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Decision No. 76726

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the practices, contracts, service and facilities of The Pacific Telephone and Telegraph Company.	Case No. 8858 (Filed November 6, 1968)

OPINION

The Commission on its own motion on November 6, 1968 instituted this investigation into the practices, contracts, service and facilities of The Pacific Telephone and Telegraph Company for the purpose of allowing The Pacific Telephone and Telegraph Company, a corporation, respondent herein, to adduce evidence with respect to the reasonableness of prices paid by it to Western Electric Company as related to Western's costs and profit for products manufactured by Western and sold to respondent; and for the purpose of further consideration of the effects and treatment of respondent's California bank and corporation franchise tax for rate fixing purposes.

After due notice ten days of public hearing were held before Commissioners William Symons, Jr., Fred P. Morrissey and Examiner William N. Foley on June 13, 24, 25, 1969; July 23, 24, 25, 30, 31, 1969; and September 10 and 23, 1969 in San Francisco.

In addition to the Commission staff, the Department of Justice, the Cities of San Francisco, Los Angeles and San Diego, the United States Department of Defense and Executive Agencies, and the Association of California Consumers actively participated. Oral argument on motions to dismiss the proceeding was heard by the full Commission on June 24, 1969. These motions were denied.

Pacific presented the testimony of four witnesses regarding the Western Electric adjustment. It presented two witnesses on the California Franchise Tax adjustment. The Commission staff presented one. Altogether nineteen exhibits were introduced along with a record totaling 1,550 pages. In addition, the parties stipulated to incorporate the relevant portions of the record and exhibits from the recent rate case (App. No. 49142) into this record. Concurrent opening briefs were filed on October 31, 1969, and concurrent reply briefs were filed on November 19, 1969.

WESTERN ELECTRIC COMPANY COSTS AND PROFITS FOR PRODUCTS MANUFACTURED BY WESTERN AND SOLD TO RESPONDENT

This Commission has consistently held that a manufacturing company which is not a public utility subject to its jurisdiction, nevertheless must not be permitted to profit at the expense of a public utility when the manufacturing company controls the public utility or is owned and controlled by the same interests which own or control the public utility. Such relationships between utilities and non-utility suppliers of products and/or services are designated "affiliated interests". The problem of dealing with affiliated interests commonly arises whenever the Commission has before it the fixing of rates to be charged by any type of utility subject to its jurisdiction. Whenever the Commission in such a case does other than allow for ratemaking purposes, the actual charges paid by the utility to its affiliate or affiliates, such action is designated as an "affiliated interest adjustment".

The right and the duty of the Commission to make such "affiliated interest adjustments" in proper cases has been consistently upheld by the Supreme Court of the State of California.

As this Commission stated in Decision No. 41416, Application No. 28211 (April 6, 1948),

> "It is an elementary rule of regulatory law, generally speaking, that a utility must bear the burden of showing by satisfactory evidence that all charges to operating expense are reasonable and have been reasonably incurred . . . this rule applies with special emphasis where the charge to operating expense is a charge made against the utility by an affiliate or by a holding company, which dominates and controls the utility."

In every rate case since 1949, Pacific has vigorously opposed the application of the adjustment.

In Decision No. 67369 (1964) 62 C.P.U.C. 775, the Commission determined that in order to assure that Pacific'a ratepayers will not be unduly burdened, Western's profits on sales to Pacific, for rate-making purposes, should be adjusted so as to be no greater than that allowed to Pacific.

This rate-making adjustment was affirmed by the California Supreme Court (Pacific Tel. & Tel. Co. v. PUC (1965) 62 C.P.U.C. 2d 624).

In the most recent case on this matter, Application No. 49142, the record of which was incorporated into this proceeding, Pacific presented the following testimony:

THE TESTIMONY AND EXHIBITS OF WITNESSES MERRITT AND SEYMOUR.

These witnesses placed in evidence Pacific's traditional (and previously always found to be inadequate) evidence showing that (a) on the average Western's prices were about 50 percent of those of other manufacturers of telecommunications equipment and (b) Western Electric's rate of return on its Bell business is substantially lower than the average of other manufacturers of comparable size.

THE TESTIMONY AND EXHIBITS OF DR. MORRIS TANENBAUM, WESTERN ELECTRIC'S DIRECTOR OF RESEARCH AND DEVELOPMENT AND THE HEAD OF WESTERN'S ENGINEERING RESEARCH CENTER.

It was this witness's position that Western did not and could not control the obsolescence of Pacific's investment or that of any other telephone company and that conversely Western is under constant pressure to improve the products it manufactures and the methods by which they are manufactured; that Western's record of innovation and improvement is without parallel; and that the price of Western's failure to remain in the forefront with respect to price, quality and innovation would be the loss of Pacific's business as well as that of the other Bell System's operating companies.

THE TESTIMONY AND EXHIBITS OF DR. DAVID THOMPSON, ASSOCIATE PROFESSOR OF INDUSTRIAL ENGINEERING AT STANFORD UNIVERSITY.

The thrust of the evidence adduced by this witness was that Western's lower manufacturing costs are due only in very small part to economies of scale. Rather, they are the result of extraordinary manufacturing efficiency. This witness demonstrated that a manufacturer with Western's efficiency and product line, but with just one half of Western's volume, should experience manufacturing costs only 6 percent higher than those of Western.

WITNESS DR. G. FRED WESTON, PROFESSOR OF BUSINESS ECONOMICS AT U.C.L.A.

This witness's testimony showed that integration (such as in the Bell System) is an acceptable means of improving the efficiency of an enterprise; that each segment of an integrated enterprise has its own cost of capital, risks, and opportunities, just as would be the case if it were unaffiliated; and that the individual segments in an integrated enterprise are exposed to the same risks of economic fluctuation, production problems and competition which face unaffiliated companies.

The Commission staff presented a study by the Senior Engineer in charge of the Special Studies Unit of the General Branch of the Utilities Division. The staff's study recommended the continuation of the adjustment and provided the pertinent data for this purpose (Witness Caveney).

Since Western's prices were shown to be less than those of any non-affiliated manufacturer, and since its rate of return on net investment was in the middle range of the 50 largest manufacturing companies with which it compares itself, Pacific contended that <u>ipso facto</u> Western's prices were reasonable and the adjustment was unreasonable and unjustified.

The Commission considered Pacific's evidence in rendering Decision No. 74917 on November 6, 1968. We concluded that while the adjustment reflected a proper application of regulatory principles Pacific would be allowed the opportunity in a separate proceeding to provide "more definitive information on the manufacturing costs and prices of Western Electric items" as well as on the "effects and treatment of state tax expense" (Dec. No. 74917, p. 10).

The Commission's order instituting this proceeding allowed Pacific to introduce evidence with respect to the reasonableness of prices paid by it to Western Electric Company.

Pacific's Vice President for Operations, W. L. Mobraaten, presented an analysis of what it would cost Pacific to do by itself the various service functions performed by Western. These functions are listed as repair and related activities; installation; supplies including purchasing, transportation and warehousing; and warehousing and salvage of Pacific-owned and Western-manufactured products. An accompanying exhibit was also introduced (Exhibit No. 4).

A considerable portion of the testimony (Tr. 164-5) and the exhibit (pp. 5-14) consists of a price survey made by Arthur D. Little, Inc. of the prices for supply items <u>not</u> manufactured by Western, but <u>purchased</u> by it. There is also testimony about the warehousing operations performed by Western for Pacific (Tr. 171-5); and about Western's repair, installation, and salvage services (Tr. 175-182).

Upon objection by the staff and the various intervenors that this evidence was beyond the scope of the investigation in that it did not relate to Western's prices for the products <u>it manufactures</u> and sells to Pacific, the Commission, after hearing oral argument, rules that this evidence be stricken (Tr. 286).

Near the conclusion of the hearings, Pacific was granted permission to leave this evidence in the record as an offer of proof for purposes of appeal (Tr. 1535-6). The Commission affirms its original ruling that this testimony and evidence is beyond the scope of the proceeding (see Tr. 286; and Dec. No. 74917, p. 72, note 2, concurring opinion of Commissioner Morrissey). However new and relevant evidence was adduced.

Witness Merritt brought his earlier testimony on Western's prices up to date, showing that they are now and have been approximately one half of the lowest published and unpublished prices, including all discounts, of other manufacturers of telecommunications products of comparable or even inferior quality.

Witness Dr. John Kendrick of George Washington University testified that Western's productivity and efficiency had increased and was increasing at a rate far above that of the economy as a whole and the manufacturing segment of the economy and the electrical equipment industry; that Western had employed its extraordinary increases in productivity efficiency to reduce the level of its prices to the operating companies in the face of sharply increased material and labor costs; and that Western's advances in productivity and efficiency had been made possible only by its ability to make extensive expenditures in research, development, and new facilities, which ability has been and will be entirely dependent upon adequate earnings.

Witness A. W. Harrigan showed that Western Electric's risks were different and substantially greater than Pacific's risks; that Western faces substantial actual and potential competition; that Western's low prices are made possible by its productivity which in turn results from its investment decisions, which in turn are dependent upon earnings at a manufacturer's level; and that if Western's earnings had actually been held at Pacific's utility level in the post war era, Western's retained earnings would have been insignificant; its productivity would have been stifled; its prices would have gone up instead of down, and Pacific's subscribers would have paid the difference. Harrigan further testified that Western's profits on sales for Bell business had been 4.8 percent since 1946, its return on investment devoted to Bell sales 9.1 percent, and its return on equity on Bell business 10.1 percent during the post war period. He further testified that Western's actual earnings objective was 9.5 percent to 10.5 percent on Bell investment for a return on equity of 10.6 percent to 11.9 percent. Before discussing this evidence it is necessary for the Commission to consider Pacific's contention that its evidence in this proceeding constitutes a prima facie case and must form the basis of our decision because the staff did not submit rebuttal evidence or cross-examine any of Pacific's witnesses (Pacific brief, p. 7; 31-3).

This contention is without merit. This proceeding was ordered to provide Pacific an opportunity to introduce additional definitive evidence regarding the reasonableness of these two adjustments. The burden for such evidence rests on Pacific (see Dec. No. 74917, p. 73, concurring opinion of Commissioner Morrissey).

The evidence in this proceeding demonstrates as it has in every prior proceeding before this Commission involving the same respondent, that Western Electric Company is an affiliate of The Pacific Telephone and Telegraph Company through common ownership of said two companies by The American Telephone and Telegraph Company, and we therefore so find.

The record in this proceeding shows that Pacific and Western are both subsidiaries of American Telephone and Telegraph Company and that Western is the manufacturing arm of the Bell System. It supplies respondent as well as other affiliates with equipment and supplies it manufactures, and performs other services for these companies including warehousing, installation of equipment and purchasing of equipment and supplies which it either does not manufacture or does not have in supply. Pacific purchases practically all of its equipment and supplies from Western. The record also shows that other Bell System companies operate in a like manner and that except for sales to the U. S. Government practically all of Western's transactions are with its affiliates.

It is readily apparent that Western's operations in the manufacturing field are closely associated with respondent's and other Bell System companies' utility operations but it is also clear that neither respondent nor its affiliated operating companies could individually perform this manufacturing operation as efficiently as does Western. Western deals almost entirely with affiliates and gears its operations to the servicing of the Bell System. Western's prices for the equipment it sells are lower than those of alternate sources of supply.

In each case of this kind, the question of whether or not an "affiliated interest adjustment" should be made, and if so the nature and extent thereof, is a complex problem not susceptible to any simple arithmetic computation nor application of any mechanical formula.

To begin with, the Commission must consider a great many individual factors, chief of which are whether or not the utility should itself be expected to manufacture the products purchased from the affiliate, the prices charged the utility by its affiliate as compared to prices charged for comparable products by other non-affiliated manufacturers thereof, the affiliate's manufacturing costs, the economic risks to which the affiliate is subject, the earnings which the affiliate must realize in order to be able to attract sufficient capital to finance its operations successfully through the years, and the relative efficiency of the affiliate.

The problem of the Commission is further complicated by the fact that not only do each of the above mentioned factors vary through the years and from year to year in many cases, but the whole nature of the American economy is changing at an ever accelerating pace.

The tremendous increase in recent years in the rate of technological progress tends to increase very substantially the risks to which a manufacturer is exposed because of the possibility of increased competition resulting not only from development of improved competitive products, but resulting also from the development of new and different processes and products which by reason of superior efficiency or economy of manufacture and/or operation make obsolete not only individual products which have been staples in an industry for a generation or more, but may make obsolete entire systems as well. This is perhaps particularly true in the field of communications.

On the other hand, the ever increasing trend in the American economy from private ownership and management of manufacturing enterprises to mass public shareholder ownership of such enterprises with management of such enterprises in the hands of a professional management class separate and apart from the owners of the enterprises reduces each year at an increasing rate the extent of price competition among major manufacturers and thereby reduces the element in the risk factor which price competition formerly constituted. In this present day and age when four or less firms hold two-thirds or more of the entire market in the United States for such major product lines as automobiles, aluminum, copper, sulfur, cigarettes, soap and detergents, whisky, heavy electrical gear, structural steel, cans, computers, aircraft engines, sugar, biscuits, pig iron, iron, tin plate, trucks and many other items,1/ price competition in the market place is becoming more an historical memory and less a reality of life.

1/ Ralph L. Nelson, Concentration in the Manufacturing Industries of the United States -- New Haven; Yale University Press, 1963.

Major changes in the value of the dollar with resultant major variations in interest rates similarly contribute to the need for the Commission to make its decisions in respect to affiliated interest adjustments on a case-to-case basis. In each case the Commission must give new and full consideration to changes in the value of the dollar with their concomitant effect upon interest rates and upon the rate of return an investor should and will expect to receive upon capital advanced by him to the affiliate.

This Commission historically has decided the question of "affiliated interest adjustment" in all types of utility rate hearings in accordance with the above principles. In some cases this Commission has accepted without adjustment the charges paid by a utility to an affiliate for supplies, products and/or services. In other cases it has not. In the communications field this Commission in some cases has not made any adjustment in respect to purchases by a utility from an affiliated manufacturing company. In other cases this Commission has made such adjustments. In the most recent case of this type, Decision No. 75873, Application No. 49835, General Telephone Company of California (July 1, 1969), this Commission decided that a rate of return to the General Telephone Company of California of 7.2% is a reasonable rate of return, but imposed an affiliated interest adjustment in respect to purchases by General Telephone from its manufacturing affiliate, Automatic Electric Company, restricting the return to Automatic Electric Company on sales to General Telephone to a maximum of 12% on equity.

In Decision No. 41416, Application No. 28211 (April 6, 1948) this Commission found that a return of 5.6% was a reasonable rate of return to respondent and made no affiliated interest adjustment but on the contrary accepted at face value the actual prices paid by its affiliate to the Western Electric Company. Subsequently, in Decision No. 43145, Application No. 29854 (July 26, 1949), this

Commission allowed the respondent a basic return of 5.6% and disallowed prices paid by respondent to its affiliate, Western Electric Company, to the extent of reducing them so as to allow the affiliate a return of only 5.6%, the same rate of return allowed the respondent on its utility operations.

When this respondent came before this Commission five years later, Decision No. 50258, Application No. 33935 (July 6, 1954) this Commission allowed the respondent as a reasonable rate of return 6.25%, and made an affiliated interest adjustment disallowing prices paid by respondent to its manufacturing affiliate so that the affiliate, the Western Electric Company, would receive a return of not more than 6.25%. It would appear that the Commission in this decision recognized that Western Electric was a manufacturer and was entitled to a return as a manufacturer although the Commission in that decision allowed Western Electric as a manufacturer a rate of return identical to the rate of return allowed the respondent.

The exhibits submitted by the respondent and the testimony of the witnesses who appeared for respondent show that one of the risks to which Western Electric Company as a manufacturer is exposed to a greater extent than other manufacturers engaged in the same industry, results from the fact that the Western Electric Company manufactures products for Bell System operating companies, including respondent, in advance of receipt of firm orders from these operating companies and in effect keeps such products "on the shelf" despite the risk that such products may remain on the shelf tieing up capital for an extended period of time or conceivably never even be purchased by an operating company. This additional risk which many other manufacturers of telephone system equipment do not incur, is assumed by the Western Electric Company in order to enable it to provide the respondent and other

Bell System operating companies with fast and efficient service by avoiding the long delays which would result if manufacture of equipment were not begun until receipt of firm orders from respondent and the other operating companies. While it appears that due to highly efficient organization and long-range planning, the Western Electric Company has not thus far incurred any substantial losses because of the assumption of such risk, it would clearly be contrary to the public interest to penalize the Western Electric Company indirectly and the respondent directly for assuming this additional risk in the interest of efficiency by ignoring it. The record in this proceeding is replete also with other such evidence of the efficient conduct of the operations of the Western Electric Company and the resultant efficiencies and savings in cost to the respondent and thereby ultimately to the respondent's ratepayers.

As this proceeding is not an application by a utility for authority to increase rates, but an investigation on the Commission's own motion to inform itself more fully respecting the manufacturing costs and prices of Western Electric items, the Commission properly can and should take notice of technological and other developments which are common knowledge and which are relevant to the subject of the investigation, whether or not evidence respecting the same was presented in this proceeding by the respondent, the Commission's own staff, or by any of the other participants. In this connection, we note that among the new risks which face Western Electric today is the fact that whereas formerly the telephone was the primary electrical communications medium in the United States, new technological developments have made it possible for numerous other companies to enter into competition with the respondent and other telephone companies by installation of microwave communication systems which can offer services in the most profitable volume areas while refraining from providing similar services in areas where volume is low and less profitable.

Another new development which was the subject of the recent Federal Communications Commission Carterphone Decision (Carter vs. A.T. & T., et al., 365 F2d 486), constitutes additional new risk resulting as much from a change in applicable law as from technological advancement. By reason of the Carterphone Decision the Bell System operating companies which are the primary customers of the Western Electric Company can no longer insist that their customers utilize solely equipment manufactured by Western Electric and purchased or leased from Bell System operating companies. As a result there is a growing number of rival concerns now engaging in manufacturing equipment, in competition with the Western Electric Company, which by reason of change in federal law the respondent must connect to its overall communications system upon demand in lieu of purchasing similar equipment from Western Electric for sale or lease to respondent's customers.

Clear and uncontroverted evidence shows that the respondent by purchasing necessary products from its affiliated company, to wit, Western Electric Company, has saved substantial sums as respondent has paid to the Western Electric Company prices considerably less than those at which similar products could have been purchased from other manufacturers. We therefore shall not labor this point.

The Commission staff has pointed out that as presented by the respondent, the figures respecting Western's costs and profit for products manufactured by Western and sold to respondent do not provide a detailed breakdown of actual costs of production, but are based upon Western's standard cost system. For Western to do otherwise would require Western to revise drastically its internal accounting system in respect to all of its operations, a major project which would necessarily require many months if not years to accomplish, and would serve no truly useful purpose. It is sufficient that the bookkeeping and accounting system followed by

Western reflects as fairly as would any other reasonable system, Western's costs and profit for products manufactured by Western and sold to respondent.

It is true that respondent's rate base is largely a function of the prices charged by Western. However, this does not give the utility, i.e., the respondent herein, a double profit. The fact that stockholders of AT&T receive a return upon that portion of their funds which are invested in the respondent and also receive a return upon that portion of their funds which are invested in Western Electric simply gives them a single return upon each of their investments.

The Commission frequently has official occasion to examine closely the financial characteristics of the utilities within its jurisdiction. In evaluating the evidence in this record, we think that it is clear that Western Electric does not have the financial characteristics of a utility. Usually the income statement of utilities show that employment costs and purchased materials are less than 50 percent of gross income; and taxes, interest, and depreciation comprise well over 30 percent of gross income. Like many other manufacturers, over 80 percent of Western's gross income is used for purchased material and labor while depreciation and taxes use less than 10 percent of gross income. This indicates clearly that Western electric has the financial characteristics of a manufacturer.

In reviewing the earnings of Western Electric Company related to businesses of similar risk, or other manufacturers, the evidence shows that Western's average return on total capital during the period 1946-1967 was 9.1 percent while the median or net investment of the fifty largest manufacturers in the United States was 10.5 percent.

The present record establishes that Western is a manufacturer; that the risks of the manufacturer, Western, are different and significantly greater than the utility, Pacific; that Western has risks of competition; that Western's prices are the lowest available; that Western's cost levels have been disclosed; that Western's cost savings have been passed on to its customer, Pacific; and that Western's financial characteristics are those of a manufacturer.

There is one other element of consideration closely related to the Western Electric issue. On July 1, 1969, the Commission issued its Decision No. 75873 in the General Telephone Company of California's application for increased rates. In that decision the Commission, for the first time, made a rate-making adjustment to General's plant and expenses for excess prices and profits on items purchased from and through Automatic Electric, the affiliated manufacturer of the General Telephone and Electronic system. The Commission treated Automatic as a manufacturer.

In our opinion, we cannot fairly, reasonably, or lawfully continue to treat Pacific and General Telephone of California differently. Since we treated Automatic as a manufacturer, we must treat Western as a manufacturer; and as a manufacturer, Western's earnings and profits must be compared to other manufacturers. Accordingly, we are convinced that as a manufacturer Western's earnings must be viewed separately and apart from the utility earnings of Pacific.

TREATMENT OF RESPONDENT'S CALIFORNIA BANK AND CORPORATION FRANCHISE TAX FOR RATE FIXING PURPOSES.

This dispute has arisen because the respondent files and pays its California Franchise Tax (the California State Corporate Income Tax) on a consolidated return basis with the parent company, American Telephone and Telegraph Company, and all its affiliates. In each of the last two rate cases, however, the Commission has accepted the staff's recommendation that respondent's tax should be computed on a separate return basis in order to insure that respondent receives an allowance for State Income Tax which is limited to its intrastate utility operations.

Respondent maintains that its tax payment under the consolidated return method should be accepted in full by the Commission. The staff opposes such acceptance on the ground that respondent is not required to pay its tax on a consolidated return basis, and that even if it is, the claimed tax expense is unjust and unreasonable to the extent that it is based on earnings of American Telephone and Telegraph Company's other out-of-state subsidiaries and its interstate operations.

The California State Franchise Tax Board considers respondent to be part of a unitary business enterprise, within the meaning of the tax laws. Consequently, the Board requires that respondent file a consolidated income tax return which utilizes the total Bell System unitary business income.

Up until 1960 respondent had filed its tax return on a separate return basis. Commencing in 1958, however, the Board requested that respondent submit the data necessary for determining its tax on a consolidated return basis. Respondent did so, but it resisted the Board's position that such a report was reasonable or fair.

The staff contends that since respondent does refuse to litigate the issue of whether or not respondent is the victim of arbitrary action under the Board's interpretation, it has in effect voluntarily filed its tax returns on the consolidated basis. Viewing the matter realistically, however, we conclude that it is reasonable to assume that, absent a court decision to the contrary, respondent is required to file a consolidated return as part of the Bell System. This conclusion does not resolve, however, the question of whether or not all the tax expense claimed under this type of return should be recognized in setting rates for respondent's intrastate operations.

It is true, as respondent asserts, that normally this Commission endeavors to permit a tax allowance in ratemaking proceedings which "reflect, as nearly as possible, taxes actually paid and the methods of tax calculation authorized under federal and state laws" (Greyhound Lines, Inc., 64 Cal. P.U.C. 641, 653 (1965)).

However, in the last two decisions regarding respondent's rates, we accepted the staff's contention that an adjustment of respondent's tax was required "in order to relieve California ratepayers of the burden of assuming taxes on American Telephone and Telegraph's holding company functions ..." (Dec. No. 67369, 62, Cal. P.U.C. 779, 868 (1964): (Dec. No. 74917, P. 12)).

We reaffirm the principle that it is necessary to determine each time the matter comes before the Commission whether or not the payment by respondent of California taxes under then-existing conditions does in fact burden California ratepayers with additional tax expense over and above that which would result from payment by respondent of such taxes on a separate return basis.

In this proceeding the staff continued to be of the opinion that an adjustment of respondent's tax was required in order to relieve California ratepayers of the burden of assuming taxes on American Telephone and Telegraph's holding companies' functions. The record in this proceeding indicates, however, that as a result of filing a Federal consolidated income tax return in which Pacific participates, the income tax which would otherwise be payable on Western Electric's profits on properties capitalized on Pacific's books for deferred income taxes, results in a lessening in rate base of Pacific of approximately eighty-five million dollars. Assuming a 6.9% rate of return this results in a diminishing of the gross revenue requirement in the amount of approximately ten million eight hundred thousand dollars per annum to Pacific's ratepayers. Consequently, under present conditions, in return for payment of approximately five million six hundred thousand dollars in California franchise taxes the respondent's ratepayers in California stand to realize a savings of approximately ten million eight hundred thousand dollars a year.

FINDINGS AND CONCLUSIONS

1. This Commission has the right and the duty in setting rates to be charged by any utility company subject to its jurisdiction to disallow all charges of the utility which it finds to have been unreasonable or to have been unreasonably incurred. This rule applies whether the charges are made against the utility by an affiliate of the utility, by a nonaffiliated supplier, or by a governmental agency.

2. The Western Electric Company is an affiliate of The Pacific Telephone and Telegraph Company through its affiliation with American Telephone and Telegraph Company.

3. The Western Electric Company is a manufacturing company which operates efficiently in providing products to the respondent with consequent benefit to the respondent and to the respondent ratepayers.

4. The reasonableness of the prices paid by the respondent, during any period of time in the future to the Western Electric Company for its products, must be judged as of such time by analyses of such charges with due regard to all general and specific economic circumstances at that time including consideration of the economic advantages enjoyed by Western Electric Company as well as the need of the Western Electric Company to realize a reasonable level of profits from its operations in the manufacture and sale of products to respondent so that Western Electric Company can, to the extent required, attract sufficient capital from the investing public to finance its operations adequately.

5. The contention of The Pacific Telephone and Telegraph Company that this Commission should adopt a specific return by application of which this Commission would allow or disallow prices paid for products by telephone and/or other utilities to their affiliates to precisely the same extent in each case, is without merit and this Commission rejects said contention.

6. In each proceeding concerned with fixing respondent's rates, the determination of a reasonable earnings level for Western Electric Company from its manufacturing operations and sale of products to respondent will be based on what constitutes reasonable earnings for a manufacturing company.

7. In the performance of its manufacturing functions, Western's prices to Pacific and its earnings on its sales of manufactured products to Pacific have been fair and reasonable when compared to the earnings of manufacturing companies. The prices paid by Pacific to Western for manufactured products are fair and reasonable.

8. The payment by respondent of its California Franchise Tax upon a consolidated return basis with American Telephone and Telegraph Company and its affiliates does not necessarily under all circumstances impose any additional burden upon California ratepayers over and above the burden which would be imposed if respondent computed and paid its California Franchise Taxes on a separate return basis and may in fact benefit California ratepayers under some circumstances.

9. As this case is an investigation on the Commission's own motion to inform itself more fully regarding the subject matter hereof and not a general rate proceeding, it would be neither fair, reasonable, nor proper for us to conclude this investigation with more than Findings and Conclusions, and the request of respondent herein that this Commission amend its

prior Decision No. 74917 in Application No. 49142, dated November 6, 1968, to allow the collection of increased rates to offset the Western Electric affiliate and California Franchise Tax adjustment made in said Decision No. 74917, is therefore rejected.

No additional proceedings in this Case No. 8858 will be held. No order is necessary in this proceeding and none will be issued.

Dated at San Francisco, California, this 27th day of JANUARY, 1970.

William Symons Jr.
President

J. P. Vukasin Jr.

Vernon L. Sturgeon
Commissioners

I will file a dissent.
Thomas Moran

I will file a dissent
A. W. Gatov

Appendix A

LIST OF APPEARANCES

Pillsbury, Madison & Sutro, by George H. Eckhardt and Richard W. Odgers, for The Pacific Telephone and Telegraph Company, respondent.

A. M. Hart and H. Ralph Snyder, Jr., by H. Ralph Snyder, Jr., for General Telephone Company of California; Roger Arnebergh, by Charles E. Mattson, for the City of Los Angeles; Louis Possner, for the City of Long Beach; Robert W. Russell and Manuel Kroman, for the Department of Public Utilities and Transportation, City of Los Angeles; Thomas M. O'Connor, by William C. Taylor and Robert L. Laughead, for the City and County of San Francisco; William M. Bennett, in the public interest; Curtis M. Fitzpatrick, for the City of San Diego; Lt. Colonel Frank J. Dorsey and Gerald P. Flannery, for the Department of Defense and all other executive agencies of the United States; Michael Peevey, for the California Labor Federation; Robert E. Burt, for the California Manufacturers Association; W. Knecht, for the California Farm Bureau Federation; Thomas C. Lynch, by Donald B. Day, for the State of California; Mrs. Borghild Haugen, for California Farmer Consumer Information Committee; and Sylvia M. Siegel, for Association of California Consumers, interested parties.

Hector Anninos, Leonard L. Snaider, Counsel, and Bruno Davis and John Gibbons, for the Commission staff.

C-8858 MM D-76726

COMMISSIONER A. W. GATOV, Dissenting:

I dissent.

An open-minded examination of the record in this proceeding will show beyond any doubt that it is completely and utterly devoid of evidence which would support the rubber stamp decision of the Commission's majority with respect to the so-called Western Electric adjustment.

Should it be considered that my views of this grossly erroneous and anonymous decision are contentious or rancorous, I am quick to point out that they are shared by (1) the Hearing Examiner who heard the case and who, incidentally, is a lawyer, (2) the staff of the Public Utilities Commission, (3) the Chief Counsel of the Public Utilities Commission, (4) the United States Department of Defense and Executive Agencies, (5) the Attorney General and Chief Legal Officer of the State of California, (6) the City Attorney of the City and County of San Francisco, (7) the City Attorney of the City of Los Angeles, and (8) the City Attorney of the City of San Diego.

The majority has gone outside the record in its wholehearted adoption of the views of PT&T.

This decision sets the stage for reversal of an economically sound and court-affirmed position which this Commission has uniformly maintained for over twenty years, and that is the rejection of attempts to promote wholly-owned, special function subsidiaries in regulated utilities and which system provides means of avoiding regulation and/or establishing hidden profits through double mark-ups for AT&T. Whereas the past treatment has been reflected in lower rates to subscribers, the reversal will increase rates with no corresponding benefits.

The majority may not be aware of or remember its own angry denunciation of these practices in its Decision No. 75873 (General Tel. Co.) issued just six months ago, and from which I quote as follows with underscoring added:

> "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."

Even while these thunderclaps are still reverberating, the majority now overlooks the consanguinity of The Pacific Telephone and Telegraph Company (90% owned by AT&T) and Western Electric Company (100% owned by AT&T), and concludes that for rate making purposes Western Electric is in fact an independent manufacturing and service organization fighting for its existence in the rough and tumble of a highly competitive market place. According to

Finding and Conclusion No. 4, it has "to realize a reasonable level of profits from its operations in the manufacture and sale of products to respondent (PT&T) so that Western Electric Company can, to the extent required, attract sufficient capital from the investing public to finance its operations adequately". The fact is that Western Electric has no need for and does not seek capital from the investing public. It has issued no debentures and has no other form of long-term public debt. The public cannot invest in Western Electric. Its one common share of stock is owned by AT&T, and additional shares are not available.

Notwithstanding AT&T's long and expensive hard sell to the contrary, Western Electric has been and is still largely a phantom company with but one customer, i.e., its parent AT&T, and a lead-pipe cinch captive market for all it manufactures and for all the services it provides.

This seemingly innocent decision in the guise of a declaratory judgment (and which type of judgment this Commission has in the past uniformly refused to issue) is an invitation to "come and get it".

I confidently predict that PT&T will within a few weeks file its largest yet rate increase application, which increase application will include a significant ingredient based on the majority's declaration that the public interest no longer requires it to treat Western Electric as part of a regulated utility.

The majority should have signed the decision prepared by the Hearing Examiner, and which decision I append hereto and incorporate by reference as part of my dissent. I believe that the public and all the participants are entitled to know that though rejected, a well written, carefully constructed and thoughtful decision based on the record was available.

That the majority's treatment of the California Bank and Franchise Tax adjustment phase of this proceeding is without reason or logic is discernible by simply reading it. The treatment now proposed will burden California subscribers an additional $2½ Million. General Telephone Company of California, Continental Telephone, and United Utilities, as is the case with PT&T, are also affiliates of nationwide telephone companies. Since these others have heretofore reported and paid the California franchise tax on a separate basis, it is reasonable to expect these similarly situated companies to insist upon equal treatment.

Vukasin
Commissioner

Dated at San Francisco, California,
January 27, 1970.

JR

Decision No. ______________

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Investigation on the Commission's own motion into the practices, contracts, services and facilities of The Pacific Telephone and Telegraph Company.

Case No. 8858
(Filed November 6, 1968)

(Appearances are listed in Appendix A)

OPINION

In conjunction with the Commission's decision in the most recent application (Decision No. 74917 in Application No. 49142, Cases Nos. 8608, 8609, 8690, dated November 6, 1968) by The Pacific Telephone and Telegraph Company (Pacific) to increase its rates for intrastate telephone service, the Commission issued an order instituting an investigation "into the practices, contracts, service and facilities of The Pacific Telephone and Telephone Company for the purpose of allowing Pacific to adduce evidence with respect to the reasonableness of prices paid by it to Western Electric Co. as related to Western's costs and profits for products manufactured by Western and sold to respondent; and for the purpose of further consideration of the effects and treatment of Pacific's California Bank and Corporation Franchise tax for rate fixing purposes" (Order Instituting investigation, Case No. 8858, issued November 6, 1968).

Based upon the evidence presented by Pacific and the Commission staff during the recent rate case, the Commission found that two ratemaking adjustments, one referred to as the Western

Electric adjustment and the other as the California Franchise tax adjustment were fair and reasonable (Decision No. 74917, pp. 9, 10).[1/] The Commission stated, however, that more definitive information on the adjustments was desirable, and it initiated this proceeding for that purpose.

Ten days of public hearing were held on June 13, 24, 25; July 23, 24, 25, 30, 31; September 10 and 23, 1969 in San Francisco before Commissioners Symons and Morrissey and Examiner Foley.

In addition to the Commission staff, the Department of Justice, the Cities of San Francisco, Los Angeles, San Diego, the United States Department of Defense and Executive Agencies, and the Association of California Consumers actively participated. Oral argument on motions to dismiss the proceeding was heard by the full Commission on June 24, 1969. These motions were denied.

Pacific presented the testimony of four witnesses regarding the Western Electric adjustment. It presented two witnesses on the California Franchise tax adjustment. The Commission staff presented one. Altogether nineteen exhibits were introduced along with a record totaling 1,550 pages. In addition, the parties stipulated to incorporate the relevant portions of the record and exhibits from the recent rate case (App. No. 49142) into this record. Concurrent opening briefs were filed on October 31, 1969, and concurrent reply briefs were filed on November 19, 1969.

I. THE WESTERN ELECTRIC ADJUSTMENT

Background

In exercising its duty to fix the rates of public utilities this Commission has been concerned on numerous occasions

1/ Citations to Decision No. 74917 in App. No. 49142, dated November 6, 1968, refer to the unbound printed opinion.

with transactions between a regulated utility and its affiliate. Since the natural human and corporate tendency is to prefer one's own advantage, such transactions have been closely scrutinized to prevent excessive profits from flowing to the utility's affiliate. On the other hand, affiliate transactions have not been considered improper per se.

Consequently, in some cases the Commission has found payments for property or services from an affiliate to be reasonable (See e.g., Suburban Water Systems, Decision No. 59646 (1960) unreported; Kern Mutual Telephone Co., Decision No. 61795 (1961) unreported; Southwest Water Co., 61 Cal. P.U.C. 458, 462 (1963)). In other cases, the Commission has disallowed portions of payments for services rendered by a parent corporation (City of San Jose v. Pacific Tel. & Tel. Co., 3 C.R.C. 720, 732, 736 (1913); East Pasadena Water Co., 66 Cal. P.U.C. 10, 16 (1966)). It has also dismissed an application for increased rates because the utility refused or declined to make a full showing regarding the cost of materials and water rights purchased from an affiliated corporation which had been included in the rate base (San Gabriel Valley Water Co., 52 Cal. P.U.C. 729, 731 (1953)). And it has adjusted the prices paid by a utility to its parent company for gas supplies to reflect the same rate of return (Southern California Gas Co., 49 Cal. P.U.C. 276, 278, 282 (1950); Southern Counties Gas Co., 51 Cal. P.U.C. 419, 436 (1952)).

In City of San Diego v. San Diego Consolidated Gas and Electric Co., 39 C.R.C. 261 (1935), the Commission disallowed as includable operating expense in the cost of service over a million dollars in management and engineering fees paid by the utility to an affiliated engineering and management company. The rationale and purpose of the adjustment were stated as follows:

> "While court and commission have firmly established cost (and cost, of course, includes a reasonable return on investment or property) as the controlling factor in accounting for holding or management company fees, there are persuasive reasons of a practical nature supporting the rule. Cost is tangible and may be ascertained with reasonable precision. This may not be said of other suggested standards of evaluating such fees. Again, granting that services such as are here involved are of a valuable nature, (See Smith v. Ill. Bell Tel. Co., supra) the same characterization may be made of services rendered by the engineering, the fiscal, the purchasing, the operating, and other departments of the various great utilities in this State which operate independently. Nevertheless, in the year by year process of regulation of these utilities the cost of such services has universally been used as the basis of operating expense allowances and in building up historical property bases. To allow an affiliated corporation profit on top of the cost of the service, where the affiliates 'are and always have been intended to be one single entity' would not only bring about an inconsistency in treatment of utilities but would be a positive discrimination against those independently operated." (39 C.R.C. 277.)

Pacific and the Western Electric Company, Inc. (Western) are members of the Bell System. American Telephone and Telegraph Co. (AT&T), the corporate headquarters of the Bell System, owns 100 percent of Western's stock as well as approximately 90 percent of Pacific's (Tr.447, App. No. 49142). Western controls three other companies, the Teletype Corporation, Nassau Smelting and Refining Co., and Weco Corporation, all 100 percent owned. Western and AT&T each own 50 percent of Bell Telephone Laboratories, Inc., which was created in 1924 as the research organization of the Bell System.

Western is the manufacturing and supply department of AT&T. It manufactures telephone equipment which it sells to Pacific under a standard supply contract Western has with each of the Bell

System operating telephone companies. The operating companies do not buy equipment from sources other than Western, and Western holds at least 80 percent of the total market for such equipment (Tr.3801, App. No. 49142).[2/] It also acts as purchasing agent for Pacific and the other operating companies. As such it purchases and stores all the various items required by them. Finally, it is the installer, repairer, and salvager for these companies.

In 1968, Western's total sales of telephone equipment, cable, wire and supplies amounted to $3.94 billion, an increase of 8.7 percent from 1967 (Exh. No. 18, p. 3). In 1968, 86 percent of Western's total sales were to Bell operating companies, and 13 percent were to the U. S. Government. In 1967, these figures were 84 and 15 percent, respectively (Exh. No. 18, p. 4). Western's net income for 1968 totaled over $192 million, as compared to approximately $153 million in 1967. Dividends paid to AT&T in 1968 amounted to over $86 million, and earned surplus as of December 31, 1968 came to just over $1 billion (Exh. No. 18, p. 4). For 1967 dividend payments to AT&T totaled $81 million, and earned surplus amounted to $919 million (Exh. No. 19, p. 5).

In the light of the affiliated relationship between Western and Pacific, the Commission, commencing in 1949, decided to adjust the prices paid by Pacific to Western for telephone apparatus and supplies in order to limit Western's return on these sales to the same level as Pacific receives on its operations. The Commission explained the adjustment as follows:

2/ The size of this market can be visualized by considering the number of telephones serviced in the U. S. In 1967 the telephone industry in the U. S. was servicing over 100 million phones; at the end of 1968 this figure grew to 109 million. There has also been a great increase in the volume of use. (See Jarmon, What's Ahead for the Telephone Industry, 84 Public Utilities Fortnightly 38, July 17, 1969.) The Bell operating companies provide 85 percent of all the telephone service in the U. S. (Amer. Tel. & Tel. Co. (Interstate and Foreign Rates), 9 F.C.C. 2d 30, 38 (1967).)

"The company introduced evidence showing Western Electric prices to be lower than those of independent manufacturers for comparable items. Comparability of manufacturers was not established and, inasmuch as the record shows that Western Electric manufactures over 90 percent of all telephone apparatus and equipment, while the independent manufacturers compete for the remaining business, little weight can be given these price comparisons in judging the reasonableness of the Western Electric Company's prices.

"Western contends its earnings are less than those of the 50 largest manufacturing corporations of the nation. This, likewise, is no criterion. It is the cost to Western that is essential."

* * *

"American Telephone and Telegraph Company owns 99.8 percent of the stock of Western Electric, and 87.93 percent of the capital stock of applicant. Western is, in fact, the manufacturing department of the Bell System, as was so pertinently and well pointed out by the Supreme Court of the United States in the case of Smith v. Illinois Bell Telephone Company, 282 U. S. 133, 152-153; 75 L. ed. 255, 265. Obviously, the American Company, lawfully, may not, through the corporate device of the Western Electric Company, realize a profit from the transactions between Western and applicant, which, in turn, is capitalized by applicant or charged by it to operating expense, thus subjecting applicant's rate-payers to the burden of paying a profit upon a profit. This sort of practice should not be condoned. It is just such practices that rate-fixing authorities should be vigilant to detect. (American Telephone and Telegraph Company v. U.S., 299 U.S. 232, 246; 81 L. ed. 142, 153). As a general rule, a dominating holding company is not entitled to realize a profit at the expense of one of its operating subsidiaries. (U.S. v. New York Telephone Company, 326 U.S. 638, 654; 90 L. ed. 371, 381. San Diego v. San Diego etc. Company, 39 CRC 261, 277). The same rule applies as between affiliates. (San Diego v. San Diego etc. Company, supra, p.277). If any claimed profit between affiliates would disappear when placed in a system-wide profit and loss statement, such claimed profit should not be recognized. (U.S. v. New York Telephone Company, supra, at p.654, U.S. Report).

"Western Electric, in its relationship to applicant and other operating subsidiaries of the Bell System is not at all comparable to an independent manufacturing concern. This fundamental difference and distinction was pointed out by the Supreme Court of the United States in the Illinois Bell Telephone Company case at pages 152-153 of the U.S. Report. We will not elaborate on such an obvious fact but merely will point to this decision of the Supreme Court.

"We hold that Western Electric is entitled to no greater return on its sales to applicant than applicant is entitled to as against its rate payers, which we have found to be not over 5.6 percent. We, therefore, reduce the contemplated interim rate increase by $900,000 and will reserve further consideration until the final decision herein." (Pacific Tel. & Tel. Co., 48 Cal. P.U.C. 487, 492-3, interim decision (1949); affirmed in final decision, 48 Cal. P.U.C. 823 (1949).)

The adjustment was approved in the final decision issued the same year (Dec. No. 43145, 48 Cal. P.U.C. 823, 826-35); and it has been reapplied in the four subsequent rate cases. (See Dec. No. 50258, 53 Cal. P.U.C. 275, 305 (1954); Dec. No. 56652, 56 Cal. P.U.C. 279, 283 (1958); Dec. No. 67369, 62 Cal. P.U.C. 779, 809-16 (1964); Dec. No. 74917, dated November 6, 1968, pp. 9-10, 12. After the issuance of Decision No. 67369, Pacific sought judicial review of the reasonableness of the adjustment. It was upheld by the California Supreme Court (Pacific Tel. & Tel. Co. v. P.U.C., 62 Cal. 2d 634, 659-662 (1965)).

In every rate case since 1949, Pacific has vigorously opposed the application of the adjustment. In the most recent case (App. No. 49142), Pacific again introduced evidence on this matter. A detailed survey of prices for four general classes of telephone equipment was presented by AT&T's Engineering Manager of Price Surveys in the Engineering Economics Department (Witness Merritt). The advantages to Pacific of operating with Western pursuant to the standard supply contract, under which Western manufactures or purchases all equipment or materials needed by Pacific and sells them to it at prices no higher than Western's prices to its most favored customers, were explained by Pacific's Vice President of Engineering (Witness Frey). Western's sales and earnings history, including the average return on net investment; its business risk and its comparability with the 50 largest manufacturing companies, was related by its Director of Corporate Analysis in the Regulatory Matters Division (Witness Seymour). The pressures under which Western operates because of its affiliated relationship with Pacific, in particular the necessity to remain in the forefront of innovation in order not to lose its Bell System business, as well as various new products and manufacturing processes developed by Western, were described by its Director of Research and Development, and head of its Engineering Research Center (Witness Tanenbaum).

In addition to the testimony and evidence of the Bell System executives set forth above, Pacific presented a study by an Associate Professor of Industrial Engineering at Stanford University on the relationship between the volume of Western's production and its unit costs (Witness Thompson). Another study presenting criteria for evaluating Western's prices and earnings since 1945 in order to assist the Commission in evaluating the reasonableness of these prices and earnings was provided by a Professor of Business Economics and Finance at U.C.L.A. (Witness Weston).

The Commission staff, on the other hand, presented a study by the Senior Engineer in charge of the Special Studies Unit of the General Branch of the Utilities Division. The staff's study recommended the continuation of the adjustment and provided the pertinent data for this purpose (Witness Caveny).

Since Western's prices were shown to be less than those of any non-affiliated manufacturer, and since its rate of return on net investment was in the middle range of the 50 largest manufacturing companies with which it compares itself, Pacific contended that ipso facto Western's prices were reasonable and the adjustment was unreasonable and unjustified.

The Commission considered Pacific's evidence in rendering Decision No. 74917 on November 6, 1968. We concluded that while the adjustment reflected the proper application of regulatory principles Pacific would be allowed the opportunity in a separate proceeding to provide "more definitive information on the manufacturing costs and prices of Western Electric items" as well as on the "effects and treatment of state tax expense" (Dec. No. 74917, p. 10).

Respondent's Evidence

The Commission's order instituting this proceeding allowed Pacific to introduce evidence on Western's costs and profits which would show that Western's prices "for products manufactured by Western and sold to respondent" are reasonable. Pacific's Vice President for Operations presented an analysis of what it would cost Pacific to do by itself the various service functions performed by Western. These functions are listed as repair and related activities; installation; supplies including purchasing, transportation and warehousing; and warehousing and salvage of Pacific-owned and Western-manufactured products. An accompanying exhibit was also introduced (Exh. No. 4).

A considerable portion of the testimony (Tr.164-5) and the exhibit (pp. 5-14) consists of a price survey made by Arthur D. Little, Inc. of the prices for supply items not manufactured by Western, but purchased by it. There is also testimony about the warehousing operations performed by Western for Pacific (Tr.171-5); and about Western's repair, installation, and salvage services (Tr.175-182).

Upon objection by the staff and the various intervenors that this evidence was beyond the scope of the investigation in that it did not relate to Western's prices for the products it manufactures and sells to Pacific, the Commission, after hearing oral argument, ruled that this evidence be stricken (Tr.286).

Near the conclusion of the hearings, Pacific was granted permission to leave this evidence in the record as an offer of proof for purposes of appeal (Tr.1535-6). The Commission affirms its original ruling that this testimony and evidence is beyond the scope of the proceeding (see Tr.286; and Dec. No. 74917, p. 72, note 2, concurring opinion of Commissioner Morrissey).

The remainder of Pacific's evidence related to Western's prices and costs; its productivity and efficiency; and its earnings and risks as compared to a selected group of manufacturing companies. Before discussing this evidence, however, it is necessary for the Commission to consider Pacific's contention that its evidence in this proceeding constitutes a prima facie case and must form the basis of our decision because the staff did not submit rebuttal evidence or cross-examine any of Pacific's witnesses (Pacific brief, pp. 7, 31-3).

This contention is without merit. This proceeding was ordered to provide Pacific an opportunity to introduce additional definitive evidence regarding the reasonableness of these two adjustments. The burden for such evidence rests on Pacific (see Dec. No. 74917, p. 73, concurring opinion of Commissioner Morrissey). Moreover, it overlooks the fact that Pacific and the staff stipulated to incorporate into this record the testimony, exhibits, and cross-examination from the recent rate case relating to both adjustments.

As a consequence the staff has in this record its evidence, presented by Witness Caveny (Exh. No. 62, App. No. 49142), which prevailed over Pacific's evidence in that proceeding. The staff's current position is that this evidence still prevails because Pacific has not presented any new evidence sufficient to outweigh its own. The question in this proceeding, therefore, is whether all Pacific's evidence is sufficient to prove changed circumstances or new conditions, or erroneous judgment by past Commissions with regard to these two rate-making adjustments, with the result that this Commission finds it reasonable to reverse the present regulatory policy (see Southern Pacific Co., Dec. No. 76133 in App. No. 51122, dated Sept. 3, 1969, p. 3, mimeo).

A. Western's Prices, Costs, and Efficiency

1. Prices

The Engineering Manager of Price Surveys in the Engineering Economics Department of AT&T presented a study (Exh. No. 1) which compared Western's prices for various classes of telephone equipment (telephone apparatus, cable, outside plant material, switching and carrier equipment) with the prices of similar equipment charged by unaffiliated manufacturers. The study demonstrates that Western's prices to the Bell System operating companies are substantially lower, generally from 40 to 50 percent lower, than the general trade prices for similar items produced by possible competitors of Western (Tr.79).

Pacific argues that these price comparisons are conclusive in determining the reasonableness of Western's prices. It asserts that such a comparison is the only test which an economist or housewife would apply (Pacific brief, p. 8 supplement). We do not agree.

It is readily apparent that this study is essentially the same as the study presented in Application No. 49142 by the same witness (see Exh. No. 8, App. No. 49142). The two exhibits are different only to the following extent:

App. No. 49142 Exh. No. 8	Case No. 8858 Exh. No. 1
a. Organized in five parts.	a. Organized in nine parts.
b. Utilizes prices up to and including 1964.	b. Utilizes 1967 and a few 1968 prices.
c. Price comparison of Central Office and Private Branch Exchange Material of Calif. Water & Tel. Co. for July 1958-9.	c. Price comparison of purchases of telephone material by a domestic Independent Tel. Co. for Feb. 1965 - Jan. 1966.
d. Number of Items Compared 1. Station apparatus - 684 2. Central office and private branch apparatus - 2,166 3. Cable - 219 4. Outside plant material - 129	d. Number of Items Compared 1. Apparatus - 3,053 2. Cable - 148 3. Outside plant material - 134 4. Carrier Terminals

Furthermore, during cross-examination of this witness in the recent rate case, he admitted that his testimony and exhibit in that proceeding were the same as those presented in the 1964 rate case (Case 7409), except for the updating of the comparisons (Tr.3732, App. No. 49142).

While Pacific urges the Commission to follow the various states which have accepted Western's price studies as sufficient evidence that its prices are reasonable, it fails to mention that the Federal Communications Commission (FCC) has not. In its investigation of AT&T's private line rates, it stated:

"103. The company seeks to justify Western's prices to the Bell System companies on the grounds that they are lower than those of other manufacturers for the same equipment. Western has the advantage of volume and specialization in this field of manufacture which these other companies do not have, and also enjoys a lack of substantial competition plus having an assured market. The business transactions between the Bell System companies and Western are not conducted at arm's length. The sales of Western to the Bell System companies are, in essence, sales of goods and services to itself and it is reasonable to assume that there will be a market for Western's products as long as the Bell System companies operate. Western's sales to Bell System companies are made under a projection program under which it has no promotional sales expense, and no credit losses or uncollectibles, which are expenses that must be borne by general trade suppliers. Also, the research and fundamental development costs are excluded from Western prices[12] but must be reflected directly or indirectly in the price of the product of smaller independent manufacturers since they have no other way to recover this cost." (American Telephone & Telegraph Co. (Private Line Rates), 34 F.C.C. 244, 280 (1961); footnote omitted.)

The FCC rejected AT&T's presentation on Western's prices as "without probative value" (34 F.C.C. 244, 281).

This Commission has similarly rejected such price comparison studies in the prior proceedings because of the inherent advantages Western obtains from being the supplier of the massive Bell System market (Dec. No. 67369, 62 Cal. P.U.C. 779, 811 (1964)). We also rejected such studies in our recent decision involving the rates of the General Telephone Company partly because the comparability of manufacturers was not established and the advantage General's affiliated manufacturer attains in volume alone prevents the existence of a competitive market situation (see General Tel. Co., Dec. No. 75873 in App. No. 49835, dated July 1, 1969, p. 50 mimeo).

The critical weakness in the price comparison study is its assumption that the independent suppliers compared with Western are its real competitors. Pacific apparently believes that the study proves the existence of a competitive market in the telephone equipment manufacturing field. This belief is not realistic. The independent suppliers are potential competitors of Western only in the most remote sense.

Pacific has not sought to buy any product which Western makes from some other source. The present supply contract has been in effect since 1930. Its predecessor dates from 1906. Despite the fact that Western has failed at times to meet the peak demands of the operating companies, Western's Vice President for Finance could recall only one occasion when an unnamed operating company purchased an item of equipment from a different manufacturer (Tr. 1329-30). Nor has any legal action ever been taken against Western under the contract. The witness also admitted that an independent, non-telephone manufacturer could not move into Western's field without a firm commitment from the operating companies (Tr. 1347-48).

We conclude that this huge market, consisting of the companies which provide 85 percent of all the telephone service in the United States, easily makes Western the dominant producer in the telephone equipment field. Given the size of this market Western's prices should be the lowest. Therefore, the fact that they are the lowest is not enough by itself to permit a finding that its prices are reasonable *per se*. Furthermore, Western's Director of Corporate Analysis testified in the recent rate case that the primary consideration in setting its prices is that they be acceptable to the various regulatory commissions concerned with them (Tr. 3913, App. No. 49142; See Dec. No. 74917, pp. 9-10). Significantly, the staff's study in that case (Exhibit No. 62, App. No. 49142) shows that Western has adjusted its prices for apparatus and equipment, as well as for cable, to maintain its return on net investment at a relatively constant level of around 9 percent (Exh. No. 62, Chart 5A, Sheets 1 & 2). This suggests that Western's prices are not set under normal market conditions and that its profit margins may not be uniform or consistent.

Control of this huge uncompetitive market gives Western the power to fix arbitrary and unreasonable prices. The purpose of the Western Electric adjustment is to prevent excess profits from being extracted from Pacific's ratepayers by means of affiliated transactions. We cannot make an informed judgment regarding the presence of excess profits when only the prices are presented. At the same time it must be recognized that we have not concluded that Western's prices are unreasonable. We conclude only that price comparisons with such remotely potential competitors, who hold so little of the telephone equipment market, do not prove the reasonableness of Western's prices. Only Western's costs can do this.

2. Costs

Pacific contends that it has provided adequate current cost data from Western for the Commission to conclude that its prices are reasonable. This data consists of the annual Report on Operating Results of Western for 1967 and 1968, and the ten year report, 1958 through 1967, prepared by Western at the request of the NARUC[3/] Committee on Communications (Exh. No. 69, App. No. 49142; Exh. Nos. 18, 18A, 19 and 19A in this proceeding).

3/ The National Association of Regulatory Utility Commissioners.

These exhibits were not sponsored by any particular witness, and Pacific did not present any witness to explain them or to be cross-examined on them. They appear to contain weaknesses. First, the 1967 report was included in the record of the recent rate case. It was not considered worthy of substantial weight. Second, Exhibit No. 19A in this proceeding makes abundantly clear that these current cost figures are not based upon the actual costs of production.

Exhibit No. 19A contains a table setting forth Western's "current costs" by product line for its Bell business, based upon Western's standard cost system for its shop costs. Under this system, "the costs of labor, materials and manufacturing overhead are carefully predetermined for each operation under efficient operating conditions" (Exh. No. 19A, p. 12). Adjustments are made at some later time to allocate the variations in the costs actually experienced among the various product classes (Id.). These standard shop costs are derived only after various accounting and engineering studies are conducted. Job or historical costs, i.e. recorded costs after they are incurred, are utilized "only when necessitated by special circumstances" (Id., p. 13). It is apparent, therefore, that these "current costs" submitted by Western are only predictions and not the actual historical costs for items manufactured by Western and sold to Pacific.

In addition, the manner in which the data is set forth is not convincing. The tabular format of the estimated current costs commences by stating first the gross sales figure. It then shows a breakdown of this figure, rather than commencing with the actual incurred costs, and finally terminating with the gross sales figure (Exh. No. 18A, p. 28).

The Commission also takes note of our recent decision in Fisher-Berkeley Corp. v. Pacific Tel. & Tel. Co., Decision No. 74618 in Cases Nos. 8662 and 8663, dated August 27, 1968, in which we considered a showing by Pacific regarding the hospital interphone system it purchases from Western. An exhaustive showing, including 21 exhibits, was made by Western's Director of Pricing and Customer Contracting to develop Western's cost data and prices for this equipment. We observed that Western's total shop cost for the two items involved "is the predetermined cost of manufacturing based on engineering and accounting data for a period of time during which the cost will be used for accounting, pricing control and material transfer purposes" (Dec. No. 74618, p. 18, mimeo). After considering Western's data, we expressly found that Western's unit prices were not based on actual manufacturing costs (Dec. No. 74618; Finding of Fact No. 10, p. 28, mimeo).

Pacific has not introduced the actual historical costs of the items produced by Western and sold to it. In light of the fact that Western's reports to the NARUC do not appear to contain its actual historical costs, and in light of Fisher-Berkeley, these reports are not entitled to substantial weight.

3. Efficiency

Pacific presented a study by a Professor of Economics at George Washington University regarding the concept of total factor productivity (Witness Kendrick, Exh. No. 2). The witness concluded from his study that Western had demonstrated a record of superior productivity performance with the result that productivity has been substantially increased. As a result Western has been able to reduce prices.

He stated that investments are the key to productivity, and he ranked Western high in this regard (Tr. 102). He found that Western's growth in productivity was 50 percent greater than that in the electrical equipment industry. He stated that most of this superior productivity performance was due to Western's effective management investment decisions, and its efficiency (Tr. 94; 99). He testified that Western's productivity improvement has been better than that achieved by industry in general or by Western's own industry (Tr. 103). He presented a detailed exhibit in support of these major conclusions (Exh. No. 2).

While this particular study has not been introduced in prior proceedings, we agree with the staff that it is not the definitive information with which this Commission can find that Western's costs and prices are reasonable. The difficulty lies in the fact that proof of efficiency, increased productivity, and several price reductions, all of which we recognize, does not _ipso facto_ prove that the reduced prices are reasonable. This type of evidence is no different from Western's price comparison studies, in that it requires the Commission to accept on faith, rather than on facts, that Western's prices are reasonable.

B. Western's Earnings and Risk

In response to Commissioner Morrissey's statement that the Commission should have further detailed information "on the economic implications or consequences" of the adjustment, Pacific presented Western's Vice President for Finance (See Decision No. 74917, p. 73).

This witness sought to set forth the economic criteria for evaluating the reasonableness of Western's return (Tr. 108).

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These criteria consist of an analysis of Western's risks, and of its earnings on net investment in its Bell business, as well as its earnings on equity, compared to that of the nation's 50 largest manufacturers.

The witness stated that Western is comparable to the large manufacturing companies and that Western's earnings objective is a return about in the middle of the range of return achieved by such companies (Tr. 117). This goal amounts to a return on net investment in Bell business of between 9.5 to 10.5 percent, and a return on equity of near 12 percent (Tr. 117-8).

With regard to risk, the witness concluded that Western's risk is greater than Pacific's (Tr. 134). He found three major areas of risk for Western: (1) the risk of fluctuations in business; (2) the risk of innovation in a technologically dynamic industry; and (3) the risk arising from the obligation to meet estimated demands of the operating companies (Tr. 124-5). In addition, he stated that affiliation increases Western's risk because it cannot diversify; it must be ready instantly to meet the operating companies' needs; it must justify its performance to regulatory bodies; and it faces loss of business to competitors who offer better products (Tr. 124).

The witness introduced various exhibits which support Western's position that it is comparable with the selected group of manufacturers (Exh. Nos. 3, 10-14). The comparisons cover equity earnings, debt ratios and dividend payout ratios and others. After comparing these ratios and other statistics with those of the largest manufacturing companies, he concluded that Western is similar to a manufacturing company, and not to a public utility.

He further concluded that Western must be seen as a separate corporate entity in the electrical equipment industry, except for the caveat that the Commission should consider Western's affiliation with AT&T in making a separate determination of its risks (Tr. 1116; 1249; 1255). On the other hand, he opposed the view that Western's source of capital should have any influence in considering rate of return (Tr. 1253).

In our decision in the 1964 rate base (Dec. No. 67369, 62 Cal. P.U.C. 779 (1964)), the Commission rejected similar evidence by Pacific that Western's risks and earnings record demonstrated that it is comparable to an independent manufacturing company, and that as a result its prices to Pacific are reasonable (62 Cal. P.U.C. 779, 812). This decision was based on the ground that Pacific's position totally disregarded the unique conditions under which Western operates because of its affiliation with the Bell System. Therefore, the comparisons were rejected, even assuming that the returns of the largest manufacturing companies provided the proper criteria evaluating Western's earnings for rate-making purposes (62 Cal. P.U.C. 779, 812).

The FCC has also rejected such evidence presented by AT&T:

> "104. The company also seeks to justify Western's prices on the grounds that Western's profits have been less than those of other manufacturers. The company compares Western's earnings with the 50 largest manufacturers in the country as selected by the National Industrial Conference Board. These companies earned between 12 and 12-1/2 percent on their net investment during the postwar period 1946 through 1957, as compared to 9.1 percent for Western. Even if we were to concede that the reasonableness of a company's earnings could be evaluated merely by a comparison with the earnings of other companies, it would be an essential condition to such a comparison that the companies involved be in fact comparable. We think the record is clear that this condition has not been met. Western's type of operation, the unique conditions under which it operates, and its corporate affiliations are important factors to be considered in comparing it with other companies. There must be a common denominator for the companies involved in

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> the comparison. Our review of the record fails to disclose one. Accordingly, we find and conclude that AT&T's presentation is without probative value in demonstration of the reasonableness of Western's prices and profits with respect to its sales of equipment, services, and supplies to the operating telephone companies in the Bell System" (American Telephone and Telegraph Co. (Private Line Rates), 34 F.C.C. 244, 281 (1961)).

In evaluating Pacific's showing in this proceeding, we are asked to accept the proposition that Western is comparable to the largest independent manufacturing companies. We find this position unrealistic and untenable. There are fundamental differences between Western and the largest independent manufacturers. Almost all the 50 largest manufacturers alleged to be comparable operate in a competitive market; i.e., there is another seller present in the market and some degree of rivalry exists between them.[4/] This is not true with regard to Western. There are other manufacturers of telephone equipment, but there is no rivalry for the operating companies' business. In addition, Pacific did not segregate the 50 manufacturers found comparable into two obvious groups; one, which like Western, produces only capital goods, and the second, those which produce some or all consumer goods. Many of Pacific's 50 manufacturers produce consumer goods, and are to this extent in a different market environment.

There are other distinctive characteristics about Western. On questioning by the Commission, Pacific's witness could not name another manufacturer owned by a parent corporation which controls through its operating companies between 80 and 85 percent of the market involved (Tr. 1115). While he rejected the idea that Western

4/ The major exception appears to be International Business Machines Corp., which has been charged by the U.S. Justice Department with monopolization under Section 2 of the Sherman Act on the ground that it controls 74 percent of the computer field. (Wall Street Journal, Jan. 22, 1969, p. 1, col. 3).

has a captive market, he conceded that no other company has $3 billion in sales to an affiliate (Tr. 1162; 1176). The witness also agreed that "few, if any," companies have the same relationship with their customers as Western has with its patrons (Tr. 1232).

Nor do we agree that Western's risks are as great as it claims. Pacific's exhibits show that Western's sales to Pacific have fluctuated about to the same degree as Pacific's gross plant construction, and that Western's sales to Pacific fluctuate more than Pacific's revenues (Exh. Nos. 11, 14). Balanced against these indications that Western is confronted with risks greater than those faced by utilities, are the facts that Western's sales have steadily increased since 1958, and that the range of the fluctuation in its earnings on net investment for Bell System business for the years 1954-1966 is very narrow, only 1.2 percent (Exh. Nos. 3, p. 6; Exh. No. 159, App. No. 49142).

In terms of dollars available for interest and dividends, Western's earnings have declined in only one year between 1961 and 1968 and then only from $146.6 million in 1966 to $146.2 million in 1967 (Tr. 1195-6; Exh. No. 3, p. 7a). Only in four years of the 53 year period, 1916-1968, has Western not earned a profit on its sales to Bell Companies (Exh. No. 10, p. 4). This fact alone indicates a long term stable market, particularly in a full employment or near full employment economy.

The degree to which the Bell System market permits Western to insure the stability of its operations is shown by the fact that unlike many manufacturers, Western has never cancelled construction of a new production facility on account of change in market conditions or for any other reason (Tr. 1198). Future prospects appear to be excellent; AT&T's chairman has stated that the growth in telephone demand and in average daily calling rates has been beyond "our most optimistic forecasts" (New York Times, Oct. 2, 1969, p. 23, col. 5).

There is no question but that with such a large, assured, and growing market Western's risks are greatly reduced. The U. S. Supreme Court has observed that when a gas pipeline utility has protected established markets through affiliated distribution companies in populous and industrialized areas, its business risks have been minimized (Federal Power Commission v. Hope Natural Gas Co., 320 U. S. 591, 604 (1944)). Western is in a similar situation; almost all its market consists of affiliated operating companies. In fact, under the terms of the consent decree in the antitrust action against Western, its market is essentially limited to fulfilling the requirements of the Bell System, and to the Federal Government. It cannot establish distributorships for its products, and it cannot execute requirements contracts with independent telephone companies (United States v. Western Electric Co., 5 Trade Reg. Rep. (1956 Trade Cases) par. 71, 134 (D.N.J. 1956)).

In the face of these factors, which demonstrate Western's uniqueness and incomparability with independent manufacturers, we cannot conclude that Western's level of earnings prove that its prices are reasonable. Only by ignoring the fact of affiliation and viewing Western as a separate, independent company, do its earnings appear modest. Viewing the reality of AT&T's corporate organization, the effect of Western's affiliation can be very significant for the ratepayers of a Bell operating company. Pacific's rate base is largely a function of the prices charged by Western. The result is that even under this Commission's adjustment, AT&T receives a double profit. For example, if the rate of return for Pacific is 10 percent, and it is applied to Western on the sale of equipment costing $100, the price to Pacific becomes $110, on which Pacific likewise is permitted to earn 10 percent, or $11. The result from AT&T's point of view, is a gross return of $21, or 21 percent, on the $100 investment. The adjustment does not eliminate this double profit; it only limits Western's part of it, in terms of rate of return, to the same level as Pacific's.

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The reasonableness of the adjustment can be measured to some degree by considering the fact that the Federal Power Commission has a far stricter rule. In dealing with affiliated transactions, it will not allow a regulated utility under any circumstances to include in its rate base <u>any profits</u> paid to an affiliated corporation for supplies or services (See <u>Louisville Hydro-Elec. Co.</u>, 1 F.P.C. 130, 1 P.U.R. 454, 458; affirmed <u>Louisville Gas & Elec. Co.</u> v. <u>F.P.C.</u>, 129 F.2d 126 (6th Cir. 1942), cert. denied, 318 U.S. 761 (1943); <u>Pennsylvania Power & Light Co.</u> v. <u>F.P.C.</u> 139 F.2d 445, 450 (3rd Cir. 1943); <u>Florida Gas Transmission Co.</u>, 31 F.P.C. 1402, 54 P.U.R. 3rd 498, 504 (1964); reversed on the ground that no affiliation existed, <u>Florida Gas Transmission Co.</u> v. <u>F.P.C.</u>, 362 F.2d 331 (5th Cir. 1966)).

Viewed in this light, the adjustment is not unreasonable. There has been no showing that under it Western separately, or AT&T collectively, have failed to maintain their credit position in the capital market or to attract additional capital. As the U.S. Supreme Court has observed, affiliation with large corporations can place a utility in a strong position for future financing (<u>Federal Power Com.</u> v. <u>Natural Gas Pipeline Co.</u>, 315 U.S. 575, 597 (1942). Whether viewed as a manufacturer or a utility manufacturing department, Western's financing ability is strong. Its sales and earnings in terms of dollar amounts have grown significantly over the years. Income available for interest payments and dividends to its only stockholder, AT&T, increased 30 percent in 1968 from 1967 (Exh. No. 3, p.7a). Its earnings before taxes cover interest payments by a factor of fifteen (Tr. 1314; 1317). Its amount of debt is low. There have been no business failures in the Bell System. We conclude, therefore, that on this record the reasonableness of Western's prices is not demonstrated by a study on the amount of profits accruing from these prices which is based upon the theory that Western is comparable to an independent manufacturing company.

C. Applicability of the recent General Telephone Decision.

In our recent decision concerning the rates of the second major telephone company operating in California, the Commission was faced with another affiliate-supplier situation in that General Telephone Co. (General) wholly owns its supplier, Automatic Electric Co. (Automatic). In that proceeding we decided to limit Automatic's return on its sales to General to a "12 percent return on equity, a return which may be slightly generous" (General Tel. Co. of California, Dec. No. 75873 in App. No. 49835, dated July 1, 1969, p. 57 mimeo).

In light of the General decision, Pacific insists that Western must be given the same level of equity return. It asserts that there are no significant differences between the Western Pacific and the Automatic-General relationships (Pacific brief, p. 12). As a consequence, Pacific contends that due process and equal protection under the Fourteenth Amendment require the Commission to provide for exactly the same level of return in the Western Electric adjustment as it permitted to Automatic in the General case.

In denying that there are any "pertinent differences" between the Western and Automatic situations, Pacific has set forth in its brief numerous financial statistics which compare the two (Pacific brief, p. 8-11). Pacific also denies that the four distinctions between Western and Automatic which the Commission has found significant in the past have any bearing on the purpose of the affiliate adjustment. Therefore, Pacific argues, they are meaningless; Western and Automatic are affiliated producers with corresponding risks, and equal protection requires equal treatment.

This argument is without merit. Pacific overlooks the different historical background between the two companies; the important difference in the market situations; and, most important, that under individual company cost-of-service regulation each public utility's rates and any adjustments applied to the utility are set to fit the particular circumstances of that one company viewed during a particular test year.

While Western has been part of the Bell System since 1882, Automatic did not become affiliated to General until 1955. In the 1958 rate case involving General, therefore, our experience with General's affiliation was very short. The Commission rejected the staff's recommendation that an adjustment identical to that applied to Pacific and Western be adopted:

> "While the evidence in this proceeding indicates that certain analogies may be drawn between the applicant-affiliate and the Pacific-Western 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 aspects and there are numerous distinctions between the corporate relationships and the methods of transaction of business of the two." (Gen.Tel.of Calif., Dec. No. 57076, 56 Cal. P.U.C. 477, 481-482 (1958).)

In making this determination, the Commission gave considerable weight to evidence that more than 58 percent of the sales by General's affiliates were made in the competitive market to nonaffiliated customers (56 Cal. P.U.C. 482-3).

In the recent General rate case, the market situation Automatic operates in was found to have changed. Automatic was found to be only partly in a competitive market situation (General Tel. of Calif., Dec. No. 75873 in App. No. 49835, July 1, 1969, pp. 56-7 mimeo). As a result of corporate acquisitions and growth

79 percent of Automatic's sales were found to be affiliates. The Commission decided that an affiliate price adjustment was necessary, but that in our judgment differences existed to a degree that the Western Electric type adjustment was not appropriate:

> "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." (Gen. Tel. of Calif., Decision No. 75873 in App. 49835, July 1, 1969.)

Nevertheless, the adjustment was not insignificant. General's purchases from Automatic were adjusted to reflect a 12 percent return on equity for Automatic, where before its average equity return was 26.3 percent for the 1959-1966 period. On sales to General, this amounts to a 50 percent reduction in this return. In addition, at the same time we stated that circumstances in the future may require application of the Western type adjustment:

> "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 non-affiliated telephone companies, and other pertinent considerations, will require us to make a Western Electric type of adjustment." (Id. at p. 77.)

Likewise, the market situations that Western and Automatic operate in are not the same. Western has a huge captive market while Automatic has one much smaller (Tr. 6265, App. No. 49142). Insofar as its decreasing nonaffiliated sales are concerned, Automatic operates partly in a competitive market. Since the Commission has had only 14 years experience with the General-Automatic affiliation, we declined to apply a Western type adjustment. At the same time, the application of such an adjustment at sometime in the future was not disavowed.

Pacific claims that Western's larger dollar volume of non-affiliated sales ($658.6 million), as compared to Automatic's

($168 million), prevents any different treatment by the Commission. However, almost all of Western's nonaffiliated sales are to one customer, the U. S. Government. The figures also serve to indicate how small a share of the nation's telephone business is available to the suppliers of the independent telephone companies.

Pacific's argument that due process and equal protection require equal treatment with Automatic is clearly misplaced. Under the traditional method of regulation of public utilities, rates are fixed for each utility company which will cover its costs and in addition provide its stockholders with a specified fair return on their investment in the enterprise. No single formula, or combination of formulas is required (Federal Power Com. v. Natural Gas Pipeline Co., 315 U.S. 575, 586-7 (1942)). Pragmatic adjustments are permissible as long as, viewed in its entirety, the impact of the rate order is not unjust or unreasonable (Federal Power Com. v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944)). The return provided should be "commensurate with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" (320 U.S. 603). But regulatory agencies cannot confine their inquiries "either to a computation of costs of service or to conjectures about the prospective responses of the capital market"; rather a regulatory agency "is obliged at each step of its regulatory process to assess the requirements of the broad public interests ..." (Permian Basin Area Rate Cases, 390 U.S. 747, 791(1968).

Relying upon the statement in Hope that the return should be equivalent to that received by companies with corresponding risks, Pacific contends that the Commission's adjustment in the Pacific-Western relationship must provide the same result as far as Western's equity return is concerned, as was permitted in the General-Automatic situation. This argument ignores the fact that fixing rates for each telephone utility must necessarily be on a separate basis. Costs, corporate financial structures, corporate history, as well as financial conditions, service practices and conditions vary between companies. Ratemaking policies found applicable to one may not be reasonable to another. The history of the affiliation is an important factor. Several years of operations must pass before a regulatory body can have sufficient information and data upon which it can rely in determining such an important issue as an adjustment based upon the conduct of affiliated companies. Pacific's position is tantamount to requiring that as a matter of law all utilities operating under similar circumstances must receive exactly the same treatment on all issues, including rate of return. There is no such requirement in the Hope decision. Pacific's reliance upon various cases dealing with discriminatory classifications of persons and businesses established by specific state statutes is misplaced (Pacific brief, p. 12-17). The rates, allowances or disallowances for costs, and rate of return for each utility established under the jurisdiction of a regulatory commission empowered to determine just and reasonable rates, necessarily depend upon the facts and circumstances involved in each proceeding.

II. THE CALIFORNIA FRANCHISE TAX ADJUSTMENT

This dispute has arisen because Pacific files and pays its California Franchise Tax (the state's corporate income tax) on a combined report basis with AT&T and all its affiliates. In each of the last two rate cases, however, the Commission has accepted the staff's recommendation that Pacific's tax should be computed on a separate return basis in order to insure that Pacific receives an allowance for state income tax which is limited to its intrastate utility operations. In making this recommendation, the staff used the "source-of-taxable-income method", which involves an estimate of Pacific's taxable income generated from its California utility operations only (Exh. No. 77, App. No. 49142, p. 12-6). This method is also used by both the staff and Pacific for determining the Federal income tax allowance.

Pacific maintains that its tax payment under the combined report method should be accepted in full by the Commission. The staff opposes such acceptance on the ground that Pacific is not required to pay its tax on a combined report basis, and that even if it is, the claimed tax expense is unjust and unreasonable to the extent that it is based on earnings of AT&T's other out-of-state subsidiaries and its interstate operations.

When all the income of a corporation doing business in California is attributable solely to sources in this state; i.e., when all its operations are in California, the company's book income is utilized to determine its income tax. When a corporation derives income from out-of-state, because it either has operations outside the state itself, or because it is part of a larger, multistate business enterprise which the Franchise Tax Board (Board) classifies as unitary in nature, the book income of the company's California business is not utilized by the Board. Instead, it uses for tax purposes the business income of the entire enterprise, i.e., the combined income of all the company's divisions or affiliates, regardless of the location of their operations. This is accomplished by requiring a combined report, or return, to be filed. It applies a three-factor apportionment formula to this unitary income figure to derive the amount of income attributable to California sources. The Board then applies the tax rate to this amount.

The Board considers Pacific to be part of a unitary business enterprise, because it is an operating company of the Bell System. This unitary business is the nationwide telephone communications service operated and managed by AT&T. Consequently, the Board requires that Pacific file a combined income tax return which utilizes the total Bell System unitary business income. In 1967, this Bell System unitary income came to $3.76 billion (Exh. No. 7). Under the three-factor apportionment formula based upon California wages, property and gross revenues, the portion of this total Bell income allocated as income attributable to the Bell companies operating in California was $418.9 million. Income tax on this sum came to $29.3 million.

Since four Bell System companies operate in California, the $418.9 million of California net taxable income was in turn apportioned among Pacific, AT&T, Western, and Bell Telephone Laboratories, Inc., by means of the three-factor apportionment formula, as follows:

Company	Share of California Taxable Income	Amount of Tax Liability	Percent Share of Tax
AT&T	$ 5,489,251.43	$ 384,247.60	1.3%
Pacific	399,764,785.83	27,983,535.01	95.4%
Western Electric	13,721,249.98	960,487.50	3.3%
Bell Tel. Labs.	11,271.56	789.01	0%
Total	$418,986,558.80	$29,329,059.12	100.0%

Up to 1960 Pacific had filed its tax return on a separate return basis. Commencing in 1958, however, the Board requested that Pacific submit the data necessary for determining its tax on a combined report basis. Pacific did so, but it resisted the Board's position that such a report was reasonable or fair. Pacific's Assistant Comptroller testified that after a conference with the Board's representatives, Pacific's attorneys, who represented both AT&T and Pacific, concluded that a combined report should be filed by the Bell System and that Pacific should litigate the question. In 1962 Pacific initiated suit against the Board to test the assertion that it must file a combined return. After the Supreme Court issued opinions in 1963 in two cases[5/] involving the same subject, however, Pacific's attorneys stipulated to withdraw this particular issue.

The staff contends that since Pacific has refused to litigate the issue whether it is the victim of arbitrary action under the Board's interpretation, it has in effect voluntarily filed its tax returns on the combined basis. In particular, the staff points to the absence of any specific order or directive from the Board which expressly requires Pacific to file a combined return.

We do not entirely agree with this contention of the staff. It is more accurate to say that Pacific has agreed to file a combined report on advice of counsel and its own accountants. We will not speculate on the wisdom of the advice that as a result of the Superior and Honolulu decisions Pacific has no choice in this regard (See Memorandum Opinion, Pacific Tel. & Tel. Co. v. Franchise Tax Board, No. 5272222, S.F. Sup. Ct., p.4). Any conclusion to the contrary would likewise be conjectural. Nevertheless, the testimony of the Board's Assistant Executive Officer, who appeared on behalf of

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5/ Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 (1963).

Pacific to explain the Board's position, adequately demonstrates that it views Pacific as merely a unit of a larger, unified and centrally directed enterprise (Tr. 1046-54; 1058-59).[6/] In addition, the record shows that the Board's position appears to be similar regarding the tax return of the General Telephone Co. (TR. 927-8).

Nor do we accept the staff's position that the Superior and Honolulu decisions have been overruled by the enactment of Revenue and Taxation Code (R&T Code) Section 25137 as part of the Uniform Division of Income for Tax Purposes Act (R&T Code Sections 25120-25139). At the very most that section merely permits a taxpayer to petition the Board for separate accounting treatment. All that can be said is that AT&T and Pacific have declined to file such a petition. We conclude that it is reasonable to assume that, absent a court decision to the contrary, Pacific is required to file a combined return as part of the Bell System. This assumption does not resolve, however, the question whether all the entire tax expense claimed under this type of return should be recognized in setting rates on Pacific's intrastate operations.

The question raised by the Commission staff is whether Pacific's taxes as determined by use of the Bell System combined return is reasonable for the purposes of fixing intrastate rates. On the one hand, Pacific argues that since it pays the tax under a combined return the Commission should recognize the entire amount

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6/ This witness did not express any view as to what amount of taxes should be recognized by this Commission for ratemaking purposes (TR. 1071).

of $27.9 million for 1967. It criticizes the staff's tax calculation under its source-of-taxable-income method as hypothetical, contrary-to-law and unfair to Pacific because it is not applied to any other utility.

On the other hand, the staff urges that we confirm as reasonable its source-of-taxable-income method. This method concentrates on Pacific's intrastate operations, and it is intended to allow Pacific those tax expenses directly associated with intrastate operations. Under this method Pacific's 1967 net state taxable income totals $305.7 million, or about $94 million less than allocated to Pacific on the combined return. Its tax amounts to $21.4 million, resulting in a difference of $6.6 million from the combined report (Exh. No. 15, p. 3).[7/]

The staff presented an Associate Utilities Engineer in support of its position. He testified that the staff studied the merits of both its and Pacific's methods, and concluded that its method is reasonable for ratemaking purposes because it is more closely related to Pacific's California operations. He found the result under the combined report to be unreasonable because the tax applied to Pacific is greater than its California operations

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7/ This difference of $6.6 million is not the amount of the adjustment or disallowance. In terms of revenue requirements (i.e., how much rates would have to be increased to render Pacific whole on this item) Pacific's Assistant Comptroller stated that after giving effect to Decision No. 74917, the adjustment or disallowance for 1967 is $2.5 million (TR. 1097-8).

should require. It is greater because by applying the three factor formula to the taxable income of the entire Bell System, Pacific is taxed on profits received by other Bell System affiliates operating outside California or from AT&T's interstate and holding company operations.

Several comparisons concerning the effect of the two methods were advanced by the staff. One shows that the difference between the two methods in the amount of tax applicable to Pacific is declining. While the difference for 1967 was shown to be $6.6 million, the difference declined to $5.8 million for 1968, and after allowing for the effect of the $50.2 million rate increase granted in Decision No. 74917, this difference is estimated to be only $2.8 million in 1969 (Exh. No. 7, p. 3). The staff study also shows that eventually, when Pacific's gross revenues after uncollectibles are greater by $115.95 million than those revenues for 1967, the tax allowance under the staff's method will be greater than under the combined report method (Exh. No. 7, p. 8. Chart 1).[8/]

Two specific comparisons were advanced to show the unreasonableness of the result if the combined report method is adopted. One shows that under it Pacific would be allocated $344 million as its net taxable income, which results in a tax of $24.1 million, even if Pacific's had no net revenues in 1967 (Exh. No. 7, p. 9-10). The other shows that if an out-of-state Bell System affiliate, the New York Telephone Co., was granted a $175 million rate increase on its intrastate operations, Pacific's tax liability under the combined report would increase $1.18 million (Exh. No. 16).

8/ The estimate of $115.95 million does not include the effect of the $50.2 million rate increase granted in Dec. No. 74917.

It is true, as Pacific asserts, that normally the Commission endeavors to permit a tax allowance in rate-making proceedings which "reflects, as nearly as possible, taxes actually paid and the methods of tax calculation authorized under Federal and State laws" (Greyhound Lines, Inc., 64 Cal. P.U.C. 641, 653, (1965)). However, in the last two decisions regarding Pacific's rates, we accepted the staff's contention that an adjustment of Pacific's tax was required "in order to relieve California ratepayers of the burden of assuming taxes on AT&T's holding company functions ..." (Dec. No. 67369, 62 Cal. P.U.C. 779, 868 (1964); Dec. No. 74917, p. 12). Furthermore, the Supreme Court specifically held in its review of Decision No. 67369 that this adjustment is reasonable for rate-making purposes (Pacific Tel. & Tel. Co. v. Public Utilities Comm., 62 Cal. 2d 634, 664-665 (1965)).

While we will assume that Pacific is required to pay its taxes under the combined report method, we are concerned about the effect such a tax return has upon determining the reasonable tax expense for Pacific's intrastate operations. The fact remains that under the combined report, it is likely that interstate and intrastate profits earned out-of-state by Bell System companies will be allocated to Pacific by means of the three factor formula. This situation is similar to the separations question; namely, how are the telephone utilities' plant and operations to be separated between interstate and intrastate functions for rate-making purposes.

If interstate or non-Pacific intrastate income is taxed by the Board, and this tax is included in Pacific's cost-of-service, the Bell System may receive from its various interstate and intrastate rates, more money for taxes than it is actually required to pay. On the other hand, if out-of-state intrastate income is assigned to Pacific by the Board's apportionment method, the California tax paid by Pacific on such income may not be recovered in the rates of these other Bell companies because the states in which they operate may well have a different apportionment method. From the Bell System point of view, the result may be that on a nationwide basis, state taxes levied against all the operating companies may exceed the total tax expense allowances permitted by the states' various rate-fixing bodies. But it is also possible that the opposite result occurs; the total state tax allowance in all Bell's rates (interstate and intrastate) exceed the total state taxes paid, resulting in an excessive burden on the ratepayers. Obviously, this Commission can only attempt to deal with the California aspects of this problem, and try to achieve a reasonable balance of this conflict between the interests of the California ratepayers and AT&T.

It must be recognized that the $3.7 billion Bell System unitary business income figure appearing on the combined report (Exhibit No. 7) appears to contain at least three types of income: (1) the interstate profits from telephone operations of all the Bell companies, including those of AT&T's Long Lines Department; (2) the intrastate profits of the various Bell operating companies; and (3) the profits of AT&T from its holding company operations. It must also be recognized that to the extent interstate profits are included, the interstate rates established by the FCC presumably include an allowance for state taxation of Bell's interstate operations. 9/

9/ Although the subject of state taxation of income from interstate commerce has been judicially described as a "quagmire", there is no question that states may impose a net income tax on foreign companies having a sufficient nexus with the taxing state, provided that these taxes are nondiscriminatory and fairly apportioned (Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457 (1959).

Therefore, the inclusion by the Commission of an allowance in the intrastate rates of Pacific to cover any state taxes on any of Bell's interstate income would result in the double collection of these taxes.

The record does not contain a breakdown of this Bell System unitary income figure by these types of income, or of the $418.9 million portion of it assigned to California. Consequently, we do not know how much of the $418.9 million can fairly be said to be interstate income of the Bell System apportioned to Pacific. It seems reasonable to conclude, however, that upon considering the growing volume of interstate telephone traffic, this interstate income is considerably greater than the $5.49 million assigned to AT&T by the Board's apportionment formula. Since 95.4 percent of the total California tax on the Bell System is allocated to Pacific, a significant, but unknown portion of this tax must reflect California's tax on Bell's interstate operations.

In addition to the problem presented by the presence of interstate income in the combined report, there is the further problem that some out-of-state intrastate income of the Bell System may be assigned to Pacific. Acceptance of Pacific's position could result in the assignment of large amounts of out-of-state earnings by other Bell System companies to Pacific. In this regard, Pacific's Assistant Comptroller agreed that the staff's figure for Pacific's taxable income ($305.7 million; Exh. No. 15, p. 3) was closer to its 1967 recorded results of operation than the figure which results from the use of the combined report. (Tr. 982-3.) He estimated that the operating income of Pacific, excluding its subsidiaries, came to $212.3 million (Tr. 1096); and that Pacific's taxable income figure would approximate $307.3 million on a California separate return basis (Tr. 1095). It can be seen, therefore, that the staff's calculation is closer to these two amounts than the combined report's figure of $399.7 million.

While the above factors give weight to the staff's calculation as reasonable for rate-making purposes, its witness admitted that the source-of-the-taxable-income method produced a different result than would occur if a separate California Franchise tax return was actually made by Pacific (Tr. 1445). The staff further indicated that a fourth and different figure would result if Pacific's taxable income was determined on a Separations Manual basis (Tr. 1452). Except for the estimate that Pacific's separate return taxable income figure would be about $307.3 million, neither of these calculations was introduced in detailed form. A more informed decision might result if all four figures were presented to the Commission in the next rate proceeding.

We conclude that the subject of Pacific's tax allowance should receive further consideration in the next rate proceeding. In particular, we would like to see if the difference between the two methods submitted in this proceeding is shrinking in accordance with the staff's prediction. If it is, the difference may become <u>de minimus</u> for rate-making purposes. We would like to see not only the detailed figures for the two methods submitted herein, but also the computation of Pacific's taxable income as developed by means of a separate California Franchise tax return, and as developed on a Separations Manual basis. If it is possible, a fifth calculation, which segregates the total Bell System income apportioned to California under the combined report into the specific types of income it includes, would be worthy of consideration. In this manner, it may be possible for the Commission to make a better informed judgment regarding this question.

III. PACIFIC'S REQUEST FOR IMMEDIATE RATE RELIEF

Pacific requests that the Commission amend Decision No. 74917 in App. No. 49142, dated November 6, 1968, to allow the collection of increased rates sufficient to compensate for the Western Electric and California tax adjustments (Pacific brief, p. 50-3). This rate increase amounts to $8.4 million. The increase would be accomplished by changing four specific rate mileage segments for Pacific's intrastate toll rates (Pacific brief, p. 52).

This request is denied because we have concluded that insofar as the Western Electric adjustment is concerned, Pacific has not introduced convincing evidence or reasons to justify its termination. With regard to the tax adjustment, we also deny the request because this proceeding was commenced only to receive and consider additional evidence concerning the two adjustments. It was not intended to take up the subject of which rates should be revised, or by how much, in the event that Pacific's evidence fulfilled the burden of proof. More important, no hearing has been held on the specific rate changes proposed by Pacific. Since rates would be permanently increased under Pacific's request, the public, as represented by the Commission staff, as well as the municipal and other intervenors, are entitled to a hearing on any such request. None has been held.

Pacific's reliance upon Section 1708 of the Public Utilities Code is incorrect. That section calls for providing the public utility the opportunity to be heard as in complaint cases. Our complaint procedure requires that the adverse party be given the opportunity to answer and be heard. Due process requires that such an opportunity be provided for the parties adverse to Pacific herein.

Findings of Fact

The Commission finds that:

1. This proceeding was initiated by the Commission as an outgrowth of its most recent rate decision involving Pacific: Decision No. 74917 in Application No. 49142, dated November 6, 1968.

2. The purpose of this proceeding was to allow Pacific to adduce evidence with respect to the reasonableness of the prices paid by it to Western as related to Western's costs and profits for products it manufactures and sells to Pacific; and for the purpose of further consideration of the effects and treatment of Pacific's California Franchise tax for rate-fixing purposes.

3. Pacific presented evidence regarding Western's operations which included a price comparison study of Western's prices with those of independent manufacturers of telephonic equipment; its efficiency; its earnings and business risks compared to those of the 50 largest manufacturing companies as reported in Fortune Magazine; and its standard cost system as reported annually to the Staff Committee on Communication Problems of the NARUC.

4. Viewing this evidence in its entirety, and for the reasons set forth in the opinion above, we find that it is repetitious of the evidence presented by Pacific in past proceedings, and it is not sufficient to justify a finding that Western's prices to Pacific for equipment manufactured by Western are reasonable.

5. With regard to the California Franchise tax adjustment, we have considered Pacific's and the staff's testimony, exhibits, and arguments. The record shows that the difference between the staff's source-of-taxable-income method for determining Pacific's reasonable state income tax allowance, and Pacific's combined report method, may be diminishing. The record also shows that there are other

possible computations of the amount of tax which Pacific should reasonably be allowed for rate-making purposes, which were not presented in detailed form during this proceeding.

6. We find that the state income tax adjustment should be reviewed in the next proceeding in which it is involved in order that the Commission may be more fully informed as to the makeup of Pacific's taxable income for California tax purposes, thereby providing the Commission with the opportunity to make as well informed a judgment as possible on this expense item in balancing the interests of Pacific's ratepayers and its owners.

O R D E R

IT IS ORDERED that investigation under Case No. 8858 is discontinued.

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

Dated at ______________________, California, this ______ day of ___________________, 19__.

Appendix A

LIST OF APPEARANCES

Pillsbury, Madison & Sutro, by George H. Eckhardt and Richard W. Odgers, for The Pacific Telephone and Telegraph Company, respondent.

A. M. Hart and H. Ralph Snyder, Jr., by H. Ralph Snyder, Jr., for General Telephone Company of California; Roger Arnebergh, by Charles E. Mattson, for the City of Los Angeles; Louis Possner, for the City of Long Beach; Robert W. Russell and Manuel Kroman, for the Department of Public Utilities and Transportation, City of Los Angeles; Thomas M. O'Connor, by William C. Taylor and Robert L. Laughead, for the City and County of San Francisco; William M. Bennett, in the public interest; Curtis M. Fitzpatrick, for the City of San Diego; Lt. Colonel Frank J. Dorsey and Gerald P. Flannery, for the Department of Defense and all other executive agencies of the United States; Michael Peevey, for the California Labor Federation; Robert E. Burt, for the California Manufacturers Association; W. Knecht, for the California Farm Bureau Federation; Thomas C. Lynch, by Donald B. Day, for the State of California; Mrs. Borghild Haugen, for California Farmer Consumer Information Committee; and Sylvia M. Siegel, for Association of California Consumers, interested parties.

Hector Anninos, Leonard L. Snaider, Counsel, and Bruno Davis and John Gibbons, for the Commission staff.

C. 8858
D. 76726

THOMAS MORAN, COMMISSIONER, Dissenting:

I dissent, although I do not disagree with the substance of the Findings and Conclusions set forth in the majority Opinion, because in my judgment said Findings and Conclusions are more extensive than is appropriate in a proceeding of this nature which does not involve the fixing of rates.

Thomas Moran
Commissioner

Dated: San Francisco, California
January 27, 1970