments | | | |
| Wage Increases 1962 and 1963 | - | 18,456,000 | (18,456,000) |
| Relief and Pensions | (1,998,000) | 6,604,000 | (8,602,000) |
| Western Electric - Maint. Expense | (1,720,000) | - | (1,720,000) |
| General Services and License - Cost Basis | (541,000) | - | (541,000) |
| Dues, Donations and Contributions | 145,000 | 542,000 | (397,000) |
| Postal Rate Increases | 462,000 | 591,000 | (129,000) |
| Legislative Advocacy | (17,000) | - | (17,000) |
| Maintenance Expense Adj. - Retroactive Depreciation | - | 2,000 | (2,000) |
| Maintenance Expense Adj. - Investment Tax Credit | - | (5,000) | 5,000 |
| Total Intrastate Adjustments | (3,669,000) | 26,190,000 | (29,859,000) |
| Adjusted Intrastate Operating Expenses, Excluding Depreciation and Taxes | 388,936,000 | 421,268,000 | (32,332,000) |

(Red Figure)

We have already discussed the difference in separations, the Western Electric expense adjustments and the investment tax credit. The other differences are discussed next.

Adjustments made by respondent to its test year results of operations for wages, pensions and other fringe benefits, including payroll taxes, have the effect of reducing test year net revenues by $12,852,000 for total California operations ($10,546,000 for intrastate operations) and reducing rate of return by approximately one-half of one percent as set forth in the following tabulation:

ADJUSTMENTS MADE BY RESPONDENT
TO ITS TEST YEAR RESULTS OF OPERATIONS
FOR WAGES, PENSIONS AND OTHER FRINGE BENEFITS
INCLUDING PAYROLL TAXES

| Adjustments to: | Total California Operations | California Intrastate Operations |
|---|---|---|
| Expenses | | |
| Current Maintenance | $ 9,264,000 | $ 7,580,000 |
| Traffic Expenses | 6,715,000 | 5,085,000 |
| Commercial Expenses | 4,261,000 | 3,852,000 |
| General Office Salaries and Expenses | 2,270,000 | 1,939,000 |
| Other Operating Expenses | 8,033,000 | 6,604,000 |
| Total Expenses | 30,543,000 | 25,060,000 |
| Taxes | | |
| Payroll Taxes | 291,000 | 239,000 |
| Federal Income | (16,172,000) | (13,267,000) |
| Other Taxes | ( 1,810,000) | ( 1,486,000) |
| Total Taxes | (17,691,000) | (14,514,000) |
| Total Expenses and Taxes | 12,852,000 | 10,546,000 |
| Net Revenue | (12,852,000) | (10,546,000) |
| Rate of Return | (.53)% | (.51)% |

(Red Figure)

Supervisory Positions

The General Services Administration (GSA) presented testimony and Exhibit 111 and recommended that the Commission disallow approximately $2,500,000 of executive salaries charged in the test year to respondent's California operations (approximately $2,150,000 intrastate) for rate-making purposes. GSA maintained that for respondent's California operations the number of executives at division level and higher increased from 201 in 1956 to 334 in 1962 (a 66% increase) and they were paid aggregate salaries applicable to California of $3,125,967 in 1956 and $7,217,687 in 1962 (a 131% increase); that in the same period respondent's California employee force declined from 71,926 to 67,522 (a 6% decrease); that in 1956 to conduct its operations in Washington, Oregon and Idaho, as well as in California, respondent had 285 executives at division level and higher and a total employee force of 89,685; that in 1956 respondent administered approximately the same number of main telephones in an area twice its present size with 15% fewer executives; that respondent's California executive salaries increased from $.92 per main station in 1956 to $1.64 in 1962; that respondent's executive expense is excessive for rate-making purposes; and that the burden of excessive executive expense should not be imposed on the California ratepayer.

While GSA's exhibit and testimony referred to "executive" salaries and positions, the real thrust of GSA's presentation was directed at supervisory positions at division level or higher. A summary of the information contained in GSA Exhibit 111 follows:

Number and Compensation of Executives, Division Level and Higher and Other Statistics

| Item | | Total PT&T Company// 1956 Number | Total PT&T Company// 1956 Compensation | California Operations 1956 Number | California Operations 1956 Compensation | California Operations 1962 Number | California Operations 1962 Compensation |
|---|---|---|---|---|---|---|---|
| Executives: | | | | | | | |
| President | I | 1 | $ 122,500 | 1 | $ 96,082 | 1 | $ 99,035 |
| Vice President | II | 11 | 366,950 | 9 | 249,063 | 8 | 310,167 |
| Vice President | III | 4 | 110,862 | 4 | 110,862 | 6 | 210,079 |
| Asst. Vice President | IV | 32 | 572,601 | 26 | 389,761 | 35 | 874,541 |
| Department Head | V | 26 | 534,092 | 18 | 322,212 | 38 | 860,356 |
| Division Head | VI | 211 | 3,015,184 | 143 | 1,957,986 | 246 | 4,863,508 |
| Total | | 285 | 4,722,189 | 201 | 3,125,967 | 334 | 7,217,687 |

| Other Statistics: | Number or Amount | Number or Amount | Number or Amount |
|---|---|---|---|
| No. of Employees | 89,685 | 71,926 | 67,522* |
| Total Wage Payments | $ 408,000,000 | $ 325,000,000 | $ 416,000,000* |
| Plant in Service | $2,232,000,000 | $1,760,000,000 | $2,922,000,000 |
| Operating Revenues | $ 781,000,000 | $ 616,000,000 | $1,041,000,000 |
| No. of Central Offices | 1,097 | 788 | 956 |
| No. of Main Stations | 4,354,000 | 3,383,000 | 4,388,000 |

* Year ending September 30, 1962.

// Included operations in Washington, Oregon, Idaho and California

The testimony of the GSA witness on executive salaries was the only testimony given by any witness on the results of operation phase of the proceeding on which respondent did not present rebuttal evidence. Respondent did, however, cross-examine the GSA witness.

Respondent argues that the GSA presentation is replete with errors, guesswork and misconceptions and is entitled to no weight. The principal infirmities in the GSA presentation according to respondent are:

1. GSA estimated the salaries of 215 out of the 334 employees GSA designated as management in 1962 using an average salary of $19,500 for each of the 215.

2. GSA made no job or functional analyses of the positions assigned by GSA to management.

3. While approximately one-half of one percent of respondent's work force is personnel of division level and above, GSA had made no comparison of the corresponding percentage for other corporations or organizations of comparable size.

4. GSA's reference to emoluments of division level and higher is unsupported.

5. The personal judgment of GSA's witness played a substantial part in his calculations.

6. GSA's calculations included job titles which were vacant and GSA's witness had no particular knowledge of respondent's job classifications.

The record reveals (Tr. 1075-1090) that GSA by letter of January 30, 1963, requested respondent to furnish information on current and historical organization tables and annual compensation

of its key personnel and that respondent by letter of February 6, 1963, advised GSA that it was impracticable for respondent to supply GSA with organization charts for past years or to provide the salary information requested by GSA. GSA modified its initial request on March 8, 1963, requesting respondent to provide organization charts for the years 1953 and 1956 and further requesting that annual salaries of respondent's staff at division level and higher be identified on the organization charts or in a separate submission. Respondent declined to furnish such information to GSA, claiming excess work effort to supply the data. Not having the precise information supplied by respondent as requested, GSA used sources of information at its disposal such as respondent's annual reports filed with the Federal Communications Commission and its responses to General Order No. 77 of this Commission in preparing its estimates contained in Exhibit 111.

The record discloses no reason for the substantial increase in compensation for and number of supervisory personnel at division level and higher in light of the split-off of the Oregon, Washington and Idaho properties and operations and the reduction in personnel revealed by the evidence.

We find that the amount charged for such salaries in the test year operating expenses for rate-making purposes is excessive and should be reduced by $2,500,000 applicable to California operations and by $2,150,000 applicable to intrastate operations.

Wages

Amounts included by respondent for wages in its adjusted intrastate test year expenses, exclusive of depreciation and taxes, exceed by $18,456,000 the amounts included by the staff in its exhibits. The recommendation of the General Services Administration with respect to executive salaries has been discussed under a separate heading.

Respondent actually recorded on its books of accounts in the test year for total California operations $416,280,000 for wages, charging $331,674,000 of the total amount to California operating expenses and $84,606,000 to construction and removals. The Commission staff made no adjustments to the wages that were recorded as paid in the test year. Respondent, on the other hand, included not only all wages that were recorded as paid in the test year but also included in its adjusted test year California operations $28,587,000 of additional wages, allocating $22,510,000 to total California operating expenses ($6,077,000 to construction and removals) and $18,456,000 to California intrastate operating expenses. Respondent maintained that these additional amounts for wages must be included in the test year; first, to give full twelve-month test year effect to increases in wage rates awarded from time to time during the test period (October 1, 1961 through September 30, 1962); and second, to give full twelve-month test year effect to all increases in wage rates awarded from time to time subsequent to the end of the test year, September 30, 1962. The following tabulation shows in more detail the adjustments made by respondent to test year wages.

ADJUSTMENTS MADE BY RESPONDENT TO WAGES
Test Year Ending September 30, 1962

| Item | Total California Operations: Wages Charged Construction, Removals & Expense | Total California Operations: Wages Charged Expense | Intrastate Operations Wages Charged Expense |
|---|---|---|---|
| Unadjusted Test Year | $416,280,000 | $331,674,000 | $272,404,000 |
| Adjustments made by Respondent | | | |
| 1962 Increase in Wage Rates not paid in Test Year | 12,543,000 | 9,976,000 | 8,210,000 |
| 1963 Increase in Wage Rates | 16,044,000 | 12,534,000 | 10,246,000 |
| Total Adjustments for Wages | 28,587,000 | 22,510,000 | 18,456,000 |
| Respondent's Adjusted Test Year | 444,867,000 | 354,184,000 | 290,860,000 |

Respondent's adjustment of $16,044,000 shown above for 1963 increases in total California wage rates charged construction, removals and expense includes $15,533,000 for increases in wage rates and $511,000 for vacation liberalization.

The increase in 1962 wages which respondent folded back to the beginning of the test year was not fully included in its recorded results until about August 1963. None of the 1963 wage increase which respondent folded back to the beginning of the test year was paid by respondent until May 1963, when a small amount was paid to executive personnel. Most of the 1963 wage increase which respondent folded back into the test year started in August and September, 1963 and will not be fully recorded in respondent's results until the fall of 1964.

The subject of wage payments has played a prominent part in each application of respondent for a general increase in rates since 1940. In its Application No. 31300, filed on April 14, 1950, respondent alleged:

> "While the increased annual revenues resulting from rate increases authorized by this Commission since 1940 amount to about $59,000,000, the increased wage payments and related wage costs chargeable to applicant's California intrastate operating expenses, which result from higher wage rates bargained and granted since 1940, alone amount to approximately $70,000,000 annually."

In said Application No. 31300 respondent asked for an annual revenue increase of $36,000,000. By Decision No. 44923 dated October 19, 1950, the Commission dismissed the application (50 CPUC 247). By Decision No. 46270, dated October 8, 1951, in Application No. 32640, the Commission granted in entirety respondent's request for a $14,452,000 annual increase in revenues to cover wage increases (51 CPUC 154). By Decision No. 51143, dated March 1, 1955, in Application No. 33935, the Commission denied entirely respondent's request for an annual increase in revenues to cover increase in wages of $4,980,000 (54 CPUC 58). On August 7, 1957, respondent filed Application No. 39309 requesting an increase of $28,781,000, and on November 29, 1957, filed an amendment thereto requesting an additional annual increase of $12,018,000 to offset wage increases, revised pension accruals and depreciation rates. The total annual increase in revenues granted by Decision No. 56652, dated May 6, 1958, was $27,500,000 out of a total requested amount of $40,799,000. Thus, in each of the rate proceedings the Commission has made a determination for rate-making purposes of the reasonable amount allowable for expenses, including wages, rate base and revenues based upon the record made in each proceeding.

The results of operations presented by the staff and by respondent are based on the jointly selected test year commencing

October 1, 1961, and ending on September 30, 1962, that being the most recent period available. This test period has been relied upon by all parties to the proceeding. In making its analysis of the test year results of operations the Commission staff concluded that regularly occurring changes in revenues and expenses tend to be offsetting and, accordingly, made neither an adjustment for the increased wage rates nor for the long-term trend of increased revenues per telephone. It was the staff's position that respondent had absorbed the annual wage increases awarded each year since 1959 through increased revenues, increased productivity in plant and operating forces and other factors and that through the operation of these same factors it could absorb the wage increases it had negotiated and granted in 1962 and in 1963 if the Commission should enter a rate reduction order. Further, the staff contended that in setting rates for the future if it is proper to include the future effect of wage increases (which is respondent's method), then it would be equally proper that an adjustment for the effect of increases in revenue per telephone should also be made. Respondent's position is that it cannot absorb these wage increases without increases in rates and that economies of operation which were effected in the '50's have run their course and exhausted their effect to offset to some degree increases in wage expense.

The procedure followed by respondent in adjusting test year wages essentially was to reprice base period labor hours to reflect new wage rates. However, wage rates by themselves do not produce increased labor costs.[10] The number of employees, composition of the force, salary level, productivity of plant and operating

10/ Respondent awarded increases in wage rates in 1957 but respondent's total California wage payments declined from $352,269,000 in 1957 to $347,509,000 in 1958, a reduction of $4,760,000.

forces, the state of technology, extent of construction, and overtime policy, as well as other factors, acting together result in the total wage bill. It is not enough to look at only wage rates or expenses in considering test year results of operations. Trends in earnings and trends in revenues in relation to expenses and to net plant also are important factors, among others, to consider.

We examine first the trends in reported earnings. On a consolidated basis respondent reported earnings per share of common stock of $1.39 for the test year ending September 30, 1962, compared with $1.42 for the year 1962 and $1.45 for the year 1963. Trends in earnings and dividends per common share on a consolidated basis and the trend in California net operating income per $100 of average net plant in service follow:

| Year | PACIFIC COMPANY AND SUBSIDIARY CONSOLIDATED: Earnings Per Share of Common Stock | Dividends Per Share of Common Stock | CALIFORNIA: Net Operating Income Per $100 of Average Plant in Service Less Depreciation Reserve |
|---|---|---|---|
| 1957 a | $ 1.09 | $ 1.00 | $ 5.91 |
| 1958 b | 1.13 | 1.00 | 6.26 |
| 1959 c | 1.47 | 1.07 | 7.11 |
| 1960 | 1.39 | 1.14 | 6.85 |
| 1961 | 1.43 | 1.155 | 6.35 |
| 1962 | 1.42* | 1.20 | 6.96 |
| 1963 | 1.45* | 1.20 | 6.95 |
| Test Year | | | |
| Unadjusted | 1.39* | 1.20 | 6.72 |
| Adjusted by Respondent | 1.24* | | 6.10 |

a. Application No. 39309 to increase rates filed August 7,1957.
b. Decision No. 56652 authorizing increases in rates issued May 6, 1958.
c. First full year at rates authorized by Decision No. 56652.
* Reflects normalization of investment tax credit.

The above reported earnings per common share do not reflect the flow through to net income of the reduction in Federal income taxes resulting from the investment tax credit. On an investment

tax credit flow through basis the earnings per common share would have been $1.47 for 1962 and $1.52 for 1963. Respondent does not avail itself of liberalized depreciation in computing Federal income taxes. Total adjustments made by respondent to test year net income are equivalent to a reduction in earnings of about 15 cents per common share, of which 12 cents is attributable to its adjustments for wages and benefits including payroll taxes.

Respondent reported its unappropriated earned surplus at $178,935,000 at the end of 1961, $200,746,000 at the end of 1962 and $226,343,000 at the end of 1963, an increase of $47,408,000 or 26 percent, in two years. These amounts would have been greater by $5,390,000 for 1962 and greater by $6,768,000 for 1963 (a total of $12,158,000) if respondent had flowed through to net income the reduction in Federal income taxes resulting from the investment tax credit in those two years.

The trends in respondent's reported California wages are set forth in the tabulation below:

RESPONDENT'S TOTAL CALIFORNIA OPERATIONS
TRENDS OF WAGES

| Year | Total Wages Charged Construction Removals & Expense | | Wages Charged Construction & Removals | | Wages Charged Expense | |
|---|---|---|---|---|---|---|
| | Amount | Increase | Amount | Increase | Amount | Increase |
| a 1957 | $352,269,000 | $27,680,000 | $69,423,000 | $14,967,000 | $282,846,000 | $12,713,000 |
| b 1958 | 347,509,000 | (4,760,000) | 65,753,000 | (3,670,000) | 281,756,000 | (1,090,000) |
| c 1959 | 355,083,000 | 7,574,000 | 65,702,000 | (51,000) | 289,381,000 | 7,625,000 |
| 1960 | 381,611,000 | 26,528,000 | 68,561,000 | 2,859,000 | 313,050,000 | 23,669,000 |
| 1961 | 392,838,000 | 11,227,000 | 71,879,000 | 3,318,000 | 320,959,000 | 7,909,000 |
| 1962 | 425,777,000 | 32,939,000 | 87,614,000 | 15,735,000 | 338,163,000 | 17,204,000 |
| 1963 | 458,930,000 | 33,153,000 | 100,750,000 | 13,136,000 | 358,180,000 | 20,017,000 |
| Test Year Unadjusted | 416,280,000 | | 84,606,000 | | 331,674,000 | |
| Adjusted by Respondent | 444,867,000 | | 90,683,000 | | 354,184,000 | |

a. Application No.39309 requesting increases in rates was filed August 7, 1957.
b. Decision No.56652 authorizing increases in respondent's rates was issued May 6, 1958.
c. First full year at rates authorized by Decision No. 56652.
(Decrease)

The comparison shown below of the year-by-year increases in respondent's California revenues and California wages charged expense is significant.

Respondent's Total California Operations

| Year | Annual Increase in Revenues | Annual Increase in Wages Charged Expense | Annual Increase in Revenues Less Wages Charged Expense |
|---|---|---|---|
| 1957 | $58,249,000 | $12,713,000 | $45,536,000 |
| 1958 | 63,473,000 | (1,090,000) | 64,563,000 |
| *1959 | 85,532,000 | 7,625,000 | 77,907,000 |
| 1960 | 77,767,000 | 23,669,000 | 54,098,000 |
| 1961 | 68,508,000 | 7,909,000 | 60,599,000 |
| 1962 | 88,101,000 | 17,204,000 | 70,897,000 |
| 1963 | 91,185,000 | 20,017,000 | 71,168,000 |

(Red Figure)

* First full year at rates authorized by Decision No. 56652.

The effect of respondent's test year California adjustments was to reduce by $6,592,000 the recorded annual increase in revenues and to increase by $22,510,000 the recorded annual increase in wages charged expense, thus reducing the recorded annual increase in revenues less wages charged expense by $29,102,000.

We examine next the trends in respondent's reported California wages per $100 of revenues. The test year California operations as adjusted by respondent includes $34.44 of wages charged expense for each $100 of revenue. This is $2.40 more per $100 of revenue than actually experienced in the test year, $2.39 more per $100 of revenue than experienced in the year 1962 and $3.19 more per $100 of revenue than experienced in 1963.

California Operations

| Year | Annual Wages Charged Construction, Removals and Expense Per $100 of Revenue | Annual Wages Charged Expense Per $100 of Revenue |
|---|---|---|
| 1957 | $52.44 | $42.10 |
| 1958 | 47.26 | 38.32 |
| *1959 | 43.26 | 35.26 |
| 1960 | 42.47 | 34.84 |
| 1961 | 40.62 | 33.19 |
| 1962 | 40.35 | 32.05 |
| 1963 | 40.03 | 31.25 |
| Test Year | | |
| Unadjusted | 40.22 | 32.04 |
| Adjusted by Respondent | 43.26 | 34.44 |

*First full year at rates authorized by Decision No. 56652.

Trends in respondent's reported California revenues and wages per average telephone are next examined. In its adjusted test year California results, respondent has matched $151.44 of revenue per average telephone against $52.15 of wages charged expenses per average telephone resulting in the net figure of $99.29 per average telephone. Respondent's figure of $99.29 of revenues less wages charged expense per average telephone is $4.28 per average telephone less than experienced in the test year, $4.66 per average telephone less than experienced in the year 1962 and $8.88 per average telephone less than experienced in the year 1963. The tabulation below demonstrates the imbalancing of the relation between revenues and wages accomplished by respondent's wage adjustments for the test year.

Respondent's Total California Operations
Trends of Revenues and Wages Per Average Telephone

| Year | Revenues Per Average Telephone | | Wages Charged Expense Per Average Telephone | | Revenues Less Wages Charged Expense Per Average Telephone | |
|---|---|---|---|---|---|---|
| | Amount | Increase | Amount | Increase | Amount | Increase |
| 1957 | $132.10 | $1.16 | $55.62 | $(2.04) | $ 76.48 | $3.20 |
| 1958 | 137.10 | 5.00 | 52.54 | (3.08) | 84.56 | 8.08 |
| *1959 | 143.13 | 6.03 | 50.46 | (2.08) | 92.67 | 8.11 |
| 1960 | 146.41 | 3.28 | 51.01 | .55 | 95.40 | 2.73 |
| 1961 | 149.08 | 2.67 | 49.48 | (1.53) | 99.60 | 4.20 |
| 1962 | 152.97 | 3.89 | 49.02 | (.46) | 103.95 | 4.35 |
| 1963 | 157.33 | 4.36 | 49.16 | .14 | 108.17 | 4.22 |
| Test Year | | | | | | |
| Unadjusted | 152.41 | | 48.84 | | 103.57 | |
| Adjusted by Respondent | 151.44 | | 52.15 | | 99.29 | |

(Red Figure)

*First full year at rates authorized by Decision No. 56652.

Respondent's total California revenues per average telephone increased from $152.41 for the test year to $157.33 for the year 1963, an increase of $4.92 per average telephone. In the same period, respondent's total California wages charged construction, removals and expense increased by $1.69 per average telephone (from $61.29 to $62.98) while total California wages charged expense increased by $.32 per average telephone (from $48.84 to $49.16). As indicated below, respondent's total California wages charged expense increased by $26,506,000 between the test year and the year 1963, while its revenues increased by $111,291,000 in the same period.

COMPARISON OF INCREASES IN REVENUES AND WAGES

| | Test Year 12 Months Ending Sept. 30, '62 | Year 1963 | Year 1963 Exceeds Test Year |
|---|---|---|---|
| Total California Operations | | | |
| Operating Revenues | $1,035,061,000 | $1,146,352,000 | $111,291,000 |
| Amount Per Avg. Telephone | 152.41 | 157.33 | 4.92 |
| Wages Charged Construction, Removals & Expense | 416,280,000 | 458,930,000 | 42,650,000 |
| Amount Per Avg. Telephone | 61.29 | 62.98 | 1.69 |
| Wages Charged Expense | 331,674,000 | 358,180,000 | 26,506,000 |
| Amount Per Avg. Telephone | 48.84 | 49.16 | .32 |
| Operating Revenues Less Wages Charged Expense | 703,387,000 | 788,172,000 | 84,785,000 |
| Amount Per Avg. Telephone | 103.57 | 108.17 | 4.60 |

We turn next to respondent's assertion that economies of operation which were effected in the '50's have run their course and exhausted their effect to offset increases in wage expense. While the particular economies effected in the '50's may, to some extent, have run their course, new economies are to be expected from such items as dedicated outside plant, prewiring of homes and apartment units, new traffic service positions, and new and improved automated procedures to which the telephone industry is uniquely adapted. For example, lower traffic expenses per unit of revenue may be expected from the trend of respondent's operator-handled and customer-dialed toll messages in California shown below:

Toll Messages in California

| Year | Operator Handled | Customer Dialed | Total |
|---|---|---|---|
| 1957 | 184,266,000 | 25,811,000 | 210,077,000 |
| 1958 | 176,671,000 | 48,984,000 | 225,655,000 |
| 1959 | 182,537,000 | 73,582,000 | 256,119,000 |
| 1960 | 186,803,000 | 94,076,000 | 280,879,000 |
| 1961 | 186,231,000 | 109,332,000 | 295,563,000 |

The growth in toll messages since 1957 has been handled through customer dialing. As customers are encouraged to dial more of their toll calls through the inducements of convenience, advertising, and certain rate advantages, the proportion of customer-dialed toll messages reasonably may be expected to increase, thereby reducing traffic expense per dollar of toll revenue.

The record reveals many other examples of past and expected future labor and other expense savings for respondent's operations (see, for example, Exhibits 76 and 77 and testimony relating thereto). Moreover, respondent's top management can and does control the number of employees, the salary level of exempt employees, amount of overtime, standards of service and efficiency of operations.

We find that to include $22,510,000 more wages in total California expenses ($18,456,000 intrastate) than were paid in the test year as claimed by respondent, without at the same time giving effect to the offsetting effects resulting from growth in revenues and operating economies and efficiencies, so unbalances the revenue-expense-plant relationship in the test year results of operations as to render respondent's adjusted test year results of operations meaningless for rate-fixing purposes. We further find that increasing revenues and the effects of operating economies and efficiencies make it unnecessary to adjust test year wages for the effects of wage rate increases paid or awarded subsequent to the end of the test period. We find, also, that the treatment we have accorded respondent's claim for wages could not lawfully prejudice it.

C. 7409 AH*

Relief and Pensions

Account 672, Relief and Pensions, includes costs and expenses in connection with employees' service pensions, accident and sickness disability benefits, death benefits, and certain other employees' benefits. It also includes medical department expenses and other medical expenses, such as the cost of physical examinations for applicants for employment, periodic physical examinations of employees and miscellaneous medical costs. The portion of such costs and expenses applicable to construction and custom work is credited to this account.

Respondent's adjusted test year California expense for Account 672, Relief and Pensions, exceeds the test year recorded amount by $8,033,000, or by 26 percent, and exceeds the staff's amount by $10,478,000 ($8,602,000 intrastate). Approximately $5,712,000 of this California expense difference relates to service pension accruals and the balance, or $4,766,000, relates to estimated increases in other employee benefits negotiated in 1963.

In the test year respondent included in its books of account for California operations $38,413,000 for relief and pensions, charging $30,667,000 to operating expenses (Account 672) and $7,746,000 to construction and removals. Accruals to the service pension fund in the test year amounted to $25,561,000, of which $23,530,000 represented pension accrual charges computed at 6.16 percent applied to test year accruable payroll of $381,982,000 and $2,031,000 represented an amount to amortize the unfunded actuarial reserve requirement over the ten-year period ending December 31, 1968.

The trends in California expenses charged to Account 672 for the period 1957 - 1963 compared with the unadjusted and adjusted test year amounts are set forth below:

RELIEF AND PENSIONS ACCOUNT 672

| Year | Ac. 672 Relief and Pensions | Index | Annual Cost Per Avg. Company Telephone | Annual Cost Per $100 of Operating Revenue | Annual Cost Per $100 of Payroll Charged Expense |
|---|---|---|---|---|---|
| | Total California Operations | | | | |
| 1957 | $20,329,000 | 100.0 | $4.00 | $3.03 | $7.19 |
| 1958 | 22,598,000 | 111.2 | 4.21 | 3.07 | 8.02 |
| *1959 | 24,996,000 | 123.0 | 4.36 | 3.05 | 8.64 |
| 1960 | 26,843,000 | 132.0 | 4.37 | 2.99 | 8.57 |
| 1961 | 30,026,000 | 147.7 | 4.63 | 3.10 | 9.36 |
| 1962 | 30,485,000 | 150.0 | 4.42 | 2.89 | 9.01 |
| 1963 | 31,746,000 | 156.2 | 4.36 | 2.77 | 8.84 |
| Test Year Unadjusted | 30,667,000 | 150.9 | 4.52 | 2.96 | 9.25 |
| Adjusted by: CPUC Staff | 28,222,000 | 138.8 | 4.16 | 2.73 | 8.51 |
| Respondent | 38,700,000 | 190.4 | 5.70 | 3.76 | 10.93 |

* First full year at rates authorized by Decision No. 56652.

Respondent's adjusted test year amount is at considerable variance from the trends through the year 1963.

Net charges to Account 672 for the year 1962 amounted to $30,485,161 as set forth below. Of the $7,141,027 paid directly to beneficiaries in 1962, about $744,459 was not covered by any formal pension or benefit plan which had been adopted by respondent. At the end of 1962 respondent was paying 6,563 service pensions, 716 disability, 1 special and 86 supplementary pensions. Financing of the service pensions is on an accrual basis, while financing of the disability, special and supplementary pensions is on a pay-as-you-go

basis[11/] as are the other direct payments to beneficiaries shown below.

California Operations
Account 672, Relief and Pensions
Year 1962

| Item | Amount |
| --- | --- |
| Payments to Trustees or Insurers Charges for Service Pensions | $25,938,502 |
| Premiums for group life and extraordinary medical insurance | 3,497,856 |
| Subtotal | 29,436,358 |
| Direct Payments to Beneficiaries, Disability, Special and Supplementary Pensions | 674,229 |
| Accident, sickness, death and miscellaneous benefits--active employees (11,327 cases) | 6,153,154 |
| Death and miscellaneous benefits--retired and former employees (140 cases) | 313,644 |
| Subtotal | 7,141,027 |
| Benefit and Medical Department Expenses and Miscellaneous Charges | 1,966,878 |
| Total Charges to Account 672 | 38,544,263 |
| Less Amount Transferred to Construction and Custom Work | 8,059,102 |
| Net Charge to Account 672 | 30,485,161* |

*The corresponding test year figure is $30,667,000.

The staff adjusted test year service pension accruals downward by $3,063,000 (allocating $2,445,000 to California expenses and $1,998,000 to intrastate expenses) to reflect a 3½ percent actuarial interest rate (rather than 3 percent) and to reflect the

[11/] Under a pay-as-you-go basis the amounts actually paid out to beneficiaries are charged to expense when and as paid. There is no advance funding.

remaining cost method of amortizing the unfunded actuarial reserve requirement (rather than the 10-year amortization period). In its calculations the staff used an effective pension accrual rate of 5.89 percent applied to test year accruable payroll of $381,982,000. The staff maintained that the test year results of operations should not be adjusted for increases in employee pensions and other benefits paid or awarded outside the test year unless at the same time adjustments are made for the effect of the increasing trend in revenue per telephone and for the effects of expected future expense savings from improved methods, for example, dedicated outside plant. It was the staff's position that respondent could absorb the effects of the fringe benefit increases respondent had negotiated and awarded in 1962 and 1963 if the Commission should enter a rate reduction order.

Respondent, on the other hand, included all amounts for relief and pensions that were charged to operations in the test year, and also included in its adjusted test year total California operations an additional amount of $10,057,000 for service pensions and other employee benefits, allocating $8,033,000 to total California operating expenses (Account 672) and $6,604,000 to intrastate operating expenses. Respondent maintained that these additional amounts must be included in the test year results to give a full 12-month effect to computed increases in employee pensions and other benefits awarded from time to time during the test year, to give a full 12-month test year effect to computed increases in employee pensions and other benefits awarded from time to time subsequent to the end of the test year, and to reflect a 3½ percent actuarial interest rate and certain other changed actuarial assumptions. Respondent's position is that it cannot

absorb these increases in costs for employee pensions and other benefits without an increase in rates. The adjustments made by respondent to test year relief and pensions are as follows:

ADJUSTMENTS MADE BY RESPONDENT TO RELIEF AND PENSIONS
TEST YEAR ENDING SEPTEMBER 30, 1962

| Item | Total California Operations Relief and Pensions: Charged Construction Removals and Expense | Total California Operations Relief and Pensions: Charged Expense | Intrastate Operations Relief and Pensions Charged Expense |
|---|---|---|---|
| Adjustments Made by Respondent | | | |
| Service Pensions | | | |
| Effect of 1962 wage program not paid in test year | $ 711,000 | $ 572,000 | $ 470,000 |
| Effect of 1963 program on pensions: | | | |
| Wage increase | 954,000 | | |
| Vacation liberalization | 31,000 | | |
| Reduction in social security deduction from 1/2 to 1/3 | 4,329,000 | | |
| Survivors pension option | 827,000 | | |
| Pension at age 65 with 15 rather than 20 years service | 157,000 | | |
| Subtotal 1963 program | 6,298,000 | 5,028,000 | 4,134,000 |
| Effect of 3½% interest rate and changed actuarial assumptions | (2,922,000) | (2,333,000) | (1,918,000) |
| Total pension adjustments | 4,087,000 | 3,267,000 | 2,686,000 |
| Other Employee Benefits-1963 Program | | | |
| No scale down of death benefits | 51,000 | | |
| Group life insurance | 307,000 | | |
| Extraordinary medical expense (EME Plan) | (200,000) | | |
| Hospital-Medical-Surgical plan (HMS Plan) | 5,812,000 | | |
| Total other employee benefits adjustment | 5,970,000 | 4,766,000 | 3,918,000 |
| Total adjustments | 10,057,000 | 8,033,000 | 6,604,000 |

(Red Figure)

The 1962 pension and other employee benefits which respondent folded back to the beginning of the test year were not fully included in recorded results until about August 1963. None of the 1963 pension and other benefit increases which respondent folded back to the beginning of the test year were paid until May 1963 and some will not be fully recorded until the end of 1965.

From time to time American prepares and submits to respondent an actuarial report on service pension accrual rates which American considers appropriate for use by respondent during certain periods. Respondent, without exception, has used the service pension accrual rates developed by American in such reports. A service pension accrual rate of 6.16 percent of payroll and an additional amortizing accrual of $2,031,000 were developed for use starting July 1, 1961, in the May 24, 1961, actuarial report. This accrual rate and additional amortizing accrual were continued in effect without change in the November 15, 1961, report. The July 15, 1963, report developed an accrual rate of 5.41 percent of payroll and an amortizing accrual of $2,060,000 while the September 19, 1963, report developed an accrual rate of 6.76 percent of payroll and continued in effect the $2,060,000 amortizing accrual.

Respondent has had a pension and benefit plan since January 1, 1913. The service pensions are based upon years of service and the last (or highest) five consecutive years of service. The employees are not required to pay any part of the cost of pensions. As previously indicated all benefits, other than service pensions, are financed on a pay-as-you-go basis. Service pensions were financed on a pay-as-you-go basis for the first 14 years (1913 to 1926, inclusive) of the pension plan. Since January 1, 1927, service pensions have been financed by advance accruals paid into pension trust funds. In 1927 service pension accruals were made on the 15-year-service basis, and from 1928 to 1936 on the full-service basis. The unfunded actuarial reserve requirement at the end of 1927 was approximately $14,238,000 and by the beginning of 1937 had increased to $21,827,000. Between January 1, 1937, and December 31, 1958,

the unfunded actuarial reserve requirement was held "frozen" at $21,827,000 by: (1) an additional accrual equivalent to interest requirements on the frozen unfunded requirement, and (2) adoption of the "modified remaining-cost" accrual basis, under which any pension fund inadequacies which developed (other than the frozen unfunded requirement and interest thereon) were spread over future accruals charged to Account 672, Relief and Pensions. Starting on January 1, 1959, respondent began amortizing the $21,827,000 unfunded actuarial reserve requirement by equal annual payments over the 10 year-period ending on December 31, 1968.

At December 31, 1962, the service pension funds of respondent amounted to $337,542,223 and the unfunded actuarial reserve requirement was $11,154,262. Bankers Trust Company of New York City is trustee of respondent's pension funds. While in the year 1962 respondent accrued to the pension fund $25,939,000, it actually disbursed to service pension beneficiaries in that year $10,037,000, or $15,902,000 less than the service pension accruals charged to Account 672 and $1,750,000 less than the interest and dividend accretions on the funds in 1962. An analysis of the pension fund for the year 1962 follows:

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# ANALYSIS OF PENSION FUND
## YEAR 1962

| Item | Pension Fund |
|---|---|
| Balance at January 1, 1962 | $310,083,058 |
| Increase During Year 1962: | |
| Amounts charged to Account 672 | 25,938,502 |
| Interest and dividend accretions | 11,786,772 |
| Total Increases | 37,725,274 |
| Decreases During Year 1962: | |
| Disbursements to service pension beneficiaries | 10,036,605 |
| Loss on sale or redemption of fund assets | 229,504 |
| Total Decreases | 10,266,109 |
| Net Increase in Service Pension Fund | 27,459,165 |
| Balance at December 31, 1962 | 337,542,223 |

At the end of 1962 the pension fund was invested principally in bonds and other obligations and common stocks as follows:

| Type of Investment | Book Value of Funds | Approximate Rate of Yield |
|---|---|---|
| Bonds and Other Obligations | $297,913,668 | 3.78% |
| Common Stock | 33,923,641 | 2.90 |
| Savings Bank Deposits | 760,000 | 3.75 |
| Total Investments | 332,597,309 | |
| Cash Not Invested | 1,840,715 | |
| Accrued Interest and Dividends Receivable | 3,104,199 | |
| Total in Fund | 337,542,223 | |

The service pension accrual rate used by respondent each year from 1957 through 1962 reflected an assumed actuarial interest rate of 3 percent. However, the yield on the pension trust fund in each of those years, as indicated below, exceeded the assumed 3 percent rate. In its July 15, 1963, actuarial report to respondent American recommended use of a 3½ percent interest rate for 1963. As previously noted, the staff used a 3½ percent interest rate in the test year.

YIELD ON PENSION TRUST FUND AND INTEREST RATE
ASSUMED BY RESPONDENT IN ACTUARIAL CALCULATIONS
OF PENSION ACCRUALS 1957 - 1962

| Year | Yield: Including Gains and Losses on Investments Disposed of | Yield: Excluding Gains and Losses on Investments Disposed of | Actuarial Interest Rate Used by Respondent |
|---|---|---|---|
| 1957 | 3.05% | 3.24% | 3.0% |
| 1958 | 3.34 | 3.37 | 3.0 |
| 1959 | 3.35 | 3.41 | 3.0 |
| 1960 | 3.15 | 3.53 | 3.0 |
| 1961 | 3.64 | 3.63 | 3.0 |
| 1962 | 3.63 | 3.71 | 3.0 |

The choice of an actuarial interest rate has a significant effect upon pension accruals charged to Account 672. This effect is illustrated in the tabulation set forth below for respondent's California operations in the test year. For example, the test year recorded accrual of $25,561,000 at a 3 percent interest rate would become $19,500,000 at a 3-3/4 percent interest rate, or $6,061,000 less.

| Actuarial Interest Rate | Effective Pension Accrual Rate | | Total Pension Accrual to Account 672 | |
|---|---|---|---|---|
| | CPUC Staff[a] | Respondent[b] | CPUC Staff[a] | Respondent[b] |
| 3% | 6.43% | 6.69% | $24,561,000 | $25,561,000 |
| 3-1/4 | 5.89 | 6.15 | 22,499,000 | 23,477,000 |
| 3-1/2 | 5.37 | 5.62 | 20,512,000 | 21,470,000 |
| 3-3/4 | 4.86 | 5.11 | 18,564,000 | 19,500,000 |
| 4 | 4.38 | 4.62 | 16,731,000 | 17,646,000 |

[a] Reflects the remaining cost method of amortizing the unfunded actuarial reserve requirement.

[b] Reflects the 10-year amortization of the unfunded actuarial reserve requirement.

Respondent contended that costwise any pension accrual basis is cheaper than a pay-as-you-go basis because compound interest on accumulated accruals pays for part of the pensions and also contended that under the pay-as-you-go basis the charges start out at a low rate, increase steadily for many years, and ultimately reach a very substantial percentage of payroll. However, we observe that, after 50 years' experience under respondent's plan, the pay-as-you-go basis (if used in 1962) would have cost in that year approximately $15,902,000 less (60 percent less) than respondent's accrual basis. Moreover, in 1961 service pensions as a percentage of payroll on a pay-as-you-go basis for American and its principal subsidiaries would have been 2.58 percent. The comparable service pension accrual rate for the same Bell System companies was 7.23 percent. Because of this indicated very substantial cost difference between the two methods of financing service pensions after 50 years of experience and since there are utility companies, such as Public Service of New Jersey and Consolidated Edison of New York, on a pay-as-you-go basis for service

pensions, we shall require respondent to prepare and file certain pension studies to show when in the future respondent expects that its pension accrual rate calculated as a percentage of payroll will equal or be less than the pension rate if computed on a pay-as-you-go basis.

We find that the inclusion of $8,033,000 more for pension accruals and other employee benefits in California expenses than recorded as paid in the test year ($6,604,000 more for intrastate) as urged by respondent without at the same time giving effect to the offsetting effects resulting from increasing revenues and operating economies and efficiencies, so unbalances the revenue-expense-plant relationship in the test year results of operations as to render respondent's adjusted test year results of operations meaningless for rate-fixing purposes. We further find that the effect of growth in trends in revenues and the effects of operating economies and efficiencies make it unnecessary to adjust test year amounts for relief and pensions, as respondent urged, to reflect increases in wages, pension and other employee benefits paid or awarded after the end of the test year. However, we find it reasonable for rate-fixing purposes to adopt the staff's adjustments to test year service pension accruals to reflect a 3½ percent interest rate and the remaining cost method of amortizing the unfunded actuarial reserve requirement. Accordingly, we find it fair and reasonable for rate-fixing purposes to adjust the test year recorded expense amount for relief and pensions downward by $2,445,000 for total California operations ($1,998,000 intrastate). Our test year allowance for relief and pensions (total California operations) exceeds by over $12,000,000 the payments made by respondent in the test year to beneficiaries of pensions and other employee benefits.

General Services and Licenses

The Bell System operating companies have for many years paid to the American Company and charged to operating expense, Account 674, General Services and Licenses, a fee computed as a percentage of their gross revenues. This fee is intended to compensate American for advice, assistance and services which it furnishes to its associated operating companies under the license contract agreement (Exhibit 86). The percentage of revenue fee, originally established at 4½ percent, has been reduced over the years. In the test year respondent paid its license fee to American computed on the basis of one percent of operating revenues in Accounts 500 through 516 less uncollectibles (Account 530). However, under the express terms of the agreement (Exhibit 86) American may increase the fee to 2½ percent of the sum of revenue Accounts 500, 501, 504, and 510 less Account 530, without prior notice and without obtaining the consent of respondent.

The license fee charged by respondent to total California operations (Account 674) has increased from $6,282,000 in 1957 to $10,698,000 in 1963. The test year total California amount charged by respondent is $9,666,000. If American had elected to collect the fee based on 2½ percent in the test year, it would have collected in excess of $23,000,000 from respondent.

The respective amounts recommended by the Commission staff and by respondent for general services and licenses (Account 674) in the test year results of operations at present rates follow:

| Item | CPUC Staff | Respondent | CPUC Staff Exceeds Respondent |
|---|---|---|---|
| Total Calif. Operations | $9,477,000 | $9,666,000 | $(189,000) |
| California Intrastate | 7,519,000 | 8,060,000 | (541,000) |

(Red Figure)

Consistent with past Commission decisions,[12] the staff made a determination of American's service costs allocable to respondent's total California and intrastate operations. This determination is contained in Exhibit 2, Table 11-E and reflects a 6.75 percent return on American's net investment devoted to California intrastate license contract services and a Federal income tax rate of 52 percent. The staff accepted for this proceeding American's allocations of all costs except those costs estimated by the staff to be incurred by American in connection with its operations as an investor, and to reflect the amortization of the unfunded pension reserve on a remaining cost basis and the use of a 3½ percent interest rate in all actuarial calculations.

It is the staff's position that the Commission should adhere to its past decisions in finding that the license contract expense allowable for rate fixing purposes should be based on allocated reasonable costs, and that "investor costs" should be excluded.

Respondent's position is that the full amount of the license contract payment computed as a percentage of revenue is reasonable and must be recognized in the fixing of respondent's rates; that the expenses incurred by American in providing the license contract services to respondent have been in excess of the payments received; that the payments represent the least costly method of obtaining a wide variety of necessary services; that the value of the services to respondent exceeds the amount of the payment to American; and that the staff's recalculation of the payment contains fatal errors in method and theory.

12/ Decision No. 50258 (53 CPUC at 289) and Decision No. 56652 (56 CPUC at 286.)

This Commission historically has placed emphasis on cost as a factor in rate making. The fallacy of the arbitrary one percent of revenue fee charged by American for services rendered respondent is obvious. By a rate reduction or a rate increase, this Commission could automatically decrease or increase the payments that respondent makes to American. For example, if intrastate rates were reduced by $40,000,000, as suggested by the staff in its brief, or by $69,000,000, as suggested by the GSA in its brief, American would collect either $400,000 or $690,000 less than before for the services it renders with no change either in cost to American or in benefits to respondent. Nothing has been presented herein to change the Commission's previous holdings that a flat percentage of revenue is an inappropriate way of determining service and license expenses for rate-making purposes.[13] We turn then to a determination of the reasonable cost of the services furnished, including a fair return on the property reasonably devoted to such services.

In support of a license fee of $8,060,000 based on revenues, American allocated $3,340,000 of its test year expenses to respondent's California intrastate operations (Exhibit 93). The staff excluded $1,386,000 of the claimed expense as related to American's investor interests, $657,000 representing items identifiable as related wholly to American's investor interests and the remainder of $729,000 representing the staff's estimate of the "investor interest" portion of activities which it contends involves both service functions and investor functions.

13/ Decision No. 50258 (53 CPUC at 289.)

Some $560,000 of the staff's exclusion represents California intrastate allocation of the cost of servicing American's securities. Respondent contended that the staff has not recognized the substantial saving to respondent in investor expense which results directly from American's carrying the burden of raising and supplying the majority of respondent's capital and that if the capital did not come from American (at the cost of servicing its shareholders), respondent would be having to bear the cost of servicing a far greater number of stockholders of its own at a substantially greater expense. The staff's position is that respondent's ratepayers should not be required to pay the cost of servicing American's securities; that there are few investors in any security that have not found it necessary to engage the services of lawyers, accountants, engineers, bankers, stockbrokers or trustees in the administration of the ownership of securities; that of the many security holders of respondent, American is the only one that allocates the cost of ownership to the utility; and that only by its dominant control of respondent can such an allocation of ownership cost be made. We find the staff's exclusion of costs related wholly to American's investor interests is consistent with the Commission's past decisions and is fair and reasonable for rate fixing purposes herein.

The staff's estimate of $729,000 as additional expense allocable to American's investor interests represents 9½ percent of the remainder of American's expenses allocated to respondent's California intrastate operations, after deducting $657,000 which the staff excluded as wholly related to investor interests. The use of the 9½ percent is based upon the staff's presentations in prior rate proceedings involving respondent and upon the Commission's

adoption of the staff's adjusted allocated costs in those proceedings. Respondent challenged the staff's investor cost exclusion, claiming that it was based exclusively on a ratio of investor expense to holding company investment derived by the staff in respondent's 1948 rate proceeding through an extrapolation of 1944-1946 data for 13 holding companies extended eight times the entire range of the basic data; that bringing the 1948 study up to date utterly destroys the figure derived by the staff; and that using the same ratio of investor expense to holding company investment as General Telephone (.075 percent) would result in increasing the staff's intrastate allocated service costs to the point where the staff's proposed disallowance would disappear even on its own basis of computation. It is only because American's accounting procedures prevent a precise determination of costs related to investor interests that an estimate must be made. Respondent has been on notice for a long time that American's costs related to investor interests would not be allowed for rate-fixing purposes. Nevertheless, respondent has done nothing to obtain from American a precise determination of costs related to American's investor interests. Nor has respondent produced an estimate of American's investor costs allocated to respondent's intrastate operations, the staff's estimate being the only such estimate in the record. We find that the staff's estimate of the additional expense allocable to American's investor interests is reasonable.

The staff's deduction of $29,000 in American's allocated California intrastate pension expense is consistent with our finding relating to respondent's pension expense and is fair and reasonable.

Respondent claims as part of its allocated costs a return on a pool of funds which American allegedly holds available for advances to the licensees. The Commission has previously held that such cost is not a proper charge to respondent's operating expense for rate-fixing purposes. (48 CPUC 1.) Nothing has been presented to change our holding in this regard.

The staff made no adjustments to American's costs to reflect the investment tax credit on a flow-through basis or to reflect the use by American, Bell Laboratories or Western Electric of liberalized depreciation allowed for Federal income taxes. We are of the opinion that the cost effects of these items should be given further consideration at an appropriate time.

Basically respondent's position on the license fee in this proceeding is no different than the position it has taken in each of its rate cases since 1947. The Commission consistently has held against respondent on this issue in each of those cases.

We find that the payment required to be made by respondent to American pursuant to the so-called license agreement is unjust and unreasonable for rate-fixing purposes. We further find that the staff's intrastate allocated cost of $7,519,000, when adjusted to reflect a 6.3 percent rate of return which we are allowing respondent, becomes $7,490,000 at a 52 percent Federal income tax rate, or $570,000 less than the one percent license fee which respondent claims as expense. We find that an allowance of $7,490,000 in test year intrastate expenses for general services and licenses is fair and reasonable for rate-fixing purposes.

Dues, Donations and Contributions

In its test year total California operating results, respondent has included $852,000 for dues, donations and contributions which it proposes to impose upon ratepayers. On its books of account, however, respondent during the test year recorded only $192,000 of dues, donations and contributions in various operating expense accounts and charged an additional $660,000 to its stockholders through Account 323, Miscellaneous Income Charges. The Commission staff deducted $77,000 from the amount respondent charged to operating expenses and included $247,000 of the amounts charged to Account 323, Miscellaneous Income Charges, for a total of $362,000. The net result was that respondent increased the test year recorded California operating expenses by $660,000 (intrastate by $542,000) and the Commission staff increased respondent's recorded California operating expenses by $170,000 (intrastate by $145,000).

It is a matter of record that American requested the Federal Communications Commission to change the Uniform Systems of Accounts so that all contributions might be charged directly to operating expenses; that on June 27, 1963, the FCC refused to make the requested revision; and that, although American protested, the FCC declined to reconsider its decision.

Respondent contended that its contributions fall into four broad categories: (1) Contributions to United Fund, Community Chests and the Red Cross; (2) Contributions to colleges and universities; (3) Contributions to hospitals; and (4) Contributions to various cultural organizations and dues to Chambers of Commerce and service clubs. Respondent encourages its employees to give,

and desires its ratepayers to give. By seeking to include all of its contributions as an operating expense for rate-fixing purposes, it did not assess any of these gifts against its stockholders although in the past it has charged a substantial portion of such gifts against its stockholders.

Dues, donations and contributions, if included as an expense for rate-making purposes, become an involuntary levy on ratepayers, who, because of the monopolistic nature of utility service, are unable to obtain service from another source and thereby avoid such a levy. Ratepayers should be encouraged to contribute directly to worthy causes and not involuntarily through an allowance in utility rates. Respondent should not be permitted to be generous with ratepayers' money but may use its own funds in any lawful manner.

The staff's suggested allowance of $305,000 in intrastate expenses for dues, donations and contributions essentially is based upon the methods of inclusion or exclusion employed in the last rate proceeding. For the purpose of this proceeding we find it reasonable to allow the staff's suggested amount as an operating expense However, for reasons heretofore discussed, respondent hereby is placed on notice that it shall be the policy of this Commission henceforth to exclude from operating expenses for rate-fixing purposes all amounts claimed for dues, donations and contributions. Accordingly, we find that the test year intrastate expenses should be increased by $145,000; intrastate test year recorded expenses already include $160,000 for these items.

Postal Rate Increases

Increases in postage rates became effective January 7, 1963, after the close of the test period. The Commission staff made an upward adjustment of $462,000 in respondent's intrastate expenses for postal rate increases. The staff's figure reflected

the postage increase limited to the mailing of customer bills. Respondent's upward adjustment of $591,000 reflected all of its principal mailings.

Changes in revenues, expenses and plant costs both up and down have occurred during and subsequent to the end of the test year. However, to adjust test year results for every change would be a never ending task and no rate proceeding would ever end. Moreover, it is unreasonable selectively to adjust test year expenses for such items as postal increases occurring outside the test year while ignoring offsetting items as previously discussed.

We find the staff's and respondent's proposed adjustments to test year expenses for postage increases relate to the category of so-called level or period changes and no test year adjustment should be made for this item.

Legislative Advocacy

The staff requested respondent to furnish the amount included in its test year operating expenses on account of legislative advocacy. In response, respondent advised that three of its employees had worked as legislative advocates during the 1962 session of the California Legislature and that its intrastate test year expenses included $17,000 of salaries and expenses for these three employees on account of such activity. The staff made no independent study of this matter but consistent with Commission precedent excluded the $17,000 amount from intrastate test year expenses for rate-fixing purposes.

Additional amounts ($8,415 for 1962) of this kind of expense are excluded for rate-fixing purposes because respondent, as a matter of accounting, charges said expense to Account 323, Miscellaneous Income Charges.

Respondent claimed that in California it is the largest private employer, the operator of the largest privately owned motor vehicle fleet and the largest corporate taxpayer. According to respondent some 500 bills are introduced in the average session of the Legislature that affect telephone service directly or indirectly and that it is essential for respondent to maintain legislative advocates to find the bills that may affect telephone service and operations, analyze them, evaluate the consequences on respondent's ability to serve telephone customers, discuss the bills with legislators and their staffs, provide additional research and statistical information and generally to impart to everybody involved in the legislative process the specialized knowledge necessary to insure that only workable legislation becomes law. Respondent contended that the entire amount should be allowed because these activities provide direct benefits to its ratepayers by protecting and benefiting the efficiency and economy of the telephone service.

We do not here reach the issue of respondent's right to engage in such activity. We do observe, however, that when respondent claims benefits to its ratepayers from such activities, it is presuming to determine without consent or prior knowledge of such ratepayers what pending legislation is or is not beneficial to them. Even conceding that such activity in a given instance may prove to be beneficial to respondent's ratepayers, we hold that they should not be required to pay for costs of such legislative advocacy without having the opportunity to make their own judgments on what legislative proposals they would or would not favor

and to designate who, if anyone, should advocate their interests before the Legislature. Accordingly, we find that respondent's test year intrastate expenses should be adjusted downward by $17,000, as was done by the staff, to reasonably exclude for rate-fixing purposes respondent's claimed costs of legislative advocacy.

Summary

Based on the evidence, the Commission finds that the amount of $390,291,000 represents a fair and reasonable estimate of respondent's test year California intrastate expenses, excluding depreciation and taxes, for the purposes of this proceeding. This figure is derived as follows:

| | Intrastate Test Year |
|---|---|
| Unadjusted Operating Expenses, excluding Depreciation and Taxes (Ex. 115, Col.(a)) | $396,144,000 |
| Adjustments | |
| Western Electric - Maintenance | (1,696,000) |
| Clearing | (57,000) |
| Supervisory Positions | (2,150,000) |
| Relief and Pensions | (1,998,000) |
| General Services and License | (570,000) |
| Dues, Donations, and Contributions | 145,000 |
| Legislative Advocacy | (17,000) |
| Depreciation Expense Clearances | 490,000 |
| Total Adjustments | (5,853,000) |
| Adopted Amount | 390,291,000 |

(Red Figure)

DEPRECIATION EXPENSE

The staff's intrastate depreciation expense of $119,045,000 is $3,080,000 less than respondent's amount of $122,125,000. Of this difference, $1,411,000 is the depreciation expense effect of the staff's Western Electric adjustment previously discussed, $93,000 is due to the staff's adjustment for offsetting losses on sales of private mobile communications equipment, and the balance of $1,576,000 is due to differences in respondent's treatment of the investment tax credit, differences in depreciation method and estimates of average service lives and salvage factors, and differences in separations.

The staff used the straight-line remaining-life method for its computation of depreciation expense, whereas respondent used the straight-line total-life method. The staff contended that the proper basis for determining depreciation for rate-fixing purposes in California is the straight-line remaining-life method, that the staff's estimates of depreciation lives and salvage are reasonable and should be adopted, that its adjustment to depreciation expense for Western Electric purchases is consistent with Commission policy and is reasonable, and that it considers respondent's investment in private mobile communication systems to have been imprudent and its adjustment for this item is necessary so that the losses sustained will not be a burden on the ordinary users of telephone service.

Respondent contended that the estimated lives and salvages used in computing its depreciation rates are reasonable; that the staff's estimated lives and salvages are unreasonable; that the staff's adjustment relating to the sale of private mobile equipment is unwarranted; that the staff's computations are erroneous in certain respects resulting in understatement of expense on the

remaining-life basis; and that the total-life basis of depreciation used by respondent in its official accounts and prescribed by the Federal Communications Commission should be used by this Commission for intrastate rate-making purposes.

The trend in depreciation expense charged by respondent to Account 608 for its total California operations for the years 1957 through 1963 and for the test-year ending September 30, 1962 is shown in the following tabulation. Also shown are the amounts of depreciation expense in the test year urged by the staff and by respondent for total California operations and for intrastate operations for rate-making purposes.

DEPRECIATION EXPENSE

| Year | Depreciation Expense Ac. 608 | Index | Annual Cost Per Avg. Company Telephone | Annual Cost Per $100 of Avg. Tel. Plant in Service | Annual Cost Per $100 of Total Operating Revenue |
|---|---|---|---|---|---|
| Total California Operations | | | | | |
| 1957 | $ 83,233,976 | 100.0 | $16.37 | $4.42 | $12.39 |
| 1958 | 97,422,395 | 117.0 | 18.17 | 4.58 | 13.25 |
| 1959 | 106,605,955 | 128.1 | 18.59 | 4.57 | 12.99 |
| 1960 | 115,566,677 | 138.8 | 18.83 | 4.57 | 12.86 |
| 1961 | 130,609,641 | 156.9 | 20.13 | 4.75 | 13.51 |
| 1962 | 142,074,084 | 170.7 | 20.60 | 4.76 | 13.46 |
| 1963 | 153,887,922 | 184.9 | 21.12 | 4.77 | 13.42 |
| Test Year | | | | | |
| Unadjusted | 143,177,000 | 172.0 | 21.08 | 4.90 | 13.83 |
| Adjusted by: | | | | | |
| CPUC Staff | 135,896,000 | 163.3 | 20.01 | 4.65 | 13.15 |
| Respondent | 139,072,000 | 167.1 | 20.48 | 4.76 | 13.52 |
| California Intrastate Operations | | | | | |
| Test Year | | | | | |
| Adjusted by: | | | | | |
| CPUC Staff | 119,045,000 | | 17.53 | | 13.72 |
| Respondent | 122,125,000 | | 17.98 | | 14.14 |

From January 1, 1957, to the end of 1963, the balance in respondent's depreciation reserve for the State of California increased by $217,056,432, from $359,693,589 to $576,750,021, as set forth in the tabulation below. In this period total credits to the reserve amounted to $862,082,356, mostly from charges to operating expenses and clearing accounts, and total debits amounted to $645,025,924, mostly from net charges for plant retired.

DEPRECIATION RESERVE - TOTAL-LIFE METHOD
State of California

| Year | Balance Beginning of Year | Total Credits | Total Debits | Net Credits | Balance End of Year |
|---|---|---|---|---|---|
| 1957 | $359,693,589 | $ 87,202,789 | $ 67,191,878 | $20,010,911 | $379,704,500 |
| 1958 | 379,704,500 | 101,870,642 | 73,445,614 | 28,425,028 | 408,129,528 |
| 1959 | 408,129,528 | 110,992,368 | 74,906,222 | 36,086,146 | 444,215,674 |
| 1960 | 444,215,674 | 120,165,805 | 89,531,923 | 30,633,882 | 474,849,556 |
| 1961 | 474,849,556 | 135,318,821 | 97,996,537 | 37,322,284 | 512,171,840 |
| 1962 | 512,171,840 | 146,886,529 | 119,878,878 | 27,007,651 | 539,179,491 |
| 1963 | 539,179,491 | 159,645,404 | 122,074,873 | 37,570,531 | 576,750,022 |

Respondent contends that pursuant to Section 220 of the Communications Act of 1934, the Federal Communications Commission has pre-empted the field in prescribing total-life depreciation rates and that said statute effectively precludes state commissions from independent prescription of depreciation rates for intrastate rate-making purposes. It must be noted that respondent assigns approximately 88 percent of its total depreciation expenses to intrastate operations, and for some accounts, such as step-by-step central office equipment in southern California, respondent assigns over 97 percent of its depreciation expense to intrastate operations. While respondent is required to keep its books of account in accordance with the Uniform Systems of Accounts prescribed by the Federal Communications Commission and reflect in its books of account total-life depreciation rates prescribed by it, we specifically reject respondent's contentions either that the Federal Communications Act

of 1934 has prescribed depreciation rates for intrastate rate-making purposes in California or that Congress has the power to do so. What we are dealing with here is the determination of a fair and reasonable depreciation allowance for intrastate rate-making purposes in California. That determination lies with this Commission.[14/]

The Commission has previously held that the primary objective of depreciation is to recover, during its useful service life, the original cost of plant, no more, no less, and that the remaining-life method is the best method to accomplish this objective where the characteristics of service life and net salvage vary over the life of the plant because of wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and changes in cost of removal and salvage market (53 CPUC @ 293).

In determining reasonable depreciation for rate-making purposes, the Commission is faced with problems not unlike those inherent in intercorporate affiliations. There is no market place nor are there arms-length dealings with third parties which can be relied upon to determine reasonable depreciation rates. In the final analysis it is management that determines the rate of depreciation and, of course, it is the utility stockholder that is the beneficiary of depreciation expense. It is incumbent upon the Commission, as a trustee for the public, to exercise even a higher degree of scrutiny in determining depreciation expense for rate-making purposes than it is otherwise required to exercise.

14/ That Congress itself recognizes the limitation on its power in the field of utility rate making is evident from its recent enactment of legislation relating to the investment tax credit. By specific terms such legislation is made applicable only to federal regulatory agencies. (Sec. 203(e) Revenue Act of 1964)

The straight-line remaining-life depreciation method is now embraced and used by all large California utilities except this respondent. This Commission adopted the straight-line remaining-life method as the proper basis for setting intrastate rates of respondent in the 1954 and 1958 rate proceedings (Decision No. 50258, 53 CPUC 275, and Decision No. 56652, 56 CPUC 277). By Decision No. 50258 respondent was directed to maintain straight-line remaining-life memorandum records so that the proper depreciation information would be available for setting respondent's intrastate rates. In again seeking to relitigate this issue, respondent ignores such precedents yet it has presented no new or compelling reasons why this Commission should depart from them.

The total-life method consists of an estimate of the number of years items of plant will be in service and an estimate of the net salvage that will be realized from the items. The annual accrual equals the cost less estimated net salvage divided by the estimated number of years items of plant will be in service.

The remaining-life method starts similarly but provides for frequent reviews of the service lives, salvage and percent condition of the depreciation reserve with a resultant frequent correction of depreciation rates. By this process, the remaining-life method assures the recovery of cost, less salvage, no more, no less, over the life of the property. In Decision No. 50258 (53 CPUC 275) this Commission thoroughly explored the relative merits of the two methods and found the remaining-life method to be the proper one for fixing respondent's intrastate rates. We affirm the Commission's previous finding that the straight-line remaining-life method is the proper one to use in fixing respondent's intrastate rates.

Respondent maintained that if the remaining-life method is to be employed for rate-making purposes, the remaining-life rates shown in its Exhibit 82 should be employed, resulting in test year total California depreciation expense of $146,931,000 compared with the staff's amount of $137,616,000 before its adjustments for common utility plant, mobile communication systems and for Western Electric purchases. The staff maintained that its remaining-life rates set forth on Table 14A of Exhibit 2 are reasonable and should be adopted for rate-fixing purposes.

The staff and respondent were in agreement on the remaining-life depreciation rates applicable to 25 of the 28 depreciable plant accounts or subaccounts in northern California and 23 of the 27 depreciable plant accounts or subaccounts in southern California. The following tabulation summarizes the remaining-life depreciation rates that are in dispute and the extent of the differences. We observe that for the accounts in dispute respondent assigned over 91 percent of the depreciation accrual to intrastate operations compared with about 87 percent for the accounts not in dispute.

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## Comparison of Test Year Depreciation Accruals
## Remaining-Life Bases

| Ac. No. | Account | Average Depreciable Plant | Accrual Rate: CPUC Staff | Accrual Rate: Respondent | Depreciation Accruals: CPUC Staff | Depreciation Accruals: Respondent | Depreciation Accruals: Respondent Exceeds Staff | Percentage Respondent Assigned to Intrastate |
|---|---|---|---|---|---|---|---|---|
| | **Northern California** | | | | | | | |
| 231 | Station Apparatus | | | | | | | |
| -01 | Teletypewriter | $ 21,730,000 | 7.38% | 12.27% | $1,604,000 | $2,666,000 | $1,062,000 | 88.34% |
| -02 | Telephone & Misc. | 99,036,000 | 5.73 | 8.20 | 5,675,000 | 8,121,000 | 2,446,000 | 88.34 |
| 234 | Large Private Branch Exchanges | 46,171,000 | 5.21 | 6.21 | 2,406,000 | 2,867,000 | 461,000 | 87.49 |
| | Total Disputed | 166,937,000 | 5.80 | 8.18 | 9,685,000 | 13,654,000 | 3,969,000 | 88.14 |
| | Not Disputed | 1,263,117,000 | 4.86 | 4.86 | 61,332,000 | 61,332,000 | -- | 86.58 |
| | Total No. California | 1,430,054,000 | 4.97 | 5.24 | 71,017,000 | 74,986,000 | 3,969,000 | 86.81 |
| | **Southern California** | | | | | | | |
| 221 | Central Office Equip. | | | | | | | |
| -02 | Step-by-Step | 228,265,000 | 2.92 | 3.69 | 6,665,000 | 8,423,000 | 1,758,000 | 97.27 |
| 231 | Station Apparatus | | | | | | | |
| -01 | Teletypewriter | 21,940,000 | 6.05 | 8.42 | 1,327,000 | 1,847,000 | 520,000 | 89.18 |
| -02 | Telephone & Misc. | 121,093,000 | 5.46 | 7.71 | 6,612,000 | 9,336,000 | 2,724,000 | 89.18 |
| 234 | Large Private Branch Exchanges | 57,381,000 | 5.04 | 5.64 | 2,892,000 | 3,236,000 | 344,000 | 91.47 |
| | Total Disputed | 428,679,000 | 4.08 | 5.33 | 17,496,000 | 22,842,000 | 5,346,000 | 92.71 |
| | Not Disputed | 1,038,995,000 | 5.26 | 5.26 | 54,620,000 | 54,620,000 | -- | 87.24 |
| | Total So. California | 1,467,674,000 | 4.91 | 5.28 | 72,116,000 | 77,462,000 | 5,346,000 | 88.70 |
| | **State of California** | | | | | | | |
| | Total Disputed | 595,616,000 | 4.56 | 6.13 | 27,181,000 | 36,496,000 | 9,315,000 | 91.14 |
| | Not Disputed | 2,302,112,000 | 5.04 | 5.04 | 115,952,000 | 115,952,000 | -- | 86.89 |
| | Total | 2,897,728,000 | 4.94 | 5.26 | 143,133,000 | 152,448,000 | 9,315,000 | 87.78 |

Prior to reaching its ultimate conclusions on services lives used in developing its depreciation accrual rates on Table 14B of Exhibit 2, the staff had discussions with respondent. Originally the staff developed lives for six accounts in northern California and for six accounts in southern California that differed from those respondent was proposing or using. Subsequent to its discussions with respondent, the staff reduced its originally developed lives in four accounts in northern California and in four accounts in southern California. In no instance did the staff increase the life in any account following its discussions with respondent.

Account 221-03, Step-by-Step Central Office Equipment, Southern California

The difference in the remaining life accrual rate for this account urged by the staff and by respondent comes about through differences in estimates of service life and salvage as follows:

| Item | Estimates Made By CPUC Staff | Estimates Made By Respondent |
|---|---|---|
| Total Service Life | 29 years | 27 years |
| Life Span | 40 years | 37 years |
| Remaining Life | 21 years | 19 years |
| Future Net Salvage Factor | 10.0% | 1.1% |
| Annual Remaining-Life Accrual Rate | 2.92% | 3.69% |

In its annual report to this Commission for the year 1962, respondent reported with respect to this account that it had used under its total-life method an estimated service life of 27 years, an estimated net salvage factor of 10 percent, and an annual accrual rate of 3.3% at the end of the year. These are the same amounts used by respondent for this account in 1961. The staff made no change in its originally developed service life for this account following its discussions with respondent.

Account 231-01, Teletypewriters, Northern and Southern California.

The difference between the staff's and respondent's remaining-life accrual rate for this account is caused by differences in estimates of service lives as follows:

| | Estimates Made By | | | |
|---|---|---|---|---|
| | CPUC Staff | | Respondent | |
| Item | No. Calif. | So. Calif. | No. Calif. | So. Calif. |
| Total Service Life | 15 years | 17 years | 10 years | 13 years |
| Remaining Life | 11.8 years | 13.5 years | 7.1 years | 9.7 years |
| Future Net Salvage Factor | 1.0% | 1.0% | 1.0% | 1.0% |
| Annual Remaining Life Accrual Rate | 7.38% | 6.05% | 12.27% | 8.42% |

In its annual report to this Commission for the year 1962, respondent reported with respect to this account that it had used under its total-life method an estimated service life of 16 years, estimated net salvage of 2 percent and an annual accrual rate of 6.1 percent at the end of 1962 in both northern and southern California. These same lives, salvage factors and accrual rates were used by respondent in 1961 for this account. The staff originally developed a service life of 20 years for this account both in northern and southern California, but following its discussions with respondent, the staff shortened its lives to 15 and 17 years, respectively.

Account No. 231-02, Telephone and Miscellaneous
Northern and Southern California

The difference between the staff's and respondent's remaining-life accrual rate for this account is caused by a difference in estimates of service lives as follows:

| Item | Estimates Made By CPUC Staff No.Calif. | CPUC Staff So.Calif. | Respondent No.Calif. | Respondent So.Calif. |
|---|---|---|---|---|
| Total Serivce Life | 19 years | 19 years | 15 years | 15 years |
| Remaining Life | 14.2 years | 14.9 years | 9.9 years | 10.5 years |
| Future Net Salvage Factor | 1.0% | 1.0% | 1.0% | 1.0% |
| Annual Remaining-Life Accrual Rate | 5.73% | 5.46% | 8.20% | 7.71% |

In its annual report to this Commission for the year 1962, respondent reported with respect to this account that it had used under its total-life method an estimated service life of 16.4 years for northern California and 16.5 years for southern California, net salvage of 2 percent in both areas and annual accrual rates of 6.0 percent in northern California and 5.9 percent in southern California. These are the same lives, salvage factors and accrual rates used by respondent in 1961. The staff made no change in its originally developed life of 19 years for this account following its discussions with respondent.

Account 234, Large Private Branch Exchanges,
Northern and Southern California

The staff and respondent estimated different service lives and salvage for this account resulting in the difference in accrual rates as follows:

| Item | Estimates Made By: CPUC Staff No.Calif. | CPUC Staff So.Calif. | Respondent No.Calif. | Respondent So.Calif. |
|---|---|---|---|---|
| Total Service Life | 17 years | 17 years | 16 years | 16 years |
| Remaining Life | 14.4 years | 14.9 years | 13.7 years | 14.2 years |
| Future Net Salvage Factor | 10.0% | 10.0% | 0% | 5% |
| Annual Remaining-Life Accrual Rate | 5.21% | 5.04% | 6.21% | 5.64% |

In its annual report to this Commission for the year 1962, respondent reported with respect to this account that it had used under its total-life method an estimated service life of 17 years for both areas, a salvage factor of 12 percent for northern California and 18 percent for southern California and an annual accrual rate at the end of the year of 5.2 percent and 4.8 percent, respectively. These are the same lives, salvage factors and accrual rates used by respondent in 1961. The staff originally developed a service life of 21 years for this account both in northern and southern California, but following its discussions with respondent the staff shortened its service life to 17 years in both areas.

It must be realized that at best the annual depreciation allowance is an estimate and the mortality and life statistics kept and different methods used are but aids in making this estimate. The Commission finds that the staff's test year annual remaining-life accrual rates are reasonable for intrastate rate-fixing purposes and, when applied to average test year depreciable plant, result in total depreciation accruals of $143,133,000, of which $137,616,000 is reasonably allocable to total California depreciation expense ($120,805,000 to intrastate). We further find that the $120,805,000 amount should be adjusted downward by $5,000 for common utility plant, and downward by $1,332,000, as discussed elsewhere, for purchases from Western Electric, resulting in an allowance of $119,468,000 which we find is reasonable for test year intrastate

depreciation expense for rate-fixing purposes. We find that no adjustment is warranted for respondent's private mobile radio transactions.

Transfers From Clearing to Expense Accounts

Both the staff and respondent allocated remaining-life depreciation accruals between the clearing accounts and depreciation expense. Respondent maintained that the staff's test year total California operating expenses are understated by $557,000 because the staff allocated $5,517,000 of its remaining-life accruals to clearing accounts but used respondent's lower booked total-life transfers from the clearing accounts to expense accounts. We find it to be reasonable that the test year expenses as presented by the staff for rate-fixing purposes should be increased by $557,000 total California ($490,000 intrastate) for this item.

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## TAXES

### Payroll Taxes

The trend in payroll taxes for the period 1957-1963 compared with test year amounts, unadjusted as well as adjusted by the staff and by the respondent, is set forth in the tabulation below:

PAYROLL TAXES

| Year | State Unemployment | Federal Unemployment | Federal Insurance Contributions | Total Payroll Taxes | Annual Cost per Avg. Co. Telephone | Annual Cost per $100 of Tot.Oper. Revenue |
|---|---|---|---|---|---|---|
| | | | Total California Operations | | | |
| 1957 | $ 909,780 | $ 531,375 | $4,915,829 | $ 6,356,984 | 1.25 | 0.95 |
| 1958 | 1,251,357 | 505,811 | 4,852,750 | 6,609,918 | 1.23 | .90 |
| 1959 | 2,283,937 | 472,580 | 5,575,365 | 8,331,882 | 1.45 | 1.02 |
| 1960 | 2,278,477 | 501,447 | 6,901,211 | 9,681,135 | 1.58 | 1.08 |
| 1961 | 2,076,956 | 673,635 | 6,925,225 | 9,675,816 | 1.49 | 1.00 |
| 1962 | 5,497,055 | 1,357,590 | 7,536,423 | 14,391,068 | 2.09 | 1.36 |
| 1963 | | | | 15,883,856 | 2.18 | 1.39 |
| Test Year | | | | | | |
| Unadjusted | 4,763,000 | 1,192,000 | 7,370,000 | 13,325,000 | 1.96 | 1.29 |
| Adjusted By CPUC | | | | | | |
| Staff | 2,613,000 | 1,315,000 | 8,542,000 | 12,470,000 | 1.84 | 1.21 |
| Respondent | | | | 15,426,000 | 2.27 | 1.50 |
| | | | California Intrastate Operations | | | |
| Test Year | | | | | | |
| Adjusted By CPUC | | | | | | |
| Staff | 2,133,000 | 1,074,000 | 6,977,000 | 10,184,000 | 1.50 | 1.17 |
| Respondent | | | | 12,681,000 | 1.87 | 1.47 |

The staff's intrastate test year amount of $10,184,000 for payroll taxes is $2,497,000 less than respondent's amount of $12,681,000. This difference results from several items as summarized below:

| Item | CPUC Staff | Respondent | CPUC Staff Exceeds Respondent |
|---|---|---|---|
| Total California Operations | | | |
| Unadjusted Test Year Payroll Taxes | $13,325,000 | $13,325,000 | $ - |
| Adjustments | | | |
| State Unemployment Tax Rate and Base (Staff Rate 1.3% Respondent 2.5%) | (2,150,000) | 345,000 | (2,495,000) |
| January 1, 1963 change in Tax Rate for - Federal Unemployment | 123,000 | 145,000 | (22,000) |
| Federal Insurance Contributions | 1,172,000 | 1,320,000 | (148,000) |
| 1962 Wage Increase Effect | - | 115,000 | (115,000) |
| 1963 Wage Increase Effect | - | 176,000 | (176,000) |
| Total Adjustments | (855,000) | 2,101,000 | (2,956,000) |
| Adjusted Payroll Taxes | 12,470,000 | 15,426,000 | (2,956,000) |
| Intrastate Operations | | | |
| Adjusted Payroll Taxes | 10,184,000 | 12,681,000 | (2,497,000) |

(Red Figure)

With respect to California unemployment insurance, the staff derived an average tax rate for the ten years ending with 1962 in the amount of 0.8 percent to which the staff added 0.5 percent to reflect the supplemental tax which became effective January 1, 1962. Thus, the staff used a tax rate of 1.3 percent for California unemployment. Respondent used the 1963 rate of 2.5 percent. The

California unemployment insurance tax rate varies from year to year depending on both the experience of all California employers and on the experience of the particular employer. Respondent's tax rate for this tax has fluctuated from a low of 0.1 percent to a high of 2.7 percent over the ten years ending with 1962. The staff contended that since the basic rate can fluctuate so widely, an averaging method should be used for this tax consistent with the averaging treatment given this tax in Decision No. 50258 (53 CPUC 275) and Decision No. 51143 (53 CPUC 58). Respondent, on the other hand, contended that the 1963 tax rate of 2.5 percent should be used for test year results since, according to respondent, there is no evidence that this rate will be reduced in the immediate future.

In computing its adjustments to payroll taxes the staff unknowingly used a taxable wage base that did not include general office payrolls. If the staff had used the taxable wage base, which included general office payrolls, its payroll taxes would have been increased by $214,000 for total California operations and by $175,000 for intrastate operations.[15]

Respondent included payroll tax adjustments for 1962 and 1963 wage increases which it had reflected back to the beginning of the test year on an estimated basis. The staff, not having included the effect of 1962 and 1963 wages not paid in the test year, as earlier discussed, did not adjust test year payroll taxes for these items.

15/The amounts are segregated as follows:

| | Total California Operations | Intrastate Operations |
|---|---|---|
| State Unemployment | $ 44,000 | $ 36,000 |
| Federal Unemployment | 22,000 | 18,000 |
| Federal Insurance Contributions | 148,000 | 121,000 |
| Total | $214,000 | $175,000 |

Based on the evidence, we find that the full amount of payroll taxes paid in the test year should be allowed for the purpose of this proceeding; that the use of a ten-year average California unemployment tax rate produces an unreasonable result; that it is unreasonable to adjust test year payroll taxes for changes in the rates and wage increases paid after the close of the test year without, at the same time, similarly reflecting back to the beginning of the test year the increasing trends in revenues and effects of operating economies. We find that an allowance of $10,984,000 for test year intrastate payroll taxes is fair and reasonable for rate-fixing purposes.

Taxes Other than Based on Income and Payroll

The staff's test year intrastate amount for taxes, other than based on income and payroll, is $79,766,000, or $190,000 less than respondent's amount of $79,956,000. This difference results from a difference in separations. Taxes for local licenses, vehicles and sales and use, account for about $277,000 of the staff's intrastate amount and ad valorem taxes of $79,489,000 account for the balance.

The Commission finds that for rate-fixing purposes an amount of $79,960,000 is fair and reasonable for test year intrastate taxes, other than based on income and payrolls.

Taxes Based on Income

The trend in California bank and corporation franchise tax and in Federal income tax for the years 1957-1963 compared with test year amounts, unadjusted as well as adjusted by the staff and by the respondent, is set forth in the tabulation below:

TAXES BASED ON INCOME

| Year | California Bank and Corporation Franchise Tax | | | Federal Income Tax | | |
|---|---|---|---|---|---|---|
| | Amount Charged Operating Expense | Annual Cost Per Avg. Co. Telephone | Annual Cost Per $100 of Operating Revenue | Amount Charged Operating Expense | Annual Cost Per Avg. Co. Telephone | Annual Cost Per $100 of Operating Revenue |
| **Total California Operations** | | | | | | |
| 1957 | $ 5,225,928 | $1.03 | $0.78 | $ 64,587,000 | $12.70 | $ 9.61 |
| 1958 | 5,367,204 | 1.00 | .73 | 82,175,581 | 15.32 | 11.18 |
| 1959 | 6,604,065 | 1.15 | .80 | 107,709,000 | 18.78 | 13.12 |
| 1960 | 11,988,834 | 1.95 | 1.33 | 113,536,000 | 18.50 | 12.64 |
| 1961 | 14,644,102 | 2.26 | 1.51 | 122,734,910 | 18.92 | 12.69 |
| 1962 | 20,164,150[a] | 2.92 | 1.91 | 130,823,965 | 18.97 | 12.40 |
| 1963 | 17,755,207 | 2.44 | 1.55 | 139,944,271 | 19.21 | 12.21 |
| Test Year | | | | | | |
| Unadjusted | 17,341,503 | 2.55 | 1.68 | 133,014,000 | 19.59 | 12.85 |
| Adjusted By CPUC | | | | | | |
| Staff | 15,538,000 | 2.29 | 1.50 | 130,201,000 | 19.17 | 12.60 |
| Respondent | 14,833,000 | 2.18 | 1.44 | 113,682,000 | 16.74 | 11.05 |
| **California Intrastate Operations** | | | | | | |
| Test Year | | | | | | |
| Adjusted By CPUC | | | | | | |
| Staff | 13,055,000 | 1.92 | 1.50 | 109,357,000 | 16.10 | 12.60 |
| Respondent | 12,389,000 | 1.82 | 1.43 | 93,382,000 | 13.75 | 10.81 |

[a] Includes amounts applicable to prior years.

The impact on test year taxes based on income from respondent's downward adjustments to revenues and upward adjustments to expenses is apparent. However, the actual 1963 trend in taxes based on income shows no such drastic reduction as would result from respondent's adjustments.

The above taxes for the test year reflect a California Bank and Corporation Franchise tax rate of 5.5 percent and a Federal

income tax rate of 52 percent (30 percent normal tax rate and 22 percent surtax rate).

In addition to differences in taxes based on income resulting from different adjusted test year revenues and expenses used by the staff and respondent, it is respondent's position that the staff's total California Bank and Corporation Franchise tax was understated by about $2,212,000 and the staff's Federal income tax was understated by about $3,703,000, a total of $5,915,000. Respondent maintained that these understatements result from the following items:

| Item | Total California Operations: California Bank & Corp. Franchise Tax | Total California Operations: Federal Income Tax |
|---|---|---|
| 1. Staff's use of a separate return rather than a "combined report" basis | $1,800,000 | $ - |
| 2. Staff's use of a hypothetical capitalization for computing fixed charges | 188,000 | 1,683,000 |
| 3. Staff's failure to carry through rate base disallowances into allocation of fixed charges between operating and non-operating expenses. | 49,000 | 452,000 |
| 4. Staff's use of recorded depreciation expense as a deduction for tax purposes rather than staff's lower calculated depreciation expense | 175,000 | 1,568,000 |
| Total | 2,212,000 | 3,703,000 |

The staff's total State and Federal taxes based on income applicable to total California operations for the adjusted test year amount to $145,739,000 ($15,538,000 plus $130,201,000), compared to respondent's adjusted figure of $128,515,000 and the recorded figure of $150,355,000. If the staff's allowance were increased by $5,915,000, as suggested by respondent, the resulting

figure would be $151,654,000. Such amount is $1,299,000 larger than the test year recorded amount and $23,139,000 larger than respondent's adjusted amount.

For income tax purposes, both the Internal Revenue Service and the California Franchise Tax Board consider respondent to be a part of the holding company combine of the American Telephone and Telegraph Company. For Federal income tax purposes, respondent is permitted to join in a consolidated return with the other associated companies of American, thus freeing American from the obligation of paying income tax on dividends received from its subsidiaries. As a result of filing a consolidated return, American's tax savings on dividends received from respondent alone amounted to $8,735,460 in 1961. In addition to the dividend tax savings, intercorporate profits of Western Electric are also exempt from Federal income taxation.

The actual income tax due the United States is paid by American as agent for the Bell System companies. Although the return is filed on a consolidated basis, the amounts that the individual companies, including Western Electric, forward to American are determined on a separate return basis. The aggregate of the amounts forwarded to American are greater than the consolidated tax liability by the amount of the "phantom" taxes of Western Electric. American passes these "phantom" taxes back to the operating associated companies as a rebate on purchases of plant items. Since the elimination of taxes on Western Electric plant items lowers the cost of plant, the amounts that may be claimed for tax depreciation purposes are reduced. Respondent considers that the lower plant costs resulting from the plant credit are actually "deferred taxes".

The staff contends that the plant credit rebate method is a necessary result of American's filing a consolidated Federal income tax return so as to secure the sizable saving in taxes on dividends; that there is no practical way that American could retain the "phantom taxes" forwarded to it by Western Electric; and that this reduction is a reduction in the cost of plant, not "deferred taxes". We find that the plant credit is a reduction in the cost of plant and does not result in deferred taxes.

The California Franchise Tax Board, rather than permitting, requires respondent to pay its taxes on a combined report basis. The principal effect of the combined report basis is that, by means of the interest equivalent concept, a portion of the intercompany dividends of the American Telephone holding company group are subjected to the State corporation franchise tax.

For rate-fixing purposes, the staff determined both Federal and California taxes based on income attributable to respondent's utility operations on a separate return basis. The staff did not include either increases or decreases in taxes arising from the corporate structure of the Bell System group. Respondent determined Federal income taxes on a separate return basis and the California Bank and Corporation Franchise tax on a combined report basis. Respondent insists that it has no alternative but to file and pay its Bank and Corporation Franchise tax on a combined report basis as required by the California Franchise Tax Board and that the tax which it has legally been required to pay pursuant to regulations of the Franchise Tax Board must be recognized in full as an expense for rate-fixing purposes.

The staff maintained that respondent did not consistently compute the Bank and Corporation Franchise tax on a combined report basis but rather used a separate return basis with respect to its many revenue and expense adjustments. Additionally, the staff contended that respondent's method permits its parent (American) to reap the benefit of reduced Federal tax and forces respondent's ratepayers to assume the entire load of California taxes on American's holding company operations; that respondent has included State corporation franchise tax on American's nonoperating income and capital gains without including in revenues the nonoperating income on which the tax is levied; that the rate-making treatment for taxes based on income should be consistently applied on a separate return basis and should apply to utility operations only.

If we were to treat this matter as respondent contends, namely, determine State income tax on a consolidated return basis and Federal income tax on a separate return basis, we would be forcing respondent's ratepayers to assume the entire load of California taxes on American's holding company functions. We have elsewhere herein found that respondent's expenses for rate-fixing purposes should not include costs of American's holding company functions. Similarly, if we were to treat this matter on a consolidated return basis for both State and Federal income tax, we would be inconsistent in our treatment of American's holding company functions. We find that the staff's separate return method for both California and Federal income tax allowance for rate-making purposes is fair and reasonable.

We do not find it necessary or reasonable to adopt a hypothetical capitalization as urged by the staff in computing fixed charges for income tax purposes, but the facts with respect thereto have been given due consideration in reaching our finding and

conclusion with respect to a fair rate of return to be accorded respondent in this proceeding.

We find no merit in respondent's position regarding reallocation of test year fixed charges between operating and nonoperating expenses to reflect staff adjustments to plant.

With respect to depreciation expense deduction for tax purposes, we do not here reach the issue of the rate-making treatment to be accorded respondent regarding liberalized depreciation permitted but not taken by respondent for income tax purposes. That issue is held open for further consideration. We find that respondent and the staff both used for income tax purposes the tax depreciation claimed by respondent for income tax purposes. Such depreciation deduction for income tax purposes we find to be fair and reasonable for the purposes of this decision but such treatment is not to be understood as a precedent as applied to further action which we may take herein.

We have previously discussed, and made findings with respect to the treatment to be accorded the investment tax credit for rate-making purposes.

Based on the evidence and our findings with respect to test year revenues, expenses and taxes other than based on income, the Commission finds that the sum of $13,247,000 and $111,815,000 represent respectively the fair and reasonable intrastate California Bank and Corporation Franchise tax and Federal income tax for rate-fixing purposes during the test year at present rates. These amounts reflect a 5.5 percent Bank and Corporation Franchise tax rate and a 52 percent Federal income tax rate.

We find that the fair and reasonable intrastate operating taxes for the test year for rate-fixing purposes at present rates are:

| Type of Tax | California Intrastate Test Year - Present Rates |
|---|---|
| Taxes on Income: | |
| California | $ 13,247,000 |
| Federal | 111,815,000 |
| Payroll Taxes | 10,984,000 |
| Other Taxes | 79,960,000 |
| Total | 216,006,000 |

C. 7409 ds/ep*

## SUMMARY OF ADOPTED RESULTS OF CALIFORNIA INTRASTATE OPERATIONS

A summarization of the adopted results of operations indicates the following for the test year at present telephone rates and a 52% Federal income tax rate:

| | Present Rates |
|---|---|
| Operating Revenues | $ 870,057,000 |
| Operating Expenses, Excluding Depreciation and Taxes | 390,291,000 |
| Depreciation Expense | 119,468,000 |
| Taxes | |
| Based on Income: | |
| California | 13,247,000 |
| Federal | 111,815,000 |
| Payroll | 10,984,000 |
| Other Taxes | 79,960,000 |
| Total Expenses and Taxes | 725,765,000 |
| Net Revenue | 144,292,000 |
| Rate Base | 1,996,533,000 |
| Rate of Return | 7.23% |

The evidence is clear, as the above tabulation indicates, that respondent's intrastate operations, on the test-year basis under present telephone rates, produce a rate of return in excess of the 6.3 percent which we have herein found to be fair and reasonable.

Revenue Reduction

Applying a rate of return of 6.3 percent to the fair and reasonable intrastate test year rate base of $1,996,533,000, indicates the need for approximately $125,782,000 in net revenues, or $18,510,000 less than the net revenues produced at present rate levels. Under test year tax rates, a net-to-gross multiplier of 2.200 is indicated, which when applied to a reduction in net revenues of $18,510,000, yields a reduction in gross revenues of approximately $40,722,000. Such gross revenues represent a reduction of approximately 4.7 percent from those produced at present rates during the test year. We find such results fair and reasonable for the purposes of this decision.

The above amounts reflect a 52 percent Federal income tax rate. We take official notice of the fact that Federal income tax rates were reduced to 50 percent effective January 1, 1964 and are scheduled to be further reduced to 48 percent effective January 1, 1965. Additional rate reductions thus may be forthcoming, if the evidence yet to be adduced should so warrant.

Effective Date

By Decision No. 65702, dated July 9, 1963, the Commission denied motions for interim rate reductions made by the City of Los Angeles and the City and County of San Francisco on March 15, 1963 and renewed on May 3, 1963. Said decision was a simple order of denial.

Subsequent to Decision No. 65702, the Commission staff moved for an interim order reducing respondent's California intrastate gross revenues by approximately $31,200,000.

Respondent opposed all motions for interim rate reductions upon the essential grounds that the Commission was without authority to do so, contending among other things that when the Commission acts to authorize interim rate increases, it does so by consenting to such interim increases in behalf of the public, but that when the Commission proposed to reduce rates, it must either obtain the consent of respondent or wait until after full hearings have been completed and appropriate findings and order are made. It is not important to determine here the capacity in which the Commission acts when it authorizes interim increases in rates, except that it should be noted that the Commission's authority to so do has been challenged upon claims that a full hearing has not been had on the issue of need for such action.

It is important to note, however, that regardless of whether the Commission acts to authorize interim increases or contemplates interim decreases, it does so as a trustee for the public acting in the public interest. When the Commission authorizes interim increases, it does so in order to insure against prejudice to the utility's owners which can result if the Commission were to withhold increased revenues to which the utility may be lawfully entitled until all issues are fully litigated, and, also, to protect the integrity of the service which the utility performs for the public, thus benefitting the public by maintaining reasonsonable service. Characteristically, interim increases have been granted upon a truncated showing of justification. The risk of allowing a greater increase in revenues upon such a showing than that to which it may ultimately be determined the utility is entitled is minimized by access to a practical remedy; the utility may be ordered to refund to its ratepayers such revenues collected during the interim period as may finally be determined to be in excess of revenues to which the utility is entitled. When the Commission is contemplating ordering interim reductions, however, the Commission does not have available to it the same kind of practical remedy to minimize the risk of being wrong as to how much rates should be reduced on an interim basis. Thus, if prior to full hearing, the Commission were to order interim revenue reductions in an amount greater than it ultimately finds is warranted, it would not be practical to thereafter make the ratepayers return to the utility the amount of revenues to which the utility was entitled during the interim period. However, while the Commission may find itself disabled from ordering interim revenue reductions, because of the lack

of such a practical safeguarding remedy, its obligation effectively to protect the lawful interest of the ratepayers cannot be diminished as a result of this circumstance. From a practical standpoint, therefore, the only way that the Commission can effectively discharge its obligation to ratepayers, when it finds that revenue reductions are warranted, is to order such reductions to be made effective as of the date when it undertook its investigation, in this case July 26, 1962. We find such action will not result in prejudice to respondent and will be fair to its ratepayers. Respondent is not prejudiced because to the extent that it has received excess revenues in the amounts herein found, it necessarily has continued to receive them at least since the institution of this investigation as the evidence of record shows and our findings demonstrate. Thus, requiring respondent to refund such amounts is requiring it to do nothing more than give back that to which it is not entitled. On the other hand, it is fair to the ratepayers because they finally get back in full the excess portion of the rates which they were required to pay during the pendency of the proceeding. Accordingly, we find it fair and reasonable to make the rates herein prescribed effective on July 26, 1962, and to require respondent to file an appropriate refund plan to refund to customers amounts collected by respondent in excess of the rates herein prescribed between July 26, 1962 and the date respondent files with this Commission the rates herein prescribed. This procedure does not constitute retroactive rate fixing or offend constitutional due process.

Overall Findings

The Commission finds that:

1. At the rates herein directed to be filed on an interim basis pending the fixing of final rates herein, reasonable intrastate test year operating revenues are $829,335,000; reasonable intrastate test year operating expenses, including depreciation expense and taxes,[16/] are $703,553,000; the reasonable intrastate test year rate base is $1,996,533,000. Said operating revenues and expenses produce reasonable intrastate test year net revenues of $125,782,000 which when applied to said rate base results in a fair and reasonable rate of return of 6.3 percent.

2. Respondent's intrastate rates since the date of the filing of the investigation herein (July 26, 1962) have produced an excessive and unreasonably high rate of return. The extent of such excessive rate of return translated into annual gross test year intrastate revenues is $40,722,000.

3. Respondent's present intrastate rates will for the future produce an excessive and unreasonably high rate of return. The extent of such excessive rate of return translated into annual gross test year intrastate revenues is $40,722,000.

4. Respondent's rates from and after July 26, 1962 should be reduced by $40,722,000 annually based on test year operations.

5. Pending completion of hearings on final rate spread and other matters, rate reductions on an interim basis reasonably should be made as set forth in Appendix A. Said resulting interim rates will produce the fair and reasonable intrastate test year operating revenues of $829,335,000 previously indicated.

16/ At a 52% Federal income tax rate.

6. Respondent should be required to refund to customers amounts which it collected in excess of the rates herein prescribed from July 26, 1962 (the date of filing this investigation) to the date respondent files with this Commission the rates herein prescribed.

7. Within thirty days after the effective date of this order, respondent should be required to file with this Commission a refund plan designed to refund to customers amounts collected in excess of the rates herein prescribed in harmony with finding 6 above. However, said refund plan should be subject to prior Commission authorization or modification by supplemental order herein before the making of refunds.

8. Within ninety days after the effective date of this order, respondent should be required to prepare and file in writing studies of its service pension fund and expense related to total California and intrastate operations, separately showing: (a) current service pension accrual rate on a pay-as-you-go basis compared with its accrual basis both as a percentage of payroll and in dollars; (b) estimated service pension accrual rate as a percentage of payroll on a pay-as-you-go basis and on its accrual basis as of January 1, 1965, January 1, 1970 and January 1, 1980; and (c) the estimated future date on which respondent's service accrual rate calculated as a percentage of payroll will equal and thereafter be less than the service pension rate computed on a pay-as-you-go basis.

9. Under the rates herein prescribed respondent will have a reasonable opportunity to earn a fair and reasonable return on its fair and reasonable intrastate rate base and will be afforded a reasonable opportunity to attract additional capital as reasonably may be required on reasonable terms in order to enable it lawfully to discharge its duty to the public.

10. The rates and practices of respondent are and each of them is unreasonable to the extent they differ from the rates and practices herein prescribed, which are, and each of them is, found to be just and reasonable rates and practices from and after July 26, 1962.

11. This investigation should be continued.

Based on the findings herein, we conclude that respondent's motion for rate increases should be denied and that rate reductions should be prescribed in accordance with the following order.

ORDER

IT IS ORDERED that:

1. Respondent is directed to file in quadruplicate with this Commission, within fifteen days after the effective date of this order and in conformity with the provisions of General Order No.96-A, revised tariff schedules with rates, charges and conditions modified as set forth in Appendix A attached to this order and, on not less than five days' notice to the public and to the Commission, to make said revised tariffs effective for all service rendered on and after July 26, 1962.

2. Within thirty days after the effective date of this order, respondent shall tender to this Commission for filing a refund plan to refund to customers amounts which it collected in excess of the rates herein prescribed from July 26, 1962 to the date respondent files with this Commission the rates herein prescribed. Upon approval

by this Commission of a reasonable refund plan, respondent shall make refunds in accordance with such approved plan.

3. Within ninety days after the effective date of this order, respondent shall prepare and file with this Commission a written report setting forth studies of its service pension fund and expense related to total California and intrastate operations separately showing: (a) current service pension accrual rate on a pay-as-you-go basis compared with its accrual basis both as a percentage of payroll and in dollars; (b) estimated service pension accrual rate as a percentage of payroll on a pay-as-you-go basis and on its accrual basis as of January 1, 1965, January 1, 1970 and January 1, 1980; and (c) the estimated future date on which respondent's service pension accrual rate calculated as a percentage of payroll will equal and thereafter be less than the service pension rate computed on a pay-as-you-go basis.

4. This investigation is continued.

5. Respondent's motion for rate increases is denied.

The Secretary of the Commission is directed to cause a certified copy of this order to be served forthwith upon The Pacific Telephone and Telegraph Company and to cause a copy to be mailed to each appearance of record.

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

Dated at San Francisco, California, this 11th day of June, 1964.

I concur. Concurring opinion attached hereto. George G. Grover, Commissioner

My views by way of concurrence and dissent will be separately stated. William M. Bennett

I dissent. Copy thereof attached hereto. Peter E. Mitchell

President

George G. Grover

Frederick B. Holoboff

Commissioners

RATES

Respondent's rates, charges, and conditions are changed as set forth in this appendix.

Schedules Nos. 4-T and 5-T
Individual and Party Line Service

All Exchanges Where Offered:

| | Decrease Per Month |
|---|---|
| Business Service - Each Primary Station: | |
| Individual Line - Flat Rate | $0.70 |
| Individual Line - Message Rate | .70 |
| Two-Party Line - Flat Rate | .60 |
| Suburban - Flat Rate | .40 |
| Semi-Public - Rate Per Month | - |
| - Minimum Guarantee Per Day | .02 per day |
| Residence Service - Each Primary Station: | |
| Individual Line - Flat Rate | .45 |
| Two-Party Line - Flat Rate | .35 |
| Two-Party Line - Message Rate | .35 |
| Four-Party Line - Flat Rate | .30 |
| Suburban - Flat Rate | .30 |

| Message Rate Service | Rate Per Exchange Message |
|---|---|
| Rate for each exchange message over allowance, except semi-public service: | |
| All Exchanges Where Offered | 4.05 cents |

Schedules Nos. 6-T and 7-T
Message Unit Service

| | Each Message Unit |
|---|---|
| Rate (2)(b), Other Services | 4.05 cents |

Schedules Nos. 9-T and 10-T
Farmer Line Service

All Exchanges Where Offered:

| | Decrease Per Month |
|---|---|
| Each Business Farmer Line Station | $0.15 |
| Each Residence Farmer Line Station | .10 |

APPENDIX A



## RATES

**Schedules Nos. 13-T and 14-T**
**Private Branch Exchange Trunk Line Service**

Exchanges Where Offered:

Trunk Rate:
Flat Rate Service:
Each trunk line - 150% of the individual line primary station flat rate rounded to the lower 25¢ multiple.

Message Rate Service, Except Hotel:
First two trunks - business individual line message primary station rate with no message allowance.

Each additional trunk - 50% of the rate for first two trunk lines rounded to the lower 25¢ multiple.

Exchange Message Rates:

| | Rate Per Exchange Message |
|---|---|
| Exchanges Where Offered: Commercial manual and dial private branch exchange service, business key station dial private branch exchange service and order receiving equipment service: | |
| Each exchange message | 4.05 cents |

**Schedule No. 18-T**
**Intercommunicating System Service**

Exchanges Where Offered:

Trunk Rate:
Flat Rate Service:
Each trunk line - 150% of the individual line primary station flat rate rounded to the lower 25¢ multiple.

Message Rate Service:
First two trunks - business individual line message primary station rate with no message allowance.

Each additional trunk - 50% of the rate for the first two trunk lines rounded to the lower 25¢ multiple.

Exchange Message Rate:
The rate for each exchange message in connection with message rate service is 4.05 cents.

APPENDIX A



RATES

Schedules Nos. 34-T and 35-T
Foreign Exchange Service

Primary service rates for all foreign exchange services are reduced to the same extent as the reductions in the basic individual line, party line and trunk rates.

C. 7409 **



## RATES

Schedule No. 53-T
Message Toll Telephone Service

Two-Point Service - California Schedule A:

| Mileage | | STATION SERVICE | | | | | | PERSON SERVICE | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Day (Except Sunday) | | Night and Sunday | | "After 9" | | Day, and Night and Sunday | | |
| | | | | | | | | | Each Addl. Min. | |
| Over | Up to and Incl. | First 3 Mins. | Each Addl. Min. | First 3 Mins. | Each Addl. Min. | First 3 Mins. | Each Addl. Min. | First 3 Mins. | First 3 | After 3 |
| 0 | 8 | $0.10 | $0.05* | $0.10 | $0.05* | $0.10 | $0.05* | $0.35 | $0.10 | $0.05 |
| 8 | 12 | .15 | .05 | .15 | .05 | .15 | .05 | .40 | .10 | .05 |
| 12 | 16 | .20 | .05 | .20 | .05 | .20 | .05 | .45 | .10 | .05 |
| 16 | 20 | .25 | .05 | .25 | .05 | .25 | .05 | .50 | .10 | .05 |
| 20 | 25 | .30 | .10 | .30 | .10 | .30 | .10 | .55 | .15 | .10 |
| 25 | 30 | .35 | .10 | .35 | .10 | .35 | .10 | .65 | .15 | .10 |
| 30 | 35 | .40 | .10 | .40 | .10 | .40 | .10 | .70 | .15 | .10 |
| 35 | 40 | .45 | .15 | .45 | .15 | .45 | .15 | .80 | .20 | .15 |
| 40 | 50 | .50 | .15 | .50 | .15 | .50 | .15 | .90 | .20 | .15 |
| 50 | 60 | .55 | .15 | .50 | .15 | .50 | .15 | 1.00 | .25 | .15 |
| 60 | 70 | .60 | .20 | .50 | .15 | .50 | .15 | 1.10 | .25 | .20 |
| 70 | 90 | .65 | .20 | .55 | .15 | .55 | .15 | 1.15 | .30 | .20 |
| 90 | 110 | .70 | .20 | .60 | .20 | .60 | .20 | 1.25 | .30 | .20 |
| 110 | 130 | .75 | .25 | .65 | .20 | .65 | .20 | 1.35 | .35 | .25 |
| 130 | 175 | .80 | .25 | .70 | .20 | .65 | .20 | 1.45 | .35 | .25 |
| 175 | 200 | .85 | .25 | .70 | .20 | .65 | .20 | 1.55 | .40 | .25 |
| 200 | 225 | .90 | .30 | .75 | .25 | .70 | .20 | 1.60 | .40 | .30 |
| 225 | 250 | .95 | .30 | .80 | .25 | .70 | .20 | 1.70 | .40 | .30 |
| 250 | 275 | 1.00 | .30 | .85 | .25 | .70 | .20 | 1.80 | .45 | .30 |
| 275 | 300 | 1.05 | .35 | .90 | .30 | .75 | .25 | 1.90 | .45 | .35 |
| 300 | 330 | 1.10 | .35 | .95 | .30 | .75 | .25 | 2.00 | .50 | .35 |
| 330 | 360 | 1.15 | .35 | .95 | .30 | .75 | .25 | 2.05 | .50 | .35 |
| 360 | 395 | 1.20 | .40 | 1.00 | .30 | .80 | .25 | 2.15 | .55 | .40 |
| 395 | 430 | 1.25 | .40 | 1.05 | .35 | .80 | .25 | 2.25 | .55 | .40 |
| 430 | 470 | 1.30 | .40 | 1.10 | .35 | .80 | .25 | 2.35 | .60 | .40 |
| 470 | 510 | 1.35 | .45 | 1.15 | .35 | .80 | .25 | 2.45 | .60 | .45 |
| 510 | 550 | 1.40 | .45 | 1.20 | .40 | .85 | .25 | 2.50 | .60 | .45 |
| 550 | 685 | 1.45 | .45 | 1.20 | .40 | .85 | .25 | 2.60 | .65 | .45 |
| 685 | 905 | 1.50 | .50 | 1.25 | .40 | .85 | .25 | 2.70 | .65 | .50 |

* $0.05 for each additional two minutes.

RATES

Conference Service:

Rates and conditions applicable to conference service are revised to the extent necessary by the changes ordered herein in two-point service.

Schedule No. 117-T
Airport Intercommunicating Service

Exchange Message Charges:
Each exchange message, in excess of allowance, 4.05 cents.

Schedule No. 121-T
Centrex Service

Exchange Message Rate - Rate Group I
Each exchange message in connection with commercial message rate service, 4.05 cents.

All Schedules Affected

Changes in respondent's rates heretofore authorized by the Commission but not made effective as of the filing date of the tariffs herein amended are not revised by the changes in rates and charges set forth in this appendix.

LIST OF APPEARANCES

For the Commission staff: William R. Roche, J. Thomason Phelps, Mary Moran Pajalich, John R. Gillanders and Lawrence Thormod.

For Respondent: Pillsbury, Madison & Sutro by Arthur T. George, Francis N. Marshall, G. H. Eckhardt, Jr.

Interested Parties: Robert C. Abrams, for Western California Telephone Company; Emerson E. Bolz, for Western Union Telegraph Company; Ellis L. Bovaird, for himself; Philip G. Brierly, for himself and other PT&TCompany pensioners; Julius Cohen, for himself; Robert G. Coleman, for San Mateo County Chapter, National Electric Contractors Association, Inc., and himself; Belli, Ashe & Gerry, by Seymour L. Ellison, for Anti-Digit Dialing League; Bacigalupi, Elkus & Salinger, by William G. Fleckles, for Citizens Utilities Company of California; Neal C. Hasbrook, for California Independent Telephone Association; Clarence W. Hull, Thomas J. O'Reilly, Richard Gabel, for General Services Administration, U. S. Government; Silver and Cole by William L. Cole, for Anthis Answering & Radio Service, Auto Phone Co., Central Exchange Mobile Radio, Cook's Telephone Answering and Radio, Inc., Delta Mobile Radio Service, Fresno Mobile Radio, Inc., Hanford Mobile Radio, Inc., Industrial Communication System, Inc., KME 438, Mobile Radio System of Ventura, Inc., Orange County Radio Telephone Service, Inc., Peninsula Radio Secretarial Service, Radio Dispatch Fresno, Radio Dispatch Service, RCS Inc., Riggs Radio Dispatch, Salinas Valley Radio Dispatch, Tadlock's Radio Dispatch KMA 259, Tulare Co. Radio Dispatch; William L. Knecht and Ralph Hubbard, for California Farm Bureau Federation; Nelson H. Meyer, James H. Krieger, John H. Barrows, for California Interstate Telephone Company; Peter A. Nenzel, Bacigalupi, Elkus & Salinger by Claude N. Rosenberg and William G. Fleckles, for California Water and Telephone Company; Thomas M. O'Connor, Orville I. Wright and Robert R. Laughead, for the City and County of San Francisco; James P. O'Drain, for the City of Richmond; Orrick, Dahlquist, Herrington & Sutcliffe, by Warren A. Palmer, for California Independent Telephone Association, California-Pacific Utilities Company, Western California Telephone Company, Central California Telephone Company, Kern Mutual Telephone Company, Colorado River Telephone Company, Western Telephone Company and Gilroy Telephone Company; Minor J. Schmid, for Wade H. Poole and Michael S. Montalbano; Lester W. Spillane, for Industrial Communication Systems, Inc., and Walter F. Corbin, dba United Radio Communication, Delta Mobile Radio Service; W. A. Taylor, for himself; Frank E. White, for AFL-CIO Community Services; Roger Arnebergh, Robert W. Russell, Manuel Kroman, Arthur Karma, Charles W. Sullivan, for the City of Los Angeles; Edward L. Blincoe, for himself and Utility Users' League of California; Robert C. Crabb and Kay Kelso Kidd, for Radio Public Utilities; The Reverend Waldo L. Ellickson, for Montebello-East Los Angeles Ministerial Association; Albert L. Engi, for Local No. 428 International Brotherhood of Electrical Workers; Hill Farrer & Burrill by C. M. Gould, for National Electrical Contractors Association, Los Angeles Chapter; James K. Higgins and

C.7409 NB



LIST OF APPEARANCES

Arron W. Reese, for San Diego County Chapter, National Electrical Contractors Association; Henry E. Jordan, for the City of Long Beach; Maurice E. Kennedy, for Los Angeles County; Stanley M. Lanham, Edwin L. Miller, for the City of San Diego; Lew Lauria, Stanley O. Sackin, Soloman Fuchs, Avery H. Simon, for Telephone Answering Services of California, Inc.; Allan R. Stacey, for Sunland-Tujunga Telephone Company; Albert M. Hart and H. Ralph Snyder, Jr., for General Telephone Company of California; Harold H. Heidrick, for Wilsey, Ham & Blair; William W. Carstens, William L. Todd, Jr., for the City of National City; Melvin Handberg, for himself; Richard E. Saladana, for himself, and Newcastle Community Club; Lewis Nelson, for Santa Cruz County Board of Supervisors; Milton Goldinger, for Solano County; E. Warren McGuire, for County of Marin; Floyd R. Mitzner, for County of Sacramento; Tom C. Carrell, for himself, and State Assembly.

McKEAGE, Commissioner, concurring:

I concur in the decision of the Commission for the reason that said decision is fully supported by its underlying record. However, I desire to point out some of the rules of law and factual predicates which impel such concurrence.

In approaching the resolution of the issues presented in this case, it must ever be remembered that the Respondent, Pacific Telephone and Telegraph Company, and its corporate owner and ultimate beneficiary, American Telephone and Telegraph Company, are both public utilities, subject to all the regulatory privileges, perquisites, pains and penalties which inhere in such status. We are not here dealing with an ordinary commercial concern subject to the usual hazards and risks of rugged individualism and the harsh laws of the market place. A public utility occupies a sheltered position in our capitalistic economy.

Unlike ordinary business organizations, a public utility occupies a trustee status in dealing with its customers. A public utility is created for public purposes and performs a function of the state. (Smyth v. Ames, 169 U.S. 466, 544, 42 L. ed. 819, 848; Western Canal Company v. Railroad Commission, 216 Cal. 639, 647.) In operating as a public utility, Respondent exercises an extraordinary privilege granted to it by the state, and it occupies a privileged position. (United Fuel Gas Company v. Railroad Commission, 278 U.S. 300, 309, 73 L. ed. 390, 396.) In such circumstances, standards of public service are the guide. This Respondent is obligated by the most fundamental rules of law and morals to operate in the public interest, the property and operations of Respondent being impressed with that interest. A public utility devotes its property to the public use and, thereby, "grants to the public an interest in that use . . . ." (Munn v. Illinois, 94 U.S. 113, 126, 24 L. ed.

77, 84; Southern California Edison Co. v. Railroad Commission, 6 Cal. (2d) 737, 754.) In fine, a public utility is charged with the administering of a public trust delegated to it by the state. (Acme Brick Co. v. Arkansas Public Service Commission (Supreme Court of Arkansas, (1957)), 18 P.U.R. (3d) 13, 17.) There is respectable authority to the effect that--

> "The utility must use all its receipts as though they were a public trust." (City of Ft. Smith v. Southwestern Bell Telephone Co. (Supreme Court of Arkansas), 247 S.W. (2d) 474, 483; 94 P.U.R. (N.S.) 214, 225.) (Emphasis supplied.)

The rate of return of 6.3 percent prescribed by the decision of the Commission is certainly ample, fair and reasonable, based upon the record herein. The Commission did not undertake to adjudicate a rate of return for the Respondent prior to the test year, but I desire to point out that the 6.75 percent rate of return prescribed for Respondent in 1958, although found then to be within the zone of reasonableness, constituted abundant generosity at the expense of Respondent's ratepayers.

The rate of return prescribed herein is based upon a 52 percent federal income tax expense due to the fact that such income tax rate subsisted during the test year which ran from October 1, 1961 to September 30, 1962. However, we take judicial notice of the fact that the Congress has reduced the federal income tax, as applied to this Respondent, from 52 percent to 50 percent effective January 1, 1964, and to 48 percent effective January 1, 1965. During the time that the rates prescribed in the Commission's decision will be in effect prospectively, these reduced income tax rates will be applicable. Thus, it is seen that the rate of return of 6.3 percent will be actually greater than 6.3 percent because of this federal income tax reduction which will result in several million dollars reduction in Respondent's operating expense.

The record shows the tremendous customer and income growth of the Respondent, and the fact that the test year is well in the past constitutes an element in favor of the Respondent, so far as rate of return may be concerned. This growth trend of the Respondent clearly indicates that a more current test year would show a more favorable earnings position for Respondent, thus resulting in a larger rate reduction, if judged by the prescribed 6.3 percent return.

The record shows that the Respondent has not availed itself of the privilege of liberalized depreciation for federal income tax purposes. Had Respondent chosen to avail itself of liberalized depreciation for income tax purposes on a so-called "flow-through" basis (that is, passing the reduction in income tax to the income account), such fact would have lifted a considerable burden from Respondent's ratepayers. Certainly, it would have represented several million dollars in tax saving on an annual basis, which would have inured to the benefit of the customers of Respondent. As yet, the Commission has not accorded treatment to the operating results of Respondent on the predicate that Respondent is lawfully required to take liberalized depreciation for tax purposes on a "flow-through" basis. Such action on the part of the Commission would result in a considerable lessening of the operating expense of Respondent. <u>It may well be argued that it is the duty of Respondent to avail itself of this federal income tax reduction to the end that its ratepayers may enjoy such tax reduction in the form of reduced rates</u>. In other words, such action on the part of Respondent would fit into the general rule <u>that a public utility is required to take all reasonable action to lighten the burden cast upon its ratepayers</u>.

Respondent and its parent, American Telephone and Telegraph Company, persistently assert as a paramount article of faith that this monopolistic corporate combine, denominated the Bell System,

is in the public interest and constitutes a public benefit because, allegedly, it results in superior service at reduced cost. Certainly, the public should receive some very substantial benefit from the operation of this corporate aggregation in turn for its being relieved from much of the rigors of the anti-monopoly laws. I assert that earnings for Respondent should be prescribed which take this "public benefit" claim out of the talk stage and which translate it into substantially reduced rates to be enjoyed by the ratepayers of Respondent, a voluntary act Respondent and American have not seen fit to perform, their persistent protestations of "public benefit" to the contrary notwithstanding.

Respondent's contention that it is operating and exercises all reasonable effort to operate in the public interest is prominently belied by two stubbornly outstanding facts: (1) Respondent's failure to employ liberalized depreciation for income tax purposes on a "flow-through" basis, and (2) its similar failure to adopt a "flow-through" basis for its investment credit deduction from federal income taxes. Respondent's failure in these matters adds considerably to the burden of its ratepayers, which burden would go unremedied were it not for the compulsion of regulation.

From the foregoing, it will be seen that the 6.3 percent rate of return prescribed by the decision of the Commission, in truth and in fact, is really greater than 6.3 percent. In such circumstances, a lesser rate of return would well be within the zone of reasonableness.

McKEAGE
Commissioner

June 11, 1964.

BENNETT, WILLIAM M., Commissioner:

I am unable to concur in that portion of the opinion which requires The Pacific Telephone and Telegraph Company (respondent) to make reductions in its rates and charges and a refund back to July 26, 1962. At the outset I note that the decision does not refer to any provision of California law which permits such action, nor does it refer to any past Commission decision asserting such authority, nor does it refer to any decision of any other jurisdiction in support of its conclusion. I have researched diligently and have awaited the furnishing of adequate authority to support such action. None has come forth.

Accordingly, I dissent to that portion of the opinion as my view of the law compels me so to do. I am gravely concerned as to the impact of this action of the majority upon a decision which might otherwise result in substantial benefits to respondent's ratepayers.

My reasons for departing from the conclusions reached by the majority are dictated by a review of the relevant constitutional and statutory provisions pertaining to this Commission.

THE CALIFORNIA CONSTITUTION
AND THE
PUBLIC UTILITIES ACT

Article XII, Sec. 23 of the Constitution of the State of California provides that this Commission "shall have and exercise such power and jurisdiction to supervise and regulate public utilities, in the State of California, and to fix the rates to be charged for commodities furnished, or services rendered by public utilities as shall be conferred upon it by the Legislature, ..."

An examination of the Public Utilities Act discloses those powers which the Legislature has conferred upon this Commission with regard to rates and charges.

Section 728 of the Public Utilities Act provides:

> "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force." (emphasis added)

The words are simple and the meaning is plain. In seeking to impose an obligation to make refund as of the date the Order of Investigation was filed (July 26, 1962) the Commission is in reality making rates and charges effective on a date before--not "after a hearing." Further, we are doing violence to the plain language of the statute which permits us to fix rates for the future "after hearing" and the rates "to be thereafter observed and in force."

I note in passing that Section 702 of the Public Utilities Act directs every public utility, and in this case respondent, to "obey and comply with every order, decision, direction, or rule made or prescribed by the commission . . ." Query: Could respondent have lawfully disregarded the decision of this Commission, No. 56652 (Volume 56, Opinions and Orders of the Public Utilities Commission of California, 277)? In that decision on May 6, 1958, this Commission, after due notice

and hearing, found that the rates it now prescribes were fair, reasonable, justified, and in the public interest. The respondent was ordered to put these rates in effect on June 1, 1958. The order became final and binding to everyone--except this Commission.

The Public Utilities Act, Section 734, permits a recoupment by way of reparations but it does so only upon the filing of a complaint--which means appropriate notice--and then only after an investigation has determined for whatever reasons that an unlawful rate has been collected. It is most significant, however, that Section 734 states:

> " . . . No order for the payment of reparation upon the ground of unreasonableness shall be made by the commission in any instance wherein the rate in question has, by formal finding, been declared by the commission to be reasonable, and no assignment of a reparation claim shall be recognized by the commission except assignments by operation of law as in cases of death, insanity, bankruptcy, receivership, or order of court." (emphasis added)

I conclude from a reading of the Constitution and of the Public Utilities Act of the State of California that the Legislature has not conferred upon us the jurisdiction to relate rates back to the date of the commencement of these proceedings. If such a technique of regulation is desirable, the Legislature should be requested to confer it upon us.

PREVIOUS COMMISSION DECISIONS AND PRECEDENTS

This Commission, since 1911, has construed and applied its own authority. Our interpretation and understanding of our own powers is entitled to great consideration and unless clearly wrong, should be persuasive. I will not cite the host of cases

which support, generally speaking, administrative interpretations by administrative agencies of their own powers.

This Commission has, however, never assumed nor applied the power which is being imposed here. To the contrary, the cases go the other way without exception.

As early as 1913, in Decision No. 579, Scott, Magner & Miller, et al. vs. Western Pacific Railway Company,[(1)] Case No. 283, decided April 15, 1913, the Commission made it plain that the Commission itself could not impeach a rate which it has determined to be just and reasonable and lawful. While this was a reparations case, nonetheless the language of it is quite relevant. At page 636 the Commission held "We are accordingly of the opinion that if the Railroad Commission had established defendant's rates, as it was its duty under the constitution to do, no right to reparation could have arisen, on the theory of unjust or unreasonable rates on the facts as stated in this complaint prior to October 10, 1911. The shipper's remedy would be to petition the Commission to alter the rate . . ." The members of the Commission at that time were John M. Eshleman, H. D. Loveland, Alex. Gordon, Max Thelen and Edwin O. Edgerton. As I understand it, Commissioner Max Thelen is credited with writing the Public Utilities Act in a large measure, and most, if not all of the other Commissioners were personally aware of the purposes and powers of the Public Utilities Act. Why did these Commissioners, among them the author of the Act, fail to apply the doctrine of retroactivity for the benefit of a ratepayer?

Later cases run to the same conclusion and there are many of them. For this opinion let it suffice, however, to cite

(1) Vol. 2 Opinion and Order of Railroad Commission at page 626.

the following: Pacific Cement and Aggregates, Inc. v. P. G. & E., 58 Cal. P.U.C. 600 (1961); Boswell Co. v. A. T. & S. F. Rwy. 33 C.R.C. 308, 321 (1929); Engels Copper Mining Co. v. Great Western Power Co., 17 C.R.C. 191 (1919); Merchants Traffic Association v. A. T. & S. F. Rwy, 4 C.R.C. 268 (1914).

In a discussion of notice to respondent and the obligations to confer due process, this consistent refusal in the past to order refunds as is done here becomes very meaningful.

THE LACK OF DUE PROCESS

There will be paraded in judgment before this proceeding is concluded all of those cases setting forth the requirements of due process. A regulatory body cannot ignore them. For the purposes of this discussion and taking an assumption beyond the limitations of reason, let me assume that this Commission may order the refund as was done here. Can it do so however without apprising the parties to the proceedings that it is about to embark upon such a course of action?

The Order of Investigation initiating these proceedings contained no specific reference and not the slightest suggestion or hint that this action would be taken. No party to this proceeding at any time requested this action of the Commission nor, particularly, did the staff counsel representing this Commission make such a request. The transcript is silent as to this refund proposal from all parties. Neither was it briefed, neither was it argued; and during the oral argument, in which I participated, neither was it raised.

As a matter of fact, the City and County of San Francisco, the City of Los Angeles and the City of San Diego, by letter

addressed to this Commission, urged that these proceedings be expedited--and their request was well taken. They took pains to point out that they were eager for a prompt decision in view of the elapsed time because " . . . telephone subscribers have been required to pay more than $150,000 per day in excess rates to The Pacific Telephone and Telegraph Company, no part of which excess can be refunded to the rate-paying public under existing law." (emphasis added)

As the matter now sets, respondent was under no notice from previous Commission precedents that we were about to order refunds. In fact, its reliance was well placed to the contrary. Further, no reasonable or, indeed, any past construction of statutory powers would lead even the most keen to suspect that our powers would be exercised in this way. And over and above all this, the lack of notice that this was to be done prevented respondent from rightfully making that type of showing and that type of argument and appeal to us, which was consistent with fair play and due process, before this trap was sprung.

## SOME OBSERVATIONS ON RETROACTIVE RATE-MAKING

This Commission has always disclaimed the power to cure past deficits at the expense of ratepayers. This is the reverse situation of curing excessive earnings by refunds based upon the doctrine of retroactive rate-making. In Decision No. 43145, in Application No. 29854, 48 Opinions and Orders of the Public Utilities Commission of California, 823, this Commission held:

"Furthermore, the provisions of Section 32 of the Public Utilities Act plainly and unequivocally state that rates are to be established for the future. It is elementary that rate-fixing is purely legislative and that legislative action operates prospectively and not retroactively. One of the cardinal distinctions between legislative action and judicial action is that the former operates prospectively and the latter generally operates retrospectively, addressing its action to past occurrences. This is the distinction between the prescription of rates and the granting of reparation. (Southern Pacific Company v. Railroad Commission, 194 Cal. 734, 739.) In addition to the statutory requirement that rates not be fixed retroactively, as laid down in Section 32 of the Public Utilities Act, it is a general rule of law, irrespective of statute, that rates may not be so prescribed. (Ohio Public Utilities Commission v. United Fuel Gas Company, 317 U. S. 456, 461-462, 87 L. ed. 396, 399-400; Transcontinental & Western Airlines v. Civil Aeronautics Board (Supreme Court of the U.S. April 18, 1949), 17 L.W. 4339, 93 L. ed. 911; Michigan Bell Telephone Company v. Michigan Public Service Commission, 315 Mich. 533, 24 N.W. 2d 200.) This Commission has specifically held that it has no authority to issue a retroactive rate order. (Merchants Traffic Association v. A.T. & S.F. Ry Co., 4 C.R.C. 268, 276.)

Here the Commission refused, and properly so, to impose past expenses and deficits upon present ratepayers.

The danger of the technique of retroactivity is that it opens the way not only to the ratepayer but to the stockholder. What is fair for one is fair for the other and, if this doctrine be sound, I would expect us in the future to honor public utility rate increase applications the purpose of which is to cure past deficits.

Why did not the Order of Investigation which was filed herein direct that respondent create an appropriate reserve into which excess rates and charges collected could be assigned for the ultimate benefit of ratepayers by a refund order? This would

have had the obvious virtue of permitting the respondent to guard against the day when the refund bill fell due. Further, it would have been notice to them that such action was contemplated. The difficulty with such a pat solution, however, is that there is no way in the world whereby this Commission could have prescribed the amount of the reserve, since we had no way of knowing what our ultimate determination as to a fair return would be. As a result, in the first instance, the public utility must guess as to whether or not a retroactive rate-making power is to be used; then it must guess as to whether a reserve should be set up; and then it must guess as to what the ultimate finding on fair return is to be. The law cannot assume clairvoyance. All of my experience in regulation compels me to conclude that such a situation is monstrous and impossible.

THE LAWFUL RATES OF RESPONDENT

On May 6, 1958, by Decision No. 56652, in Application No. 39309, Vol. 56, Opinions and Orders of the Public Utilities Commission of California, 278, the fair return and lawful rates of respondent were prescribed. The Commission found at page 290, "that a return of approximately 6.75 per cent . . . is warranted by the evidence and we hereby find such rate of return to be fair and reasonable." Again, at page 299 of the decision is stated, "the findings hereinabove set forth produce an over-all result which we find to be fair and reasonable and in the public interest. Further, we hereby find as a fact that the increases in rates and charges authorized herein are justified . . ." Whether I, personally, would have been of that opinion at that time is

irrelevant. But now, by an order in midpassage, the Commission is impeaching the findings of the Commission, all of the rates and charges collected by respondent since July 26, 1962, are ipso facto unlawful if the refund order is valid. Certainly if this were a reparations case, the only basis upon which reparations could be made would be that the charges collected were unlawful.

The incurable difficulty I find with this concept is determining how the respondent was to ascertain that it was unlawfully collecting rates and charges while acting pursuant to a lawful order of this Commission setting the rates and charges collected (review incidentally denied by the Supreme Court of the State of California). Apparently, respondent has collected these moneys on some undisclosed trust theory which is a novelty in regulation. Moreover, the most frustrating portion of the opinion is its complete failure to marshal the slightest authority in support of its novel conclusion as to the powers of this Commission.

## JUDICIAL PRECEDENTS

The Supreme Court of this state has not passed upon this question, but the United States Supreme Court has addressed itself to it: Board of Public Utility Commissioners v. New York Telephone Company (1925), 271 U.S. 23, 70 L. ed. 809; Public Utilities Commission of Ohio v. United Fuel Gas Co., et al, (1943) 317 U.S. 456, 87 L. ed. 401; Arizona Grocery Co. v. Atchison, Topeka and Santa Fe Railway Co., et al., (1932) 284 U.S. 370, 76 L. ed. 348.

Other regulatory bodies may by specific statutory language have the refund power. I am quick to point out, however, that we do not operate under such a law. Note that the Natural Gas Act (52 Stat. 821-833; Title 15, U.S.C. 717-717w) Section 4 (e) in precise language provides that rates may be increased without hearing under certain conditions subject to refund. We have no such provision in our statute.

Accordingly, then, for all of the reasons herein set forth, I dissent from that portion of the opinion and order which, based upon the theory of retroactivity, seeks to compel respondent to make refunds back to the date of the commencement of the investigation.

The respondent has currently filed a Petition to Set Aside Submission and Reopen the Proceeding based upon the premise that the test year is obsolete. It is true that time has elapsed. The Commission has an obligation, however, to render a decision upon the record as made in this case. If respondent is in fact experiencing operating results resulting in less than a fair return and which is confiscatory of its investment, then under law it may file an application for relief. I note that that petition makes reference to proposed depreciation rates which might result in an intrastate depreciation expense of approximately $11 million annually. Significantly, however, the expense is not set forth as a reality but as a mere possibility. The petition is silent as to the capital cost of respondent, and respondent does not state that it is operating at less than a fair return. A "downward trend" of certain factors is not necessarily persuasive--related with others to delineate a

broader scope of operations, it may be so.

The reference to the reduction in federal corporate income taxes discloses to me that respondent is overcollecting upon its tax expense and, if anything, discloses no reason to reopen. The manner and method as to procedure rests with respondent; but the obligation of this Commission here, as always, is to render a decision with some degree of expedition so as to meet our responsibilities to ourselves, the ratepayers, and the public utilities.

The record is not so old, nor is the test year so stale, that it does not furnish the basis upon which the Commission can make informed judgment. Accordingly, then, and in conclusion I concur in the finding of the Commission as to a fair and reasonable rate of return of 6.3 per cent, even though I disagree and have concern for the ultimate result here because of the action of the majority in ordering refunds.

I condemn the effort to grasp power which the law does not give us, that is, the order making refunds -- because it places in jeopardy an otherwise sound decision. If the Commission be reversed upon its position that refunds as here made are unlawful, then it may well be that when this occurs in the future, we must resume rate-making as to this respondent all over again.

WILLIAM M. BENNETT, Commissioner

C 7409

COMMISSIONER PETER E. MITCHELL DISSENTING:

A decision of the California Public Utilities Commission which reduces the rates of a utility is always popular with the customers. A decision of the California Public Utilities Commission which requires a utility to refund millions of dollars to customers is even more popular. Put them together, as this decision does, a rate reduction and a refund, and huzzas will and should explode from all customers. Were this decision founded in justice and in law, I would hope that the entire Commission could share in the spotlight of commendation. To receive the accolade of ratepayers, news media, and others, is indeed pleasing to a public servant. But logic and reason compel me to turn away from the majority decision and to seek refuge in the certitude of my convictions.

The California Public Utilities Commission has today embarked on the greatest giveaway in the history of the State of California. The Pacific Telephone and Telegraph Company has been ordered by this Commission to be the "giver" of $80,000,000 in refunds, and its subscribers the "receivers" of $80,000,000 in refunds. Until this very moment, Pacific had considered this money, earned under rates authorized by this Commission, as their own private property.

The financial resources of a utility have been sequestered through this decision by the California Public Utilities Commission for distribution to subscribers as the Commission sees fit. In summary, this order extracts millions of dollars from a utility by means of inapplicable State action, with the consequent result of utter chaos in utility regulation in California.

REFUNDS

If the participants in this proceeding were polled, all would register surprise, even amazement, that Pacific has been ordered to refund $80,000,000. Not once, from the commencement of the investigation to the presentment of the majority decision, was the subject of refunds, albeit retroactive rate making, made an issue. Search the record from the pre-hearing conferences through the forty-nine days of hearing, and review the briefs of the parties. Wherein can be found any notice to the respondent, to the staff, to the municipalities, to the other representatives, that the Commission was considering a rate reduction retroactive for a period of two years?

Certainly, the respondent would have strongly litigated this issue, for at stake is its capital stability. Too, the staff, municipalities and others, would have demanded an opportunity to be heard on: (1) the amount of the refund; (2) the division of the refund; and (3) the spread of the refund.

Indeed, the cities of Los Angeles and San Francisco on March 13, 1963, moved for an interim order reducing future rates and annual charges of respondent in the amount of approximately $15,363,000 on an annual basis; on September 27, 1963, the Commission staff[1/] moved for an interim order reducing respondent's future California intrastate revenues by approximately $31,200,000. Were these two motions consistent with an understanding by the parties that the Commission order would relate back to July 26, 1962? Obviously not, for there was no such understanding.[2/]

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1/ Supported by the municipalities.

2/ See late-filed motion dated June 8, 1964, by cities of Los Angeles and San Francisco, page 1...."There appears little prospect that any excess revenues over that considered sufficient in Decision Nos. 55936 and 56652 will ever be refunded."

Assuming, for argument, that the Commission had accepted the evidence of the respondent as to inadequacy of earnings for the test year, would the Commission then have increased the telephone rates effective as of July 26, 1962? Would Pacific have been mandated by this Commission to collect X number of dollars from every subscriber for delinquency in telephone rates since July 26, 1962? They should be, for, needless to point out, the converse must be just as lawful.

Paradoxically, impossible conclusions arise from the holding by the majority of a retroactive rate of return. Any future rate application filed by a utility, or an order instituting investigation by the Commission, should now obviously relate back to the initial date of filing. Depending on the time for culmination of the proceedings, a consumer may be indebted to a utility for hundreds of dollars, or the utility may likewise be so obligated to the consumer. The consumer may receive a sizeable refund or, in lieu, repossession of his automobile. The utility may reap millions of dollars or go bankrupt. I fail to see how, in conscience, the majority can disavow in the future their "new look". Or, indeed, is this "new look" just a one-time, one-way street?

The California Public Utilities Commission, on May 6, 1958, issued Decision No. 56652, which found a rate of return of 6.75 per cent lawful for Pacific. There have been no subsequent decisions of this Commission to this time which changed the aforesaid rate of return to Pacific.[3/]

In the years in question: 1962, 1963, 1964, Pacific was collecting revenues lawfully under rates prescribed as reasonable by

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3/ See Utility Users League v. Illinois Bell Telephone Company 43 PUR 3d (1962) 38 at pages 41, 42

the California Public Utilities Commission. The order instituting investigation, issued on July 26, 1962, did not suspend, alter, or affect the last authorized rate of return established by Decision No. 56652. At best, the order can be construed as an inquiry by the Commission into the operations of Pacific, its rates, and its service.

Pacific was, and for that matter still is - until the effective date of today's decision - under authority of the Commission to obtain a 6.75 per cent rate of return. Even today they are lawfully receiving revenue at rates established in May, 1958. Nonetheless, when today's decision becomes effective, those rates - authorized by this Commission, and which Pacific has been charging subscribers lawfully during 1962, 1963, and 1964 - will become unlawful. If today's decision remains, what trust and reliance may a utility or a ratepayer place in an order of this Commission?

It is noteworthy that Pacific is not ordered to refund monies collected in excess of 6.75 per cent, the last authorized rate of return prior to today, but, indeed, must refund on the basis of a 6.3 per cent rate of return, which is selected two years after the actual operations of the utility.

Indeed, the onus for a delay in the instant decision belongs to the Commission. The investigation was instituted by the Commission on July 26, 1962, and the staff was not prepared to proceed until January 23, 1963.[4/] Again, the case was partially submitted on November 21, 1963, but the decision was not issued by the Commission for over six months.

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4/ No adverse reflection is intended on the staff. They have done excellently. Necessary preparation is always time consuming.

Meanwhile, during the entire period to date, Pacific has been receiving revenues and disbursing funds with no revelation from the Commission of the proposed action. The record indicates Pacific has recently concluded a wage settlement ($13,456,000 annual increase); plans to invest $1,300,000,000 for construction of facilities in California during 1964-1966; raising $650,000,000 during the next three years to finance the construction program. The unreasonable rate of return coupled with the retroactive rate adjustment will not only affect Pacific's operations and services but also propel a decline in the economy of the State. If Pacific has placed reliance on decisions of this Commission, and it has, certainly the Commission, as a matter of law, would be estopped from changing those decisions to the detriment of the utility. No utility earns a guaranteed income. Not one utility in a hundred receives the exact rate prescribed by a Commission. Because a utility is unable to "toe the line" exactly, a Commission does not reward or penalize it in retrospect.

Furthermore, there is no showing in the record that Pacific has the ability to refund $30,000,000 to its subscribers. The financial condition of Pacific as of the present date, 1964, has not been established. The effect of this order on the ability of the Company to continue its operations and furnish new services in the future, is questionable. Suppose a private corporation active in the State of California were required by a governmental agency to pay out over 60 per cent of its net revenue for one year. How many corporations could continue operating in the same manner as before? Yet, the majority decision finds the reasonable intrastate net revenues of

Pacific should be $125,732,000 per year. It also finds that Pacific should refund $30,000,000 to its subscribers - over 60 per cent of its intrastate net revenue for one year.

Ultimately, the attempt by this decision to fix rates ex post facto is not only unjust but also unlawful. Article XII, Section 23, of the Constitution of the State of California, provides in part that:

> "The Railroad Commission shall have and exercise such power and jurisdiction to supervise and regulate public utilities in the State of California and to fix the rates to be charged for commodities furnished, or services rendered by utilities as conferred upon it by the Legislature."

Note that Section 23 states: "to fix the rates to be charged." The jurisdiction to fix rates is only prospective, not retrospective. Supplementary to Section 23, the Legislature enacted Section 728 of the Public Utilities Act, which reads as follows:

> "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

Thus, we have both the State Constitution and the Legislature enabling and limiting the Commission to the establishment of rates prospectively. Both Section 23 of the Constitution and Section 728 of the Public Utilities Act are clear, unambiguous and require no interpretation.

The cases in which this Commission in the past has refused to sanction retroactive rate making are legion and the more pertinent cases which have been printed are cited: Merchants Traffic Association v. AT&SF Ry. 4 CRC 268, Engels Copper Mining Co. v. Great Western Power Co. 17 CRC 191, Wm. I. Govan 23 CRC 234. But the most emphatic pronouncement of the California Public Utilities Commission on the subject is contained in Decision No. 43145, dated July 26, 1949, <u>relating to an application of The Pacific Telephone and Telegraph Company for a rate increase</u>. At page 836, the Commission states:

> "There are definite rules of law governing rate fixing and this Commission is bound thereby. Broad and plenary as its authority may be to fix rates, it is not free to disregard cardinal principles of rate fixing. There is no better established rule with regard to the prescription of rates for a public utility than the one that holds that rate fixing may not be established retroactively, unless some specific statutory or constitutional authority permits."

The decision concludes that the setting of rates retroactively is prohibited by the Public Utilities Act and the Supreme Court of the United States. There have been no legislative enactments or court decisions since Decision No. 43145 which would repudiate this "established rule".

RATE OF RETURN

This investigation of Pacific was instituted by the Commission with my support. A review of the evidence introduced in the proceeding compels the finding that Pacific's earnings should be reduced. I adopt such a finding. What I cannot adopt is an unexplained "exercise of judgment"[5/] of the majority which finds a rate of return of 6.3 per cent to be fair and reasonable.

The decision is totally devoid of any rationalization as to why 6.3 per cent was selected as a rate of return. A figure of 6.0 per cent, 7.0 per cent, or even 3.0 per cent could be substituted as an equally inexplicable "exercise in judgment". Apparently, the formula is to place figures - any figures - before the words, "per cent", then include the magical phrase, "exercise of judgment", and, presto, you have arrived at a reasonable rate of return.

I submit a rate of return which is fair and reasonable must achieve the following objectives:

(1) Enable the company to earn a return approximately equal to that being earned on alternate investments of comparable risk;

(2) Create a credit standing in the capital market which will enable the company to secure new capital under reasonable terms;

(3) Be sufficient to induce the company to seek additional capital for improvements;

(4) Provide the equity owners a return comparable to that earned by other equity owners.

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5/ Page 40

These objectives are nothing more than a restatement in non-legal language of the guide lines indicated by the United States Supreme Court in the Hope Natural Gas Case 6/ wherein it stated:

> "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock .... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital ...."

In the last rate decision of this Commission involving The Pacific Telephone and Telegraph Company, 7/ a rate of return of 6.75 per cent was found reasonable by the Commission when applied to a rate base of $1,279,418,000. The last sentence in the rate of return paragraph of that decision is most significant. It reads as follows:

> "Such rate of return, in our opinion, will provide net revenues sufficient adequately to service applicant's debt and allow a reasonable return on equity capital including a reasonable provision for surplus."

In the current decision, no such finding is made <u>for the simple reason</u> that it cannot be made. The allowed rate of return will not provide the company with the net revenues it requires to adequately service the securities that have been issued to finance the construction of telephone facilities to serve the people of the State of California. Even though the average cost of debt capital to the company has increased from 3.44 per cent in 1957 to 3.67 per cent in 1962, the allowed rate of return has been decreased from 6.75 per cent to 6.3 per cent.

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6/ Federal Power Commission v. Hope Natural Gas Co. 320 US 591 (1944)
7/ Decision No. 56652, dated May 6, 1958

The net revenues which will be produced under the allowed 6.3 per cent rate of return which the majority has found reasonable in this proceeding clearly does not meet the standards of the United States Supreme Court.

The majority decision finds as reasonable from intrastate operations for the test year:

| | |
|---|---|
| Operating revenues | $829,335,000 |
| Operating expenses including depreciation expense and taxes | 703,553,000 |
| Net operating revenues | $125,782,000 |

To the above must be added the net operating revenues which it is reasonable to expect would be derived from interstate operations in order to ascertain the amounts available to service the company's outstanding debt and preferred stock and to provide earnings on the common stock equity. The total earnings available from total California operations would then be as follows:

| | |
|---|---|
| Earnings from intrastate operations[8] | $125,782,000 |
| Earnings from interstate operations | 26,319,000 |
| Interest during construction[9] | 3,133,000 |
| Total available earnings | $155,234,000 |

The total available earnings from California operations of $155,234,000 for the test year must service average total capitalization of $2,421,255,000 considered applicable to California operations. The $2,421,255,000 was derived by deducting from the total company average capitalization for the test year of $2,792,931,000

8/ Based on a 7.25 per cent rate of return on unadjusted rate base of $363,025,000 which represents the separated plant less reserve for depreciation, on a recorded basis allocable to interstate operations.

9/ Tabulation on page 23 of decision

an amount of $371,676,000 which represents the capitalization assignable to the average amount carried in other investments during the test year.

On the basis of an 8.25 per cent earning allowance on common stock equity 10/ and the average capitalization ratios during the test year (63.75 per cent common stock equity), the financial requirements applicable to total California operations are:

| | |
|---|---|
| Long term debt | $ 29,827,000 |
| Preferred stock | 4,650,000 |
| Common stock equity | 127,332,000 |
| Total requirements | $161,809,000 |

The earnings of $155,234,000 which will be available under the majority decision are $6,575,000 less than the financial requirements of the utility if an 8.25 per cent return is to be allowed on common equity. The effect of such deficiency is to reduce the earnings on common equity to 7.82 per cent or $1.33 per share as compared to the $1.40 per share which would be available if earnings equal to 8.25 per cent were allowed.

In addition to the above deficiency in earnings resulting from the allowing of an inadequate return, consideration must also be given to the fact that the company, with the exception of the investment tax credit item of about $4,000,000, in all probability will not be in a position to actually eliminate the $10,000,000 of expenses disallowed in this proceeding. If the company continues to incur disallowed expenses in the amount of $6,000,000 ($10,000,000 less the $4,000,000 investment tax credit), the earnings on common equity capital will be further decreased to 7.43 per cent or $1.27

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10/ The lowest earning allowance recommended in the proceeding.

per share. This, of course, means that the company would be unable to continue its current common dividend of $1.20 per share.

In the majority decision[11] it is implied that low utility rates will insure a healthy California economy. Such a statement by itself sounds attractive but if the rates allowed the utility are too low, it will refrain from investing the additional capital which growth requires. It was expected prior to this decision that the company would expend in excess of $400,000,000 for construction in California in 1964 and that future plans call for the expenditure of even larger sums.

Is it reasonable to expect any corporation to invest large sums of money in California facilities when confronted with depressed earnings? As a businessman, I must answer in the negative. In my opinion, the depressed earning position which will be created by the majority decision can only result in the curtailment by the company of its construction and/or operations which curtailment will exert a depressing influence on the economy of the State. The majority decision is actually a misapplication of regulatory power and a disservice to the people of the State of California.

The 6.3 per cent rate of return, which the majority conjectures, is confiscatory and impairs the constitutional rights of the utility. The additional impact of the retroactive refund on the earnings of the utility is further violative of the constitutional rights of the respondent.

There are several other spheres of controversy contained in the decision which are overshadowed by the provisos for refund and rate of return.

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11/ Page 29

EXECUTIVE SALARIES

In the area of operating expenses, the decision finds that Pacific is paying excessive executive salaries in the amount of $2,150,000 for its intrastate operations. The utility must either: (1) fire executives at salaries totaling $2,150,000, or (2) absorb such expenses itself out of its allowed rate of return.

The General Services Administration presented testimony and an exhibit summarized in the majority decision.[12/] The staff of the Commission made no presentation whatsoever on the subject. It must be conceded that respondent was uncooperative in furnishing information on salaries and unsound in not presenting rebuttal. Nevertheless, the burden of proof remains with the proponents of the disallowance, either the General Services Administration or the staff.

Whether the respondent declined to furnish information to any appearance in the proceeding is not of evidentary moment, although the majority decision indicates weight was given to this consideration. The Rules of Procedure of this Commission[13/] state the method by which subpoenas and subpoenas duces tecum may be obtained. No request was made for subpoenas directed to the respondent on this issue.

On such a generic statistical study as contained in the majority decision,[14/] it is the order of this Commission that the payroll of the respondent be reduced $2,150,000 for intrastate operations. One hundred executives eliminated by statistics; the tragedy of abstractness.

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12/ Page 88
13/ Rule 50 and Rule 51
14/ Page 88

WORKING CASH

In the majority decision, a negative amount of $6,800,000 is allowed for working cash. This is a new treatment of working cash and one not consonant with established principles of rate making. This procedure necessarily assumes that the subscriber, as a part of his payment for services received, also provides an investment in the assets of the company and that he is entitled to receive a return on this investment. This is illogical since the subscriber is not advancing money for construction but merely paying for services rendered.

It was also noted that in the lead and lag studies which were developed in computing the amount of working cash, the item of bond interest is regarded as an available source of dollars. Under this premise, the company is deprived of its right to utilize funds provided by its earnings as it sees fit. Indeed, a company with a substantial amount of debt outstanding would presumably have a larger negative working cash position than would a company with little or no debt.

In the last rate proceeding involving Pacific, the Commission allowed zero working cash. This action was and is supported by the fact that the company bills exchange charges in advance.

The majority decision cites one previous instance[15/] where it contends a negative working cash was adopted. We cannot presume that reliance on that instance is substantial grounds for a departure from a well-established practice.

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15/ 59 Cal PUC 610 - Page 68

DUES, DONATIONS AND CONTRIBUTIONS

The Commission has for some time recognized as an operating expense all dues paid by a utility for membership in trade and technical organizations. The exchange of professional data and communication of information is fostered through these channels. The ability of a utility to keep abreast of the rapid technological advances occurring daily, benefits not only the company but also the ratepayer. The majority decision will disallow all dues in the future. I do not concur.

The Commission has also allowed in the past as an expense one half of the donations made by a utility to charitable, educational, and cultural organizations. One half of the amount is supplied from the funds of the utility and one half is treated as an operating expense. Contributions to the Red Cross, United Crusade, and other charities have long been regarded as deserved and as essential humanism for every company, regulated or not. A utility must assume a normal business relationship in the community in which it operates. It cannot close its financial heart when charity is needed. These charges are no less an expense to a utility than advertising, public relations, home economic advice and numerous other activities conducted by California utilities. Even a utility must participate in the world of today.

The staff of this Commission has always had free reign to examine dues, donations and contributions of any utility and attract the Commission to items which appear unreasonable. The present practice is feasible. The statement of the majority "that it shall be the policy of this Commission henceforth to exclude from operating expenses for rate-fixing purposes all amounts claimed for dues, donations and contributions"[16/] is not representative of my views.

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16/ Page 121

ADDITIONAL PROCEDURES

The Commission, until its decision in Case No. 7409, historically has normalized revenues and expenses in virtually all major rate cases, including Pacific rate applications. This was not done in Case No. 7409. Failure to adjust for known future changes in revenues and expenses and in lieu thereof, reliance upon actual recorded figures, results in rates for the future based on obsolete records of the past. The trends drawn upon by the majority decision are "significant" - significant statistical studies. A comparison of a trend of revenues versus a trend of wages may be less significant than a comparison of a trend of revenues versus a trend of total expenses. Indeed, when confronted with known future changes both comparisons may be utterly "insignificant". Recorded figures, without a doubt, are a valuable adjunct in rate making but this Commission heretofore has always demanded supplementation in major rate proceedings to prepare a utility to meet the future.

It should be added that this Commission (in past decisions which I signed) has made adjustments to Pacific which have not and are not made to so-called affiliated utilities by other regulatory bodies. These include a Western Electric rate base adjustment, a depreciation deduction, a license fee deduction, and additional items, all of which total millions of dollars.

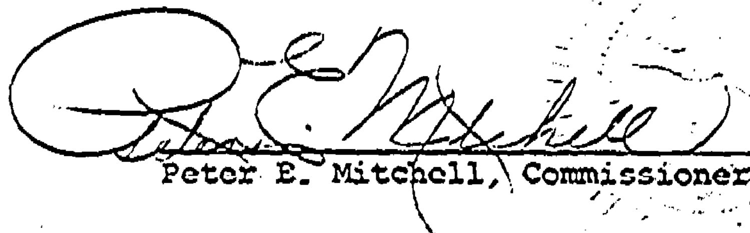
Perhaps, in epilogue, the compass of my belief can more eloquently be described in a treatise by the well-known jurist, Supreme Court Justice Benjamin N. Cardozo:[17/]

> "There, in the final precept, is the gist of the difference between 'le phenomene Magnaud', and justice according to law. The judge, even when he is free, is still not wholly free. He is not to innovate at pleasure. He is not a knight-errant roaming at will in pursuit of his own ideal of beauty or of goodness. He is to draw his inspiration from consecrated principles. He is not to yield to spasmodic sentiment, to vague and unregulated benevolence. He is to exercise a discretion informed by tradition, methodized by analogy, disciplined by system, and subordinated to 'the primordial necessity of order in the social life'. Wide enough in all conscience is the field of discretion that remains."

This language has its application then:

> in the overturn of Decision No. 56652, issued by the Public Utilities Commission of the State of California on May 6, 1958, which overturn effects a rate refund;
>
> in the disregard of rate-making precedents in the treatment of revenues, expenses, and rate-base;
>
> in the adoption of a confiscatory rate of return, with its imponderable formulation.

This is "le phenomene Magnaud" of the majority decision.



Peter E. Mitchell, Commissioner

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17/ "The Judge as a Legislator"; The Nature of the Judicial Process, Benjamin N. Cardozo, p. 141.