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Decision No. 75873 **ORIGINAL**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a corporation, for authority to increase its rates and charges for telephone service.	Application No. 49835 Filed December 1, 1967 Amended December 2, 1968
Morris M. Conklin and Petitioners, Complainants, vs. General Telephone Company, a corporation, Defendant.	Case No. 8682 Filed August 28, 1967
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, service, and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA.	Case No. 8749 Filed January 16, 1968
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY.	Case No. 8750 Filed January 16, 1968

(Appearances are listed in Appendix A)

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O P I N I O N

General Telephone Company of California (General) seeks to increase its rates for intrastate telephone service by $41,934,000 annually, plus an additional sum of approximately $8,400,000 annually to compensate for the 10 percent federal income tax surcharge. Concurrently with General's application, in order to make certain that all aspects of General's operation were adequately explored, the Commission instituted an investigation into the reasonableness of General's rates, tolls, rules, charges, operations, costs, separations, practices, and contracts; the adequacy of its service and facilities; the quality of its service as compared with that of telephone corporations in adjacent territory; the permissible rates for comparable service charged by telephone corporations in adjacent territory; the relationships of its corporate affiliates; and the reasonableness of charges for services performed or equipment furnished by such affiliates to it.

The Commission, at the same time, opened an investigation of The Pacific Telephone and Telegraph Company (Pacific) limited to Pacific's relationship with General in the following areas: (1) separation procedures affecting toll and other settlements; (2) multimessage unit rates; (3) plans for splitting telephone directories; (4) the adequacy of facilities and the quality of service of Pacific as they affect the service furnished by General; and (5) agreements between Pacific and General applicable to interconnection of facilities and exchange of traffic and settlements related thereto.

Both of the Commission investigations were consolidated for hearing with General's application. Also consolidated for hearing was Case No. 8682 (Conklin v. General Telephone) which asked the Commission to order General to improve service and reduce rates.

After due notice 60 days of public hearing were held before Commissioner Fred P. Morrissey and Examiner Robert Barnett from February 15, 1968 to January 17, 1969, on which date the matter was submitted. On January 9, 1969 General moved for an interim order to increase rates 1.30 percent to offset a federal tax surcharge. Said motion was heard on February 3, 1969 and denied (Decision

No. 75318, dated February 11, 1969). A proposed report was issued April 15, 1969. Exceptions to the proposed report have been received, and replies thereto. Oral argument was heard May 26, 1969.

I

BACKGROUND

In the United States today approximately 83 percent of all telephone service is provided by the American Telephone and Telegraph Company (Bell). The remaining 17 percent of service is provided by a large number of telephone companies known collectively as the "independents." One of these independent telephone companies is General Telephone and Electronics (GT&E) which now provides over 45 percent of the total independent telephone service. General is the largest of GT&E's telephone operating subsidiaries.

The General Telephone Company of California had its origin in 1929 when six independent telephone operating companies were consolidated to become Associated Telephone Company, Ltd. Included in the consolidation were the Associated Telephone Company in Long Beach and San Bernardino, Home Telephone Company of Covina, Redondo Home Telephone Company, Laguna Beach Telephone Company, Huntington Beach Telephone Company, and Santa Monica Bay Home Telephone Company. The new company commenced operations with an investment of about $10,000,000, 64,000 telephones, and 600 employees.

The company was little more than a year old when it purchased the properties of the Home Telephone Company of Etiwanda, starting a program of acquisition and growth which soon made it the largest independent telephone operating company in the United States. This program of expansion was marked by the acquisition of companies serving Pomona and Ontario in 1932, all of Santa Barbara County in

1939, Downey in 1946, Whittier in 1948 and Oxnard, Santa Paula, and Thousand Oaks in 1949. The Delta Telephone and Telegraph Company, operating in the Sacramento River Delta area, and the Sunland-Tujunga Telephone Company in the San Fernando Valley, were acquired in 1964. The most recent acquisition took place on August 31, 1967 with the merger of the California Water and Telephone Company (Cal Water & Tel). This acquisition more than doubled the operating area of General. In 1953, after its acquisition by GT&E, the Associated Telephone Company, Ltd. changed its name to General Telephone Company of California. General interconnects with facilities of Pacific pursuant to contracts negotiated from time to time between the parties. Among other things such contracts specify the basis for the division of costs and revenues.

General is controlled by GT&E which owns 100 percent of its common stock and has 98.47 percent voting control. GT&E owns and controls over 30 telephone operating companies in 34 states of the United States and several operating companies in Canada and the West Indies. GT&E also owns 100 percent of the common stock of Automatic Electric Company, GT&E Laboratories, Inc., GT&E Service Corporation, General Telephone Directory Company, General Telephone Credit Company, Inc., GT&E Communications, Inc., GT&E Data Services Corporation, Sylvania Electric Products, Inc., and GT&E International, Inc.

GT&E was incorporated on February 25, 1935 under the name of General Telephone Corporation. It took over, reorganized, and managed the assets of the Associated Telephone Utilities Company, which was in receivership. Those assets consisted of 33 operating and holding companies serving customers in 26 states, and one directory publishing company. The telephone operating companies generally did not include major metropolitan areas but were located in some of the suburban fringes of such areas, in smaller cities and towns, and in rural localities. After some paring of operations, at the end of 1935 GT&E was operating 23 telephone operating and holding companies in 18 states. At that time the number of company-owned domestic telephones numbered almost 381,000, with a telephone plant investment of about $84 million.

The GT&E telephone system has grown at a rapidly increasing rate from the scattered group of companies that it took over in 1935 and operated with little change through 1945, to a position at the end of 1967 in which it operated 45 percent of the telephones and collected 48 percent of the annual gross operating revenues of the independent telephone companies in the United States. Its domestic telephones have multiplied over 20 times, from 381,000 to 7,729,000, and its undepreciated domestic telephone plant investment has grown over 48 times, from $84 million to $4,090,000,000. Approximately one-third of this growth has been by acquisitions. General operates 30 percent (2,208,000 telephones) of the total telephones operated by the GT&E System.

GT&E entered the manufacturing field in 1950 by acquiring Leich Electric Company and its subsidiary, Leich Sales Corporation. In 1954 it acquired the Alphaduct Wire and Cable Company. In 1955 it merged with Theodore Gary and Company which, in addition to controlling 24 domestic telephone companies in 16 states and foreign telephone companies in Canada, Haiti, and the Dominican Republic, also had over 78 percent voting control of Associated Telephone and Telegraph Company which, in turn, owned 100 percent of Automatic Electric Company (Automatic). Automatic was then, and is now, the largest domestic manufacturer of telephone switching equipment and telephone instruments for the independent telephone industry. Electronic Secretaries, Inc., was purchased in 1957. In 1959, the remaining two-thirds outside interest in Lenkurt Electric Company, in which GT&E had acquired a one-third interest with the Gary merger, was acquired by exchange of stock. Also in 1959, Sylvania Electric Products, Inc. was acquired. In 1960 and 1961 the remaining 22 percent outside interest in Associated Telephone and Telegraph Company (and hence, Automatic) was acquired by exchange of stock. This permitted merging Leich Electric and Electronic Secretaries into Automatic and designating Lenkurt Electric as an Automatic subsidiary. During the period 1951 through 1967 annual volume of net sales by GT&E manufacturing subsidiaries to domestic telephone subsidiaries increased almost 59 times, from $5.4 million to $316.8 million. Of the total sales during the 17-year period, $627.8 million was to General.

At the end of 1954, the year before the merger of GT&E and Theodore Gary and Company, independent telephone companies operated 15 percent of the telephones in the United States with 11 percent of the investment in plant, and collected 9 percent of the annual gross operating revenues, the remainder being controlled by the Bell System. The independents have grown until at the end of 1967 they operated 17 percent of the telephones with 17 percent of the plant investment and they collected 14 percent of the annual gross operating revenues.

Of the independent portion of the industry in 1954, about 40 percent of the telephones were controlled by holding companies. GT&E was the largest of these with 23 percent; Theodore Gary and Company, through its subsidiary holding companies, was second with 7 percent, and United Utilities, Inc. third with 4 percent. The other

6 percent were scattered among a number of holding companies. The remaining 60 percent of the non-Bell telephones were operated by telephone companies that were not affiliated with any other telephone company.

By 1967 GT&E operated about 45 percent of the non-Bell telephones. Four smaller telephone companies operated an additional 18 percent of the non-Bell telephones with the remaining 37 percent scattered among fewer and fewer independent telephone companies, as these smaller companies are merged into or acquired by larger independent telephone companies.

A detailed description of three GT&E subsidiaries, General Telephone and Electronics Service Corporation, General Telephone Directory Company, and Automatic Electric Company and subsidiaries, will be set forth below in a discussion of affiliated interests.

The last general rate case of General resulted in Decision No. 57086, dated August 5, 1958 (56 CPUC 477), wherein this Commission authorized a rate of return of 6.6 percent but set rates to return General approximately 7.1 percent on a net investment rate base of $302,381,000.

If many of the arguments in this opinion sound familiar it is not coincidence - we are journeying down a well-traveled road.

II
RATE OF RETURN

Probably the most important function in rate-making is that of fixing the rate of return which a utility will be allowed to earn. A common misconception of public utilities and the public is that a public utility is guaranteed a profit on its operations, or a return of some specified percentage. This, of course, is not true. Public utilities are not guaranteed that they will earn profit. The law does no more than give them an opportunity to earn a fair and reasonable return on the value of their property used in the public service. The regulatory agency's problem is to determine what will be a fair and reasonable return which the utility shall have an opportunity to earn under efficient and economical operation of its business.

Rate of return in simplest terms is a percentage expression of the cost of capital utilized in providing service. It is just as real a cost as that paid for labor, material and supplies, or any other item necessary for the conduct of business. Generally, in public utility regulation, it is understood to be the measure of that amount of money, compensation, or return received by the owners of capital in the company over and above operating expenses and other allowable revenue deductions. It is from this return that the different classes of capital are compensated. Stated in another way, the return comprehends the interest payable by the company on its long-term debt, dividends on preferred stock, and earnings on common equity. The amount of dollars that a utility is permitted to earn depends upon the amount of the rate base and the allowed rate of return. Any change in either of these factors has a substantial impact. Accuracy in determining a fair rate of return is much more important than accuracy in determining rate base because even the slightest variation in the rate of return counts much more, in terms of dollars, than a variation in the rate base. For example, a change in the rate of return allowance of only 1 percent - from 5 to 6 percent - can have the same effect on the level of rates as a 20 percent increase in the value of the property. Thus, if the utility's rate base is $1,000,000, the return in dollars at 5 percent would be $50,000. If the rate of return were increased to 6 percent on the same rate base, the return in dollars would be $60,000. That would amount to a return of 5 percent on a rate base of $1,200,000, or 20 percent more than the original $1,000,000 rate base.

The computation of the cost of each of the components of the rate of return, cost of bonds, cost of preferred stock, and cost of equity, does not have the same complexity. The cost of bonds and preferred stock is fixed by the terms of the offerings. There is no dispute as to this embedded cost. It is the reasonable return on equity around which the controversy rages.

The guidelines for determining the fair rate of return are necessarily broad. The United States Supreme Court has set them forth in the following terms: "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but has no constitutional right to profits such as realized or anticipated in highly profitable enterprises or speculative ventures." (Bluefield Water Works and Improvement Co. v. West Virginia Public Service Commission (1923) 262 US 679, 692, 693, 67 L ed 1176.)

In a later case, the Supreme Court restated this view, and in addition said: "That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital"; "... the rate-making process ... involves a balancing of the investor and the consumer interests"; and "... it is the result reached not the method employed which is controlling." (FPC v. Hope Natural Gas Co. (1944) 320 US 591, 602, 603, 88 L ed 333, 345.)

Because of the importance that we attach to the formulation of the fair rate of return, we shall set out the testimony of each of the parties in some detail.

A. General's Evidence

General presented one witness, Dr. J. Rhodes Foster, an economist, to testify on the subject of the fair rate of return. Dr. Foster testified that the basic criterion in earnings regulation is economic. It is provided by the competitive standard. A generally accepted regulatory principle is that regulation substitutes for competition, with the purpose of assuring the public the dual advantages of the results of competition and of monopoly in the markets served, but without the disadvantages of either. By this economic standard, regulation gives to investors in regulated enterprises an opportunity to earn a return equal to, but no more than that being earned on efficiently managed investments in competitive enterprises of similar risk. Economic cost of capital is a prospect of earnings which are sufficient to attract the capital from alternative opportunities of corresponding risk. He said that a fair return must satisfy three economic and legal criteria. Specifically, it must be (1) commensurate with return on investments and other enterprises of corresponding risk and uncertainty; (2) sufficient to attract capital; and (3) adequate to maintain the financial integrity of the enterprise. These three tests of a fair return are interrelated. However, in the witness's opinion, maintenance of financial integrity is an aspect of the capital attraction test because the mere statement that rates should be adequate to enable a public utility to attract capital does not go far enough to be meaningful. Ability to attract capital is a relative, not an absolute quality. Almost any enterprise, even when in bankruptcy, can raise some additional capital at some price. Ability of a company to raise additional capital is no indication that its credit has not been impaired or that it is earning a fair return. The real question concerns the amount and kind of capital to be raised and the effects on the interests of those who own the already committed capital.

The witness stated that a public utility has an obligation to construct the additional capacity needed to provide service of good quality. Where the demands for the utility service are growing rapidly, as in the territory served by General, the capital attraction standard should not be applied in such a way as to dilute the fair return on already committed capital. The regulatory treatment should aim to attract the needed new capital and at the same time protect the already dedicated property against unfair treatment. New investors commit dollars of current purchasing power and look to the future. They are not directly affected by unfair regulatory treatment of capital already sunk in the regulated enterprise. The cost of new capital is higher only in the degree that new investors come to expect future unfair treatment of the new investments.

The witness said that reasonable investor expectations can be measured by various methods. The comparable earnings method determines the percentage rate to be applied to a book cost rate base by looking to the returns which have been earned on book investments in regulated and unregulated undertakings having generally similar risks. The comparable earnings method thus seeks to apply the alternative opportunity cost principle of economics. The market value method uses the market prices of common stocks, in relation to earnings, dividends and growth rates as evidence of investors' return requirements, disregarding the rates of return being earned on book equity. It is referred to by use of different phrases, such as the "cost of capital", the "cost of money", the "capital attraction", and "discounted cash flow" method. This method also seeks to apply the alternative opportunity cost principle.

Dr. Foster explained that the comparable earnings test is relevant and useful but involves an element of circularity, which is most pronounced when the test is restricted to earnings of companies in the same industry as the regulated company. The further one broadens the inquiry to take account of the earnings of other regulated and unregulated companies, the less becomes the impediment of circularity. Comparative analysis of past earnings of telephone and other industries to provide a basis for estimating investors' reasonable expectations avoids the element of circularity. The limitations of the comparable earnings approach are particularly pronounced in the case of independent telephone companies. The earnings experience of independent telephone utilities generally have been much less favorable than that of electric utilities, although risk and return requirements are higher. This is due in large part to the disadvantageous cost behavior of telephone exchange service under growth conditions in comparison with the behavior of costs of electric service and to lags in adjustments of rates under these relatively unfavorable conditions. The witness felt that perhaps all students of the fair rate of return problem agree that as a matter of both law and economics a business with relatively higher risks should be given an opportunity to earn a higher rate of return. It should not be assumed, however, that a given company in a relatively risky industry actually will earn a higher rate of return commensurate with the greater risk, or that the given industry as a whole will do so. Indeed, the very fact of more risk means a greater chance that the business will be relatively unsuccessful, and that earning power will be less than was hoped by those who committed the capital to the enterprise. Therefore, a wide dispersion of experienced earnings is to be expected in a case of both regulated and unregulated industries and over both a short and long term. The witness declared that the comparable earnings method should not be rejected because it is difficult to select samples of companies in regulated or unregulated industries which are demonstrably of corresponding risk. Comparisons with alternative investment opportunities do not depend upon similarities with respect to market and operating characteristics. Differences in character of business are not an index of differences in risk. An inability to identify other companies or industries having precisely the same characteristics does not mean that the comparative earnings standard is invalid.

The witness stated that the rationale of the market value approach is that the investors' return requirement is measured by the rate at which investors capitalize what they believe to be the prospective earnings from an investment in the enterprise. More precisely, the cost of capital is the rate at which anticipated future dividends and other income payments from the particular common stock investment are discounted by investors under the given risk conditions. Such a cost of capital formula is relevant and useful but it does not provide a reliable measure of a fair rate of return for application to a net investment rate base. There are four reasons for this:

(1) the outstanding stock and debt of the company may be closely held, so that no evidence of investor evaluations is available for market transactions. This is the situation with respect to the common stock of General; (2) stock prices cannot be accepted as a reliable measure of the informed investor's opinion of the present worth of prospective dividends, even though the stock represents the given investment or an investment of corresponding risk; (3) assuming common stock prices to reflect investment appraisals, the analyst has no direct or objective evidence of investors' expectations regarding dividends to be received in a long-term future. Current earnings do not measure prospective earnings; (4) even a reliably determined current cost of capital would not be, under present economic conditions, a proper measure of the equity portion of a fair rate of return for application to a historical cost rate base. Because of experienced inflation, a rate of return measured by reference to current cost per dollar of new capital and expressed in money of current purchasing power would dilute the reasonable investment value of the already committed capital.

Dr. Foster thought that regulatory determinations ought to be made within the limits of a sensible zone of reasonableness, as an exercise of informed judgment in the light of the relevant facts and the guiding standards because (1) the process of earnings regulation is imprecise. Actual earnings below the range of reasonableness would indicate that a rate increase may be desirable, and earnings in excess of that range would indicate that rate reductions may be desirable; (2) recognition of a sensible zone of reasonableness affords flexibility. The purpose is to regulate future, not past, earnings and charges for telephone services. The regulatory agency is, of course, concerned that its decisions will maintain the flow of capital to the regulated enterprise without diluting the reasonable value of investments already made and without placing an unreasonable burden on users of the telephone services. The additional flexibility would lessen the regulatory burdens; (3) there is no other practical method by which the Commission can reward exceptional performance. The inducement offered to management should not be limited by the strict cost of service formula. There should be opportunity for the enterprise to realize an additional margin of earnings through technological innovations, economies, and development of new services.

He concluded his format of approach by asserting that the market value and comparable earnings methods are appropriate in determining the fair rate of return. In his opinion, both methods should be applied with understanding of their limitations and in a manner consistent with the alternative opportunity cost principle. Determination of a fair rate of return should be the product of informed judgment with the broadest possible basis in comparative analysis of all relevant information. Within a framework of economic principle, the problem is to reduce the range within which the result depends upon subjective opinion not supported by relevant facts. If the telephone company is to have the continuing support of investors and is to attract capital on reasonable terms, preserve the integrity of past investment, meet the demands of consumers, and serve the goals of society, its earnings must be reasonably comparable with the rates of return generally available on alternative equity investment opportunities. The comparative earnings and market value methods are not alternatives, but are integral parts of analytical process. Thus, the witness evaluated both information on comparative earnings and market values in the light of general economic background, stock market trends, growing capital requirements of General, and factors which determine its alternative opportunity cost of capital.

Dr. Foster then turned to a discussion of the various studies he made relevant to determining General's fair rate of return. He first made a comparable earnings study of the performance of several different industry groups with respect to returns earned on total book capital and on book equity over a period of 1951 through 1966. These groups included ten GT&E operating companies, the Bell System, 16 electric utilities, all Class A and B electric utilities, and all natural gas distributors as reported by the American Gas Association. The results of this earnings study show that the level of return on book capital has been rising over the past 15 years. This study shows that the rate of return on average total capital of the groups rated, for the most recent 5-year period, is: 10 General Telephone companies, 7.3 percent; Bell System, 7.7 percent; 16 electric utilities, 7.4 percent; Class A and B electric utilities, 7.1 percent; AGA gas distributors, 8.3 percent; and General Telephone of California, 6.9 percent. Dr. Foster believes that investments in telephone utilities are subject to greater risk than investments in electric utilities as a class. With respect to degree of risk, he feels that General is above the 16 electric utilities and the Bell System, but below the gas distributors. Therefore, he concluded that the rate of return on total capital indicated for General by this comparable earnings test is in the range of 7.4 to 8.3 percent. A more precise conclusion depends upon further analysis of risk differences which involves consideration of earnings on equity capital.

For a study of comparable earnings on equity capital, Dr. Foster took the same industry groups cited above, plus Moody's 24 utilities and Moody's 125 industrials. The results of this study showed that for the most recent 5-year period in the study, the Bell System earned 9.5 percent on equity; GT&E telephone companies earned 11.7 percent; General earned 11.1 percent; and the balance ranged from a low of 11.2 percent for Moody's 24 utilities to a high of 13.7 percent for Moody's 125 industrials. These differences in earnings are an indicator of risk differences. Dr. Foster then looked at the already incurred cost of debt and preferred stock capital and the trend in interest rates. He found the average cost of long-term debt to General was 4.68 percent and the average for preferred stock was 4.91 percent. He felt that consideration should be given to the trend in interest rates and current cost of debt capital to General because rate regulation looks to the future. As a result of studies that he made, Dr. Foster concluded that it is reasonable to assume that the average cost of new debt capital to General, including a margin for cost of financing, in addition to investors' return requirements, will average at least 6.25 percent to 6.5 percent for three or four years into the future. Dr. Foster is of the opinion that in determining reasonable rates the Commission should take account of probable capital requirements for three or four years into the future. Since General does not plan to issue preferred stock within the near future, he did not adjust the 4.91 percent cost of outstanding preferred stock.

Dr. Foster then analyzed information on general economic trends as it related to the fair rate of return. He studied trends in gross national product and in industrial production, together with population growth in the United States, and the effect of experienced inflation. These studies show that since World War II the United States has experienced a substantial rise of real income, but not without inflation. In his opinion, because of the effect of inflation, the rate of return on a historical cost rate base should be higher than if inflation had not been experienced. If regulation is to function as a substitute for competition and seek the ends of effective competition, returns on already invested capital are properly to be fixed at the current competitive cost level. General should be allowed the opportunity to earn returns generally equal to those alternatively available to investors from past investments under conditions of fair competition in other industries of corresponding risk; the upward adjustment on account of already experienced inflation is a matter for informed judgment in the light of other considerations relevant to the question of a fair return.

Dr. Foster then considered other aspects of risk. He felt that the rate of growth in capital requirements for General is far more rapid than the average for the Bell operating companies or for the 16 electric utilities. Further, in the case of the independent telephone companies, in his opinion, growth is accompanied by attrition of earnings, and therefore is an additional risk factor. He said that the opinion of investors that telephone utilities are subject to more business risk and have a higher cost of capital than electric utilities apparently had its origins in the impact of the 1930 depression on market demands for these services. His charts showed that demand for telephone service in 1930 declined sharply with the onset of the depression, although the growth in household demand for electric service scarcely faltered. Although he, himself, does not believe that the experience of the 1930's is sufficient to base a prediction relative to the stability of telephone and electric utilities, in his opinion, over the post-war years the telephone industry has been continuously subject to investor uncertainty regarding stability of the business under adverse economic conditions. Dr. Foster felt that market data reflects a relative preference of investors for the securities of electric utilities. One of his schedules shows that outstanding mortgage bonds of six among the 16 electric utilities are rated "Aaa" by Moody's, and that the rating is "Aa" in ten instances. General's bonds are rated "A". He also compared the investment quality as between independent telephone companies and the Bell operating companies and found that the independent telephone companies were considered riskier by the investment community. He then considered the trend in book cost of plant per unit of service from 1951 to 1966, and the rate of growth in demand for telephone service in the area served and the rate of growth in capital requirements of General. He found that General has grown at an annual growth rate of 13.5 percent during 1962 to 1966 and that if this growth continues in the future, the capital requirement during the next 10 years would be approximately $3.25 billion. His analysis of growth trends in population, demand for telephone service, and capital requirements leads him to conclude that past trends will probably continue in the near future.

Dr. Foster then compared the sources of new capital for General and 16 electric utilities. His studies showed that General will have an extraordinary dependence on capital from outside sources, particularly the common stock capital supplied by the parent company. In his opinion, this is due in considerable part to the relatively rapid increase in the new capital requirements, and also to the inadequacy of equity earnings realized by General. He said that if the company's equity earnings had been at the same rate as the average for the 16 electric utilities in 1964 to 1966, the income available for capital expenditures would have been somewhat more than double, assuming dividends to have been at the same ratio to earnings as the average for the 16 electric utilities.

Dr. Foster concluded that the risk in return requirement is substantially higher for General than for the electric utilities because of General's sensitivity to business cycle change, instability of earnings, growth rate in conjunction with cost behavior, and narrow margins of protection available to the securities. He feels that market opinion as reflected by bond yields and ratings is consistent with this conclusion.

Dr. Foster then proceeded to estimate the present cost of common stock capital to General. Based upon his analysis of various stock market indicators, he found that purchasers of electric utility stocks expect an earnings and dividend growth of about 7.5 percent. His analysis of market data for the most recent five years, which he feels should be given the most weight, leads him to believe that the current cost of equity capital is about 10.75 percent for electric utilities comparable in size with General. To this he added 1 percent for the risk difference between General and the electric utilities so that his estimated cost of equity capital for General is 11.75 percent. The margin for difference in risk is necessarily a judgment determination. Considering the factors which he had already discussed, he felt that 1 percent is reasonably within the results of the comparable earnings test. Finally, because this Commission uses a historical cost rate base, he said that the cost of capital method of determining a fair rate of return is inappropriate and inapplicable unless an upward adjustment is made for the difference between historical and current cost. His analysis shows that the average net investment expressed in 1967 dollars is 119 percent of the same equity investment expressed in historical cost dollars. Making the appropriate adjustments to reflect this already experienced inflation, he arrived at the amount of 13.79 percent as a return on equity for the purpose of its use as evidence of a fair rate of return for application to a net investment rate base. Thus, he concluded that the indicated fair rate of return is 8.34 percent on the basis of General's already embedded cost of debt and preferred stock capital and 8.63 percent on the basis of the projected cost of debt capital through 1971. However, by applying judgment to this range of 8.34 percent to 8.63 percent, he concluded that the fair rate of return should be between the range of 7.5 percent and 8.5 percent, which is within a range consistent with both the comparative earnings and the capital attraction tests. He said that General must be allowed the opportunity to earn about 8 percent on total capital if its earnings are to be equivalent to the earnings experienced during recent years by other corporate enterprises of generally similar risk. Electric utilities of approximately the same size as General averaged 7.4 percent on total book capital over the past five years; gas distributors earned 8.3 percent. General is subject to greater risk and has a higher earnings requirement than the typical electric utility of comparable size, but less than for industrials as a class and somewhat lower than for typical gas distributors. The 8 percent mid-point is within the limits indicated by the earnings experience of the electric and gas utilities.

B. Staff Testimony

The staff presented one witness, Thomas L. Deal, the head of the Rate of Return Branch of the Finance and Accounts Division of the Commission, to testify on the subject of the fair rate of return. Mr. Deal testified that in his opinion there is no mathematical formula that will determine a reasonable rate of return for any company. The reasonable rate of return is an exercise in judgment which considers the elements and circumstances governing the financial needs and desires of a given company. Of the three components of the rate of return, debt, preferred stock, and common stock, the cost of debt and preferred stock is reasonably certain. The witness prepared his presentation primarily in relation to the return on equity. For a starting point in determining rate of return the witness considered the reported earnings of General as compared with other telephone companies and groups of telephone companies because they are all engaged in the same kind of business. He does not consider this method similar to the comparable earnings approach because that approach involves the measurement of risk between companies or groups of companies and, in the witness's opinion, there is no known formula by which risk can be measured. The information from which Mr. Deal started is summarized as follows:

5-Year Averages 1962-1966	Average Earnings on Total Capital	Average Earnings on Common Equity	Average Common Equity Ratio	Times Long-Term Debt Interest Earned
16 GT&E Cos.	6.76%	10.45%	41.69%	3.33
16 Indt. Cos.	7.48	12.47	40.37	3.38
7 Cal. Ind. Cos.	6.91	10.78	45.67	3.82
22 Bell Cos.	7.33	8.60	74.20	10.65
General	6.58	10.47	38.64	3.35

From this starting point Mr. Deal then considered 24 factors in determining the reasonable rate of return. He rated these factors in the manner of judgment rather than on a quantitative basis. That is, he rated each factor on the basis of whether or not it would tend to increase the company's return requirement, decrease the return requirement, or have no effect on the return requirement. He did not attempt to quantify each of these factors by estimating a percentage to be added or subtracted from a given rate of return. The following table shows each factor plus Mr. Deal's judgment as to whether it should be considered a positive factor (+), that is, tending to increase the rate of return, a negative factor (-), that is, tending to decrease the rate of return, or a neutral factor (N), that is, a factor that has no effect on the rate of return, and his reason for rating each factor:

Factor	Rate	Reason
1. The company's experienced earnings.	-	General is by far the largest of the GT&E companies; size alone is an indication of less risk; General has not had any trouble over the past 6 years in financing.
2. The reported earnings of other telephone companies and groups of telephone companies.	-	General's 5-year average earnings 1962 through 1966 on common equity were slightly greater than the average of all the other GT&E companies; were greater than the average of all the Bell companies; and were less than the independents, which are much smaller companies with more risks involved.
3. The company's capital structure.	+	General's common equity ratio is relatively low and usually the lower the common equity ratio, the higher the rate of return on equity should be.

	Factor	Rate	Reason
4.	The company's affiliation with GT&E and the control exercised by the parent company.	-	The large size of GT&E makes General less risky.
5.	The great size and strength of GT&E with its vertical combinations.	-	The large size of GT&E makes for greater stability, financing, technical assistance, and efficiency, all of which decrease risk.
6.	The growth potential in areas in which the company operates.	-	General should be able to effect economies of scale because of its expanding operation.
7.	Total number of employees has been increasing at a far slower rate than net investment in telephone plant.	-	General's operation should be less risky because of less dependence on the human element and more on automated equipment.
8.	Very little refunding of present debt will be necessary for the next ten years.	-	General will not have to return to the money market as frequently during a period of expected high interest costs.
9.	The embedded cost of debt will probably continue to rise in the foreseeable future.	+	Higher embedded cost of debt requires a higher rate of return.
10.	The acquisition of Cal Water & Tel in 1967.	N	Not able to determine whether operations are more or less profitable because of this merger.
11.	The quality of service as reported by staff engineers.	N	Service is considered reasonable.
12.	Net investment in telephone plant has been increasing at a faster rate than the total number of telephones in service.	+	Net investment in telephone plant has been increasing at a faster rate than the total number of telephones in service.
13.	In recent years net income per telephone has been decreasing while net plant per telephone has continued to increase.	+	In recent years net income per telephone has been decreasing while the net plant per telephone has continued to increase.
14.	In recent years net income per employee has been decreasing while net telephone plant per employee has continued to increase.	+	Net income per employee has been decreasing while net telephone plant per employee has continued to increase.

	Factor	Rate	Reason
15.	Financial impairment which could arise out of rapid and significant increase in the general level of prices during a period of inflation without offsetting authorization for increased rates.	+	Inflation is a fact at present; it will probably continue, and therefore leads to more risk.
16.	Competition as compared to a captive market.	-	There is less risk because of the monopolistic nature of General, and of the telephone industry.
17.	Trend of interest rates.	+	Interest rates will continue to be high in the foreseeable future.
18.	Shifts in population and industry.	+	If shifts occur there will be an increase in risks.
19.	Taxation.	N	There is no reliable information as to whether taxes are going to increase or decrease in the future.
20.	New inventions and technology and the need to encourage research and technology.	-	New inventions and technology eliminate some of the risk of telephone operations and lead to greater efficiencies.
21.	Essentiality of the products to the public.	-	Communication is now so essential to civilization that even a recession or depression should have only a minimal effect on the demand for telephone service.
22.	Failure to take liberalized depreciation.	-	There is less risk when liberalized depreciation is not taken.
23.	General was able to provide 71 percent of its required funds from internal sources in 1962, with only 24 percent in the year 1967.	+	Total financing has been increasing and the portion of internally generated funds has become considerably smaller.
24.	Estimated plant requirements in the immediate future and also the amount and nature of external financing that might be necessary to cover this construction.	+	An expanding utility has a need for higher revenues because of the lag between the time the plant components are purchased and the time that its full potential is realized from this additional plant investment.

Based upon the above factors, and considering the earnings of other telephone companies, Mr. Deal recommended a rate of return in the range of 6.90 percent to 7.20 percent to be applied to an original cost rate base for the intrastate operations of General. He recommended a range rather than a specific percentage because there are so many imponderables in setting rates to produce a specific allowed rate of return over a period of time that a fixed rate of return is rapidly rendered obsolete. Among these imponderables are: fluctuations in the short range demand for the utility's services; fluctuations in operating expenses; variation in the amount of plant necessary to produce a given amount of revenues; fluctuations in the cost of money; and, the continued effect of inflation. In the witness's opinion, his recommended rate of return will be sufficient to attract capital and compensate for risk. His recommended rate of return produces a return on equity in the range of 9.3 to 10 percent.

The witness said that it is not necessary to weigh risks such as reduced revenue due to business recession, cessation of operation because of strikes, destruction of property on account of earthquakes, storms, floods and the like, and the possibility of obsolescence because these are general risks applicable to all companies, and General should not be singled out to get special consideration because of this kind of risk. Mr. Deal did not consider any utilities other than telephone companies, nor did he consider nonutilities. In his opinion, nonutilities and nontelephone utilities are not comparable to General. Specifically, when asked about the comparison with electric utilities, Mr. Deal stated that he did not believe that any comparative study of General with electric utilities would be relevant.

C. City of Los Angeles' Evidence

The City of Los Angeles presented one witness, Manuel Kroman, an engineer, to testify on the subject of the fair rate of return. Mr. Kroman stated that the fair rate of return to be allowed General should be fixed in relation to the rate of return which he recommended for Pacific in its just completed rate case. (Decision No. 74917, dated November 6, 1968, in Application No. 49142.) In his opinion, the rates of return of both General and Pacific should be reasonably related to each other because (1) there has only recently been completed a full scale showing on Pacific's rate increase application including extensive evidence on the rate of return issue; (2) these two utilities, General and Pacific, are operating side by side, under the same state regulatory jurisdiction, in essentially the same economic climate, and with the responsibility for providing essentially the same service to the public; (3) both these utilities are among the largest in California, and they are both affiliates of nationwide telephone systems; and (4) the service and rate disparity problems confronting General are inherently related to the service and rates of Pacific. The witness stated that in the Pacific rate case he recommended that 6.75 percent was a fair rate of return to be allowed on Pacific's intrastate operations. Using that recommendation as a starting point and applying pertinent regulatory principles bearing upon a fair rate of return, the witness then made pragmatic adjustments to that 6.75 percent to reflect the particular facts and circumstances which distinguish General from Pacific. The first adjustment he made reflects the differences in the cost of embedded and near-term future debt, and the cost of outstanding preferred stock. Substituting General's 5.04 percent debt cost rate in place of Pacific's 4.25 percent rate, and General's 4.91 percent preferred stock cost rate in place of Pacific's 6.55 percent rate, the weighted cost of capital, which was 6.75 percent for Pacific, becomes approximately 7 percent for General.

The next adjustment the witness considered was General's smaller size and greater rate of growth. He said that both of these relationships warrant an increment in rate of return according to accepted regulatory practice. The size of the increment is necessarily a matter of judgment. Although General is smaller than Pacific, it, nevertheless, is a very large utility; it is more than twice as large as San Diego Gas & Electric Company and is also larger than a number of Bell System operating companies. For these reasons Mr. Kroman concluded that only a relatively small differential in allowed rate of return would be appropriate to reflect the difference in size between General and Pacific. The witness' studies showed that General's rate of growth has been more rapid than Pacific's, although the annual dollar growth in Pacific's plant has been some three times as great as General's. On a judgment basis the witness reflected these differences in relative size and growth by applying an increment of .15 percent to the 7 percent figure previously developed. Finally, the witness adjusted this 7.15 percent downward in the amount of .25 percent as a penalty for General's service deficiencies and high rates, using Pacific as a standard for comparison. Mr. Kroman based his opinion concerning General's poor service on the evidence present in this proceeding and the lack of complaints concerning Pacific's service. Decision No. 74917, which granted a rate increase to Pacific, also created new settlement agreements between Pacific and General which increased General's income from interchanged traffic in the Los Angeles Extended Area. This increased income was used to reduce rates in General's exchanges. In the witness' opinion, this method of eliminating a rate disparity by increasing rates to subscribers of Pacific and transferring that increase to General does not adequately meet the problem of General's higher costs and higher rates than Pacific's in adjacent territory. Based on the foregoing considerations, the witness concluded that the fair rate of return for General on its intrastate operations is 6.9 percent. This produces a return on equity of 9.3 percent.

Mr. Kroman then stated that if the Commission were to disagree that his recommended rate of return for Pacific, 6.75 percent, was inappropriate as a starting point, still, his approach should be adopted. That is, he believes that General's rate of return should be set by adding an increment to Pacific's allowed rate of return to reflect differences in size and growth, and imposing a penalty for deficient service and relatively high rates. On cross-examination Mr. Kroman computed General's rate of return using his method, but substituting Pacific's 6.9 percent rate of return as found by the Commission in Decision No. 74917. The result is 7.2 percent. He did not recommend using 7.2 percent.

Mr. Kroman also testified at great length in criticism of Dr. Foster's methods of reaching a fair rate of return. This criticism will not be set forth here but, to the extent that we feel it is valid, will be considered in our discussion of rate of return.

D. Discussion

For the reasons hereinafter stated we find that the fair rate of return for General should be within the range of 7.0 percent to 7.4 percent. Rates should be set to permit a 7.2 percent return.

A summary of the recommendation of the three experts, in tabular form, shows:

Item	FOSTER Capital Ratios	FOSTER Cost Factor	FOSTER Weighted Cost	DEAL Capital Ratios	DEAL Cost Factor	DEAL Weighted Cost	KROMAN Capital Ratios	KROMAN Cost Factor	KROMAN Weighted Cost
Total debt	55%	4.68%[1] 5.20[2]	2.57% 2.86	51.6%	5.08%	2.62%	51.80%	5.04%	2.611%
Bank loans				1.1	6.50	.07			
Preferred stock	5	4.91	0.25	4.4	4.91	.22	4.37	4.91	0.215
Common stock equity	40	13.79	5.52	42.9	9.30 10.00	3.99 4.29	43.83	9.72[3]	4.260
Total	100		8.34 8.63	100.00		6.90 7.20	100.00		7.086
Recommended rate of return	Range 7.50% to 8.50%.			Range 6.90% to 7.20%.			6.9%[4] after adjusting for General's smaller size and greater growth than Pacific's, and for service deficiencies and rate disparities.		

1 Present embedded cost.

2 Estimated embedded costs at 12-31-71.

3 Based on Los Angeles's recommended 6.75% rate of return for Pacific in Application No. 49142.

4 This figure would be 7.2% if Mr. Kroman's method and adjustments were applied to Pacific's allowed rate of return of 6.9%.

1. Capital Structure

The capital structure of a utility has a direct influence on the total cost of capital. The cost of equity capital normally will be higher if there is a large amount of outstanding debt because the risk to the equity holder is greater because of the prior claim of interest charges and the fixed nature of this claim. As the senior securities become relatively smaller in amount the risks decrease correspondingly. In the present case the staff witness used the capital structure of General as he anticipated it to be as of December 31, 1968, as a base for his rate of return study; Dr. Foster used a pro forma structure. The differences are not great.

	Deal	Foster
Total Debt	51.6%	55%
Bank Loans	1.1	
Preferred Stock	4.4	5
Common Stock	42.9	40

Occasionally, in rate cases, pro forma adjustments to capital structure are made. Such adjustments usually adjust debt upward and common equity downward to create a more favorable cost of capital and to take advantage of the tax laws. At present taxes it costs the ratepayers about twice as much to provide a one dollar return on common equity than to provide one dollar interest on debt. In our opinion, it is preferrable to use the actual capital structure, or as close an approximation as possible, unless it is entirely inconsistent with good regulatory practice. All parties agree that General's current debt-equity ratio is reasonable; therefore, we will use the capital structure advocated by the staff.

2. Cost of Capital

a. Long-Term Debt

Dr. Foster asserts that we should recognize the upward trend in interest rates and consider the prospective cost of debt capital when determining the cost of debt. In his opinion, a cost of 5.20 percent would adequately reflect this trend. Mr. Deal would only recognize the embedded costs of debt, which he computed at 5.08 percent. The Commission's general practice is to reflect only the historical cost of debt when determining rate of return and we do not feel that a departure from this practice is warranted. Our views on this are reinforced by General's recent experience in the bond market. General delayed a $60,000,000 7 percent bond issue in December 1968 because it felt interest rates were too high; it sold the bonds January 1969 at a cost of 7.2 percent. Perhaps bond interest ought to have been lower in January. We do not wish to be in a position of guessing the near-term bond market; we will use an embedded cost of 5.08 percent. To the extent that upward trends in interest, and inflation, should be considered, such consideration should be reflected in the return on equity.

b. Bank Loans and Preferred Stock

All parties agree that the cost of preferred stock should be embedded cost with no adjustment, and no one suggests that the cost of bank loans should be adjusted. We will use 4.91 percent as the cost factor of preferred stock and 6.50 percent for bank loans.

c. Common Equity

The testimony presented by Dr. Foster in this case is essentially an update of testimony presented to the Florida Public Service Commission in its rate case concerning General Telephone

Company of Florida (FPS Com. Docket No. 7766-TP, Order No. 4137, dated February 15, 1967). The Florida Commission's comments on Dr. Foster's testimony accurately reflect the conclusions we have reached after our analysis of Dr. Foster's present testimony.

The Florida Commission said:

> "Dr. Foster, on behalf of the Company, developed a series of studies concerning growth, earnings, dividend yields, etc., in regard to electric, gas distributors and pipelines, manufacturing and telephone companies. He made no attempt to study other General System companies, nor did he attempt to show or measure the effect on risk of being a part of the General System. He might have, but he did not, attempt to compare General of Florida with any of the several operating companies of the Bell System. He attempted, simply, to treat General of Florida as an independent telephone company. Frankly, this obvious disregard of the other General System Companies and Bell System operating companies as a possible step in his comparative earnings test leaves us somewhat perplexed. In the absence of probing analysis, it would appear that one would have to look far before finding two enterprises with such similar characteristics and risks. 1/
>
> "In the recent Southern Bell case we said that we were not prepared to completely agree with Respondent's witnesses in their contention that there is a greater risk connected with the telephone business than with the electric utilities. After reviewing at some length Southern Bell's relationship with the Bell System, and the obvious advantages derived from such relationship, we recalled that for many years the telephone industry, as exemplified by the Bell System, has traveled on the accepted assumption that there is a greater risk connected with the telephone industry than with the electric utility business. We then suggested that this long-accepted theory, more and more is being questioned by regulatory authorities and the telephone industry needs to update its own thinking and viewpoint in this matter. In the present case we have a very similar situation. The Company's witness attempts to show that possibly there is some

1/ In the case at bar, Dr. Foster presented some studies of selected GT&E System companies and Bell System companies, but he made no attempt to utilize these studies.

substance to this theory. We have not been convinced, and we wonder why a member of the General System would place such emphasis on comparisons with electric utilities, and completely bypass what would appear to be more easily justified comparisons with operating companies of the Bell System. We have not had the advantage, in this record, of such a comparison, and do not know what would result from such a study. Such a comparison should have been made, or some explanation given for its omission. In all frankness, we are no longer impressed with complex studies and adjustments that attempt to picture a General System operating company as an independent telephone company and then compare its earning requirements with that of strictly independent telephone operations. Operating companies of the General System, including General Telephone Company of Florida, need to update their own thinking and viewpoint in this matter. They belong to a great system of affiliated corporations, organized and operated from top to bottom along lines quite similar to the Bell System pattern. The risks inherent in the telephone business for a General System operating company and a Bell System operating company are quite different from the risks which may be related to a purely independent telephone company. The risk factor in the regulation of telephone utilities affiliated with these two great systems needs to be reevaluated and approached on a realistic basis.

"In the recent Southern Bell case we said that insofar as the investment risk is concerned, there is probably no public utility which enjoys anything like as enviable a risk position as an Associated Company of the Bell System. To a considerable degree this is also true of an affiliated company of the General System. This very affiliation, and the many benefits inherent in such a relationship, serves to lessen to some extent the return required by the affiliated company. ...

"Any study of the earnings requirement of a public utility, which ignores or overlooks affiliations and relationships that exert far-reaching influences on the whole gamut of the utility's operations, misses the mark and fails to give the regulatory agency a realistic view of actual conditions." (General Tel. of Florida (1967) FPS Com. Docket No. 7766-TP, Order No. 4137, pp. 47-49.)

The FCC has also commented on this penchant for telephone utilities to compare themselves unfavorably with electric utilities. In American Tel. and Tel. Co. (1967) 70 PUR 3d 129, the FCC said:

> "So far as individual electric utility companies are concerned, it appears that Bell faces fewer long-term risks. Individual electric companies have direct competition from the gas industry as an alternative means of providing the same service. Thus, space heating and cooling, water heating, cooking, and refrigeration can be done by either gas or electricity, and this lively competition is reflected in numerous advertising campaigns. There is no such choice between telephone companies. ...
>
> "Individual electric utilities find competition from publicly and privately owned power systems. Such power systems can and do supplant services provided by an individual electric company. On the whole, electric companies individually do face a higher degree of risk than does Bell. However, by any test, Bell does not face any long-term risk as great as any of the individual electrics. ...
>
> "Respondents contended that telephone companies are more susceptible than electric companies to loss of earnings in the event of a business decline. Respondents failed to demonstrate this, however, and relied on general contentions that telephone companies have more competition than electric companies; telephone expenses are less variable than those of electric companies, hence cannot be as well controlled in a recession; electric rate structures insure a lesser decline of revenues during a recession; electric companies have fuel adjustment clauses by which increased fuel costs can be passed on to customers; electric companies can shut down their highest cost plant as output demand declines; telephone companies have a higher proportion of labor cost which makes them more vulnerable in an inflationary period; and telephone service is more susceptible to cancellation in a recession. The only indication of record to support these contentions is that in the pre-World War II great depression years of 1932-1935, the operating revenues of the Bell System fell somewhat more than did the electrics. We do not accept so remote a period as indicative of current conditions or possibilities. We think that the dependence upon

> telephone service is now so deeply embedded in the fabric of our society and economy that the experience of the 1930's is no longer valid. This assumption is buttressed by the fact that respondents no longer contend, as they have in the past, that interstate service merits a higher return than intrastate service on the ground that it is more subject to fluctuation and riskier." (70 PUR 3d at 187-189.)

The FCC concluded that "the evidence would indicate respondents to be less risky than individual electric companies." (70 PUR 3d at 191.)

This Commission has also specifically rejected a theory of risk measurement that compared telephone utilities unfavorably with gas and electric utilities. (Pacific Tel. & Tel. (1964) 62 CPUC 775,800.) That case involved Pacific but its reasoning is just as pertinent when applied to General. In our opinion General, standing alone, is no more risky than individual electric companies and, when General is considered as a part of the GT&E System - and by far the largest telephone operating company in the system - our opinion is reinforced.

Dr. Foster's use of tables, charts, graphs, curves, trends, history, etc., albeit meliorated by judgment, can be persuasive only in relation to his underlying assumptions. The inferences drawn from the use of any series of statistics depends, to a great degree, on the assumptions applied to the statistics. For instance, Dr. Foster assumes that telephone companies are more risky than electric companies, and that electric companies are less risky than gas companies. He also assumes, in his presentation of a comparable earnings test, that averages of earnings on average common stock book capital for the period 1962-1966 are appropriate items for comparison. In this period, General's average earnings on common equity was 10.47 percent and 16 selected electric utilities was 13.3 percent. Applying his assumption that telephone companies are more risky than electric companies, Dr. Foster concluded that to the extent that this test is useful General should earn at least 13.3 percent.[2/] But underlying this result is the assumption that

2/ It seems to us that if Dr. Foster were consistent he should conclude that something more than 13.3 percent should be earned because of risk differences.

the earnings of the electric utilities are reasonable - and there is no proof that such earnings are reasonable. Further, in this same period gas distributors earned 12.2 percent on average common equity. If those earnings are reasonable, then the electric earnings are unreasonably high, since electric utilities are, by Dr. Foster's assumption, less risky than gas companies. Of course, it could be argued from these same statistics that the earnings of gas distributors are low. The point is, the statistics are a less important part of the equation than the assumptions to which they will be applied.[3/] As we do not agree with Dr. Foster's assumptions, we cannot accept his conclusions.

We will belabor the issue of statistics and assumptions only once more. Dr. Foster bases his assumption that investors consider the telephone business to be riskier than the electric business in part on certain revenue statistics compiled from the depression and war years, which statistics lend support to his thesis. His cutoff date is 1945. However, as the witness for the City of Los Angeles, Mr. Kroman, pointed out, a more relevant period to compare trends in telephone and electric revenues is between 1947 and 1966. In that period "the business recessions of 1954 and 1958 cause only slight dips in both revenue trends and that the telephone revenue trend is no more irregular than the electric revenue trend."

3/ Dr. Foster also said, and all others agree, that electrics are less risky than industrials. Yet the electric return of 13.3 percent for 1962-1966, which Dr. Foster considers reasonable, is the same as the return for Moody's 125 industrials for 1951-1966. General says this is sheer coincidence. Of course, statistics merely are; whether any two are coincidental depends on who's looking at them.

Dr. Foster's choice of data, instead of pointing to a valid result, appears, rather, to be used to substantiate a preconceived result.

We, no more than the experts who testified, have no talisman by which to determine with certainty and precision the fair rate of return. Like those who attempt such determination, we can rely on no formula, no set criteria, but only on informed judgment. Nevertheless, informed judgment must have a starting place, and the best place to start, in our opinion, is with a comparison of General with telephone companies of comparable size; which companies are all part of the Bell System. No other GT&E operating company and no independent telephone company is comparable in size with General.

In making this comparison we recognize that General is part of an extensive system of telephone operating companies and supporting companies which, to a great degree, is similar in form to the Bell System. We also recognize that the Bell System operates approximately 83 percent of the telephones in the United States as compared to GT&E's operating about 8 percent. This difference alone makes Bell a more stable and less risky system than GT&E. We also consider capital structure and assume that a company with a lower equity-debt ratio is more risky than a similar company with a higher equity-debt ratio. This is so because holders of equity in the low-equity company have less cushion, and because holders of debt require sufficient interest coverage. We must temper this comparison in the knowledge that to base a rate of return on comparisons has a circular effect. The more select the group compared with, the more circularity; the broader the group, the less comparable the features.

The evidence in this case shows the following comparison:

EXHIBIT 84 TABLE 10

Comparison of Reported Earnings on
Average Total Capital and Average Common Equity
Bell System Companies
5-Year Averages 1962 - 1966

Range of Bell System Companies	Average Earnings On Total Capital	Average Earnings On Common Equity	Average Common Equity Ratio	Times Long-Term Debt Interest Earned
Average	7.33%	8.60%	74.20%	10.65
High	8.34	9.89	90.35	40.80
Low	5.97	6.87	61.20	4.66
Median	7.41	8.73	74.02	8.03
General	6.58	10.47	38.64	3.35

At the outset, it appears to us that the recorded average earnings of General on common equity, in the recent past, have not been too low; although it may have been too high, even with allowance for capital structure variations.

From this starting point we can only call attention to the factors that have influenced our judgment. We know of no way to quantify these factors; but some have been given more consideration than others. One factor we did not consider was quality of service. For the purposes of rate of return we assume service is adequate. We will have a great deal more to say about service, and its effect on rate of return, in another portion of this opinion.

We have weighed all of the factors considered by the experts who presented testimony but we will only discuss those which we feel should be given the most weight under present economic conditions. We consider important General's ability to attract capital. General is an expanding company. In the past 10 years its net plant has grown from $300,000,000 to over $1,000,000,000. Projections predict comparable growth over the next 10 years.

Over the past ten years it has issued bonds in the amount of $305,000,000 on terms as favorable as other telephone companies of similar capital structure. Because it sells all of its common stock to its parent, there is no evidence of common stock market price and attractiveness to independent investors. But we note that GT&E has been purchasing stock of General, and, in fact, General's equity ratio has increased over the past few years. In addition, the evidence of General's chief officers is that General has never reduced capital expenditure programs or maintenance because of lack of funds. We conclude that in the recent past General has had no difficulties in attracting capital at reasonable rates.

We have also considered the physical area of General's growth. This area, chiefly the suburbs, has been growing at a faster rate than central areas. Although this growth requires commensurate increases in plant, the area will, in our opinion, provide a steady, increased use of this plant, and therefore reduce risks inherent in such expansion. We feel that when an investor looks for new business prospects a prime consideration is the location where the company will do business. The better the location, the less the risk of investment. From this viewpoint, General's location is excellent.

Inflation has also been given consideration. No one denies that we are in a period of a more than mild inflation. But, when considering this issue in determining rates for the future we must also consider our obligation not to add to the inflation, and we must weigh the effect of the efforts of other governmental agencies in curbing inflation. Just as interest rates have gone up precipitously in the past two years, so they might come down just as precipitously in the next two years, depending in part, upon the actions of various federal agencies.

Finally, we have considered the interest of consumers. Their interest in adequate service we will discuss elsewhere. Here we consider the fact that they are essentially captive customers of the utility. They must pay, willy-nilly, any rates we set, or they do without. And, of course, it is our job to see that they do not do without. Essential telephone service cannot be priced out of the range of even a small portion of potential users.

Based on the foregoing we find that a reasonable return on common equity for General is within the range of 9.50 percent and 10.50 percent. As applied to General's capital structure and embedded cost of debt, as found reasonable above, this results in a fair rate of return to General within the range of 7.0 percent to 7.4 percent.

We have chosen a range of return rather than a specific percentage in order to provide the maximum incentives to the regulated company to achieve efficiency and economy in operation; to recognize that we cannot predict the future with clarity and confidence; to acknowledge that the techniques employed in arriving at a fair rate of return are imprecise; and to lessen the prospect of another major rate case in the next few years.

Just as fixing a rate of return is imprecise, so, also, setting rates to achieve this rate of return is imprecise. On General's intrastate rate base each change of 1/10th of one percent in rate of return reflects approximately 2 million dollars of gross revenue. Yet on estimated revenues of over $300,000,000, a one percent error in fixing rates is much more than 2 million dollars. In our opinion, in order to compensate for variance in projected revenue, rates should be set to yield a 7.2 percent return. If the rates set produce revenues somewhat less than anticipated, the company will still be earning within the zone of reasonableness; and if the rates produce somewhat more, the public is still paying no more than a reasonable rate. This approach obviates the need for future hearings to adjust minor discrepancies.

To test our return we note that at 7.2 percent it provides a 10.0 percent return on common equity and at 7.4 percent, the upper end of the range, provides a 10.5 percent return on equity. This result, while lower than the return on equity earned by a selected group of 10 GT&E operating companies over the period 1962-1966 (see Exh. 105, Chart III, and Exh. 10, page 4), is higher than the 8.6 percent earned by the Bell System operating companies in the same period. In view of the success of the Bell System's financing, the authorized rate of return should permit General to finance its equity requirements satisfactorily.

The consumer bears the ultimate burden of the rates established and we feel that it is appropriate to determine the consumer burden of a 7.2 percent rate of return for General compared with the consumer burden of the return allowed Pacific in Decision No. 74917. The following table demonstrates that the 10 to 10.5 percent return on equity for General compares reasonably in this respect with Pacific's return (and incidentally with that of the 50 largest electrics referred to in Decision No. 74917).

SUBSCRIBER BURDEN OF RETURN FOR
GENERAL TELEPHONE vs. PACIFIC TELEPHONE

Item	Pac. Tel.& Tel.Co. Capital Ratios	Cost	Cost Factor	General Tel. of Calif. At 7.20% Capital Ratios	Cost	Cost Factor	Using 12.42% Total Cost Factor Capital Ratios	Cost	Cost Factor
Long-term Debt	35%	4.38%	1.55	51.6%	5.08%	2.62	51.6%	5.08%	2.62
Advances or Bank Loans	3	6.00	.18	1.1	6.50	.07	1.1	6.50	.07
Preferred Stock	2	6.55	.13	4.4	4.91	.22	4.4	4.91	.22
Common Equity	60	8.40	5.04	42.9	10.00	4.29	42.9	10.46	4.49
Total Return	100%		6.90	100.0%		7.20	100.0%		7.40
Required for Related Taxes			5.52			4.82			5.02
Total*			12.42			12.02			12.42

* Total for return and taxes using 7% for state and 48% for federal.

Finally, interest coverage may be appraised in view of General's need for a competitive position in the debt market. At a 7.2 percent rate of return on a rate base of $934 million, earnings after taxes would be $67,250,000. This would provide approximately 2.7 times interest coverage after taxes. This interest coverage compares favorably with other "A" rated bonds of GT&E subsidiaries (Exh. 105, Table XVIII).

We conclude that a 7.2 percent rate of return should enable General to continue to finance satisfactorily and at the same time avoids undue burden on the ratepayers of California.

III

AFFILIATED INTERESTS

Since the Commission was created it has concerned itself with affiliated interests and their impact on the cost of service furnished to the public. In 1912 the Commission stated in substance that when a utility's plant was constructed by a subsidiary company, the resulting affiliated relationship would always call for the most careful scrutiny by the Commission in a rate case or an application to issue stocks, bonds, or other securities to pay for the construction. (Southern Sierras Company (1912) 1 CRC 556, 558.)

The Commission's concern with affiliates has continued through its history. Typical of its regulatory treatment of transactions between a utility and an affiliate supplier is that found in a 1962 water company decision:

> "The adjustment proposed by the staff is based on the principle, among others, that services and facilities purchased by a utility from its associates should not, for rate-making purposes, include a return greater than that which would exist had the utility performed the service or installed the facilities itself.
>
> "...adjustments made by the staff assure that applicant's ratepayers will not be unduly burdened with profits of an associated company that directly or indirectly, through one or more intermediaries, control, or are controlled by, or are under common control with Southwest Water Co." (Southwest Water Co., Decision No. 64436 dated November 2, 1962 in Application No. 43589 (unreported).)

This same principle has been applied to the Pacific-Western Electric relationship.[4] In 1964 the Commission, in regard to Pacific, said:

> "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." Pacific Tel. & Tel. Co. (1964) 62 CPUC 775, 815, affirmed, Pacific Tel. & Tel. Co. v. PUC (1965) 62 C 2d 634, 401 P 2d 353.)

This principle was reaffirmed by the Commission in the recent Pacific rate case. (Decision No. 74917 dated November 6, 1968 in Application No. 49142.)

In 1958, the latest decision on a rate application by General, the Commission said in regard to a similar proposed adjustment applying the above principle to General's purchases from its affiliated manufacturing and sales companies:

> "While the evidence in this proceeding indicates that certain analogies may be drawn between the applicant - affiliate and the Pacific-Western Electric relationships, such evidence, in our opinion, does not establish that the two situations are so nearly alike that the treatment to be accorded the two should be identical or even parallel. As a matter of fact, the two situations are unlike in a number of important respects and there are numerous distinctions between the corporate relationships and the methods of transaction of business of the two." (General Tel. of Calif. (1958) 56 CPUC 477, 481-482.)

4/ In fact, the principle is commonly known as the Western Electric adjustment because its impact in dollars on utility rate making has been greatest in cases in which the rates of Pacific have been the subject of a general rate investigation.

However, the Commission went on to say:

> "It is proper and indeed essential that this Commission have before it information upon which it may form a conclusion as to the existence and extent of any unreasonableness in charges which may result from utility-affiliate relationships to the detriment of the ratepayer. The staff inquiry is helpful in reaching a conclusion in this respect. It is expected that a similar inquiry will be made in future rate proceedings concerning applicant, to the end that this Commission may be assured that the public interest will continue to be protected." (56 CPUC at 483).

A. Adjustments for Purchases from Automatic Electric Company

1. Reasonableness of Automatic's Prices

Automatic, 100 percent owned by GT&E, is the developing, manufacturing, supply, and distributing company for the telephone operating companies controlled by GT&E and is a leading supplier of telephone equipment to the remainder of the independent telephone operating companies in the United States. Automatic operates four manufacturing facilities: two in Illinois, one in Wisconsin, and one in California. These facilities manufacture such items as switchboards and dial switchboard equipment, line concentrators, PABX equipment, loading coils, switching equipment, step-by-step central office equipment, electronic central office switchboards, station apparatus, and other items too numerous to mention. Automatic divides its products into two principal categories, equipment and supplies. Equipment includes all items manufactured by the company; supplies include materials manufactured by others for which Automatic is a distributor.

Automatic has always been the leading supplier of telephone equipment to the non-Bell market. Prior to its acquisition by GT&E in 1955 Automatic, as part of the Gary group, supplied its Gary-affiliated telephone companies as well as the much larger non-Gary market. In its present position as a member of the GT&E System, Automatic's domestic telephone market continues to include the independent telephone companies but the part of that market which is affiliated has increased substantially from about 7 percent at the beginning of 1955 to about 45 percent at the beginning of 1968, as measured by the ratio of the number of affiliated telephones to the total number of independent telephones.

In the sale of equipment and supplies Automatic competes with subsidiaries of several large companies. The competitors include Stromberg-Carlson Corporation, a subsidiary of General Dynamics, I.T.T.-Kellogg, a subsidiary of International Telephone and Telegraph Company, and North Electric, a subsidiary of United Utilities.

General asserts that the prices it pays to Automatic for equipment and supplies are reasonable and, therefore, the Commission has no power to disallow any portion of such payments. General admits that it has the burden of proof on this proposition and claims that it has met such burden.

General argues that non-Bell telephone companies, including General, purchase equipment and supplies in a competitive market; equipment is manufactured for this market by Automatic and four other large manufacturers; supplies are distributed by Automatic and numerous national and regional distributors; and the competitive forces in this market determine the prices that must be paid by non-Bell telephone companies. General asserts that there are two principal tests for determining reasonableness: (1) the price General pays for equipment and supplies as compared with price of equipment and supplies from other sources; and (2) the price General pays to Automatic as compared with the price paid to Automatic by nonaffiliates for the same materials.

General compared prices paid by it to Automatic with the prices of other suppliers. A comparison of 100 items shows that Automatic's prices were lower for 84 items. For 20 of these items, Automatic's price was less than 5 percent lower than its competitors. For 10 items Automatic's price was higher than its competitors and for five of these items, the difference was less than five percent of Automatic's price.

General then offered evidence to show that prices paid by it to Automatic are no more than the prices paid to Automatic by nonaffiliates. It argues that this is a valid criterion of reasonableness because: The prices charged to nonaffiliated companies by Automatic are significantly influenced by the competitive alternatives available to those companies; these nonaffiliated companies seek to buy on the most favorable terms, all factors considered; competitive forces, therefore, limit the prices that Automatic can charge to nonaffiliated companies; Automatic sells these products at the same or lower prices to General; and for telephones and components, the same or similar prices are charged. One of General's exhibits (Exhibit 18, Schedule 8) shows that for 70 out of the 101 products listed, the prices for affiliated and nonaffiliated companies were the same, while for 31 products prices to affiliated companies were lower than for nonaffiliates. Automatic uses the same general pricing procedures to determine prices charged to affiliated and non-affiliated companies for custom manufactured equipment. Automatic asserts that its prices are determined in a competitive market which imposes a checkrein on the reasonableness of its prices; and this checkrein is effective because nonaffiliated companies buy. General's arguments are not persuasive.

Its argument based on a comparison of prices of various manufacturers resulted from an analysis of published list prices. This argument loses much of its force because there is no showing that the published list prices are the same as the actual prices paid for the products. A witness for an independent manufacturer of telephone equipment pointed out that discounts from list prices are made by telephone equipment manufacturers. It is the actual prices paid, taking into account discounts that might accrue to General because of its large purchasing needs, rather than list prices, that should be compared, if in fact any comparison is valid. 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 Automatic in the purchases by operating telephone companies provides an advantage so great in volume alone that competition is effectively eliminated. Automatic has a stable, assured, and captive market. Were Automatic's ability to manufacture not more efficient than outside suppliers who do not possess the advantages enjoyed by Automatic, the very existence of Automatic under GT&E'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 Automatic's prices.

The argument that the similarity of prices paid by nonaffiliates and General to Automatic is a valid standard to determine the reasonableness of Automatic's prices must be examined in relation to the size of the GT&E System and General to all telephone service in the United States. General's contention that the prices charged by its manufacturing and sales affiliates are reasonable is bottomed on the claim that those prices are fixed in an open, competitive market. The record does not support this claim.

Approximately 83 percent of domestic telephones in the United States are controlled by the Bell System. This market receives the bulk of its equipment and supplies from Western Electric, Bell's affiliated supplier. General does not compare its prices with this portion of the market. In fact, Western Electric's prices are approximately 50 percent less than Automatic's. General looks to the non-Bell market for comparisons. Over two thousand telephone companies comprise the independent telephone market. By the end of 1966 these companies operated about 16 million telephones. GT&E had about 43 percent of this market. Smaller holding companies held approximately 19 percent of the market and some two thousand independent companies divided the remaining six million phones.

The equipment and supplies for these independent companies are provided by Automatic and numerous other suppliers. Automatic has approximately 58 percent of the equipment market. All of the remaining suppliers divide the remaining 42 percent. With its great volume Automatic has achieved substantial economies of scale not enjoyed by its competitors. In 1967 79 percent of Automatic's sales to domestic phone companies were to GT&E affiliates, of which 25 percent were to General. Despite this heavy volume General paid the same equipment prices as the smallest independent telephone company purchasing from Automatic. There is no evidence that General has ever demanded a discount because of its large purchasing power. However, Stromberg-Carlson and Graybar, which act as distributors of Automatic's coin telephones, received discounts of 20 percent of published list prices for units and piece parts. Other items, consisting mainly of telephone instruments and repair parts, are sold at a ten percent discount to electrical contractors and others for resale in connection with the initial installation and additions to private communication systems.

A representative of a small independent telephone manufacturing equipment company testified that he gave discounts to obtain the business of such telephone companies as West Coast Telephone Company and Cal Water & Tel. When these companies were absorbed by General he lost this business. These companies now pay Automatic's prices for similar equipment, without obtaining a discount. Clearly, with its overwhelming dominance of the independent market the GT&E System could virtually dictate prices.

Automatic relies on the affiliated business. If it was independent it could be forced to give great price concessions to retain that business. The prices set for the smallest independent telephone company should in no way be a standard for GT&E or General. General recognizes this principle because in its brief it states "most manufacturers give quantity discounts for large volume purchases." Most manufacturers do, Automatic does not.

It seems quite apparent that if the affiliated telephone companies, as a single bargaining unit, had been free to purchase their requirements from the lowest bidder on a truly competitive basis, they could have obtained them at prices lower than those charged by Automatic, absent some unique advantage of Automatic of which there is no proof in the record. Instead, the benefits that might have accrued to the telephone companies and their subscribers have been pocketed by the parent. In addition, it apparently has been Automatic's deliberate policy to refrain from the sort of vigorous competition for additional business (including price reductions) one usually associates with companies dealing in an open, competitive market. General has failed to demonstrate that the market for the products of its affiliates is either open or competitive, as those terms are usually understood.

If regulation is a substitute for competition, and General in its brief says that it is, then this Commission must see that General gets the proper discount for its large volume purchases.

Our views are in accord with other Commissions that have considered this problem.

> "Whatever may be the constitutional limits to the regulation of public utilities, they do not require the Commission to overlook the differences between Brobdingnag and Lilliput." (General Tel. Co. of Upstate New York v. Lundy (1966) 17 NY 2d 373, 64 PUR 3d 302, 310.)

> "However, the mere fact that a manufacturer charges both affiliated and non-affiliated buyers uniform prices hardly establishes that the prices are either reasonable or competitive. There was no evidence that applicant had sought lower prices from its affiliates, from other manufacturers, or had sought competitive bids.... It would appear from the testimony and pricing philosophy presented by the applicant that for all practical purposes the prices involved here are 'administered prices'. The level of prices is not determined by the costs incurred by the largest and most efficient producer in a competitive market but rather are determined at a level which will permit smaller and less efficient producers to stay in business." (General Tel. Co. of Wis. (Wisc. PSL 1960) 34 PUR 3d 497, 512, 513.)

We find that General and Automatic, both wholly owned subsidiaries of GT&E, are, in effect, different departments of one business enterprise, so that there exists no incentive to real bargaining; and that despite Automatic's preferred position in the integrated system, with sales of large percentages of its production in effect guaranteed, with the results of volume production and less expense in promotional and sales costs, there has, nevertheless, been no corresponding reduction in prices, and, therefore, we find that the prices paid by General to Automatic for equipment and supplies are unreasonable.

2. Western Electric Adjustment or Some Other Method?

General's failure to justify its valuation of Automatic's products places the burden on the Commission to calculate their reasonable value. The staff asserts that the proper valuation method is to make a Western Electric type of adjustment. That is, for rate-making purposes General's rate base and expenses should be adjusted to reflect its purchases from Automatic as if Automatic was limited to its cost and a 6.6 percent return on a net investment rate base; this adjustment should reflect all purchases by General from Automatic since the last rate case of General in 1958. Applying this principle General's rate base should be reduced by $29,845,000 and expenses by $1,742,000 (Exh. 72, Table 5K).

As an alternative to the Western Electric adjustment the staff presented an adjustment based on the premise that Automatic is a manufacturing company with a different capital structure and risks from an operating telephone company. As such it is entitled to a return on investment more comparable to average returns earned by other manufacturing companies than to a return allowed an operating telephone company. Under this method comparisons are directed primarily to a return on stockholders' equity rather than to the return on total capital. On this basis a staff witness asserted that a 12 percent return on equity would be appropriate. This alternate proposal is not advocated by the staff but is presented to offer the Commission a choice.

General asserts that neither method is proper, but if an adjustment is to be made it should be based on a return on equity which, for comparable companies (four electrical manufacturing companies for the years 1964-1966), would be within the range of 16 to 17 percent.

The Western Electric adjustment has not been applied in all cases when affiliated interests are shown; it was not applied in the last General rate case. (General Tel. of Cal. (1958) 56 CPUC 477.) In that case the Commission found that the Western Electric - Pacific relationship was different from the Automatic - General relationship in a number of important respects and that there were numerous distinctions between the corporate relationship and the methods of transaction of business between the two. (56 CPUC at 482.) Further, the Commission found that Automatic's charges to General were reasonable. (56 CPUC at 483.) In this case it is our opinion that the Western Electric - Pacific relationship is still different in sufficient measure from the Automatic - General relationship so that we will not make the Western Electric adjustment.[5/]

Automatic continues to sell to nonaffiliated companies at a current annual volume of approximately $168,000,000. These sales provide economies of operation to the manufacturing enterprise; but at the same time these sales reflect a partly competitive

5/ This does not mean that the Western Electric adjustment is to be made only in cases affecting manufacturing affiliates comparable to Western Electric. We are making this kind of adjustment, in this case, in regard to the directory company. We have made a similar adjustment in case affecting a gas company (Southern Counties Gas Co. (1952) 51 CPUC 419); in water company cases (Suburban Water Systems (1963) 60 CPUC 183); and compare Soule Transportation, Inc. (1962) 59 CPUC 260 (transportation company).

market which adds to the overall risk to Automatic.[6/] In particular, we are not convinced that the manufacturing function performed by Automatic could just as well be performed by a telephone company. There appears to us to be somewhat greater risk in Automatic's manufacturing operations even with a substantially captive market than exists in a utility operation. How to quantify this difference in risk and reflect it in a reasonable return is indeed a difficult and complex problem. The evidence convinces us that to simply allow a rate of return on Automatic's investment utilized for sales to General, equal to that allowed to General's, is not correct here. We are cognizant of the economic necessity for allowing Automatic a reasonable return on its investment to compensate for the risks undertaken and the need to attract capital. Accordingly, we conclude that Automatic would be treated fairly if it earned a return on its <u>common equity</u> approximating the return on common equity of a broad spectrum of American industry. (See table on page 58.) This reasoning leads us to conclude that a range of 10 to 12 percent on common equity of Automatic would be appropriate. Because of the uncertainties heretofore discussed in our determination of a precise rate of return, which are complicated here because we are considering a manufacturing firm, albeit with a substantially captive market, we select the 12 percent return on equity, a return which may be slightly generous.

6/ This distinction should not be interpreted too broadly. It does not mean, for instance, that an affiliate that would normally be subject to the Western Electric adjustment can, by selling to nonaffiliates, perfume its operation to avoid the adjustment, e. g., the directory company.

EXHIBIT 79 SCHEDULE 13

Summary of Schedules Showing Average
Percentage Returns on Stockholders' Equity for
Industrials and Electrical and Electronics Groups
For the Period 1959 to 1966

Item	Mean Averages		Median Averages	
	Industrials	Electrical and Electronics	Industrials	Electrical and Electronics
Moody's	12.5%	11.0%	12.0%	10.7%
Standard & Poor's	--	11.7	--	11.6
Fortune's 500	11.3	11.0	11.1	11.0
First Nat'l Cy Bank	11.9	12.5	11.6	11.4
Dr. Weston's Groups:				
(1) 29 Manufacturers of one or more communication products	--	12.5	--	11.3
(2) 18 Manufacturers of Telecommunications Products[1]	--	12.3	--	11.1
(3) 19 Diversified Manufacturers seeking penetration of telecomm. market	--	12.5	--	11.1
Staff Selected Group of 26 Electrical & Electronics Companies	--	12.2	--	11.9
Automatic Electric Company	--	26.3	--	24.4

1 Telecommunications products may not be largest segment of business.

3. Rate-Making Adjustment

Having determined that Automatic's prices to General are excessive and unreasonable and that it would be reasonable to limit Automatic's profits on its equity investment devoted to sales to General to a 12 percent return we must relate this return to Automatic's investment allocated to General. GT&E in acquiring various components of Automatic between 1950 and 1962 chose various means to make these acquisitions. In some cases a company was purchased for cash. In other cases there was a merger via an exchange of stock. These mergers were treated either as purchases or a pooling of interest. In the case of a purchase the acquired company's assets were recorded in the acquiring company's books at the cost of these assets to the acquiring company. In a pooling of interest, the acquired assets are recorded on the books of the acquiring company at original book value, and the shares issued in payment are recorded to reflect this original book value. GT&E claims that it paid $92,917,000 over book value when it acquired Automatic. GT&E asserts that it should be allowed the actual purchase price that it paid to acquire Automatic; it should not be penalized for using the pooling of interest procedure. The staff asserts that this increase over book value has no logical basis and is merely an attempt to extract excessive profits from GT&E's California customers.

The staff argues that for rate-making purposes this Commission usually looks to the book value of an acquired company and rejects the inclusion of goodwill in the resulting rate base. General argues that the true cost of Automatic to GT&E is the market value of the common stock issued on the date of acquisition of the property. They assert that the staff's own witnesses testified that if GT&E had built from scratch a manufacturing company they would have used as a rate base the original cost of such a manufacturing facility, and that if GT&E had followed the accounting treatment of a cash purchase they would have recognized the price paid as the proper basis for GT&E. The staff in its brief argues that even assuming GT&E had paid 93 million or some lesser sum above the book value of Automatic this is no reason to include this sum in the investment that Automatic has devoted to sales to affiliates.

Two questions are presented here: (1) Whether we should use the original costs of Automatic thereby eliminating the additional $92,917,000; or (2) if we recognize as valid for rate-making purposes the total price paid by GT&E for Automatic, does the $92,917,000 reflect the actual cost of GT&E above original book cost?

We reject the staff theory of determining Automatic's book value. The staff argument is succinctly set forth in Conejo Valley Water Company (1965) 64 CPUC 212, 224, where this Commission stated:

> "If a regulated utility purchasing dedicated property were allowed to pass on to its customers a price higher than its original cost, the parties to the transaction would be in a position to frustrate the application of the original cost standard by arranging a transfer of ownership at a premium. The seller would receive, at the expense of future rate payers, more than his original cost, and yet the willingness of the purchaser to pay such a premium would have little significance since he himself would not bear the burden."

This principle was applied in California Water and Tel. (1966) 65 CPUC 281 where we disallowed the excess paid over original cost on a plant acquisition. The disallowance was applied to dedicated property. When original cost is considered in public utility rate making it is usually defined as "the cost of such property to the person first devoting it to public service." (Re Investigation of Accounting Procedures (1939) 41 CRC 745, 747.) Certainly in cases not involving dedicated property these principles should not be applied arbitrarily in circumstances which suggest that to apply them would be unrealistic or unfair. The staff does not discuss the question of whether Automatic's property is devoted to a public use and General states flatly "it is obvious that Automatic is not, and could not be, declared to be a public utility." General's statement is not obvious to us 7/ but, in any case, on this record, no one is asserting that the property of Automatic at the time it was acquired by GT&E was dedicated property.

There being no dedicated property involved in this acquisition we must determine whether it is realistic and fair to treat the acquisition on the basis of original cost to Automatic.

7/ Some manufacturing companies are regulated as public utilities. Public Utilities Code Section 216(a) states: "'Public utility' includes every ... gas corporation ..."; Section 222 states: "'Gas corporation' includes every corporation ... owning ... any gas plant for compensation ..."; Section 221 states: "'Gas plant' includes all real estate, fixtures, and personal property, owned ... in connection with or to facilitate the production ... of gas, natural or manufactured ..." (Emphasis added.)

In our opinion such treatment is neither realistic nor fair. Such treatment ignores the arms length bargaining that went on during the negotiations to acquire this property; and such treatment will inhibit a utility from purchasing assets in order to make for itself, at a cheaper price, that which it now buys from others. We do not see the distinction, so far as nondedicated property is concerned, that says a utility is entitled to include in its rate base the full cost of a plant that it builds brick by brick but may have to include something less if it purchases the plant from another. There is no evidence in this record that GT&E made less than the best bargain it could.

If GT&E had paid cash for Automatic its cost would be the amount it paid. However, GT&E did not always pay cash; sometimes it exchanged stock. To compute its investment in Automatic GT&E used the market price of its stock on dates that it thought were appropriate. For instance GT&E asserts that the market value of the shares exchanged in the Gary merger should be based on the market price of September 29, 1955, the date the merger was approved by GT&E's shareholders. In our opinion, this method of choosing a valuation date is wrong. The futility of relying on a single spot date in determining the market price valuation can readily be demonstrated by reference to the Gary merger in 1955. Negotiations leading to the merger were begun in August 1954. A plan of merger was adopted based on financial statements as of April 30, 1955, and apparently in anticipation of the merger, GT&E issued a 50 percent stock dividend in June 1955. Boards of Directors of both companies approved the merger at meetings in August 1955, and on September 29, 1955, the shareholders of GT&E voted their approval. The merger became effective October 31, 1955. The price of GT&E's stock on various significant dates is:

EXHIBIT 92 TABLE 2

Significant Dates in Merger of
GT&E and Theodore Gary and Co.

Item	Date	Closing Market Price of GT&E Stock	Adjusted Market Price[2]	Valuation of GT&E Stock Issued (2,746,245 Shs.)
Beginning of Negotiations Between GT&E & Gary	8/54	$34.69[3]	$23.13	$ 63,521,000[4]
Declaration Date of GT&E's 50% Stock Dividend in 1955	4/20/55	50-5/8	33.75	92,686,000
Cut-Off Date of Financial Statement Used as Basis of Merger	4/30/55	54-1/8[1]	36.08	99,085,000
Public Announcement of Gary's Proposed Merger With GT&E	8/24/55	42-7/8	42-7/8	117,745,000
Date of GT&E Stockholders' Meeting on Proposed Merger	9/29/55	40-1/4	40-1/4	110,536,000
Effective Date of Gary's Merger With GT&E	10/31/55	36-3/4	36-3/4	100,925,000

1 At April 29, 1955. Stock exchange closed on April 30, 1955 (Saturday).

2 Adjusted to reflect 50% stock dividend on June 30, 1955.

3 Average of high and low for month.

4 Nearest thousands.

Arguments with some degree of validity can be advanced for the selection of any of the above dates as a measure of the market value of GT&E's securities issued in the merger, notwithstanding that between the time that merger negotiations were initiated late in 1954, and the date that the merger was approved by GT&E's shareholders on September 29, 1955, GT&E's stock price had advanced from $23 per share to $40 per share, an increase of 74 percent.

To avoid the random fluctuations of the stock market from one day to the next a broader base from which to derive market value must be sought. It has been suggested that a computation be used that is based on the average of market prices of GT&E stock for either a 6- or 12-month period immediately preceding each acquisition. Both the 6- and 12-month averages have merit. They avoid day-to-day market fluctuations and the long periods averaged safeguard against any possibility of short-term manipulation of the market price, and more adequately reflect the underlying economic values being exchanged or acquired.

It is a well known phenomenon of the stock market that rumors of impending corporate activity, especially mergers, influence the price of stocks, at least over the short term. Also, after an exchange-of-shares merger is publicly announced the ratio of the shares to be exchanged has an effect on the relative market price of the stock. Valuing the exchanged stock on the basis of an average market price over an extended period of time reduces the possibility of valuing on the basis of speculative market maneuvering and avoids any suspicion that GT&E picked the date of valuation merely to inflate the price. For these reasons we will value the stock on the basis of the average of market prices over the twelve-month period immediately preceding each acquisition. GT&E claimed its total investment in the companies that comprise Automatic as of date of acquisition was $181,000,000 based on spot prices (Exh. 92, page 9); using a 12-month average price we find that its investment was $173,345,000 (Exh. 92, page 14).

To determine the allocation to General of GT&E's investment in Automatic, it was necessary not only for GT&E to assign a market value to its shares exchanged for shares of Gary and the other acquired companies, but also to make a further allocation of the total market price thus determined between domestic telephone equipment manufacturing and all other activities of Gary and the other companies. GT&E made such an allocation based on the percentage of net income derived from telephone equipment manufacturing activities for the three calendar years immediately prior to each acquisition. This method of allocation has fundamental defects in that it gives no recognition to differences in capital structures, differences in risk, foreign or domestic operations, or to the amount of investment required to produce each dollar of income.

A better method in this situation is an allocation based on the relative investment (book value) of the acquired companies in telephone manufacturing activities as distinct from all other activities. While this method may have shortcomings, it is more reliable than the method proposed by General. It more accurately reflects the fact that more investment is needed for telephone operations than for manufacturing operations and also that a dollar of earnings from investment in utility plant is worth more than a dollar of earnings from investment in a manufacturing operation that faces a competitive market.

The final step in valuation, for rate-making purposes, is to allocate that portion of GT&E's investment in Automatic which is used to provide service to General. Two methods of allocation have been suggested: the investment method - an allocation based on the ratio of the recorded net investment of Automatic assigned to General to Automatic's total net investment; and the income method - an allocation based on the ratio of the recorded net income of Automatic assigned to General to Automatic's total net income. We feel that the investment method is sounder. It provides a more stable criterion, not as vulnerable to broad fluctuation as a net income concept.

Applying the three chosen criteria, valuation of GT&E's stock on an averaged market price basis, allowing a 12 percent return on equity, and allocating the portion devoted to serving General on a net investment basis, we find that for rate-making purposes there should be a net rate base reduction (total company) of $18,326,000, and a net expense reduction of $1,065,000 (Exh. 92, p. 24); (intrastate $16,633,000 and $944,000). This compares with the staff suggested reduction of $29,845,000 and $1,742,000 respectively (intrastate $27,046,000 and $1,545,000).

4. Retroactive Rate Making

General asserts that the staff proposed adjustment for unreasonable prices paid by General to Automatic since the 1958 rate case is a recommendation for retroactive rate making. It says that since this Commission, in 1958, found that the prices paid by General to Automatic were reasonable and set rates accordingly, we cannot now accumulate excessive prices since 1958 and deduct them in an adjustment in this rate case. This procedure General argues, in effect reduces rates for the period between rate cases.

General's argument is without merit. In 1958 this Commission found Automatic's prices for past sales to be reasonable and set rates accordingly. Today we find that Automatic's prices since the last rate case have been unreasonable, and we set rates for the future accordingly. In simple terms General is saying that we can't squeeze water out of its operation when we find it; that we must set rates for the future based upon unreasonable cost. This is patently absurd, and if upheld would emasculate regulatory agencies. We are not altering rates or profits that General has received prior to the effect of this order. We are saying that General's rate base and expenses being considered here for future rate making are inflated and we are seeking to correct that situation prospectively.

B. Directory Company Adjustment

The General Telephone Directory Company (Directory Company), organized in 1936, is a wholly owned subsidiary of GT&E. At present Directory Company operates 19 divisions throughout the United States. The Directory Company sells yellow page advertising and compiles, prints, and delivers directories, but does not necessarily perform each of these services for all of its customers. The Directory Company serves all of GT&E's telephone operating companies in the United States, with minor exceptions, and 205 other nonaffiliated independent telephone companies. The Directory Company has been handling most of the directory operation for General since 1936, including publishing a street address directory which General rents to travel and credit agencies and others. Directory Company does not print or deliver General's directories. The total revenues for the Directory Company in 1967 were $54,525,000. Of this amount $17,403,000 (approximately one-third), came from General and $6,600,000 came from the nonaffiliated domestic telephone companies. The amount paid by General is nearly three times as large as the Directory Company's total revenues from all nonaffiliated telephone companies combined. General bills for and collects the advertising revenue, prescribes the design of the alphabetical sections, sets the publishing schedules for the directories, and contracts and pays for the delivery of the directories to its customers.

Payment for services is made monthly by General to the Directory Company pursuant to contract. If the Directory Company's net profit on General's business in any year exceeds 10 percent or drops below 5 percent of the gross directory advertising revenue collected by General in that year, the contract provides that payment for the following year shall be subject to adjustment downward or upward on a basis satisfactory to both parties, with the further provision that any amount of net profit over 10 percent shall be divided equally. There have been no adjustments because of profits exceeding 10 percent, but after the Directory Company's 1966 profits on General's business had dropped below 3 percent, an agreement was reached that beginning in March 1967, General would pay the Directory Company approximately $30,000 per month in addition to the regular monthly payments, as a net profit deficiency payment.

Because of the overall relationship of the Directory Company to General, the staff concluded that the Directory Company should not be allowed a greater return on business with General than the latter is allowed on its other utility business. Therefore, the staff made a downward adjustment to General's commercial expenses for the year 1968 estimated so as to allow the Directory Company a 6.6 percent return on such business. General, on the other hand, asserts that the nature of the Directory Company is such that it should be treated as an independent business whose charges to General are reasonable and should not be limited by General's rate of return. General claims that its expenses for directory services should be computed as recorded on the books of the company with no adjustment made. The staff adjustment would increase General's adjusted net income for 1968 estimated by approximately $811,000 ($720,000 intrastate).

General argues that it retains the services of the Directory Company because of its proven ability to maximize revenue from advertising sales and services and to produce excellent telephone directories; its ability to meet scheduled sales and publication dates; its national organization with experience in local and nationwide classified advertising markets; its management team that is responsive to the complexity of today's directory advertising sales, compilation, and production problems; its established reputation in the communications industry; and its large staff of professionally trained sales and supervisory personnel, commercial artists skilled in the preparation of high quality advertising copy, and personnel trained in the exacting skills required for compilation and production. In the opinion of General's management, the results achieved by the Directory Company in the field of directory service exceed those which would be produced if General operated its own directory company.

General asserts that employing an independent directory company is preferable to publishing its own directories not only for the reasons stated above, but also because the nature of compensation paid to directory salesmen and the need for a stable sales force require a separate entity - the Directory Company pays its sales employees on an incentive basis. This kind of payment is expected to produce the best results so far as directory advertising is concerned. If General were to operate its own directory company, it would have to continue making this incentive payment, but to do so would create operating problems with other employees of General who are paid on a nonincentive basis. Also, by having an independent directory company, that company can furnish directory sales and service arrangements to other telephone companies and thereby provide a stable labor force over a yearly period. In a company the size of General it would be impossible to maintain a stabilized sales force to properly canvass the advertising market prior to directory publication dates. General publishes 36 customer directories, but not uniformly throughout the year. To keep a stable sales force that can handle the peak demand requires business from other telephone companies. The Directory Company, by providing service to other telephone companies, can meet the needs of General's peak demand and fill in the slack periods with service to other companies thereby retaining a stable sales force.

General argues that the Directory Company has none of the characteristics of the conventional utility, that is, it does not have the heavy capital investment that is required in relationship to revenues produced; it does not have the same degree of essentiality; it is not affected by destructive competition with the accompanying wasteful duplication of costly facilities; and increases in volume add substantially to costs. General asserts that the prices charged by the Directory Company for its services are reasonable and competitive because the Directory Company, which serves 205 nonaffiliated independent telephone companies, charges the same or similar prices for its services to nonaffiliated as well as to affiliated telephone companies. However, profits on sales to affiliated companies are slightly higher than profits on sales to nonaffiliated companies because the cost of directory preparation and publication is lower.

A witness for General testified that in addition to the servicos performed by the Directory Company, General itself performs many services in connection with publishing directories. General has a special directory section which handles all the work relating to the directory cover, the makeup, the listing material, the composition of the information pages, the placement of filler copy, the activities of abbreviation or lack of abbreviation, preparation of the art work in the information pages, work associated with governmont agoncies relating to that part of the information pages relating to fire, police, and ambulance service, work associated with the delivery of the directories, requests from the various service offices to supply customers with secondary directories, arrangements for cover stock to be used in connection with DDD dial conversions, work associated with cover requirements for specialized directories, and various other directory functions. These activities are related primarily to the white-page directory and, to some extent, to the yellow-page directory. All of the activities of this section are accounted for at cost. There is no additive to reflect any profits on this work.

The staff argues that the Directory Company should be considered an integral part of the GT&E telephone operations, rather than being viewed as a separate nontelephone business functioning in a strictly competitive climate. The staff asserts that other directory companies do not solicit the business of GT&E affiliates; General has not attempted to negotiate a better contract with other directory companies; the Directory Company has no incentive to reduce prices; the Directory Company's percentage of the nonaffiliated domestic telephone company market has dropped from 17 percent in 1964 to 14 percent in 1967; and that the contract for directory service is similar to a cost-plus arrangement. For 1968 estimated a net income of 5 percent on sales would provide a return of 37.8 percent on average common equity. Other independent telephone companies, which contract with competing directory companies in arms-length negotiations, have obtained either as favorable or better settlements from directory companies than General receives from the Directory Company. The Directory Company has a higher profit ratio on its sales for companies in the GT&E system than it has on sales for independent nonaffiliated companies. A staff witness concluded that the primary function of the Directory Company is to serve the telephone companies in the GT&E system; this is essentially a captive market, so it is unrealistic to view the Directory Company as operating in an open and competitive climate. He also noted that the contract between the Directory Company and General contained certain unique provisions that significantly reduce the Directory Company's risk of loss. He gave consideration to General's size, being one-third of the total Directory Company operations, and concluded that it was large enough to provide its own directory service if it so desired. He also observed that the expert service provided by the Directory Company was similar to the operations of the service corporation (discussed below), which provides services which have the effect of increasing the overall efficiency of GT&E, reducing GT&E's costs, and increasing GT&E's revenues; yet the service company operates on a cost basis.

General's position on the Directory Company issue is not persuasive. We accept the staff position that the Directory Company should not be allowed a greater return on business with General than the latter is allowed on its other utility business and we will make a downward adjustment of General's commercial expenses for the year 1968 estimated at present rates so as to allow the Directory Company the 6.6 percent return which was set in 1958. For 1968 estimated at authorized rates we will allow a 7.2 percent rate of return.

> "A telephone directory is an essential instrumentality in connection with a peculiar service which a telephone company offers for the public benefit and convenience. It is as much so as is the telephone receiver itself, which would be practically useless for the receipt and transmission of messages without the accompaniment of such directories." (California Fire Proof Storage Company v. Brundige (1926) 199 Cal 185, 188.)

It is immaterial that the Directory Company has been formed as a corporation separate, for some purposes, from GT&E and General. Nothing magical happens in relation to function when corporate papers are filed with the Secretary of State; it is the work and function that an entity performs that determines its regulatory treatment, rather than what lawyers put in incorporation papers. All of the so-called benefits that accrue to the Directory Company because it is an "independent" company would accrue to the Directory Company if it were merely a department in GT&E, or a department in General. The benefits of incentive pay would be the same, the benefits of a stable work force would be the same, the benefits of specialized training would be the same, and all other benefits that the Directory Company supposedly has would remain the same whether the Directory Company is considered an independent corporation or merely a department of a utility.

The argument that the Directory Company must compete for business, with the implicit assumption that there is risk involved in its operation comparable to that of other directory companies, is belied by the evidence. Certainly, the company does not compete for the business of General or any GT&E operating company nor does it have any measurable risk of losing this business. Witnesses for General have testified that if any telephone operating company of GT&E can make a better deal for directory services with another directory company, such telephone company could switch its business from the Directory Company to that independent directory company. We do not believe this testimony. The evidence in this case shows that Cal Water & Tel prior to 1961 employed the Directory Company to publish its directories. Between 1961 and 1966 Cal Water & Tel used a non-GT&E directory company. Upon the acquisition of Cal Water & Tel by General and its absorption into the GT&E System, all telephone directories concerning the former Cal Water & Tel subscribers were again published by the Directory Company. Further, General, which contributes about one-third of the total income of the Directory Company and does almost three times as much business with the Directory Company as all 205 nonaffiliated companies combined obtains no better share of revenue from the Directory Company than other GT&E operating companies and non-affiliated companies. Under these circumstances we find that General is not getting the benefits that its economic power would command in a truly competitive market. This finding is supported by evidence that some California telephone utilities which are much smaller than General are receiving as good or better settlements from the independent directory companies they do business with (Exh. 80, Schedule 7).

Another objection to treating the Directory Company as an independent company is that it permits GT&E by fiat to control the expenses of General and consequently its rates. Obviously, the profits of GT&E on a consolidated basis should not be affected one iota whether General pays the Directory Company's costs (including return) or whether General pays those costs (including return) plus an additional $811,000. But, General's income statement is affected when that extra $811,000 is paid to the Directory Company. General must recover that $811,000 in higher rates to its customers in order to maintain its fair rate of return. So, the more money that General pays to the Directory Company the more profit to GT&E, with no commensurate benefit to the rate payers. This syphoning process is well illustrated by the situation that arose in 1967 when GT&E as the Directory Company came to GT&E, acting in the name of General, and requested an additional $30,000 a month to increase the Directory

Company's profits pursuant to a contract made by GT&E acting as the Directory Company with GT&E acting as General. To consider this kind of a transaction arms-length bargaining is to make a mockery of the term.

Of course, the problem is not confined solely to General and the Directory Company. Its ramifications can be felt in all phases of utility operation. If the Directory Company can be treated as a nonutility entity, permitted to make any profit it considers fair, then other functions now performed by a utility in the future might be performed by a separate subsidiary corporation with the ability to charge any price it desires. Today, General performs all of its own billing services; tomorrow, there may be the GT&E Data Services Corporation which will perform billing services for all of GT&E's telephone operating utilities. The claim might be put forward that such a computer billing corporation is in competition with other computer billing corporations and is risky, and, therefore, requires a profit more than the normal utility profit. General also has accounting departments and law departments. These, too, can be spun off into separate entities which charge, not on the basis of the utility's ability to perform the function, but on the basis of what other independent accounting firms or law firms charge. There is no need to stop there. Repairs and maintenance can be done in the same manner; repairmen perform a special function, they need special training, they need incentives different from the incentives given to the Directory Company salesmen, why not a separate corporation for these men, with higher profit requirements? To prevent this fragmentation of utility service we must maintain the position that a utility, when controlling or performing functions that are an integral part of its service to the public, cannot merely, by a separation in corporate structure of what otherwise would be a functioning department, obtain higher profits than would be available to the utility through its fair rate of return.

The difference in our treatment of Automatic and the Directory Company lies primarily in the fact that at this point in time we are not yet certain that the function of Automatic can be performed equally well by the utility within the present concept of utility service.[8/] In the future, when we again look at the operation of Automatic in its relationship to GT&E and General, we may find that the factors of lack of competition, administered prices, low risk, elimination of service to nonaffiliated telephone companies, and other pertinent considerations, will require us to make a Western Electric type of adjustment.

C. Service Company Adjustment

The General Telephone and Electronics Service Corporation (Service Company) is wholly owned by GT&E. The services provided include general advice and counsel on legal matters, corporate and public relations, advertising, financial matters, accounting practices, budget procedures, taxes, insurance, and security and safety training. The Service Company maintains key personnel records, implements intercompany transfers and management development programs, manages the pension plan, and develops and maintains operating practices and standards, depreciation and separation studies, and marketing and sales programs. All of the GT&E telephone

8/ There is at least one other way the affiliated interest problem can arise. Suppose General was a much smaller telephone company which could not possibly publish a directory economically and efficiently. Under such circumstances could GT&E contract with General to provide directory service at a price to General which would realize a profit for GT&E greater than the return authorized to General? This is essentially the Pacific-Western Electric situation. Under the facts of this case this question is not before us.

operating companies purchase this service. The cost of this service, which does not include any return, is prorated among the various telephone operating companies and allied companies on the basis of the percentage of time spent on activities pertaining to each group. For the telephone operating group, the amount of the group allocation to be prorated to each company is based on the percentage of each company's operating expenses and taxes, which percentage is revised as conditions change in the corporate structure. In 1967 General's share was 16.83 percent of the total cost.

The staff asserts that the use of operating expenses as a basis of allocation produces unreasonable and inequitable results and unduly burdens California operations. In the staff's opinion differing wage levels and material costs throughout the nation make operating expenses an unreliable basis of allocation but that an allocation based on the number of main stations will provide a fair method of allocation. On this basis General would absorb 13.58 percent of the Service Company's cost rather than 16.83 percent. The difference in dollars is approximately $400,000. In our opinion, at this time and in view of the evidence, General's method of allocation more accurately reflects the cost of the services rendered to General by the Service Company.

IV

RESULTS OF OPERATIONS

A. Separations

General's telephone equipment is used 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. It is also necessary to separate the intrastate toll operations from intrastate exchange operations because intrastate toll revenue is divided between General and Pacific on a cost basis; and it is necessary to separate extended area operations from the remaining operations because revenue from this service is also divided with Pacific on a cost basis.

The staff separated the various segments of plant as follows: Total operations were first determined; then interstate operations were determined based on methods set forth in the NARUC (National Association of Regulatory Utility Commissioners) Separations Manual, as modified by the 1967 FCC (Federal Communications Commission) separations plan for subscriber line and station equipment plant. The resulting intrastate operations were then separated to state toll, interchanged MMU (multimessage units) and exchange operations on the basis of the NARUC Separations Manual, except for the separation of exchange circuit plant where the Charleston Plan was used. General used essentially the same separation procedures. The test year is 1968.

The staff and General each applied the separation procedures to their own estimates of General's 1968 total company revenue, expenses, and rate base. The staff based its estimate of 1968 total company operations on projections of General's 1967 recorded operations and two or three months of General's 1968 recorded operations. General based its original estimate of 1968 total company operations on projections of nine months' recorded operations in 1967, later modified to reflect adjustments thought appropriate by General.

B. Accelerated Depreciation

Section 167 of the Internal Revenue Code provides that a taxpayer may determine his tax depreciation by either the straight line method or an accelerated (liberalized) method. Straight line depreciation is designed to produce a uniform annual depreciation deduction over the useful life of the asset; it is computed merely by dividing the cost of the asset, less salvage value, by the assumed service life. One accelerated depreciation method authorized by Section 167 is the double declining balance method. Under this method a uniform rate of twice the straight line rate is applied to the unrecovered tax basis of the property, i.e., the tax basis less the tax depreciation allowance in prior years. Absent a change in the tax rate, the use of declining balance tax depreciation rather than straight line depreciation does not change substantially the total taxes to be paid over the life of a particular property; rather, it simply permits a greater tax deduction in the early life of a property than available if straight line depreciation were taken, offset by a less than straight line tax deduction in the later life of a property. General has not elected to utilize accelerated depreciation.

General is required by our system of accounts to compute and record depreciation charges as an item of expense on the basis of straight line depreciation. It is also required to record, for expense purposes, the actual federal income taxes paid. Thus, if General were to use accelerated depreciation, it would first compute the straight line depreciation expense for book purposes, but utilize for tax purposes the accelerated basis, which produces higher depreciation expense charges. This results in an increase in expense deductions and thereby reduces taxable income with corresponding reductions in the income tax payment. A reduction in income tax expense in that instance is said to "flow through" to net income. This would automatically occur should General utilize accelerated depreciation for tax purposes.

General has proposed that if it be required to use accelerated depreciation, it should be permitted to "normalize" the tax payment in the following manner: it would record straight line depreciation for book purposes; it would compute depreciation on the accelerated basis for figuring its tax liability; it then would compute the theoretical higher tax liability it would have incurred had it used straight line depreciation; this difference between the actual and theoretical tax payment is then charged as an additional operating expense, and the amount thereof is placed in a special "normalization" reserve.

General does not wish to use flow through because it considers accelerated depreciation not to be a tax saving but a tax deferral. It claims that if the savings are flowed through now to users, future users will be charged with these payments, or if rates cannot be raised sufficiently in the future to offset the additional tax costs then the stockholders would be required to absorb the increased tax payments. This is a risk they do not wish to undertake. Further, General asserts that it should not be required to use accelerated depreciation because the growth patterns of General are such that the use of accelerated depreciation would cause a dilution in earnings in certain years.

The staff asserts that General should be required to compute its taxes on the basis of accelerated depreciation because a public utility is under a duty to minimize its costs. Utility rates are fixed on the basis of the cost of service of a particular utility so as to return to the utility all of its costs of providing the service plus a fair return. One of the costs of providing utility service is income taxes actually paid. Utility management is under an obligation to utilize all available cost-saving opportunities and such obligation is applicable to tax savings as well as general economies of management. If taxes rise in the future the Commission has a duty to include such rise in determining the utility's fair return and reasonable rates. A staff exhibit shows that the effect of the use of accelerated depreciation on General's revenues results in a $2.6 million total company reduction in gross revenues and a $2.4 million intrastate reduction, for 1968 estimated. Corresponding revenue reductions for the three-year average, 1968, 1969, and 1970 are $7.8 million total company and $7.2 million intrastate. The foregoing estimates did not take into effect the impact of the federal income tax surcharge. Giving effect to the surcharge the revenue reductions are $3.1 million total company, and $2.9 million intrastate, for 1968 estimated, and $9.3 million, total company, and $8.6 million, intrastate, for the three-year average. The record shows that for the period 1954-1968, General's taxes would have been approximately $70,000,000 less if it had used accelerated depreciation for the entire period. Stated another way, General's ratepayers might have had to pay some $140,000,000 less if General had availed itself of the lawful option of using accelerated depreciation for tax purposes during the same period.

In view of our decision in the recent Pacific rate case, which we shall follow (Decision No. 74917), wherein we adjusted the intrastate results of operations of Pacific to fully reflect accelerated depreciation it would serve no useful purpose to go into the pros and cons of each of the arguments concerning the use of accelerated depreciation. The arguments have been marshaled and discussed in various court cases, commission decisions, accounting bulletins, law review articles, and utility periodicals. It is profitless to replow this field. (See Midwestern Gas Transmission Company v. FPC (7th Cir. 1968) 388 F 2d 444; Re Alabama-Tennessee Natural Gas Company (1964) 31 FPC 208, 52 PUR 3d 118; Re Midwestern Gas Transmission Company (FPC 1966) 64 PUR 3d 433.) We do not agree with General's argument based on its growth patterns. If General had used accelerated depreciation between 1958 and 1968 there would have been no dilution in earnings. In 1958 General's intrastate rate base was $302,000,000; in 1968 it was almost $934,600,000. General's president predicts a similar growth over the next 10 years. We find that the use of accelerated depreciation will not dilute General's earnings in the foreseeable future. For rate-making purposes we shall compute General's income tax expense for 1968 estimated as though General had computed its taxes using accelerated depreciation but not considering the effect of the surcharge. We shall begin with plant additions in 1968 estimated.

C. Rate Base

The difference between the staff rate base and company rate base for 1968 estimated, and our adopted intrastate rate base, is:

Weighted Average Depreciated Rate Base
(1968 Estimated (Millions))

Item	Total Company		Intrastate			
	Company (Exh.113)	Staff (Exh.75 p. 6-2)	Company (Exh.116)	Staff (Exh.147)	Company Exceeds Staff Intrastate	Adopted Intrastate Rate Base
Plant in service	$1,274.9	$1,264.0	$1,166.2	$1,147.9	$ 18.3	$1,147.9
Property held for future use	3.6	3.2	3.3	2.7	0.6	2.7
Materials and supplies	12.0	12.0	11.4	10.9	0.5	10.9
Working cash allowance	5.2	(8.0)[1]	4.8	(7.3)	12.1	(7.3)
Depreciation reserve	(228.6)	(223.7)	(216.5)	(203.0)	(13.5)	(203.0)
Unadjusted rate base	1,067.1	1,047.5	969.2	951.2	18.0	951.2
Affiliated interest adjustment	-	-	-	(27.0)	27.0	(16.6)
Adjusted rate base	-	-	969.2	924.2	45.0	934.6

1 Working cash estimate amended Exhibit 109.

There is no material difference in the method of separating intrastate rate base from total company; therefore, we will discuss the differences in rate base items primarily in relation to total company operation.

1. Plant-in-Service
<u>Company Exceeds Staff by $10.9 Million</u>

The difference is primarily due to the company's use of estimated 1967 figures and estimated 1968 figures to obtain its starting point before adjustments. The staff used 1967 recorded information plus the company's computer price-out of its March 15, 1968 review of its original construction budget as its starting point before adjustments. The staff estimate, using recorded figures and later information, is more reliable and we will adopt it.[9/]

2. Property Held for Future Use
<u>Company Exceeds Staff by $0.4 Million</u>

The difference, again, is the staff's use of more current recorded figures. We will adopt the staff estimate.

3. Materials and Supplies

The company and staff agree on total company estimates, but disagree on intrastate. This results from minor differences in allocations and separation procedure. In our opinion the staff estimate is more accurate and we will adopt it.

4. Working Cash
<u>Company Exceeds Staff by $13.2 Million</u>

The staff computation of a working cash allowance results from following past Commission decisions. In Pacific Tel. & Tel. (1948) 48 CPUC 1, 22, the Commission said:

9/ On Exh. No. 49, General revised its 1968 estimated total plant-in-service on the basis of four months' actual and eight months' estimated to show plant-in-service of $1,256,125 and depreciation reserve of ($222,558); Exh. No. 64, General's third review of this subject reduces these figures slightly. These figures are based even more conservative than the staff estimate, and are based on more current information. There is no explanation why General relies on its less accurate estimate nor why the staff did not use the more up-to-date information.

"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."

The negative working cash allowance has been described as follows:

"Where, as in this case, the funds supplied to 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." (Pacific Tel. & Tel. (1964) 62 CPUC 775, 820.)

General challenges both the theory of the negative working cash allowance and its application to the facts of this case. In our opinion the theory is sound and we will not change it.

In applying the theory, the staff first determined that General needed $7,500,000 to maintain minimum bank cash deposits, maintain working funds and special deposits, and to provide for certain prepayments. Then the staff analyzed General's daily operational need for cash to cover the various expenditures included in the cost of service such as payroll, rent, taxes, materials and services, and other operating expenses. An analysis of the lag in the payment of these expenses and receipt of revenues indicated that when offsetting the payment of operating expenses by the lag in collection of revenues there is a net lag in the payment of total operating expenses of 14.2 days and this represents an average daily amount of working cash available to General of $10,500,000. In addition, $5,000,000 is available from the collection of excise taxes, employees' withholdings and the use of credit available from creditors and suppliers. The staff concluded that General has \$8,000,000 in funds in excess of its operational cash need, not supplied by the investors. This is deducted from the rate base in order to properly include, for rete-fixing purposes, only those funds supplied by the investors.

General asserts that the method used by the staff to determine the lag days for ad valorem taxes was incorrect and that the correct method would result in a positive working cash allowance. General claims that the 202.8-day lag determined by the staff for this item should have been 34.5 days. In the recent Pacific case the staff used 34.5 days as the lag in payment of the ad valorem tax; General and Pacific pay the tax on the same date; the lien date is the same; and both companies have receipts flowing in monthly. Because of these similar factors, General asserts that the lag study should have the same results for both companies.

The staff argues that the difference in treatment of Pacific and General resulted from Pacific's accruing ad valorem taxes on a fiscal year basis while General used a calendar year basis. In the 1958 General rate case the Commission fixed rates on the assumption that General accrued taxes on a calendar year basis. Results of operations is a factor in fixing rates and accounting procedure is a factor in determining results of operations. To achieve an equitable result there must be consistency in procedure. Consequently, the proper method to base a working cash study for General is by accruing ad valorem taxes on a calendar year basis. In our opinion, the staff method is reasonable.

5. Depreciation Reserve
Company Exceeds Staff by $4.9 Million

The staff depreciation reserve total company estimate is $4.9 million less than the company's; $13.5 million less intrastate. The total company difference is primarily a factor of the difference in plant-in-service. The staff depreciation reserve estimates of ($223.7) total company and ($203.0) intrastate are based on the plant-in-service which we have found reasonable, and, therefore, the corresponding depreciation reserve is reasonable.

6. Affiliated Interests

We will reduce General's rate base by $16.6 million for the reasons stated in our discussion of affiliated interests elsewhere in this opinion.

We conclude, and find, that General's intrastate weighted average depreciated rate base for 1968 estimated is $934,600,000.

D. Revenues and Expenses

The major differences in the estimates of revenues and expenses of General and the staff result from each party's using different starting points on recorded information, different trend and allocation factors, General's annualization of a 1968 wage increase, the staff's failure to recognize a portion of General's 1968 ad valorem tax, and the staff adjustment for affiliated interests. In December 1968, General adduced evidence of revenues and expenses based on 10 months 1968 recorded figures which, it asserts, substantiates its original estimates. In tabular form these differences, and our adopted intrastate results of operations, are:

1968 Estimated and Adopted Results of Operations
(At Present Rates (000))

Item	Total Company General (Exh.113(L))	Total Company Staff (Exh.109 Table 16-A)	Intrastate General (Exh.147)	Intrastate Staff (Exh.147)	Staff Exceeds Company Intrastate	Adopted Intrastate
Revenues	$ 343,423	$ 345,600	$303,196	$301,371	$(1,825)	$302,766
Uncollectible	(3,671)	(2,800)	(2,379)	(1,772)	607	(2,379)
TOTAL OPER.REVENUE	339,752	342,800	300,817	299,599	(1,218)	300,387
Operating Expenses	149,642	143,200	133,406	124,705	(8,701)	131,184
Depreciation	62,802	59,600	56,060	54,848	(1,212)	54,848
TOTAL OPER.EXPENSE	212,444	202,800	189,466	179,553	(9,913)	186,032
Taxes	63,829	68,100	55,234	58,337	3,103	56,098
Total Oper.Exp.& Taxes	276,273	270,900	244,700	237,890	(6,810)	242,130
Unadjusted Net Oper.Income	63,479	71,900	56,117	61,709	5,592	58,257
Affiliated Interest	-	2,500	-	2,218	2,218	1,664
Adjusted Net Income	63,479	74,400	56,117	63,927	7,810	59,921
Unadjusted Rate Base	1,067,095	1,047,500	969,306	951,237	(18,069)	951,237
Affiliated Interest	-	(29,800)	-	(27,046)	(27,046)	(16,633)
Adjusted Rate Base	1,067,095	1,017,700	969,306	924,191	(45,115)	934,604
RATE OF RETURN	5.95%	7.31%	5.79%	6.92%	1.13%	6.41%

(Red Figure)

The wages of General's employees were raised in July 1968. General estimated wage expense as if the wages had been in effect since January 1, 1968. The staff argues that if one expense increase is annualized, then all increases in revenue, expenses, and rate base should also be annualized. The staff argument is sound. One expense should not be considered without also considering effects of all other items comprising revenues and expenses. When trying to determine which expenses General might reasonably have incurred in 1968, we should avoid including expenses that we know were not incurred.

The staff failed to recognize certain portions of General's ad valorem tax because at the time they prepared their estimate they did not have the information. General obtained the information, presented it, and the staff agreed it should be included as an expense. We shall do so.

1. Revenues

The difference here results from the staff ad valorem adjustment and the company wage adjustment discussed above. General's evidence, based on 10 months 1968 recorded figures, shows that its original estimate is likely to be achieved. We will adopt General's estimate less that portion reflecting annualized wages.

2. Expenses Other Than Taxes

General's estimate exceeds the staff's by approximately $10 million. Differences occur primarily because of different depreciation methods, allocation factors, starting points, and the annualized wage. The major difference is the depreciation treatment for Account No. 232, Station Connections, which results in the staff's estimate of depreciation expense as $3,060,000 less than General's. The staff contends that the depreciation rate for this account should be 15 percent and the depreciation reserve should be near zero; General contends that the depreciation rate should be 17.64 percent and the depreciation reserve should grow to approximately 15 percent. The Commission has previously considered this matter and decided that the depreciation reserve assigned to Account No. 232 should be maintained at zero. (Pacific Tel. & Tel. Co. (1958) 56 CPUC 277, 286.) We shall follow this ruling. The staff depreciation rate of 15 percent is reasonable and will be used. The difference between the staff's and General's estimate of depreciation expense, as shown in the table on page 89 of this opinion, is less than the amount discussed herein because of differences in allocation factors. Considering all the evidence, we find that for 1968 estimated General's depreciation expense is $54,848,000.

In the light of General's testimony that 1968 recorded figures substantiate General's estimates of expenses other than depreciation, we shall adopt General's estimates with minor reductions.[10/] We will eliminate the wage annualization, as discussed above, plus $13,000 for legislative advocacy and $57,000 for dues and donations to social, charitable, and political organizations,

10/ We note that General's monthly reports to this Commission show total maintenance expense of $25,000,000 for first five months of 1968 and $52,600,000 for first 10 months of 1968. This shows that expenses in second five months increased by 23.5 percent annualized as compared to increases of 13.4 percent in 1966 and 7.1 percent in 1967. This kind of maintenance increase is not unknown in rate hearings. Nevertheless, in considering General's total operations and need for service improvement, we find its recorded maintenance reasonable with such modification as discussed in the opinion.

consistent with our past decisions on these matters. We include as part of General's expenses $177,000 for dues and fees for trade, technical, and professional associations.

3. Taxes

Because taxes are a factor of revenues and expenses, we have recomputed taxes based upon the test year revenues and expenses that we have adopted as reasonable. We have applied accelerated depreciation as discussed elsewhere in this opinion.

In determining results of operations we have not included the effects of the 10 percent federal income tax surcharge, which was applicable during the entire test year. In our opinion, this surcharge, because it is expected to be temporary, should be treated as a special item, separately stated on the customer's bill. Based on our estimate of intrastate federal income taxes at authorized rates we find that the applicable federal surtax should be $2,587,000. At the rates authorized herein gross company billing will approximate $367,000,000. To recover the federal surtax applicable to intrastate operations we will authorize General to add 1.61 percent of each customer's bill to said bill.[11/] General shall separately state this additive on each bill under the heading "Allowance for Federal Income Tax Surcharge." This added percentage shall terminate immediately upon expiration of the federal income tax surcharge, or shall immediately be reduced in proportion to any reduction in the tax surcharge. No money received from this additive shall be included in any revenue settlement with any other telephone company, directory company, or service company.

11/

Total company gross billing	$367,000,000
FIT on intrastate operations (before ITC) ..	25,871,000
FIT surcharge	2,587,000
Net to gross multiplier	2.29
Gross revenue requirement	5,924,000
Billing surcharge ..... $5,924,000 ÷ $367,000,000 = 1.61%	

4. Affiliated Interests

This matter has been discussed elsewhere in this opinion and we will make the adjustment there found appropriate.

5. Summary of Adopted Results of Intrastate Operations

A summarization of the adopted results of operations is set forth on page 89 of this opinion. We find that General's adjusted net income for 1968 estimated is $59,921,000. When this sum is applied to the 1968 estimated rate base of $934,600,000, the resulting rate of return is 6.41 percent. We have heretofore found that the reasonable rate of return for General is 7.2 percent. We have also found, discussed below, that General should be penalized 0.2 percent for inadequate service. For General to achieve a 7.0 percent rate of return we find that General is entitled to increase its rates by $12,200,000; an additional $4,400,000 is required to increase the rate of return from 7.0 to 7.2 percent. Rates will be authorized which should produce these sums.

Raise rate of return from 6.41 to 7.0% .59% x 2.08 (net to gross multiplier) x $934,600,000 (rate base) = $11,469,000	
Use	$11,500,000
Provision for settlements	700,000
Total	12,200,000
Raise rate of return from 7.0 to 7.2% .2% x 2.08 x $934,600,000 = $3,888,000	
Use	3,900,000
Provision for settlements	500,000
Total	$ 4,400,000

The federal income tax surcharge, discussed above, is in addition to these increases.

V

SERVICE

The duty to serve is a fundamental obligation imposed upon all utilities. Utilities have a special obligation to serve all in their territories who request it. Such obligation arises from the fact that a customer is peculiarly dependent upon a particular utility company to satisfy his needs for an essential service; he is, in a sense, a captive of the utility. The matter of rendering adequate service is equal to if not more important than the need for establishing reasonable rates. There can be no such thing as a reasonable rate without regard to the availability of adequate service. Continuous service, free from unnecessary or avoidable interruptions, is a basic requisite of adequate telephone service. But adequacy of service does not necessarily mean the highest possible quality of service; adequate service has meaning only in reference to the demands of the public, the cost of the service, and the financial condition of the company offering the service. A given quality of service may be adequate in one territory and quite inadequate in another.

The legislature has set forth in Public Utilities Code Section 451 the basic standard of adequate utility service.

> "All charges demanded or received by any public utility, or by any two or more public utilities, for any product or commodity furnished or to be furnished or any service rendered or to be rendered shall be just and reasonable. Every unjust or unreasonable charge demanded or received for such product or commodity or service is unlawful.

> "Every public utility shall furnish and maintain such adequate, efficient, just, and reasonable service, instrumentalities, equipment and facilities as are necessary to promote the safety, health, comfort, and convenience of its patrons, employees, and the public.
>
> "All rules made by a public utility affecting or pertaining to its charges or service to the public shall be just and reasonable."

Clearly, this section means that a utility must provide reasonable services in order to charge reasonable rates. Or, stated another way, the rates charged are to be commensurate with the services rendered. A utility cannot charge rates based solely on its net investment in utility plant and a fair rate of return, and not consider the quality of its service to the public.

The standard of reasonableness set forth in Section 451 is silent as to its components. But in the ordinary case reasonableness is primarily based on factors inherent to the company in question, rather than on a comparison with industry standards or with other utility systems. Therefore, to determine the reasonableness of a utility's service under Section 451 we first look to such items as the utility's net plant investment, its service area, the needs of its customers, its ability to raise capital through bond offerings and stock sales, and its ability to generate funds internally. It is only after considering these factors that comparisons with other companies may be appropriate. A small utility serving in a sparsely populated area might have a small plant investment spread over a broad service area with the result that providing, at reasonable rates, more efficient plant and improved maintenance would be beyond its ability. Such a company's service might be considered reasonable because of the difficulty in attracting funds to improve service, whereas similar service by a larger company, serving more customers within a smaller area, with the ability to attract capital, might be considered unreasonable.

As a further aid in determining the reasonableness of telephone utility service, the legislature amended Public Utilities Code Section 728 in 1963 by adding the following:

> "In determining and fixing rates for a telephone corporation pursuant to this section or pursuant to Section 455, or in determining whether or not a proposed rate increase is justified pursuant to Section 454, the Commission <u>shall</u>, among other things, take into consideration any evidence offered concerning the quality of the particular telephone corporation's services as compared with that of telephone corporations in adjacent territory, and the permissible rates for comparable service charged by telephone corporations in adjacent territory." (Emphasis added.)

By the terms of this section the legislature has ordered the Commission to consider the rate level and the quality of service of a telephone utility asking for a rate increase as compared with that of telephone utilities operating in adjacent territory. It appears to us that this section is to be read in conjunction with Section 451. That is, in addition to the factors that we would consider in determining the adequacy of service under Section 451, which sometimes includes comparing rates and services of various utilities, we are now <u>required</u> to consider such rates and services and make comparisons. However, if such comparisons are unfavorable to the applicant, still, the applicant's service might be the best that it can offer. In our opinion, Section 728 does no more than insure that comparative rates and services are considered as factors in determining the reasonable service to be expected of a utility. In almost all instances the telephone corporation in territory adjacent to General is Pacific.

A. Public Witnesses' Testimony

During the hearings of this case the Commission set aside 12 days devoted almost exclusively to hearing public witnesses. In addition, throughout the entire hearing, public witnesses were permitted to testify as they appeared. Over 145 persons took advantage of this opportunity to comment on General's service. In almost every instance the comments were to the effect that General's rates were too high and service was poor. Almost every person who commented on the quality of General's service as compared with the quality of Pacific's service said that the quality of General's service was inferior to that of Pacific's. Those who testified against General represented a cross-section of the entire population of the State, including state legislators, representatives of cities and counties, the University of California, the Santa Barbara School District, lawyers, doctors, teachers, engineers, businessmen from large, as well as small companies, workingmen, housewives, retired persons on fixed incomes, persons on welfare, and even some of General's own employees. The complaints generally fell into the following categories: no dial tone when receiver is lifted; wrong numbers are reached although dialed correctly; after dialing the line goes dead; lines are noisy; calls are connected into existing conversations; slow operator assistance; line reverts to dial tone during dialing or immediately thereafter; busy signal is encountered before dialing is completed; lines are disconnected in the middle of a call; incoming calls are not received because telephone does not ring; and busy signals are received although called telephone is not in use. It would unduly burden this opinion to set out all the complaints in detail but a few typical ones should be presented.

A lady living in Mission Hills testified that often her phone would not ring. "[T]he person dialing me will get a ring and I hear nothing on my end and my husband works in Culver City and calls me nearly every evening before he comes home and he dials two and three times and the phone will ring and I hear nothing and I am waiting for the call and I have not been on the phone. ..." On another occasion the witness had telephone trouble and called a repairman who checked out the phone. As the repairman was leaving the witness made a call and she "got a dial tone and dialed but could not get a ring. So I just held the phone and ran out to get the repairman back."

A witness from San Fernando testified that often her telephone did not ring when others called her. She said that her "husband's work depends upon the phone. Each and every evening he receives a call informing him whether or not he works in what locality, and at what starting time. During the first week of 1968, my husband lost a minimum of $100 in work because his boss assumed no one was home because he heard the phone ring and it did not ring at our end. As I said before, we were at home because we wait for these calls. They are our bread and butter." The witness also testified to numerous other service deficiencies.

The president of radio station KFOX in Long Beach testified that a rate increase for General is unjustified because of the "absolutely unbelievably poor service which is rendered by the company." The witness operates properties in New York, Washington, Memphis, San Francisco, and Chicago, but he never encountered so many problems in making telephone connections as in the Long Beach and West Los Angeles areas served by General. One of his principal complaints was that he would dial a local number and get a recording saying there was no such number in service. Then he would have to place his call through the operator, who on occasion asked why he did not dial directly. As he put it, "Everything conceivable happens except you don't get the right number, but when you call the operator you will be connected immediately."

A resident of Pacific Palisades in the Santa Monica exchange testified that:

> "I have been living in the Palisades since June of 1967 and I did not become really incensed with the service of the company until my wife and I bought a home which we moved into on February the 17th of last year, and in that time we haven't had so much as, let's say, three days pass without some annoying problem.
>
> "And I have never written such a letter before, I am not easily moved to do such a thing, but my wife and I, we came to the conclusion that handling our problems through the complaint department of the company was of no avail whatsoever.
>
> "They had been out many times. Yesterday they replaced our telephone for the fourth time since we have been living there. And we decided that, well, to repeat myself, we decided there was simply no point in dealing with the company any longer about our poor service, we had to either give up and just accept the service as it was, or we had to take our complaints to some other bodies, in this case, the Public Utilities Commission, of course."

One bright spot in this unvarying condemnation of telephone service was the almost uniform praise of the courtesy and promptness of the telephone employees, especially the repairmen. Witness after witness referred to the promptness of a service call after a complaint, and the courteous manner of the service people. To at least one witness who had a number of service complaints it appeared that General's servicemen were sent to charm school rather than repairman school.

B. General's Testimony

General's vice president for operations, the person who is responsible for the quality of the service General provides, testified that the service is good; it is "service that is comparable to that available anywhere." His opinion was based upon a number of statistical indicators of service, the amount of investment in plant, and the quality of the employees. The witness stated that one of the best indicators of the quality of service is "total customers' reports per 100 stations," because it measures the total number of trouble complaints on telephone service reported by customers. This indicator shows a gradual reduction in customer reports to a level of 6.16 in January 1968, which compares favorably with the company's objective of 6.0. Another indicator, the "dial equipment service index," is designed to illustrate the ability of central office equipment to provide rapid and trouble-free telephone service. This index has trended upwards to 94.3 in January 1968, close to the objective of 94.5. The "trouble clearing times" indicators show that a two-hour objective clearing time for business service was met in 91.7 percent of cases; four-hour objective time for residence service was met in 95.5 percent of cases. The company's objective is to meet trouble clearing times in 95 percent of cases and its indexes illustrate that General has been at or near this level of performance very consistently in recent years. The "speed of answer indices" record the speed in which toll and information operators answer the telephone. These indicators show that company objectives are being met. Other indicators measuring other phases of service also show that company objectives are being met or are close to being met. The witness stated that these statistics are overall company statistics and that objectives are not being met uniformly throughout the company, but that the trouble spots are being corrected.

The witness then went on to describe other aspects of the company program to improve service and keep it at high level. He discussed the planning needed to meet the future needs of present and new customers; the forecasting of growth estimates, made not only in terms of the number of customers to be served in the future, but also the general distribution of these customers throughout the operating territories; the service improvement programs that have been introduced in recent years which include preventative maintenance programs that involve the continual servicing of plant in order to avoid failure; the cable pressurization program which detects leaks and protects service in cables that, especially during inclement weather, can cause serious trouble; the automatic cable insulation testing equipment to help detect troubles during wet weather in portions of the plant not covered by pressurization. Centralized repair dispatch centers have been set up, 24-hour test board coverage has been instituted, two-way radio communication between test centers and repair trucks has been established, and automatic routiners have been installed in many central offices to detect deficiencies in equipment thereby helping to eliminate potential trouble before it materializes.

In the witness's opinion General's personnel program has kept pace with growing customer needs. He stated that General's training programs have been quite effective, producing highly qualified personnel who have demonstrated their abilities by creating and maintaining some of the most highly sophisticated communication services. Total company employment has grown from about 16,200 at the end of 1964 to about 21,200 at the end of 1968; those employed in maintenance from 9,950 in 1965 to 11,240 in 1968. The company tries to maintain a personal customer relationship in its overall activity by delegating authority to those in immediate contact with the customer so that day-to-day problems are corrected as they arise. This delegation of authority is continually monitored. In the witness's opinion, this total effort of management, maintenance, new investment, and statistical performance charts, adds up to good service. The witness testified that as long as he has been with the company there have been no budget restrictions placed on new plant or maintenance. Also, the wages paid to General's employees are essentially the same as wages paid to Pacific's employees; there is no problem of General training repairmen who subsequently go to work for another telephone company. The witness reviewed all of the complaints presented by public witnesses in this case, and was of the opinion that the complaints were negligible and that General was rendering good service.

C. Staff Testimony

A staff engineer testified concerning service of General. He analyzed the testimony and exhibits of General's service witness, the testimony of public witnesses in this case, and made outside surveys of service and service complaints. His conclusion was that the quality of service provided by General has been improving through 1967 and early 1968. This improvement is acknowledged by the subscribers, indicated by the indexes, and experienced by the staff members. The witness said that as a result of the upward trend in service quality, some phases of service can be considered good (installations, repairs), and others reached acceptable levels. However, in the witness's opinion, while the trend is in the right direction, by no means has service reached a level where the quality of service could be accepted without further improvement.

In the important "total customer reports per 100 stations" indicator the witness found numerous central offices with poor to fair trouble report indexes, which show the need for considerable service improvement. Some of these offices include the very large offices of Santa Monica, West Los Angeles, and Downtown Long Beach. On the "dial office performance" index at least 75 offices out of 154, in January 1968, were recorded as not meeting the objective in at least one category as shown by this index. By categories, 19 offices failed to meet the objective for line groups, 26 for connecting groups, 43 for originating interoffice trunks, 19 for incoming company connecting trunks, and 20 for intraoffice trunks. A large number of low index offices in the outgoing trunk groups is indicative of inadequate trunk facilities which not only result in customer dissatisfaction but also may result in diminished toll and message unit revenues.

In analyzing troubles as reported by dissatisfied customers, the witness stated that many of these troubles were encountered by the staff engineers when first testing the quality of service in different areas on test calls. Staff members have had more difficulty in duplicating troubles in recent months indicating a decrease in the number of such troubles. In the witness's opinion the nature of the customer's complaints are generally indications of inadequate central office equipment, trunking, and insufficient maintenance. Through the addition of equipment in trunking, rehabilitation of central office equipment, and implementation of plant maintenance programs, troubles have decreased compared to the situation prior to 1966.

D. Discussion

General has been plagued with service problems for years. In 1966 there were 140 informal service complaints against General filed with the Commission; 124 informal complaints filed in 1967; and 198 informal complaints filed in 1968. In 1964 a complaint concerning service in the Covina and Pomona exchanges of General was filed with 7,200 signatures attached. Formal hearings were opened on that complaint which culminated in the Commission finding that "telephone service rendered by (General) in the Cities of La Puente, Covina, West Covina, Baldwin Park, Azusa, Irwindale, Glendora, Walnut, and Pomona has, in the past, been below the standard (General) should have rendered." (Conklin v. General Tel. Co. (1965) 65 CPUC 57, 61.) The Commission in a later order in the same case found that "the service conditions in the

Cities of La Puente, Covina, West Covina, Baldwin Park, Azusa, Irwindale, Glendora, Walnut, and Pomona are not yet at a satisfactory level." (65 CPUC at 708.)

We agree with the staff engineer that the quality of service provided by General has been improving. We agree that while the trend is in the right direction, by no means has the service reached a level where the quality of service could be accepted without further improvement. We disagree with the engineer's conclusion that repair service is good. The testimony of the public witnesses presented in this hearing convinces us that repair service is poor. As far as overall service is concerned, we find the quality of General's service has been improving, but just as it was unsatisfactory in 1965, it is still unsatisfactory today, and we shall consider it unsatisfactory until General's service is comparable to that offered by telephone corporations in adjacent territory, that is, by Pacific.

The charts, indicators, and indexes presented by General suffer from the infirmity that they are all prepared by the company, after investigation by company men, applying standards set by the company, and used in a rate case where quality of service has a direct bearing on rates. We cannot give such indexes the weight we would accord to indexes set up by an independent body, and subject to check by independent engineers. Further, the company witness shrugs off all of the complaints by public witnesses with the statement that there are over 1,294,000 primary telephone stations on the company system and there were only 145 complainants, leading to the conclusion that such a small percentage of complaints indicates good service. Such comment does not take into consideration the fact that the kinds of trouble enumerated by the public witnesses, as analyzed by a staff engineer, are general indications of inadequate central office equipment, inadequate trunking, and insufficient maintenance. Such being the case it is clear that many more than the 145 witnesses were affected by these service deficiencies. Nor does the relatively small number of customers testifying reflect the fact that many are representing organized groups or neighbors; nor the great difficulty and inconvenience that prospective public witnesses are put to. They have to take time off from either their jobs or their household work in order to attend a hearing. Some may have to come more than once. Early in these hearings it was suggested that evening sessions be held. This suggestion, for a variety of reasons, was rejected. But it is obvious to us that holding hearings at a time when persons would not have to lose work would have shown a very large increase in witnesses testifying against General.

An important source of information concerning service deficiencies can be found in the Commission's records of informal service complaints. These records reflect service complaints in the Southern California area over the past six years against General and Pacific. We take official notice of these records and set them forth below.

	Service Complaints		Complaints per 100,000 Phones	
Year	General[a]	Pacific	General[a]	Pacific
1963	146	45	9.4	1.2
1964	223	54	13.2	1.4
1965	188	36	10.2	.9
1966	140	55	7.1	1.2
1967	124	62	5.9	1.3
1968	198	122	8.7	2.5
Total	1,019	374		

a Includes Cal Water & Tel

Because Pacific has about three times as many telephones in the Southern California area as General, the above table takes on added significance.

General is the second largest telephone company in California. It is the fourteenth largest telephone company in the United States. It is the largest independent telephone company in the United States. Its total maintenance expense has increased from $30 million in 1963 to $56 million in 1967; its total telephone plant in service has increased from $630 million in 1963 to $1,198 million in 1967; in 1968 it employed over 11,000 persons in its plant department; its construction budget for 1968 is approximately $180 million; its service witness has testified that no requested funds for construction and maintenance have ever been refused; it has never had problems raising money. In view of these facts in relation to the service complaints we have heard, and without considering the quality of General's service as compared with Pacific's, it is our opinion that General's service is inadequate; when compared with Pacific's service our opinion is confirmed.

There is no reason why General's service should be inferior to Pacific's. General has the money and manpower, and presumably the ability to rectify these service deficiencies. We recognize that some of the service deficiencies are attributable to Cal Water & Tel, but we also recognize that when General bought Cal Water & Tel it bought its liabilities as well as its assets. We also note that many complaints come from areas long served by General, Santa Monica and Long Beach, where there can be no excuse about acquiring a blemished system. To insure that General promptly corrects its service deficiencies we will reduce its fair rate of return by .2 percent. Admittedly this is a judgment figure. We have no way of knowing if such a reduction will stir General's management. However, if management acts quickly the reduction can be eliminated in a reasonable time; if management acts slowly other sanctions can be imposed.

We will authorize two sets of rates: one to produce revenues sufficient to maintain a 7.2 percent return, and one to produce revenues sufficient to maintain a 7.0 percent return when the full amount of the directory advertising increase is realized, which will be approximately 18 months. Rates to produce a 7.0 percent return will be made effective by this order. Rates to produce a 7.2 percent return will be made effective upon General's application and proof, after hearing, that its service is adequate.

We are permitting an increase in rates and charges despite service deficiencies because of General's need for additional money to maintain its present service levels.

Some appearances have requested us to order General to institute programs, formulated by us, that would improve service. At this time we will not do so. General has adequate resources, expert manpower, and sufficient knowledge to improve its system. Any program we would offer is no more than words on paper and might lull all parties into a false sense of progress. In our opinion a penalty in the form of lower rates, with a promise of higher rates when service improves, is a better method of obtaining good service.

When General files its application for increased rates based on improved service, it will facilitate the hearing and comply with Section 728 if, as part of proof of improved service, it presents service indexes developed using Pacific's standards for computing such indexes. Accordingly, General will be ordered to adopt the various service indexes now used by Pacific and to demonstrate adequate service in conformity with such indexes. Respondent Pacific will be ordered to assist General in the compilation and use of Pacific's service indexes. In so ordering this change in General's practice, the Commission has no objection to General's concurrent continued use of its present indexes.

In view of General's claim that, when determining adequacy of service, persons testifying in a rate case may not be an accurate sample of General's customers, we will order General, when it next appears before us in a hearing concerning service, to submit a market survey directed to the adequacy of General's service in the Los Angeles metropolitan area in comparison with Pacific's service. This survey is to be conducted by an independent organization approved by this Commission. Such a survey is expected to insure a statistically reliable sample. The details of the survey can be worked out by the survey organization, General, and the staff. The weight to be accorded such a survey would be that given the testimony of any expert witness. The compensation to be paid such survey organization will be charged to General. (See Evidence Code, Section 730 et seq.)

VI

RATE SPREAD

The general rule regarding the spread of rates is that the rates must not be unjustly discriminatory or unduly preferential not only as between localities but as between classes of ratepayers. Wherever the outer limits of this definition extend, it is clear that we have great latitude in making rates. But in the interests of orderly procedure and stability in basic concepts of rate making we should not stray too far from concepts previously found workable, even though alternate meritorious principles are available. One concept found workable is that the basic charge for residence service should be based on one-party flat rate and the basic charge for business service should be based on one-party measured rate. Another is that in fixing the level of rates we must not lose sight of the fact that basic residential service, one-party flat rate with a standard telephone, is a necessity, not a luxury, and, therefore, the level of residence rates should not be increased unless absolutely necessary, and certainly not merely to shift revenue requirements from nonessential services. Revenue requirements from nonessential services should rarely be reduced if the rates for basic services would have to be increased to compensate for the reduction; nor, when a general rate increase is in order, should nonessential services be exempted from the increase if the rates for basic services have to be increased. Of course, gross inequities in rate spread must be corrected, sometimes at the expense of basic services. To the extent that there is evidence in the record, we have considered cost of service and value of service. And, we have tried to spread rates so as to make comparison easier with rates of telephone companies in adjacent territory.

General provides almost 65 percent of its service in the Los Angeles Extended Area (LAEA). In the LAEA only two companies provide service: General and Pacific. General serves about 1,300,000 telephones and Pacific serves about 2,990,000 telephones. This Commission considers the LAEA not a group of separate communities, or a collection of different telephone exchanges, but a megalopolis. As far as telephone service is concerned the LAEA should be treated as one rate-making unit with substantially one basic rate throughout. We have just completed a rate spread for Pacific (Decision No. 74917) in the LAEA where we applied what we consider to be valid rate-making principles; most of these same principles should be applied to General.

By applying similar rate spread principles to what, from the Commission's point of view if not the utilities', is similar service we will avoid confusion in the mind of the public, avoid two complex rate structures, and permit the comparisons required by Section 728 to be more easily made. This procedure not only complies with the law but allays any suspicion that different companies utilize different rate spreads just to avoid comparisons.

In short, we will consider the rates for the various service offerings from the point of view of protecting the basic residence rate and conforming General's offerings to a basis comparable to Pacific's. Space does not permit a consideration of all of General's hundreds of offerings so we will limit this discussion to those items mentioned in the briefs plus one or two others.

A. Basic Rates

The basic principle General employs for exchange rate level design is station availability. Under this principle the highest rates apply in the exchanges having the greatest station availability. Such rate levels are based on a "value of service" concept. The practical effect of this principle is to have a dozen or more different rates, both business and residential, throughout the system; however, rates in the exchanges in the LAEA have been made approximately equal.

The basic principle the staff relies on is the concept of regional rate making. In the staff's view, the Los Angeles metropolitan area (which includes General's exchanges in the LAEA plus the exchanges of Pomona, Ontario, Etiwanda, Huntington Beach, and Westminster) is sufficiently homogeneous to warrant uniform rates throughout.

For local service exchanges outside the Los Angeles metropolitan area, the staff has proposed one set of basic exchange rates (except for the Isleton exchange). The staff reasons that the very rapid growth occurring throughout California is obliterating community lines. Boundaries that were once reasonable are now often arbitrary. A uniform rate level treats customers in a manner approaching equality, even for the less populated exchanges. This kind of rate making provides a basis for a simplified rate design for future conversions to extended service and facilitates the ascertainment of earnings by areas. The staff proposal contemplates the application of rate increments dependent on the relative development within the exchanges involved and the distance of their rate centers from each other. A comparable plan was found reasonable in the recent Pacific case (Decision No. 74917).

In our opinion the staff proposal is reasonable. It simplifies the rate structure and is comparable to Pacific.

B. Message Rate Service

1. Business

Although nonoptional business message rate service is presently available in certain General exchanges in the LAEA, the company proposes to withdraw such measured service and introduce flat rate business service with an optional offering of business measured service. Further, the company has proposed that message rate trunks provided in these areas be eliminated and that these trunk charges be included on a flat rate basis as a part of a charge for PBX stations and equipment. The company's philosophy is that flat rate service encourages customers to call more freely and enhances the value of telephone service to all, and is more equitable than message rate treatment which does not follow either usage or value of service. In addition, General's business foreign exchange lines and trunks, presently on a message rate basis for General and all other telephone utilities in California, would be changed to a flat rate basis.

For exchanges within the Los Angeles metropolitan area, the staff has proposed nonoptional business measured service. This service would include message rate trunks. For most other exchanges, the staff proposes an optional message rate service for business subscribers.

For decades this Commission has been importuning General to provide nonoptional message rate business service within its exchanges in the Los Angeles area. General has done so reluctantly and in only a few exchanges. In our opinion, the message rate basis of charging for business service is a more equitable way of properly assessing the cost of providing service to both small and large user. Such service has been provided by Pacific within the LAEA for over 30 years. Further, in Decision No. 74917 we authorized extension of nonoptional business message rate service to include all major metropolitan areas served by Pacific. The time for pleading is past. We will order General to provide nonoptional business message rate service in the Los Angeles metropolitan area.

2. Residence

General provides flat rate residence service. It does not propose an offering of residence measured service. The staff proposes, in addition to flat rate residence service, a one-party measured service for residence subscribers in the Los Angeles metropolitan area at $2.30 a month, with an allowance of 30 messages. This is known as a "lifeline" service, and is provided primarily to take care of the needs of the poor, the infirm, and the shut-ins; it is similar to service now provided by Pacific. We find such lifeline service to be in the public interest and reasonable.

C. Multimessage Units

General has proposed an increase in multimessage unit rates in the LAEA from 4.05 cents to 4.65 cents a unit. This increase would apply to both General and Pacific exchanges. The total amount of the increase would, in the words of its proponents, "hit a ball park figure, $20 million." That ball park is too big for us to play in at this time. We rejected a comparable request in the Pacific case; we reject it here.

D. Service Arrangement Changes Other than Measured Service

The staff and General agree that in exchanges which offer 8- and 10-party suburban services such services should be upgraded to four-party service. For other exchanges which now offer four-party residence service such service will be frozen and withdrawn by 1972. In its place two-party service will be offered.

In Decision No. 74917, all 10-cent toll and 2-message unit routes were ordered changed to extended service routes within the next three years. Included are Pacific-General routes. Consistent with this, the staff proposes that all General-General 10-cent toll routes be converted to extended service. In addition, it is recommended that the message rate allowance now provided business and residence subscribers be chargeable only against local calling area and single-unit calls as was ordered in Decision No. 74917.

All of the above recommendations are reasonable and will be ordered. We expect General to formulate plans to phase all party lines out of operation.

E. Special Rate Areas

The staff recommendations for Special Rate Areas are similar to those used by Pacific and are reasonable. They will be ordered.

F. Extension Stations (non-PBX)

The staff proposed rates for an extension station at $1 for residence and business message rate services and $1.75 for business flat rate service. General recommends $1.50 for residence and business message rate service and $2 for business flat rate. Present rates are usually $1 for residence and business message rate service and $1.25 for business flat rate.

In our opinion it is reasonable to charge $1.15 for residence service, $1.40 for message rate business service, and $1.85 for flat rate business service. The differential between residence and business service for extensions compares with the usual lower rate levels for residence service. We see no material distinction between business extensions on flat rate and business extensions on message rate. However, at this time to place business flat rate and business message rate extension service on the same level will result in an inordinate increase in the rates for message rate subscribers. Instead we will make the equalizing adjustment at the time when increases in rates are authorized to provide for conversion to message rate service in the Los Angeles metropolitan area. In setting these rates we differ from the finding in Decision No. 74917 where we set a $1 rate for residence service and business message rate service, and $1.75 for business flat rate service. As far as General is concerned, these rates haven't been increased in over 20 years and should bear their fair share of any increase. There should be no differentiation between exchanges. The new rates will be a reduction in some portions of former Cal Water & Tel territory.

G. Foreign Exchange Service

General proposes that the present system of providing business foreign exchange service on a message rate basis be discontinued and in lieu thereof a flat rate basis be adopted. It proposes to simplify the rate schedule by adding certain increments to the exchange rates of the foreign serving exchange.

For business subscribers to foreign exchange service, the staff proposes a simplified uniform measured foreign exchange service rate for individual line service and for trunk service. The uniform rate would be company wide and would not be based on adding increments to the serving exchange basic rate. Since the bulk of foreign exchange subscribers are business subscribers, the staff's proposal greatly simplifies the present schedules. The staff proposed uniform business foreign exchange rates are consistent with Decision No. 74917. General's proposal would make it the only telephone company providing business foreign exchange service on a flat rate basis. The staff's proposal for residence foreign exchange service is essentially the same as that of General. We will adopt the staff proposals; they are reasonable.

H. Extension Station Mileage Rates

General proposes to eliminate mileage charges for extensions under certain conditions. The impact of this proposal is to permit large businesses having extensive properties with numerous buildings over a wide area to be interconnected without additional charge simply by providing a conduit facility from one building to the next. In many cases the concept of subscriber premises becomes distorted to include essentially all the continuous property of the subscriber. The staff expressed concern over the present and possible future extent of such continuous property, as well as the very substantial reduction in revenues of approximately one-half million dollars. General's proposal to eliminate a half million dollar source of revenues is not persuasive.

I. Private Branch Exchange Service (PBX)

1. Present Status

Presently subscribers to PBX service in most cases must decide on the number of switches required to provide the grade of PBX service desired. The number of switches varies with customer usage rather than type of PBX equipment or number of stations. The subscriber generally depends on the telephone company to determine the number of switches and consequently the rates and charges for his system. The same situation exists in regard to the number of PBX trunks needed.

2. Company Proposal

The company proposes to offer a subscriber a package rate for his PBX services. Essentially, the package rate has two components: (1) a component relating to the cost of the attendant position and (2) a component relating to the number of stations the system will require. The company's package rates provide for the cost of all equipment and trunks needed for the basic service on an average basis. Switches and trunks would be furnished as required for any given system. Message rate PBX systems are to be eliminated. The higher costs for flat rate service are embodied in the proposed package rates.

3. Staff Proposal

The staff proposal for PBX services essentially provides for a simplified and understandable package rate structure. The rate structure contemplates an offering of various kinds and capacities of PBX equipment. The staff package rate is similar to General's, but the staff proposal would not be flat rate nor would it include the cost of trunks in the basic PBX charge. These trunks would be charged for on the basis of need for each system.

The staff simplified rate structure which excludes PBX trunks is consistent with Decision No. 71575 in Case No. 7409. It is reasonable and will be adopted.

J. Private Line and Datatel Rates

The staff and company propose that uniform mileage rates for local private line service be made effective consistent with the rates authorized for Pacific (Decision No. 74917). The proposed rates for interexchange private lines are lower per mile in excess of 50 miles to recognize decreased unit costs on longer routes.

Adjustments are proposed in rates for private line station equipment and other services in order to be comparable to Pacific's rates for similar services. The staff proposed rates for private line and datatel services are reasonable and are adopted.

K. Telephone Answering Bureaus (TAB)

To understand the problem of the TABs, as it pertains to rate structures, one must have a picture of the physical setup. The subscriber to conventional telephone service is, of course, connected with a central office of General without regard to whether he has telephone answering service. This connection is his regular service and does not enter into the picture. If, however, such subscriber does have telephone answering service, a circuit from the central office to the TAB is needed. That service is then connected to the subscriber's regular service within the central office by means of a short jumper wire. The present charges for such service are $1.25 ($1 for residence, and business message rate, subscribers) for the extension station at the TAB and 50 cents per quarter-mile circuit between the central office and the TAB. For most subscribers this means a total charge of $1.75. If, however, the subscriber and the TAB are served by different central offices, the problem becomes more complex. It is necessary in that case to use additional plant equipment to make connections through the central offices involved. In that case, under the existing tariff there is an additional charge to the subscriber of 50 cents for each quarter-mile between the central office which serves him and the central office which serves the TAB. This 50-cent charge has been effective in discouraging TABs from seeking clients outside the area served by the central office which serves the TAB. Approximately 78 percent of the clients of TABs are served from the same central office that serves their TAB.

Both the staff and General seek to change this arrangement. General proposes to raise the extension station rate for business flat rate telephones from $1.25 to $2.00; the staff would set this rate at $1.75; both would hold the residence, and business message rate service, at $1. The mileage charge between central office and TAB would remain at 50 cents per quarter-mile circuit. The mileage charge between central offices would be eliminated. General proposes an additional new charge of $2.50 which it has designated as a "secretarial line charge"; the staff would set this rate at $1.50. Under General's proposal most TAB clients would be charged $5.00 a month instead of $1.75 and under the staff proposal those clients would be charged $3.75 a month.

In addition to the very high increase in rates proposed by both General and the staff, two things will happen under the proposed rate structure: (1) additional interoffice trunking will be needed. This is so because many secretarial services will consolidate their branch offices and have one office near one central office while serving clients scattered among various central offices; and (2) since the rate attractiveness of using a TAB in the same central office as the client will no longer be available, the clients of the TABs will have a greater choice among TABs. This, of course, is a benefit to the client. However, this would seriously injure many of the TABs.

The evidence presented in this case on the subject of TABs leaves much to be desired. This is not the fault of any of the parties, as they have all done a very good job, but, because of the very small problem that the TABs have in relation to the total rate case of General, sufficient time and energy could not be devoted to developing a proper record. No adequate explanation was placed on the record for inaugurating a secretarial line charge. As far as we can see, General will not be performing any additional services which would entitle them to this charge. Further, it is apparent that additional interoffice trunking will be required under the new proposal, but no cost figures were presented to provide this additional trunking and we have no way of pricing it. Finally, on this record, we do not wish to decide the relative merits of giving subscribers to TABs a wider selection to choose from as against the strong possibility of putting some TABs out of business. We find that the evidence in this record shows that no change should be made in the present pricing practices of General other than to increase the extension station charge to $1.85, as discussed elsewhere in this opinion. We also find that there should be no distinction between residence and business extensions as far as TABs are concerned. All subscribers to TAB service should pay the $1.85 rate for extension service.

The monthly rates for switchboards equipped for 80 lines has been proposed at $83 a month. In our opinion there is insufficient evidence to justify a raise in the present $55 rate.

A serious question has been presented in this case concerning the freedom of choice of subscribers to TABs. It appears to us that under General's rate structure they are priced into one TAB rather than another. We have reservations about this policy but we feel that if anything is done to change the policy, it should be in a separate proceeding devoted solely to TABs.

L. Mobile Telephone Service

General provides dial and manual mobile telephone service. As of December 31, 1967 General reported 503 two-way mobile telephone stations in service, of which 126 are used by General. The staff asserts that General's proposed rates do not permit recovery of the full cost of providing the service. The staff recommends a rate increase, different levels of rates for manual and dial service to reflect the different cost levels of providing the services, and an interim flat rate schedule pending conversion of the dial system to a measured minutes-of-use basis. The Allied Telephone Companies Association, representing the majority of authorized radio telephone utilities in California, whose members in Southern California compete directly with General for mobile telephone business, supports the staff proposal. The staff proposal is reasonable and will be adopted. General will be ordered to phase out its flat rate offering within the next 18 months.

M. Directory Rates

General proposes a $7.8 million increase in classified directory advertising rates; the staff proposes a $5.9 million increase. The staff proposed rates are comparable to those authorized for Pacific in Decision No. 74917.

The staff differs from General in the method of determining rate group circulation for multiexchange directories. General's present and proposed method of determining rate group circulation is based on the total telephones within the largest exchange. The staff proposed method uses the total telephones in the largest exchange, plus 50 percent of the total telephones of the other exchanges covered by the multiexchange directories. The staff's method places the multiexchange directory in a rate group more in line with that of a single exchange directory and reduces the percentage of circulation considered free.

General's proposed rates are higher than those existing in most of the state. In our opinion they would unduly burden advertisers and would cause many present advertisers to eliminate or reduce their ads, thereby making the classified directory less useful to the public.

Street address directory rates have not been increased since 1961. The staff recommends a 30 percent increase in these rates; General has not requested any increase. The staff proposed increase is comparable to the percentage increase recommended for classified directories. The staff proposals for the classified and street address directories are reasonable and will be adopted.

N. Supplemental Equipment[12/]

It has been called to our attention that in an effort to promote sales of supplemental equipment and services, General engages in extensive telephone solicitations, known in company parlance as "push days." All subscribers are called, including those who have requested that their telephone numbers be unlisted just so they would be spared the annoyance of unsolicited phone calls, especially from high-pressure salesmen. Since General provides a service which protects its subscribers from unsolicited phone calls, it seems anomalous to us that it should consider itself privileged to continue this bothersome practice. General will be ordered to cease and desist from making unsolicited telephone calls to persons with unlisted telephone numbers for the purpose of selling equipment and services. The mails are available to contact these persons.

12/ We wish to acknowledge the presentation and brief of a group called "Telephone Underground" which did much to clarify the issues discussed herein.

1. Starlite Telephones

The Starlite telephone rate is 75 cents a month more than the regular telephone rate, plus a $5 nonrecurring charge in addition to regular nonrecurring charges. Telephone Underground (TU) asserts that these charges far exceed what is needed to reflect the differential in cost of the Starlite telephone over the standard telephone (the Starlite costs $4 to $7 more and has half the service life). TU's argument assumes that firm full-cost figures can be developed for this piece of equipment (as well as other equipment) and that charges should never return more than full cost. TU's argument that the current rate is excessive is based solely on the price differential of the factory price for telephone sets. But obviously much more is involved than factory price. There are many components of cost of a telephone, such as installation, annual carrying charges, repair and maintenance, burden on other parts of the system, return on investment, and general overheads (and controversy over what to include in general overheads). And, if there is agreement as to the components of cost there remains the problem of allocating the components between the various offerings of equipment and services. Also, some part of the rate should be allocated to that ineffable quality, "value of service," for surely some services are more valuable than others. Finally, reducing one rate often requires raising a different rate, sometimes the basic residence, business, or message unit rate.

Rate making is never a mathematical application of a theoretical principle. In the utility field there are always customers who are served at less than cost, and, if the overall return to the utility is reasonable, there are those who are served at more than cost. No one has been able to devise and apply a practical system of cost accounting in this field to carry out the cost of service principle literally; and if it were done, it would result in such an elaborate and complicated schedule of rates that the public could not understand it and few could apply it. It may be true that any system of rate making which ignores the cost of service as a standard invites attack, but practically, rate making is always a compromise between what would be charged if certain principles of cost allocation were adhered to and the practical necessity that a rate structure should be easily understood and simply applied.

Realistically, one balancing factor to the charge of excessive pricing is the ability of the company to sell any of its services to the public. If the price for a specific item of equipment or a particular service is too high, the company will be unable to attract customers and will either withdraw the service or reduce the price. For this reason alone certain elements of the company's business will produce greater returns than other elements regardless of cost.

The Starlite telephone, measured by the revenue it produces, is in great demand and, so far as residence customers are concerned, it appears that the pricing of the service is reasonable as to them. More important, it is our opinion that even if we could complete the prohibitive task of determining true cost of service in the case of Starlite telephones and we found that it was priced higher than full cost, any revenue reduction would have to be recovered from basic services. Such a general increase in basic rates would be detrimental and could be classified as unduly discriminatory in that a share of the burden for the special service would be imposed on the normal ratepayer subscribing to only the basic service.

If the company-wide return is maintained at a reasonable level and the rates for basic services are reasonable, then the pricing of luxury services and equipment are within reason, whether it be done on a judgment basis or a cost basis or any other basis, taking into account marketability and value of the service. (See General Services Administration v. N.Y. Tel. Co. (1965) 63 PUR 3d 451, 463.)

With these principles in mind, and considering that the Starlite telephone has special features and an attractive appearance, we find that the charges for the telephone are reasonable. This offering is comparable to Pacific's for similar equipment.

2. Long Cords

A one-time charge presently applies to the installation of most long cords. The staff and General propose to introduce a monthly rate for all long cords which will recognize that a subscriber is not purchasing these cords, but obtaining the cord plus maintenance and service. The present charge is $6 (nonrecurring) for a 25-foot cord and $5 for a 10-foot cord. General proposes a charge of $5 (nonrecurring), plus 50 cents a month for all long cords. The staff proposed a 15-cent monthly charge for a 10-foot cord and 30 cents for a 25-foot cord, plus a $5 nonrecurring charge when the cord is ordered installed without other work being done on premises and a $2 nonrecurring charge when other work is being done.

General's present charges for long cords are directly comparable to Pacific's. The proposed charges would be difficult to compare; and they would be by far the largest percentage increase of all offerings. In the interest of tariff simplicity and comparability we will authorize charges similar to Pacific's: a nonrecurring charge of $7.50 for 10- and 15-foot cords and a nonrecurring charge of $10 for 25 foot cords. There should be no extra charge for long cords used in connection with the Starlite telephone.

3. Jacks and Plugs

A one-time $6 charge presently applies for most jacks and plugs. The staff and General both propose a revised rate structure that will include a monthly rate based on the same reasoning applicable for long cords. In the interest of tariff simplicity and to make the offering comparable to Pacific's, we will authorize a nonrecurring charge of $10 for each jack and plug installation.

4. Colored Telephones

Complete elimination of the charge for color sets at this time would result in premature obsolescence of black telephones. The $5 charge for colored telephones is reasonable.

5. Rotary Charges

At present when a subscriber has two main telephones and wishes to have a rotary service (i.e., when one telephone is in use and a call comes in on it, instead of hearing a busy signal the caller would be switched automatically to the other telephone), there is no charge. Not only does this service have great value to the subscriber, but it requires additional work, equipment, and maintenance on the part of General. In our opinion it is reasonable to charge 50 cents monthly for each line on rotary.

6. Amplified Handsets

The staff recommendation to reduce the charge for this item to $1 monthly is reasonable.

7. Extension Bells

The staff recommendation to reduce the charge for this item to 50 cents monthly is reasonable.

8. Line Lock Assembly

This equipment prevents unauthorized use of the telephone by disconnecting the dial. Presently there is a nonrecurring charge of $8, plus a monthly charge of $1. TU says this is unreasonable because the switch retails for about $2, and they suggest a rate of $5 nonrecurring and 20 cents monthly. There is not enough evidence in this record to warrant a reduction in this item.

9. Service Connections

The present residence service connection charges for General are: $7 when instruments are in place, and $10 when instruments are not in place. Both the staff and General propose to increase the in-place charge to $10. This increase is reasonable because installation costs, whether or not the instrument is in place, are at least $20.

Other changes in rates and charges will not be set out herein. We find that the rates and charges set forth in Appendix B will produce revenues designed to realize for General a 7.0 percent rate of return. These rates and charges are reasonable and will be authorized. The rates and charges set forth in Appendix C will produce revenues designed to realize for General a 7.2 percent rate of return. These rates and charges are reasonable and will be authorized upon a finding by this Commission that General's service has improved.

The spread of rate increases detailed in Appendix B authorized herein to produce a rate of return of 7.0 percent is as follows:

	Annual Revenue Increase
Basic Exchange Rates	$ (500,000)
Related Basic Rates	
Extension Stations	1,600,000
Rotary Lines	300,000
Other Services	(100,000)
Elimination of 10¢ General-to-General Toll Routes	(200,000)
Miscellaneous Services	
Directory Advertising and Street Address Directories	6,100,000
Service Connection, Move & Change, etc.	3,600,000
PBX, etc.	700,000
Private Line and Datatel	600,000
Public Mobile Service	100,000
Total of Rate Increases	12,200,000
LAEA Settlement Effect	(700,000)
Total Revenue Increase	11,500,000

The spread of rate increases detailed in Appendix C required to produce a rate of return of 7.2 percent is as follows:

	Annual Revenue Increase
Basic Exchange Rates	
Business	$ 1,100,000
Residence	3,300,000
Total of Rate Increases	4,400,000
LAEA Settlement Effect	(500,000)
Total Revenue Increase	3,900,000

(Red Figure)

Upon showing by General and finding by the Commission that 50 percent of the business primary services within the exchanges of the Los Angeles metropolitan area, excluding Monrovia, San Fernando, Sierra Madre and the Downey District Area of the Downey exchange, have been converted to message rate service, the changes in rates, charges, and conditions set forth in Appendix D will be authorized.

A comparison of the principal basic rates in the Los Angeles metropolitan area in Appendixes B and C is as follows:

		Appendix B	Appendix C
Basic Monthly Rates			
Residence -	1 Party Flat	$ 4.65*	$ 4.90
	2 Party Flat	3.75*	4.00
	4 Party Flat	2.95*	3.20
	1 Party Message	2.30(30)4.05¢	2.50(30)4.05¢
Business -	1 Party Flat	10.30*	10.75
	2 Party Flat	8.25*	8.70
	1 Party Message	5.50*(80)4.05¢	5.95(80)4.05¢
	Suburban Flat	6.50*	6.95
Extension Station Monthly Rates			
Residence		1.15	1.15
Business -	Flat Rate	1.85	1.85
	Message Rate	1.40	1.40

* No change from present rates except in Pomona Valley and Orange County exchanges.

Rate comparisons between companies are more meaningful if their rate structures are based on the same principles. If one company has a flat rate business service in an area and another company has a message rate business service in an adjacent area it is difficult to make comparisons. So far as possible telephone companies should have the same rate structure although, because of different historical costs and rate of return requirements, rates may of necessity be different. This principle is recognized in Section 728. At this time it is not appropriate to consider whether all telephone companies in California should have comparable rate structures, but it is time to consider whether in the Southern California area General and Pacific should have the same rate structure. To that end we will keep this proceeding open to take further evidence.

VII

FINDINGS OF FACT

We make the following findings of fact:

A. Background

1. General seeks to increase its rates for intrastate telephone service by $41,934,000 annually, plus an additional sum of approximately $8,400,000 to recover the current 10 percent federal income tax surcharge.

2. In the United States today approximately 83 percent of all telephone service is provided by the Bell System. GT&E provides about one-half of the remaining service.

3. General is controlled by GT&E which owns 100 percent of its common stock and has 98.47 percent voting control. GT&E operates approximately 7.7 million telephones in the United States of which General operates approximately 30 percent (2.2 million telephones).

B. Rate of Return

1. For the purpose of this proceeding the capital structure of General is as follows: total debt 51.6 percent, bank loans 1.1 percent, preferred stock 4.4 percent, common stock 42.9 percent. It is reasonable to use a composite cost of 5.08 percent for long term debt, 4.91 percent for preferred stock, and 6.50 percent for bank loans.

2. It is unreasonable to utilize, in a rate of return study for a telephone utility, a theory of risk measurement that compares telephone utilities unfavorably with electric utilities. General, standing alone, and as part of the GT&E System, is no more risky than individual electric companies, and may be less risky.

3. The recorded average earnings of General on common equity for the period 1962-1966 was 10.47 percent. These earnings have not been too low. Over the past 10 years General has issued bonds on terms as favorable as other telephone companies of similar capital structure.

General has been regularly selling stock to its parent and General's equity ratio has increased over the past few years. General has never reduced capital expenditure programs or maintenance because of lack of funds. In the recent past General has had no difficulties in attracting capital at reasonable rates. General does large amounts of its business in growth areas.

4. A reasonable return on common equity for General is within the range of 9.50 percent and 10.50 percent. As applied to General's capital structure and composite cost of debt this results in a fair and reasonable rate of return to General within the range of 7.0 to 7.4 percent. It is reasonable to set rates to yield a 7.2 percent return, subject to a reduction for service deficiencies which will be considered in subsequent findings.

C. Affiliated Interests

1. Automatic, 100 percent owned by GT&E, is the developing, manufacturing, supply and distributing company for the telephone operating companies controlled by GT&E and is a leading supplier of telephone equipment to the remainder of the independent telephone operating companies in the United States.

2. The reasonableness of the prices charged by Automatic to General cannot be determined by a comparison of Automatic's prices with the prices of other manufacturers when the prices of such other manufacturers are determined by an analysis of their published list prices and there is no showing that such published list prices are the same as the actual prices paid for the products by a company with the purchasing power equivalent to General's. Further, the reasonableness of other companies' prices, even assuming comparability, was not demonstrated. Moreover, the large and unique market enjoyed

by Automatic provides an advantage so great that competition is effectively eliminated. Automatic has a stable, assured, and captive market. Were Automatic's ability to manufacture not more efficient than outside suppliers who do not possess the advantages enjoyed by Automatic, the very existence of Automatic under GT&E's control would be subject to great question. Little, if any, weight can be accorded such price comparisons in judging the reasonableness of Automatic's prices.

3. The fact that General pays the same equipment prices as other independent telephone companies for purchases from Automatic is entitled to no weight. In 1967 79 percent of Automatic's sales to domestic telephone companies were to GT&E affiliates, of which 25 percent were to General. No other independent telephone company in the United States has purchasing power comparable to General's. Clearly, with its overwhelming dominance of the independent market the GT&E System could virtually dictate prices, and General, as the largest independent telephone company, could get discounts for volume purchases. Automatic relies on the affiliated business. If it was independent it could be forced to give great price concessions to retain that business. The prices set for the smallest independent telephone companies should in no way be a standard for GT&E or General. If the affiliated telephone companies, as a single bargaining unit, had been free to purchase their requirements from the lowest bidder on a truly competitive basis, they could have obtained them at prices lower than those charged by Automatic. Instead, the benefits that might have accrued to the telephone companies and their subscribers have been retained by GT&E. General has failed to demonstrate that the market for the products of its affiliates is either open or competitive, as those terms are usually understood.

4. General and Automatic, both wholly owned subsidiaries of GT&E, are, in effect, different departments of one business enterprise, so there exists no incentive to real bargaining. Despite Automatic's preferred position in the integrated system, with sales of large percentages of its production in effect guaranteed, with the result of volume production and less expense in promotional and sales costs, there has, nevertheless, been no corresponding reduction in prices, and, therefore, the prices paid by General to Automatic for equipment and supplies are unreasonable.

5. There is a somewhat greater risk in Automatic's manufacturing operations, even with a substantially captive market, than exists in a utility operation. To prevent Automatic from making an unreasonable and excessive profit on its sales to General, it is fair to restrict Automatic's earnings on its investment devoted to serving General to a return on its common equity of 12 percent. To value such investment we should value the stock of GT&E given in exchange for assets of Automatic on an average market price basis and allocate the portion devoted to serving General on a net investment basis. This results in a net rate base reduction of $16,633,000 (intrastate) and a net expense reduction of $944,000 (intrastate).

6. No more benefits accrue to the Directory Company because it is an "independent" company than would accrue to the Directory Company if it were merely a department in GT&E or a department in General. The Directory Company does not compete for the business of General or any GT&E operating company nor does it have any measureable risk of losing such business.

7. General contributes about one-third of the total income of the Directory Company and does almost three times as much business

with the Directory Company as all nonaffiliated directory customers combined, but it obtains no better share of revenue from the Directory Company than other GT&E operating companies and nonaffiliated companies. General is not getting the benefits that its economic power would demand in a truly competitive market.

8. The function of the Directory Company can be performed equally well by General within the present concept of utility service.

9. General and the Directory Company do not bargain at arms length over the division of directory revenues. The Directory Company is used by GT&E to syphon profits from General. To prevent GT&E and the Directory Company from making an unreasonable and excessive profit on its business with General we will reduce General's expenses by $720,000 (intrastate) for the test year.

10. The amount paid to the Service Company by General for services rendered is reasonable.

D. Results of Operations

1. General's intrastate results of operations for the 1968 test year are as follows (000):

Total operating revenues	$300,387
Total operating expenses	186,032
Unadjusted net income before taxes	$114,355
Taxes	56,098
Unadjusted net income	$ 58,257
Affiliated interest (Net expense reduction)	1,664
Adjusted net income	$ 59,921
Unadjusted rate base	$951,237
Affiliated interest	(16,633)
	$934,604
Rate of return	6.41%

2. A true tax saving would result from General's use of accelerated depreciation. General uses a method of computing income taxes which results in maximum tax costs and, hence, maximum charges to its ratepayers and by so doing General has not acted in a reasonable and prudent manner, all to the detriment of the public. It is reasonable to compute General's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant additions in such year.

3. The staff's negative cash working capital adjustment is reasonable. The staff's treatment of depreciation relative to Account No. 232 (Station Connections) is reasonable.

4. To achieve a rate of return of 7.0 percent General is entitled to increase its intrastate rates by $12,200,000; and to achieve a 7.2 percent rate of return General is entitled to increase its intrastate rates by an additional $4,400,000.

5. In computing results of operations for the 1968 test year we have excluded the effects of the federal income tax surcharge. We have also excluded the effects of this surcharge in determining the rates which would increase General's net revenue to give it a reasonable rate of return. To compensate for this tax surcharge we will authorize General to add 1.61 percent of each customer's bill to said bill.

E. Service

1. By the terms of Public Utilities Code Section 728 the legislature has ordered the Commission to consider the rate level and the quality of service of a telephone corporation asking for a rate increase as compared with that of telephone corporations operating in adjacent territory.

2. During the course of the hearings in this case over 145 persons took advantage of the opportunity to comment on General's service. In almost every instance the comments were to the effect that General's rates were too high and service was poor. Almost every person who commented on the quality of General's service as compared with the quality of Pacific's service said that the quality of General's service was inferior to that of Pacific's.

3. The complaints generally fell into the following categories:

> No dial tone when receiver is lifted; wrong numbers are reached although dialed correctly; after dialing the line goes dead; lines are noisy; calls are connected into existing conversations; slow operator assistance; line reverts to dial tone during dialing or immediately thereafter; busy signal is encountered before dialing is completed; lines are disconnected in the middle of a call; incoming calls are not received because telephone does not ring; and busy signals are received although called telephone is not in use.

4. The nature of the witnesses' complaints show inadequate central office equipment, trunking, and insufficient maintenance.

5. General's service has not reached the level where the quality of service can be accepted without further improvement. General's repair service is poor. As far as overall service is concerned the quality of General's service has been improving, but just as it was unsatisfactory in 1965, it is still unsatisfactory today, and we shall consider it unsatisfactory until General's service is comparable to that offered by telephone corporations in adjacent territory, that is, by Pacific.

6. The charts, indicators, and indexes presented by General suffer from the infirmity that they are all prepared by the company, after investigation by company men, applying standards set by the company, and used in a rate case where quality of service has a direct bearing on rates. We do not give such indexes the weight we would give indexes set up by an independent body, and subject to check by independent engineers.

7. General is the second largest telephone company in California. It is the 14th largest telephone company in the United States. It is the largest independent telephone company in the United States. Its total maintenance expense increased from \$30,000,000 in 1963 to \$56,000,000 in 1967; its total telephone plant in service has increased from \$630,000,000 in 1963 to \$1,198,000,000 in 1967; in 1968 it employed over 11,000 persons in its plant department; its construction budget for 1968 was approximately \$180,000,000; its service witness testified that no requested funds for construction and maintenance have ever been refused; it has never had problems raising money. ✓

8. General's service is inadequate. Its service, instrumentalities, equipment, and facilities do not promote the safety, health, comfort, or convenience of its patrons, employees, or the public.

9. Because of the inadequate service provided by General, General's rate of return should be reduced by 0.2 percent. Rates to produce a 7.2 percent return will be made effective upon General's application and proof, after hearing, that its service is adequate.

10. General should adopt the service indexes that Pacific uses and compute them the same way.

11. General engages in extensive telephone solicitations during which employees call all subscribers including those with unlisted telephone numbers.

F. Rate Spread

1. The Los Angeles metropolitan area should be considered as one rate-making unit with substantially one basic rate throughout.

2. Within the Los Angeles metropolitan area - defined, relative to General, as all of General's exchanges in the Los Angeles Extended Area plus the exchanges of Pomona, Ontario, Etiwanda, Huntington Beach, and Westminster - General should (1) withdraw the offering of business individual line flat rate, business two-party line flat rate, and business PBX trunk flat rate services and substitute therefor individual line message rate and PBX trunk message rate services, (2) withdraw the offering of residence two-party line and four-party line flat rate services and substitute therefor individual line message rate service, and (3) reduce the parties per line on suburban service to a maximum of four. These changes should be completed no later than July 1, 1974.

3. Outside the Los Angeles metropolitan area General should (1) withdraw the offering of residence four-party line service, (2) concurrently introduce the offering of residence two-party line service where not now offered, and (3) concurrently reduce the parties per line on suburban service to a maximum of four. These changes should be completed no later than July 1, 1974.

4. General should establish extended service in lieu of toll service over all routes between General's exchanges where the toll rate mileage of such routes is eight miles or less. Such changes should be completed no later than December 31, 1971.

5. General should phase out its flat rate offering of dial mobile telephone service and institute measured minute-of-use dial service within 18 months after the effective date of this order.

6. It is in the public interest to establish a basic minimum "lifeline" residence service at a rate of $2.30 per month with a message allowance of 30 units, with restrictions as provided in Appendix B.

7. The rates and charges authorized in Appendix B attached hereto are just and reasonable and present rates and charges, insofar as they differ therefrom, are for the future unjust and unreasonable.

8. The increases in rates and charges authorized in Appendix C attached hereto will be just and reasonable when General's service is made adequate.

VIII

CONCLUSION OF LAW

The application of General should be granted to the extent set forth in the following order and in all other respects denied.

O R D E R

IT IS ORDERED that:

1. General Telephone Company of California is authorized to file with this Commission, 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 B 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 twenty-five days after the effective date of this order.

2. Within the Los Angeles metropolitan area, General Telephone Company of California shall (1) withdraw the offering of business individual line flat rate, business two-party line flat rate, and business PBX trunk flat rate services and substitute therefor individual line message rate and PBX trunk message rate services, (2) withdraw the offering of residence two-party line and four-party line flat rate services and substitute therefor individual line message rate service, and (3) reduce the parties per line on suburban service to a maximum of four. Further, General shall present to this Commission, by not later than December 31, 1969, written programs for accomplishment of the above changes and shall thereafter file semiannual reports as to the progress of such programs until completion thereof no later than July 1, 1974.

3. Outside the Los Angeles metropolitan area General Telephone Company of California shall (1) withdraw the offering of residence four-party line service, (2) concurrently introduce the offering of residence two-party line service where not now offered, and (3) concurrently reduce the parties per line on suburban service to a maximum of four. Further, General shall present to this Commission by not later than December 31, 1969 written programs for accomplishment of the above changes and shall thereafter file semiannual reports as to the progress of such programs until completion thereof no later than July 1, 1974.

4. General Telephone Company of California shall establish extended service in lieu of toll service over all routes between General's exchanges where the toll rate mileage of such routes is eight miles or less. Further, General shall present to this

Commission by not later than December 31, 1969, a written program for accomplishment of the above changes and shall thereafter file quarterly reports as to the progress of such program until completion thereof no later than December 31, 1971.

5. General Telephone Company of California shall phase out its flat rate offering of dial mobile telephone service and institute measured minutes-of-use dial service within 18 months after the effective date of this order.

6. General Telephone Company of California is ordered to present to this Commission, by not later than December 31, 1969, the results of a survey of its exchange service areas and a program to expand base rate areas and to establish special rate areas pursuant to the standards set forth in paragraph 77 of Exhibit No. 82, and shall thereafter file quarterly reports as to the progress of such programs until completion thereof at no later date than December 31, 1971.

7. No later than January 1, 1970, General Telephone Company of California is ordered to adopt the service quality indexes now used by The Pacific Telephone and Telegraph Company, and to compute such indexes by use of Pacific's practices. The Pacific Telephone and Telegraph Company is ordered to assist General in the development and application of these indexes and practices.

8. General Telephone Company of California, when it next appears before us in a hearing concerning service, shall submit a market survey directed to the adequacy of its service in the Los Angeles metropolitan area in comparison with Pacific's service. This survey is to be conducted by an independent survey organization approved by this Commission. The compensation to be paid such survey organization is to be charged to General Telephone Company of California.

9. General Telephone Company of California shall cease and desist from making unsolicited telephone calls to persons with unlisted telephone numbers for the purpose of selling or offering equipment and services.

10. To facilitate a comparison by the Commission of rates of telephone corporations in adjacent territories, to implement Public Utilities Code Section 728, General Telephone Company of California and The Pacific Telephone and Telegraph Company are each ordered to file with the Commission, within six months of the effective date of this order, a memorandum setting forth those service offerings in their respective rate structures which are comparable to services offered by the other company, but which are charged for on different bases, limited to the following: (1) basic exchange primary station services, (2) PBX switchboards, PBX dial switching service, primary Centrex service, (3) primary key telephone system service (pushbutton telephone system service), and (4) items of supplemental equipment which generate revenue in excess of $100,000 per year. Concurrently with General's and Pacific's review of their rate structures, the Commission staff is directed to make an independent report on this matter to be filed within six months of the effective date of this order.

11. General Telephone Company of California shall apply a depreciation rate of 15 percent to its Account No. 232, Station Connections, until such time as the depreciation reserve is near zero.

12. The Pacific Telephone and Telegraph Company is authorized to file with this Commission, after the effective date of this order and in conformity with the provisions of General Order No. 96-A, revisions in primary service rates for foreign exchange service

consistent with the changes in basic individual line and trunk rates set forth in Appendix B attached hereto and, on not less than five days' notice to the public and to the Commission, to make said revised rates effective twenty-five days after the effective date of this order.

13. The complaint in Case No. 8682 is dismissed.

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

Dated at San Francisco, California, this 1st day of July, 1969.

William Symons Jr.
President

Fred P. Morrissey

Commissioners

I will file a concurring opinion

I will file a dissent.

Appendix A

LIST OF APPEARANCES

Albert M. Hart, H. Ralph Snyder, Jr., and John Robert Jones, for applicant in Application No. 49835; respondent in Case No. 8749; interested party in Case No. 8750; and defendant in Case No. 8682.

Robert E. Michalski, for The Pacific Telephone and Telegraph Company, respondent in Case No. 8750, and interested party in Application No. 49835 and Case No. 8749.

Morris M. Conklin, for Committee for Better Telephone Service, complainant in Case No. 8682 and interested party in Application No. 49835.

Roger Arnebergh, City Attorney of Los Angeles, by Charles E. Mattson and Charles W. Sullivan; Edward L. Blincoe, in his own behalf and for Utility Users League of California; Neal C. Hasbrook, for California Independent Telephone Association; Robert Hope, for University of California; William L. Knecht and Ralph O. Hubbard, for California Farm Bureau Federation; Louis Possner, for City of Long Beach; John F. Rogers, for Western GEEIA Region, AFLC, USAF; Betty Smith, for Communications Workers of America; John A. Van Ryn, for City of Santa Maria; H. Warren Siegel, for State of California Department of Justice; Ernest W. Watson, for Telephone Answering Services of California and Allied Telephone Companies Association; Neville R. Lewis, City Attorney, for the City of San Fernando; Morrison, Foerster, Holloway, Clinton & Clark by Robert D. Raven, for Telephone Answering Services of California, Inc.; Jerry W. Finefrock, for Telephone Underground; Lester W. Spillane, for Allied Telephone Companies Association; and A. H. Hassan, in his own behalf and on behalf of neighbors, interested parties.

Bernard A. Peeters and Leonard L. Snaider, Counsel, James G. Shields, Paul Popenoe, Jr., and John J. Gibbons, for the Commission staff.

APPENDIX B
Page 1 of 6

RATES

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

I. Tariff schedules pertaining to basic rates and related services shall be modified as proposed in Exhibit No. 127 Appendixes A through I, as amended, except:

Schedules A-1, A-3 and A-5
Individual, Party Line, Suburban, and Semipublic Service

EACH PRIMARY STATION:	Individual, Party Line, and Suburban Service Rate Per Month							Semipublic Indiv. Line
	Business			Residence				
	Indiv. Line	2-Party Line	Suburban	Indiv. Line	2-Party Line	4-Party Line	Suburban	Rate per Month
A. L.A. Metro Area Exchanges								
1. Pomona Vly. Exchanges, (Prior to Pomona Vly. Extended Service)	NC	NC	NC	NC	NC	NC	NC	NC
2. Pomona Vly. Exchanges (Upon Estab. of Pomona Vly. Extended Service	$10.30 5.50(80)#	$8.25*	$6.50	$4.65 2.30(30)***	$3.75*	$2.95**	$3.55	$5.50
3. All Other L.A. Metro Exchanges	10.30 5.50(80)#	8.25*	6.50	4.65 2.30(30)***	3.75*	2.95**	3.55	5.50

NC - No Change.

\# Applies to all message rate services. For areas presently without message rate service, such service at that rate is to be offered concurrently with the withdrawal of business 2-party flat rate service.

* Service shall be withdrawn by July 1, 1974.

** Where now offered. Service to be withdrawn by July 1, 1974.

*** Service to be offered concurrently with the withdrawal of residence 2- and 4-party flat rate services.

Rates with figures in parentheses indicate message rate service. Figures in parentheses denote the local message allowance. Rate per local message over the allowance is 4.05¢.

Pomona Valley Exchanges:

Covina	Etiwanda	Ontario	Pomona

All Other L.A. Metro Exchanges:

Downey	Malibu	San Fernando	Sunland-Tujunga
Huntington Beach	Monrovia	Santa Monica	West Los Angeles
Long Beach	Redondo	Sierra Madre	Westminster
			Whittier

APPENDIX B
Page 2 of 6

RATES

Individual, Party Line, and Suburban Service — Rate Per Month

EACH PRIMARY STATION:	Business: Indiv. Line	Business: 2-Party Line	Business: Suburban	Residence: Indiv. Line	Residence: 2-Party Line	Residence: 4-Party Line	Residence: Suburban	Semi-public Indiv. Line Rate per Month
B. Local Service Exchanges Outside L.A. Metro								
1. Except Isleton	$11.50	$8.00	$6.50	$5.10	$3.85	$3.20	$3.70	$5.75
2. Isleton Exchange	9.25	6.50	5.50	4.10	3.10	2.45	2.95	4.75

Local Service Exchanges

Outside L.A. Metro:

Banning-Beaumont
Desert Center
Eagle Mountain
Elsinore
Hemet-San Jacinto
Idyllwild
Isleton
Lake Hughes
Lancaster
Lindsay
Lompoc
Los Alamos
Moreno
Perris
Pinyon
Salton
Santa Ynez
Thousand Oaks
Twenty-Nine Palms

Note: Long Beach local service rates to be withdrawn.

C. Extended Service Exchanges

Outside L.A. Metro:

Arrowhead	$11.50	$8.00	$6.50	$5.10	$3.85	$3.20	$3.70	$5.75
Badger	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Carpinteria	12.70	9.20	7.70	5.70	4.45	3.80	4.30	6.25
Courtland	9.25	6.50	5.50	4.10	3.10	2.45	2.95	4.75
Crestline	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Desert Hot Springs	12.70	9.20	7.70	5.70	4.45	3.80	4.30	6.25
Dunlap	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Fowler	12.70	9.20	7.70	5.70	4.45	3.80	4.30	6.25
Grant Grove	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Guadalupe	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Homestead Valley	12.70	9.20	7.70	5.70	4.45	3.80	4.30	6.25
Indio	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Joshua Tree	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Laguna Beach	12.35	8.85	7.35	5.50	4.25	3.60	4.10	6.00
Meadowview	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Miramonte-Pinehurst	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Morongo Valley	12.35	8.85	7.35	5.50	4.25	3.60	4.10	6.00
Murrieta	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Oxnard	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Palm Desert	13.55	10.05	8.55	6.10	4.85	4.20	4.70	6.75
Palm Springs	12.10	8.60	7.10	5.35	4.10	3.45	3.95	6.00
Redlands	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Reedley	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
San Bernardino	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Santa Barbara	11.55	8.05	6.55	5.10	3.85	3.20	3.70	5.75
Santa Maria	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Santa Paula	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Squaw Valley	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Temecula	11.50	8.00	6.50	5.10	3.85	3.20	3.70	5.75
Walnut Grove	9.25	6.50	5.50	4.10	3.10	2.45	2.95	4.75
Yucca Valley	11.95	8.45	6.95	5.30	4.05	3.40	3.90	5.75

RATES

	Monthly Rate			
	Business Service		Residence Service	
	Flat Rate	Message Rate	Flat Rate	Message Rate
D. Extension Stations	$1.85	$1.40	$1.15	$1.15

Schedule A-1
Individual and Party Line Service

E. Rotary Service
Each line average for rotary service: Monthly Rate $0.50

F. Add a condition to Schedule A-1 to provide that the exchange message allowance in connection with message rate service is applicable only to local service area messages.

Schedule A-19
Foreign Exchange Service

G. Add the following condition: Residence 30 unit allowance message rate service is not offered on a foreign exchange basis.

II. Tariff schedules pertaining to service connection, move and change, supplemental equipment, and miscellaneous services shall be modified as proposed in Exhibit No. 129, as amended, except:

Schedule No. A-15
Supplemental Equipment

A. Cords (any number of conductors), other than weatherproof heavy duty cords:
Cord Between Base of Set and Mounting Block (Nonretractile)

Standard Length	Nonrecurring Charge	Monthly Rate
10 feet	$ 7.50	$ -
15 feet	7.50	-
25 feet	10.00	-

Nonstandard Length (maximum 25 feet) - $1.00 plus charge for next longer standard length.

Cord Between the Set Base and Transmitter-Receiver Unit (Retractile)

Over 5 feet but not exceeding 10 feet	7.50	-

RATES

8. Jacks

	Nonrecurring Charge	Monthly Rate
Non-weather proof jacks		
Three or four-contact, each	$10.00	-
Eight contact, each	25.00	-
Auxiliary jack for operators telephone sets, each	10.00	-
Weatherproof jacks		
Four contact regular each	25.00	-
Marine assembly, each	25.00	-

III. Tariff schedules pertaining to private branch exchange, pushbutton telephone system, centrex, and telephone answering services shall be modified as proposed in Exhibit No. 131, as amended, except:

<u>Schedules A-6, A-7, A-8</u>
<u>Private Branch Exchange Service</u>
<u>PBX Trunk Service</u>

	Rate Per Month Business	Residence
A. Los Angeles Metro Area Exchanges		
1. Pomona Valley Exchanges (Prior to Pomona Valley Extended Service) Flat Rate	$ NC	$ NC
2. Pomona Valley Exchanges (Upon Establishment of Pomona Valley Extended Service) Flat Rate	15.45*	7.70
Message Rate (4.05¢ per local message)	2.75(0)**	-
3. All Other L.A. Metro Exchanges Flat Rate	15.45*	7.70
Message Rate (4.05¢ per local message)	2.75(0)**	-

* Shall be withdrawn by July 1, 1974

** Applies to all message rate services. For areas presently without message rate service, such service at these rates is to be offered concurrently with the withdrawal of flat rate trunk line service.

Pomona Valley Exchanges: Covina, Etiwanda, Ontario, Pomona

All Other Exchanges: Downey, Huntington Beach, Long Beach, Malibu, Monrovia, Redondo, San Fernando, Santa Monica, Sierra Madre, Sunland-Tujunga, West Los Angeles, Westminster, Whittier.

RATES

PBX Trunk Service (Continued)	Rate Per Month Business	Rate Per Month Residence
B. Local Service Exchanges Outside L. A. Metro		
1. Except Isleton	$17.25	$7.50
2. Isleton Exchange	13.75	6.00

Local Service Exchanges Outside L. A. Metro:

Banning-Beaumont	Idyllwild	Lompoc	Pinyon
Desert Center	Isleton	Long Beach Local	Salton
Eagle Mountain	Lake Hughes	Los Alamos	Santa Ynez
Elsinore	Lancaster	Moreno	Thousand Oaks
Hemet-San Jacinto	Lindsay	Perris	Twenty-Nine Palms

C. Extended Service Exchanges Outside L. A. Metro	Rate Per Month Business	Rate Per Month Residence
Arrowhead	$17.25	$7.50
Badger	17.25	7.50
Carpinteria	19.00	8.50
Courtland	13.75	6.00
Crestline	17.25	7.50
Desert Hot Springs	19.00	8.50
Dunlap	17.25	7.50
Fowler	19.00	8.50
Grant Grove	17.25	7.50
Guadalupe	17.25	7.50
Homestead Valley	19.00	8.50
Indio	17.25	7.50
Joshua Tree	17.25	7.50
Laguna Beach	18.50	8.25
Meadowview	17.25	7.50
Miramonte-Pinehearst	17.25	7.50
Morongo Valley	18.50	8.25
Murrieta	17.25	7.50
Oxnard	17.25	7.50
Palm Desert	20.25	9.00
Palm Springs	18.00	8.00
Redlands	17.25	7.50
Reedley	17.25	7.50
San Bernardino	17.25	7.50
Santa Barbara	17.25	7.50
Santa Maria	17.25	7.50
Santa Paula	17.25	7.50
Squaw Valley	17.25	7.50
Temecula	17.25	7.50
Walnut Grove	13.75	6.00
Yucca Valley	17.75	7.75

RATES

PBX Trunk Service

D. Rotary Service

Each trunk arranged for rotary service: Monthly Rate $0.50

Dial PBX Service - Type C - Expandable

Delete the offering of trunk link key attendant position.

Schedule A-24
Telephone Answering Service

A. Telephone Answering Equipment
Cord Type

Present rates, charges, and conditions in effect for Schedule III exchanges (defined on the Appendix cover sheet of Exhibit No. 131) shall apply to all exchanges.

B. Secretarial Lines

Present rates, charges, and conditions shall apply to all exchanges.

C. Lines Terminated on Telephone

Answering Equipment - All Exchanges

Extension handset station rate where applicable shall be $1.85 per month.

IV. Tariff schedules pertaining to private line and datatel services shall be modified as proposed in Exhibit No. 133, as amended.

V. Tariff schedules pertaining to rates for directory advertising, listings and street address directory service shall be modified as proposed in Exhibit No. 125.

VI. Tariff schedules pertaining to mobile telephone service shall be modified as proposed in Table 1, of Exhibit No. 124.

VII. Billing Surcharge

The company is authorized to add a billing surcharge of 1.61% to each customer's total bill (exclusive of federal and local excise taxes) to offset the 10% federal income tax surcharge. This billing surcharge shall terminate simultaneously with termination of the federal income tax surcharge, or, should the tax surcharge be reduced a proportionate reduction in the billing surcharge percentage shall be made concurrently. This billing surcharge amount on each bill shall be designated "Allowance for Federal Income Tax Surcharge".

APPENDIX C

RATES

By further order of this Commission following General's application and proof, after hearing, that its service is adequate, the following changes in rates, charges, and conditions will be authorized.

Schedules A-1 and A-3,
Individual, Party Line, and Suburban Services

Business Service	Monthly Rate Increase
Individual Line-Flat Rate	$0.45
Individual Line-Message Rate	.45
2-Party Line	.45
Suburban	.45
Residence Service	
Individual Line-Flat Rate	.25
Individual Line-Message Rate	.20
2-Party Line	.25
4-Party Line	.25
Suburban	.25

Schedule A-5
Semipublic Service

Exchanges Where Message Rate Service is Offered:

The semipublic rate shall be changed to equal the monthly exchange rate for business individual line message rate service.

Exchanges Where Only Flat Rate Service is Offered:

The semipublic rate shall be changed to equal 50% of the monthly business individual line flat rate rounded to the next lower 25-cent multiple.

Schedules A-6, A-7, and A-8
Private Branch Exchange Service

PBX Trunk Service

Business and Residence PBX Trunk Rate (Flat) shall be changed to equal 150% of the respective individual line flat rate, rounded to the next lower 25-cent multiple.

Business PBX Trunk Rate (Message) shall be changed to equal 50% of the business individual line message rate rounded to the next lower 25-cent multiple.

RATES

Upon showing by General and finding by the Commission that 50% of the business primary service within the Los Angeles metropolitan area excluding Monrovia, San Fernando, Sierra Madre and Downey District Area of Downey exchange, have been converted to message rate service, the following changes in rates, charges, and conditions will be authorized.

Schedules A-1 & A-3
Individual, Party Line, & Suburban Services

Business Individual Line (Message & Flat), 2-Party Line, and Suburban Services:

Los Angeles Metro Area Exchanges:

Increase basic monthly rate	$0.40
Message rate services reduction, monthly message allowance	20 Messages
Increase rate per local message over the allowance from 4.05¢ to 5¢	

Los Angeles Metro Area Exchanges:

Covina	Pomona
Downey	Redondo
Etiwanda	San Fernando
Huntington Beach	Santa Monica
Long Beach	Sierra Madre
Malibu	Sunland-Tujunga
Monrovia	West Los Angeles
Ontario	Westminster
	Whittier

Schedule A-5
Semipublic Service

Exchanges Where Message Rate Service is Offered:
The semipublic rate shall be changed to equal the monthly exchange rate for business individual line message rate service.

Exchanges Where Only Flat Rate Service is Offered:
The semipublic rate shall be changed to equal 50% of the monthly business individual line rate rounded to the next lower 25-cent multiple.

Schedules A-1, A-3 and A-5
Individual, Party Line, Suburban and Semipublic Services

Extension Stations All Exchanges	Monthly Rate Increase
Business	
Flat Rate	$0.15
Message Rate	.60
Residence	
Flat Rate	.15
Message Rate	.15

RATES

Schedules A-6, A-7 and A-8
Private Branch Exchange Service

PBX Trunk Service:

Business PBX Trunk Rate (Message) shall be increased to equal 50% of the business individual line message rate rounded to the next lower 25-cent multiple.

Business PBX Trunk Rate (Flat) shall be increased to equal 150% of the business individual line flat rate, rounded to the next lower 25-cent multiple.

Schedule A-30
Service Connection Charges

New and Additional Service - Instrumentalities not in place

	Increase in Charge
Business Service	
Each Individual or Party Line Primary Station	$ 2.00
Each Private Branch Exchange Trunk	2.00
Each Order Receiving Trunk	2.00
Each Private Branch Exchange or Order Receiving Equipment Station, Except Operators Set	1.00
Inward Dialing Service	
Initial Charge, 100 or Less Stations	100.00
Each Additional Station	1.00
Centrex Service	
Initial Charge, 200 or less Primary Stations	200.00
Each Additional Primary Station	1.00
Each Extension Station	1.00
Each Tie Line Termination	2.00
Residence Service	
Each Primary Station	2.00
Each Private Branch Exchange Trunk	2.00
Each Private Branch Exchange Station	1.00
Extension Stations	
(a) Stations to be installed at the time other installation or change work is being done on the customers' premises for which a charge has been made	1.00
(b) Stations ordered to be installed under conditions other than (a) above	1.00
Instrumentalities in place and no change of location or type of facilities involved.	
Business Exchange Service and Facilities	2.00
Residence Exchange Service and Facilities	2.00
Supersedure	1.00

J. P. VUKASIN, JR., COMMISSIONER, CONCURRING OPINION

Although I have joined with three of my colleagues in signing the foregoing order, I deem it appropriate to point out that I am deeply concerned with two aspects of that decision, namely (A) the method utilized therein to encourage the improvement of the quality of service rendered by General Telephone Company of California, and (B) the treatment of accelerated depreciation.

IMPROVEMENT OF SERVICE

The opinion herein finds that the service rendered by applicant is inadequate, and as a penalty deducts .2 of one per cent from General's rate of return (approximately $4 million gross revenue annually). As an alleged inducement to General to improve the quality of its service the order holds out the possibility that this penalty deduction may be removed if and when General can convince this Commission that its service is comparable with that of The Pacific Telephone and Telegraph Company.

This provision of the decision seems inappropriate. In the first place it completely disregards and ignores the expert testimony of the Commission's own staff to the effect that although General's service for many years was exceedingly poor, the Company has in the recent past made a major effort in this direction, and in fact its service has improved in the last two years. Further, the Company's uncontested testimony points out that major programs for further improvement of the quality of its service were in progress at the time this application was at hearing, with the resulting improved service being realized now, and within one or two years.

While there is no question but that this Commission should require adequate service for the subscribers and citizens of this State, the Commission herein disregards the substantial and meaningful effort of General in the recent past, and the programs now in progress to remedy its service problems. In view of the fact that the opinion herein finds 7.2 per cent to be a reasonable rate of return, a more fair and dispassionate approach would have taken recognition of applicant's present efforts to raise the quality of its service, and awarded General the full 7.2 per cent rate of return now, and provide for a reduction of .2 of a per cent one year hence if General has failed by then to establish the quality and standard of service required by this Commission for the subscribers of this State.

ACCELERATED DEPRECIATION

More important, I am deeply concerned with the manner in which this decision treats accelerated depreciation.

The management of General Telephone Company of California has chosen to take normal straight line depreciation on its depreciable assets for federal income tax purposes. Nevertheless the foregoing decision bases its rates on the fiscal statistics that would have resulted had General utilized the accelerated depreciation option available under Section 167 of the United States Internal Revenue Code. This process of rate making based on figures which would result from accelerated depreciation, when in fact the management of the utility utilizes normal depreciation rates, is referred to as "imputing accelerated depreciation." When the so-called "tax savings" from this imputed accelerated depreciation is passed on to the rate payers in the form of reduced rates, it is referred to as accelerated depreciation with "flow through." The decision herein adopts this policy of imputing accelerated depreciation with flow through.

I have serious misgivings about the imputation of accelerated depreciation with flow through. In the first place, the question of whether to accelerate or normalize depreciation is not a simple issue, subject to simplistic solutions. Whether to accelerate or normalize is a highly complex matter requiring consideration of a multitude of interrelated facts. It is a question which requires the most astute and enlightened judgment which management can muster. I question the propriety of a regulatory agency such as this Commission substituting its judgment for that of utility management in this unique and complicated field. In 1960 this Commission instituded a statewide investigation Re Rate Fixing Treatment For Accelerated Depreciation (Case 6148, 57 Cal. P.U.C. 598) with 45 days of hearing, 6,031 pages of transcript and 74 exhibits. The Commission therein stated: "As a general proposition, it is a matter to be determined in the first instance by the management of a public utility as to whether or not liberalized depreciation will be availed of or whether straight-line depreciation will be used." The reversal of this decision herein, sua sponte, should be a matter of concern for the whole Commission.

In the second place, imputation of accelerated depreciation with flow through bears many dangerous earmarks of shortsighted regulation. We must always keep in mind that it is our responsibility to "protect the public interest." Public interest does not mean merely low rates. It would be absurd to argue that we are protecting the public interest if we reduce rates today only to endanger the service available tomorrow.

Accelerated depreciation results in tax reductions today, which must be made up in the future if the present rate of capital expenditure is not maintained or if Section 167 of the Internal Revenue Code should be repealed. If either of these events should occur it is inevitable that there will be an immediate and substantial impact on utilities which either have taken or which have had accelerated depreciation imposed upon them and the effect thereof flowed through to income. In such case, tax savings today which are passed on to the subscribers in the form of lower rates today, must be made up in the form of higher taxes and resulting higher rates in the future. Some elements of our society find this an appealing technique. I deem it objectionable. I cannot with good conscience pass on to rate payers ten years hence the possible burden of paying for part of the service which I enjoy today.

Third, today's decision totally fails to consider or evaluate all of the consequences of its treatment of depreciation on a growth industry, in a growth area, with its great capital investment requirements in the immediate future. In addition, it fails to take into consideration the impact of accelerated depreciation on the telephone industry as compared with gas or electric firms or water companies. Unfortunately it fails to take into consideration the fact that the effect of acceleration is substantially more pronounced on a telephone company which has a 20-year average composite life on its plant (with a resulting 5 per cent per year depreciation on a straight line basis or initially a 10 per cent per year on a double declining balance accelerated method), as compared with water companies which have a 33-year average composite life (and therefore 3 per cent per year straight line depreciation and initially 6 per cent per year on the same accelerated basis).

It is further noted that in the decision consideration is only given to the flow through method of accounting for the effects of the use of liberalized depreciation. It may well be that an alternate method involving normalizing the effects of liberalization should be considered if liberalized depreciation is to be imputed. Appealing arguments have been made that liberalization with normalization results in benefits to both company and subscribers. This method would, over the years, result in benefits to the company in that it would provide a source of interest free capital, and to the subscribers, in that such interest free capital could be considered in arriving at a reasonable rate of return by assigning a zero interest cost to such capital, or in the alternative the normalization reserve could be deducted from the rate base.

CONCLUSIONS

Thus, although today's decision has many commendable features and is the result of sincere and dedicated effort, I feel compelled to point out my serious concern with the position taken on the afore two subjects.

J. P. Vukasin, Jr.
J. P. Vukasin, Jr.
Commissioner

COMMISSIONER A. W. GATOV, Dissenting:

I dissent.

Section 728 of the Public Utilities Code orders that this Commission, in determining and fixing rates for a telephone corporation or in determining whether or not a proposed rate increase is justified, shall, among other things, take into consideration any evidence offered concerning the quality of the particular telephone corporation's services as compared with that of telephone corporations in adjacent territory and the permissible rates for comparable service charged by telephone corporations in adjacent territory.

Furthermore, Section 451 imposes upon public utilities the duty to provide and maintain adequate services and facilities. Considering the nature of General's service as developed in this record and as compared with telephone service in adjacent territory, the majority finds the service inadequate 1/ and that General has violated Section 451. 2/ Viewing Sections 451 and 728 together, the conclusion is inescapable, at least to me, that the Commission should have denied the application without prejudice and reconsidered the matter at such time as applicant felt it could submit convincing evidence of good service.

1/ Finding E.5. - General's service has not reached the level where the quality of service can be accepted without further improvement. General's repair service is poor. As far as overall service is concerned the quality of General's service has been improving, but just as it was unsatisfactory in 1965, it is still unsatisfactory today, and we shall consider it unsatisfactory until General's service is comparable to that offered by telephone corporations in adjacent territory, that is, by Pacific.

2/ Finding E.8. - General's service is inadequate. Its service, instrumentalities, equipment, and facilities do not promote the safety, health, comfort, or convenience of its patrons, employees, or the public.

I agree with the majority where they point out (mimeo pages 108-109), "There is no reason why General's service should be inferior to Pacific's. General has the money and manpower, and presumably the ability to rectify these service deficiencies." and that "General had adequate resources, expert manpower, and sufficient knowledge to improve its system." These pronouncements confirm my contention that the finding for an increase is negated by Findings E.5 and E.8. The majority paradoxically is thus treating a violation of duty by granting a reward. That the impact of this increase is aimed principally at a special class of subscriber does not diminish the contradiction.

Because of my fundamental position, I do not think any useful purpose will be served if I comment separately on each of the other principal facets of the decision. There is, however, one notable exception, and that is the issue of the manufacturing affiliated interest.

The practice of promoting a proliferation of wholly owned, special function subsidiaries in regulated businesses for the purpose of avoiding regulation or of providing hidden profits, or both, is well known, and for years and years has been condemned by the courts, the Congress, state legislators, and by enlightened state and federal regulatory bodies. It is even strongly denounced by the majority of the Commission in this decision, from which I quote as follows:

> ". . . If the Directory Company can be treated as a non-utility entity, permitted to make any profit it considers fair, then other functions now performed by a utility in the future might be performed by a separate subsidiary corporation with the ability to charge any price it desires. Today, General performs all of its own billing services; tomorrow, there may be the GT&E Data Services Corporation which will perform billing services for all of GT&E's telephone operating utilities. The claim might be put forward that such a computer billing corporation is in competition with other computer

> billing corporations and is risky, and, therefore, requires a profit more than the normal utility profit. General also has accounting departments and law departments. These, too, can be spun off into separate entities which charge, not on the basis of the utility's ability to perform the function, but on the basis of what other independent accounting firms or law firms charge. There is no need to stop there. Repairs and maintenance can be done in the same manner; repairmen perform a special function, they need special training, they need incentives different from the incentives given to the Directory Company salesmen, why not a separate corporation for these men, with higher profit requirements? To prevent this fragmentation of utility service, we must maintain the position that a utility, when controlling or performing functions that are an integral part of its service to the public, cannot merely, by a separation in corporate structure of what otherwise would be a functioning department, obtain higher profits than would be available to the utility through its fair rate of return."

Having voiced great indignation about the practice, the majority then reverses itself regarding Automatic Electric with the following uncertain and tentative rationalization:

> "The difference in our treatment of Automatic and the Directory Company lies primarily in the fact that at this point in time we are not yet certain that the function of Automatic can be performed equally well by the utility within the present concept of utility service. In the future, when we again look at the operation of Automatic in its relationship to GT&E and General, we may find that the factors of lack of competition, administered prices, low risk, elimination of service to nonaffiliated telephone companies, and other pertinent considerations, will require us to make a Western Electric type of adjustment."

For the purpose of dealing with the subject of affiliated interests at length and in detail, I consider that portion of the Commission's Staff's Exceptions to the Proposed Report, which treats on this subject, to be so clearly dispositive of the issue that I attach it hereto as a part of my dissent. The majority's treatment of the Automatic Electric adjustment is contrary to the record and sweeps aside a regulatory verity.

[illegible signature]
Commissioner

Dated at San Francisco, California,
July 1, 1969.

Attachment

II

AFFILIATED INTERESTS

The Staff takes exception to a single finding in the Affiliated Interests section of the Proposed Report of April 15, 1969 in Application No. 49835, Case No. 8682, Case No. 8749 and Case No. 8750. That finding is Affiliated Interests Finding 5 at page 136 as follows:

> "5. There is a somewhat greater risk in Automatic's manufacturing operations, even with a substantially captive market, than exists in a utility operation. To prevent Automatic from making an unreasonable and excessive profit on its sales to General, it is fair to restrict Automatic's earnings on its investment devoted to serving General to a return on its common equity of 12 percent. To value such investment we should value the stock of GT&E given in exchange for assets of Automatic on an average market price basis and allocate the portion devoted to serving General on a net investment basis. This results in a net rate base reduction of $16,633,000 (intrastate) and a net expense reduction of $944,000 (intrastate)."

As a substitute finding the Staff proposes the following:

> "5. To assure that General's ratepayers will not be unduly burdened, we find that Automatic's return on sales to General, for rate-making purposes, should be adjusted so as to be no greater than that allowed General. To compute the return to Automatic we shall rely on the historical book value of the affiliate and allocate the portion devoted to serving General on a net investment basis. This results in a net rate base reduction of $27,046,000 (intrastate) and a net expense reduction of $1,545,000 (intrastate)."

The justifications for the challenged finding are presented on pages 55-67 of the Proposed Report. In the succeeding paragraphs these justifications will be analyzed. Supporting reasons for the substitute finding will be provided.

A. THE COMMISSION'S ESTABLISHED AND JUDICIALLY APPROVED RATE-MAKING TREATMENT OF AFFILIATED TRANSACTIONS SHOULD APPLY TO THE GENERAL-AUTOMATIC TRANSACTIONS

In order to prevent a utility holding company from controlling, by fiat, the expenses and rates of its utility subsidiary, the Commission has consistently held that for rate-making purposes the reasonable value of goods "purchased" from a subsidiary is the system cost, including the utility's authorized fair return on the system's investment. The Commission and the California Supreme Court have found that this treatment of affiliated transactions produces a "fair and reasonable result." Pacific Tel. & Tel. v. Public Util. Com., 62 Cal.2d 654, 662 (1965). The Proposed Report reaffirms this proper regulatory treatment of affiliated transactions.

> ". . . we must maintain the position that a utility when controlling or performing functions that are an integral part of its service to the public, cannot merely, by a separation in corporate structure of what otherwise would be a functioning department, obtain higher profits than would be available to the utility through its fair rate of return." (P.R. 76-77.)

Proper application of this principle leads to the conclusion,

> ". . . that the Directory Company should not be allowed a greater return on business with General than the latter is allowed on its other utility business and we will make a downward adjustment of General's commercial expenses for the year 1968 estimated at present rates so as to allow the Directory Company a 6.6 percent return on such business which return was set in 1958." (P.R. 73.)

A similar conclusion should have been reached with respect to the affiliated transactions between General and Automatic.

The Proposed Report correctly found that Automatic was purchased by "a utility . . . in order to make for itself at a cheaper price that which it now buys from others" (P.R. 62). It is basic regulatory policy that the savings from such an integration should benefit the ratepayer not the utility (Backman, Tr. 3631). The General System has failed to fully pass on the benefits of integration to the ratepayer (Sullivan, Tr. 6960). The Commission should, to fulfill its duty to the ratepayer, limit the valuation of goods purchased from an affiliate to cost plus the utility's fair return. This policy has been consistently applied by the Commission. The Proposed Report has applied a rate of return of 10.66 percent (Exh. 79, Table 15) for 1968. This figure is far in excess of the 7.2 percent found reasonable for General in 1968, and the 6.6 percent previously found reasonable in 1958. The Proposed Report enables the General System to earn an excessive profit at the expense of California ratepayers.

The Report, at page 73, cited the following portion of a California Supreme Court decision.

> "A telephone directory is an essential instrumentality in connection with a peculiar service which a telephone company offers for the public benefit and convenience. It is as much so as is the telephone receiver itself, which would be practically useless for the receipt and transmission of messages without the accompaniment of such directories." (*California Fire Proof Storage Company* v. *Brundige* (1926) 199 Cal. 185, 188.) (Emphasis added.)

There should be no doubt that when a wholly owned affiliate provides a telephone utility with a telephone directory it is performing an integral part of telephone utility service. This was recognized in the Proposed Report and the General System was not permitted to enjoy an excessive return through the use of its directory affiliate. There should also be no doubt that when a wholly owned affiliate provides a telephone utility with a telephone receiver it is performing an integral part of telephone utility service. The Proposed Report found at page 54 "that General and Automatic, both wholly owned subsidiaries of GT&E, are, in effect different departments of one enterprise." In providing telephone receivers and other supplies and equipment to General, "Automatic has a stable, assured and captive market" (P.R. at p. 50). Automatic, like the Directory Company, is in fact, if not in form a functioning department of an integrated utility and performs functions that are an integral part in General's service to Californians. Under these circumstances the General System should not be permitted to use affiliated transactions to "obtain higher profits than would be available to the utility through its fair rate of return." (P.R. 77.)

The Proposed Report properly applied this principle to the Directory Company, but unfortunately failed to make the necessary rate-making adjustment to the Automatic-General transactions.

B. THE PROPOSED REPORT'S ATTEMPTED DISTINCTION BETWEEN THE WESTERN ELECTRIC-PACIFIC RELATIONSHIP AND THE AUTOMATIC-GENERAL RELATIONSHIP PROVIDES NO BASIS FOR ABANDONING THE WESTERN ELECTRIC TREATMENT OF AFFILIATED TRANSACTIONS

At page 56 the Proposed Report rejected application of the "Western Electric" adjustment to the General-Automatic transactions.

> "In this case it is our opinion that the Western Electric-Pacific relationship is still different in sufficient measure from the Automatic-General relationship so that we will not make the Western Electric adjustment."

Only two purported "differences" are mentioned in the Report. At pages 56-57 the Report contends that nonaffiliated sales increase Automatic's risk. A second purported basis is the following at page 57 (reiterated at p. 77):

> ". . . . In particular, we are not convinced that the manufacturing function performed by Automatic could just as well be performed by a telephone company."

AUTOMATIC'S "RISK" ON SALES TO GENERAL

In analyzing affiliated transactions the Commission is interested in arriving at reasonable valuations for the goods and services provided the affiliated operating utility from the affiliated supplier. 1/ No attempt is made to regulate the affiliated supplier. The transactions are only analyzed to prevent the "syphoning process" (P.R. 75) which inflates the operating companies' expenses and rate base. The Commission's concern is that the affiliated transactions should not be used to gain an excessive return. In looking at the Automatic-General transactions, we are solely interested in the level of "Automatic's earnings on its investment devoted to serving General."

1/ "The treatment of the Western Electric adjustment is essentially an attempt to determine the prudent historical cost of the entire Pacific operation." Pacific Tel. & Tel. (D. 74917, November 6, 1968) Concurring Opinion of Commissioner Morrissey at p. 72.

(P.R. 136.) In determining a reasonable return on this investment we must look to the risk on Automatic's sales to General, not the "overall risk to Automatic" (P.R. 57).

Automatic does sell to nonaffiliated customers. This business is undoubtedly riskier than the affiliated sales where Automatic "has a stable, assured and captive market." (P.R. 50.) Nonaffiliate sales may increase Automatic's <u>total</u> risk, but they do not increase the risk on that portion of the General System "investment devoted to serving General." (P.R. 136.)

We do not boost General's intrastate rate of return to compensate for the greater risk of General's interstate business over which we have no jurisdiction. Likewise, there is no cause to boost Automatic's affiliated return to compensate for the risk of non-affiliated business.

The issue of nonaffiliated "risk" is a red herring. The existence or nonexistence of nonaffiliated sales is not related to the risk on affiliated business. Automatic is free to earn all the market will bear in this area but utility ratepayers should not subsidize these riskier endeavors through inflated affiliate returns such as the 12 percent return on equity recommended in the Proposed Report.

The issue of nonaffiliated sales is irrelevant to the risk on affiliated sales. It also provides no basis to distinguish Western Electric and Automatic. At page 56 the Proposed Report seems impressed by the fact that Automatic has nonaffiliated sales of approximately $168,000,000 a year. Specifically, Exhibit 72, Table 5A, page 5-5, line 30, shows that Automatic's nonaffiliated net sales in estimated 1968 were $167,885,000. In 1966 these sales were $139,784,000. Western Electric's nonaffiliated sales in 1966 were <u>$580,544,000</u> (A. 49142, Exh. 62, Table 3A, Sheet 2 of 2).

Automatic's nonaffiliated sales do not affect the risk on affiliated sales and provide no basis to distinguish Automatic from Western Electric. Both Automatic and Western Electric have stable, captive and assured affiliate markets (P.R. 50, Pacific Tel. & Tel. (1964), 62 CPUC 775, 811). As a mere department of a single enterprise Automatic should not be used to provide the General System with a greater return on General business than that found fair for General.

COULD GENERAL MANUFACTURE FOR ITSELF?

The principal basis for rejection of this Commission's normal affiliated transaction criteria seems to be the statement in the Proposed Report that "we are not convinced that the manufacturing function performed by Automatic could just as well be performed by a telephone company." (P.R. 57.) (Emphasis added.)

Assuming this statement is valid and further assuming this provided justification to permit GT&E to earn a return in excess of that found reasonable for General, the rationale provides no basis to allow GT&E to earn an excessive profit on Automatic's nonmanufacturing transactions with General. Automatic serves General as both manufacturer and supplier. In 1966 General purchased $42.5 million worth of supplies from Automatic and only $36.4 million worth of equipment. (Exh. 18, Schedule 3.)

There should be no doubt that General can and does perform a manufacturing function. The Proposed Report correctly found General and Automatic to be departments of a single enterprise (P.R. 54). Under these circumstances the General System is an integrated utility performing its own manufacturing functions. It is unrealistic to close one's eyes to this reality and view Automatic and General as separate independent entities.

If General was a totally independent company it could perform its own manufacturing. United Utilities and Continental Telephone operate their own manufacturing subsidiaries (Exh. 72, p. 5-15, Para. 26). These utilities have fewer telephones than General (Exh. 72, p. 5-15), but they are large enough to handle their own manufacturing (Sullivan, Tr. 6948, 6949). This analysis is unnecessary as General and Automatic are departments of a single integrated telephone utility. The General System does manufacture for itself. Automatic was acquired to enable the General System to manufacture for itself (P.R. 62). General's manufacturing department like each of its other departments should earn no greater rate of return than that found reasonable for the entity as a whole.

C. NO COMPETENT EVIDENTIARY SUPPORT IS IN THE RECORD TO JUSTIFY A 12 PERCENT RETURN ON EQUITY FOR AUTOMATIC ON AFFILIATED TRANSACTIONS

At page 57 the Proposed Report states,

> ". . . , we conclude that Automatic would be treated fairly if it earned a return on its common equity approximating the return on common equity of General and of comparable manufacturing companies. (See Table, page 58.)"

Presumably on the basis of these criteria the Proposed Report concludes that the General System should earn a 12 percent return on its investment in Automatic devoted to sales to General, "a return which may be slightly generous." (P.R. 57.) The 12 percent return cannot be justified as approximately the return on common equity of General nor by an analysis of so-called comparable manufacturing companies.

A 12 PERCENT RETURN ON COMMON EQUITY DOES NOT APPROXIMATE GENERAL'S RETURN

We agree with the criteria that Automatic should earn approximately the same return as General. Since General and Automatic are in effect both departments of a single entity it is reasonable each department should earn the same return on investment. It is inconceivable to have separate returns and capital structures for each of a utility's departments. In setting a rate of return we look to the utility as a whole. This reasoning has led the Commission to limit affiliated returns to that found reasonable for the utility. This has applied to manufacturing affiliates as well as service affiliates.

At page 29 it was concluded that "Rates should be set to permit a 7.2 percent return." Given General's reasonable capital structure (P.R. 31), a 7.2 percent rate of return provides a 10 percent return on common equity (P.R. 43).

The 12 percent return on common equity for Automatic does not approximate the 10 percent return on common equity of General.

> "Accuracy in determining a fair rate of return is much more important than accuracy in determining rate base because even the slightest variation in the rate of return counts much more, in terms of dollars, than a variation in the rate base." (P.R. 8.)

The 20 percent increase in return on equity above that found reasonable for General certainly treats Automatic fairly (P.R. at 57). Conversely, it treats General's ratepayers unfairly. This error is compounded when the 12 percent return on equity is applied to Automatic's capital structure to produce a 10.66 percent rate of return (Exh. 79, Table 15).2/ This excessive return permits GT&E, through its corporate instrument Automatic, to gain an unreasonable return at the expense of General's ratepayers.

2/ The Proposed Report fails to reveal that it is in fact giving Automatic a rate of return of 10.66 percent. If the Commission decision does look to Automatic's return on equity, it should make the ultimate conclusion that Automatic's profits on affiliated transactions should be limited to a specific rate of return on an original cost rate base. Merely stating the return on equity found reasonable does not disclose the capital structure or resulting rate of return necessary for rate-making.

(Excerpt from Staff's Exceptions to Proposed Report.)

THE EARNINGS OF THE SO-CALLED "COMPARABLE MANUFACTURING COMPANIES" P.R. 57-58 PROVIDE NO BASIS FOR A 12% RETURN FOR AUTOMATIC

Various comparable earnings tests have attempted to justify the excessive profits obtained through affiliated transactions. The Commission has rejected these "tests" in numerous Pacific Telephone proceedings.

> ". . . . 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. . . ." (Pacific Tel. & Tel. (1964), 62 CPUC 775, 812.)

The comparable earnings test relied upon in the Proposed Report is similar to the rejected Bell tests and is subject to the same criticisms. Unfortunately the Proposed Report seems to have accepted the applicability of the table at page 58 of the Proposed Report on the issue of Automatic's return without critically analyzing the data. If the Proposed Report had applied proper rate of return criteria, it would not have relied upon Exhibit 79, Schedule 13, reprinted at page 58 of the Proposed Report.

> ". . . . use of tables, charts, graphs, curves, trends, history, etc., albeit meliorated by judgment, can be persuasive only in relation to his underlying assumptions. The inferences drawn from the use of any series of statistics depends, to a great degree, on the assumptions applied to the statistics. . . ." (P.R. 38.)

The Proposed Report assumes that the companies on the table in the Proposed Report, at page 58, are, in fact, "comparable manufacturing companies" (P.R. 57). There is no basis for this assumption.

The thousands of companies were not shown to be comparable in any way to Automatic in risk. The witness who presented the list, Mr. Chew, agreed that it was a comparison of all of American industry (Tr. 4950). The only thing that the companies have in common is that they are manufacturing companies (Tr. 4951). When pressed on this point the witness admitted that these averages included tobacco companies, rubber companies, food and beverage companies, apparel companies and pharmaceuticals (Tr. 4962). These companies could not even be considered manufacturing companies (Tr. 4962).

Exhibit 79, Schedule 13, lists the returns of companies selected by Dr. Weston, a Bell witness in Application No. 49142. The Weston comparable earnings method was obviously defective. It was criticized by the Staff (see Staff Reply Brief at pages 15-16, A. 49142) and was not accepted by the Commission in Decision No. 74917.

> "The evidence is in no way convincing that any heretofore applied principle should now be cast aside . . . We specifically find that the staff adjustments made for (1) Western Electric prices, credit and expense . . . are . . . fair and reasonable." (Pacific Tel. & Tel. (D. 74917, Nov. 6, 1968) at p. 12.)

Witness Chew agreed that the Weston test was defective. He agreed that the Weston companies were not comparable. He used the Weston method to show that even under this company biased test Automatic had excessive earnings (Tr. 4955-56).

Mr. Chew also looked at the return of 26 selected companies. There is no basis upon which to consider these companies' risks comparable to Automatic's. Mr. Chew did not know if the companies did any business with telephone companies (Tr. 4973). At most he could say that part of their business was "somewhat related" to that of Automatic (Tr. 4974). The returns earned by these companies result only in part from related business to that of Automatic (Tr. 4975).

The numerous companies listed in Exhibit 79, Schedule 13, are not comparable to Automatic. These companies operate in various competitive markets. Unlike Automatic and Western Electric, these companies are not mere departments of an integrated company. Unlike Automatic and Western Electric, these companies do not have stable, captive and assured markets. Mr. Chew did not contend that the companies in Exhibit 79, Schedule 13, were comparable in risk to Automatic. In discussing Automatic, Mr. Chew states, "I think they have less risk than an independent manufacturing company" (Tr. 4967). Schedule 13 does not indicate that Automatic should earn a return comparable with the companies in the list. It simply shows that Automatic, with less risk than these companies, has enjoyed an excessive return (Tr. 4908).

The so-called "comparable manufacturing companies" (P.R. 57) are not comparable and are not even manufacturing companies. Even if the companies were comparable to Automatic, their earnings would not be a guide to a fair return for Automatic as there is no evidence to indicate that these companies' earnings are reasonable. It is a fundamental assumption that a comparable earnings study is valid only if the companies are comparable and the earnings of the comparable companies are reasonable. Failure to show that reasonableness of the comparable companies' earnings is a defect in Dr. Foster's showing, in Bell's presentation in Case No. 7409, and in Exhibit 79.

> ". . . . But underlying this result is the assumption that the earnings of the electric utilities are reasonable -- and there is no proof that such earnings are reasonable." (P.R. 37-38.)

* * * * *

> ". . . . 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. . . ." (<u>Pacific Tel. & Tel.</u> (1964), 62 CPUC 775, 812.)

No basis exists for reliance on the table at page 58 of the Proposed Report.

Witness Chew, who presented Exhibit 79, could name only one company that was in any way comparable to Automatic. The company was <u>Western Electric</u> (Tr. 4956). No basis exists to treat Western Electric-Pacific transactions differently than Automatic-General sales. In both cases an integrated manufacturer-supplier is providing goods to captive, stable and assured markets. (See <u>Pacific Tel. & Tel.</u>, 62 CPUC 775, 811 and P.R. 50.)

Automatic, like Western Electric, is not at all comparable to an independent manufacturing concern (<u>id.</u> at 812). The Commission should treat the Automatic-General transaction in the same manner found fair and reasonable by the Commission and the California Supreme Court for Western Electric-Pacific transactions.