

ORIGINAL

Decision No. 76852

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application
of California-Oregon Telephone Co.
for authority to increase rates.

Application No. 50990
Filed April 7, 1969

John S. Middleton, for applicant.
R. T. Perry, for the Commission staff.

O P I N I O N

By this application (filed April 7 and amended July 14, 1969) California-Oregon Telephone Co., a California corporation, seeks authority to increase its rates for telephone service rendered within Modoc and Siskiyou Counties.

After due notice, including notice to each of applicant's subscribers, public hearing in the matter was held before Examiner Emerson on September 16, 17 and 18, 1969, at Klamath Falls, Oregon. The matter was submitted subject to the receipt of late-filed exhibits (Nos. 10 and 11) which are now at hand and the matter is ready for decision.

Applicant is a wholly owned subsidiary of United Telephone Company of the Northwest (an Oregon corporation) which in turn is a subsidiary of United Utilities, Incorporated (a holding company incorporated in Kansas). Applicant provides exchange service to approximately 1,360 company telephones in two exchanges (Tulelake and Newell), toll-station service to 13 stations and a mobile radio-telephone service provided to 27 mobile units. The overall exchange areas cover about 172 square miles, primarily agricultural in nature.

Continuous dial service is provided and direct distance dialing (DDD) is available to subscribers through a three-digit access code. Operator service is provided by applicant's parent at the latter's Merrill office in Oregon. Applicant's system connects with United Telephone Company of the Northwest, with Pacific Northwest Bell Telephone Company and with Citizens Utilities Company of California.

Applicant's presently effective rates were established in 1951. The exchange rates which applicant now proposes, and which would yield approximately \$26,457 in increased annual revenues, are compared with existing rates in the following tabulation.

Comparative Monthly Exchange Rates

	<u>Present Rates</u>	<u>Proposed Rates</u>
<u>Business:</u>		
1-party	\$6.25	\$10.25
2-party	5.25	8.25
4-party suburban	-	7.00
10-party suburban	4.75	6.50
Extension telephone	1.50	1.75
<u>Residence:</u>		
1-party	3.75	5.50
2-party	3.25	4.75
4-party	2.75	4.00
4-party suburban	-	4.60
10-party suburban	3.50	4.25
Extension telephone	1.00	1.25

The proposed exchange rates would provide an approximate 33 percent increase in gross revenues. In addition, applicant seeks an increase of about 119 percent in advertising, 25 percent in auxiliary items and 60 percent in service connection revenues.

The evidence shows that at the end of 1950 (the test year used in applicant's last rate proceeding) applicant's investment in telephone plant in service was \$182,500. Since such year, applicant has erected a central office building at Tulelake, has expanded and remodeled its Newell central office and has made major equipment

additions therein, has established direct distance dialing service, has replaced substantial amounts of open-wire plant with cable plant, has installed standby-power facilities, has established mobile radio-telephone service (IMTS), has added data processing and automatic ticketing facilities and methods and has generally upgraded and improved its service. With the presently existing plant and facilities, service in both exchanges can be further upgraded to one- and two-party service in the base rate area and to four-party service in the rural areas (at additional plant costs of approximately \$60,000). At the end of 1968 applicant's gross plant investment was recorded at a total of \$720,760 with a depreciation reserve of \$108,561, thus showing a net plant in service of \$612,199. Applicant makes use of the accelerated depreciation options of the Internal Revenue Code and "flows-through" to the benefit of its customers the tax saving resulting therefrom. It also flows-through investment tax credit to the benefit of the customer.

Both the applicant and the Commission staff presented detailed analyses of applicant's earnings position; applicant for the four years of 1965 through 1968, the staff for the years 1967 and 1968. During the four-year period applicant's total plant, including allocated plant, grew from \$734,472 to \$1,037,780, while its main station growth was only 50 stations. During the same period the revenues increased from \$187,532 to \$282,849 and its

operating expenses increased from \$150,611 to \$228,990. These effects may perhaps be more clearly shown as follows:

Data from Exhibit No. 1

	<u>1965</u>	<u>1968</u>	<u>Percent Increase</u>
Main stations, year-end	854	904	5.9%
Total plant	\$734,472	\$1,037,780	41.3
Plant per main station ..	860	1,148	33.5
Revenues	187,532	282,849	50.8
Revenue per main station	220	313	42.5
Expenses, including taxes ..	150,611	228,990	52.0
Expenses per main station	176	253	43.6

This tabulation illustrates that expenses have increased at a greater rate than have revenues, both on a total and on a per-station basis. At the same time the costs of plant per station have markedly increased. The overall effect of such changes is to lower earnings to the point that rate relief becomes necessary.¹ On the basis of applicant's showing, its overall rate of return in 1968 was 6.36 percent on a depreciated rate base of \$840,909. Its rate proposals would produce a rate of return of 7.75 percent on such rate base.

Applicant's presentation respecting intrastate exchange earnings shows a 1968 rate of return of 3.44 percent on a rate base of \$288,016 under existing rates and a rate of return of 7.48 percent on the assumption that the proposed rates had been effective for such year. Applicant's rate increase proposals, of course, are in this intrastate exchange category.

The Commission staff examined the books and records of both the applicant and its parent. As a result of such examination,

¹ In 1969 (1968 is the test year in this proceeding) applicant also had to meet negotiated wage increases effective in March and September.

the staff took no exception to applicant's revenue accounting procedures and it found that applicant's separations procedures, as applied to revenues, expense and plant items, closely followed those set forth in the NARUC Separations Manual.

The presentations of applicant and the staff respecting the results of applicant's earnings in 1968 will be analyzed in two parts, the first showing elements wherein the two are in close agreement and the second wherein major differences appear. The following tabulation sets forth a comparison of those elements wherein staff and applicant are in close agreement respecting applicant's overall operations.

Comparison of 1968 Results of Operations
(Partial or Selected Items)

	<u>Applicant</u>	<u>Staff</u>	<u>Differ- ence</u>
<u>Revenues</u>			
Local Service	\$ 77,805	\$ 77,800	\$ 5
Miscellaneous	2,592	2,600	8
Uncollectibles	1,031	1,000	31
Subtotal	<u>81,428</u>	<u>81,400</u>	28
<u>Expenses</u>			
Maintenance	36,718	36,700	18
Traffic	37,829	37,800	29
Commercial	15,916	15,900	16
Accounting and General ..	27,777	27,800	23
Other	11,427	11,500	73
Payroll Tax	897	900	3
Property Tax	24,311	24,300	11
Subtotal	<u>154,875</u>	<u>154,900</u>	25
<u>Rate Base</u>			
Direct Telephone Plant ..	690,299	690,299	0
Allocated Telephone Plant	317,020	317,020	0
Staff Plant Adjustment (Average)*	-	3,432	3,432
Depreciation Reserve ...	(191,474)	(191,474)	0
Materials and Supplies ..	13,000	13,000	0
Working Cash	10,806	10,806	0
Depreciated Rate Base	<u>846,493</u>	<u>843,061</u>	3,432

* Based on correcting entries for 1966-1967 data
(subtractive item)

Not included in the foregoing comparison tabulation are the items of Toll Service Revenues, Depreciation Expense and Taxes on Income. A summary comparison of these items is as follows:

	<u>Applicant</u>	<u>Staff</u>	<u>Differ- ence</u>
Depreciation Expense	\$ 60,683	\$ 52,900	\$ 7,783
Taxes on Income	24,599	5,108	19,491
Toll Revenues	203,483	187,000	16,483

With respect to depreciation expense, applicant used the results of a depreciation study (Exhibit No. 7) prepared for it by The American Appraisal Company, a nonaffiliated organization, which in overall effect would add \$11,167 to applicant's present annual provision for depreciation. When properly applied, such added sum would have produced an annual amount of \$51,782 instead of applicant's claimed \$60,683 amount. Such corrected figure was stipulated to by applicant. The staff-derived amount of \$52,900 was determined by its customary method of applying the straight-line remaining life principle long adhered to by this Commission. It is fair and reasonable and will be adopted herein.

The substantial differences involving estimated income taxes, shown in the foregoing tabulation, basically arise from the staff's having substituted a hypothetical capital structure (that of United Telephone Company of the Northwest) for applicant's actual capital structure. The net effect of such substitution would be to inflate net operating income, by increasing interest charges (a "below-the-line" item) and thus decreasing taxes (an "above-the-line" item). Insofar as a determination of applicant's earnings position is concerned in this proceeding, this matter of substitution of the capital structure of applicant's parent for applicant's

own structure is the major issue. The respective structures as of December 31, 1968, are:

	<u>Applicant</u>		<u>Parent</u>	
	<u>Amount</u>	<u>Percent</u>	<u>Amount</u>	<u>Percent</u>
Debt	\$215,502	34.8%	\$14,756,500	52.7%
Preferred Stock ...	0	-	595,000	2.1
Common Stock Equity	404,463	65.2	12,660,595	45.2
Total	<u>619,965</u>		<u>28,012,095</u>	

Applicant's annual reports to this Commission show that in 1958 its debt-equity ratio was 27.5 percent debt. It was in this year that applicant was acquired by its parent. In 1959 the ratio became 31.3/68.7 and its debt has since gradually risen to that shown above. Applicant's president testified that it is the goal of both the applicant and its parent to achieve approximately a 50/50 debt-equity ratio but that because of the very slow customer growth in applicant's service area, investment opportunities are limited and thus it is not possible to accomplish a substantial change in its debt-equity ratio in any short period of time. It is applicant's position that risk factors are great enough not only to warrant but to require a large equity participation in the capitalization of the company at this point in time. It strenuously objects to a lowering of its existing 65 percent equity position, to the 45.2 percent equity position of its parent, for the purposes of this rate proceeding when the fact is that such change cannot actually be presently accomplished.

The staff witness's position respecting this matter of capitalization is basically that set forth in this Commission's Decision No. 65209 in Application No. 44162 issued April 9, 1963 (rate increase application of West Coast Telephone Co. of California) wherein the Commission substituted the capital structure of the parent for the capital structure of the subsidiary in determining

income tax expense for rate-making purposes. In that proceeding, the applicant company met its capital requirements, in excess of those generated internally, through its parent. Here, as in the West Coast matter, the staff urges that the benefits of income tax reductions which the parent derives should be shared with applicant and thus with applicant's customers. We find no fault with the principle involved and it is not our present intention to upset it.

If we are to apply it to the present case we must be certain that the facts surrounding the two cases are reasonably comparable. Such certainty is not apparent, for in the present case we find that all of applicant's capital stock is owned by United Telephone Company of the Northwest and that the latter's outstanding capital stock is in turn owned by United Utilities, Incorporated, which has a 63 percent debt ratio. It is reasonable to assume that, under such compounded ownership situation, the funds available to applicant are provided through both. Thus, three entirely different capital structures may be involved rather than the two which were considered by the staff. Further, the evidence (Exhibit No. 8) shows that United Utilities files a consolidated tax return, but the staff tax computations (shown in Exhibit No. 3) must have been based upon the assumption that an individual tax return would be filed by each segment.

Under the circumstances prevailing in this particular proceeding and in view of the foregoing analysis of the factual situation, it is our opinion that a fair and reasonable result can be achieved by recognizing applicant's own capital structure and cost of money in arriving at a determination as to what constitutes a reasonable rate of return for applicant for the test year here involved.

With respect to the difference in toll revenue shown in the foregoing tabulation, such difference arises from the interest element of the tax expense (above discussed) as it influences toll settlements and also from the fact that such revenues are estimated amounts. Actual toll settlement amounts for the year 1968 became known only after submission of this matter. Applicant has informed the Commission respecting the actual results by its letter of November 6, 1969 and the staff has provided the Commission with an analysis thereof by a document dated November 18, 1969, under its file number J-1317. It is fair and reasonable to consider this factual material, hence the Commission hereby receives it in evidence as Exhibit No. 11 in this proceeding. Insofar as the evidence is germane, we shall use the actual settlement figure of \$176,114 for the test year 1968 revenue rather than applicant's estimate of \$187,513 or the staff's estimate of \$171,000.

With all of the foregoing differences thus reconciled, we adopt as the fair and reasonable results of operations for the test year 1968, the summary shown in the following tabulation.

Adopted Results of Total Operations
(Test Year 1968, Present Rates)

Operating Revenues	\$271,500
Operating Expenses	221,600
Net Revenue	49,900
Rate Base	843,100
Rate of Return	5.92%

This Commission is jurisdictionally precluded from determining what is a reasonable rate of return on applicant's overall operations. Its jurisdiction relates to intrastate operations alone. The adopted results respecting intrastate operations, as a segment

of the above-adopted results of overall operations, are summarized as set forth in the next tabulation.

Adopted Results of Total Intrastate Operations
(Test Year 1968)

	<u>Present Rates</u>	<u>Under Applicant's Proposed Rates</u>
Operating Revenues	\$153,100	\$179,500
Operating Expenses	123,300	137,200
Net Revenue	29,800	42,300
Rate Base	469,100	469,100
Rate of Return	6.35%	9.02%

These adopted results of intrastate operations when further separated to the exchange category in which applicant's proposed rates would apply, indicate the following:

Intrastate-Exchange Category - 1968

	<u>Present Rates</u>	<u>Proposed Rates</u>
Operating Revenues	\$ 80,100	\$106,500
Operating Expenses	66,400	78,900
Net Revenue	13,700	27,600
Rate Base	293,100	293,100
Rate of Return	4.67%	9.42%

As hereinabove recited, applicant seeks a rate of return of 7.75 percent. The staff has recommended that applicant be afforded a rate of return in the range of 7.5 to 7.7 percent on an intrastate rate base of \$469,100, such recommended rate of return, however, being related to the staff's assumed equity earnings on the parents' capital structure. Applicant has an outstanding long-term debt of approximately \$40,500 under a 4 percent first mortgage note which falls due on June 29, 1970. We assume, in the light of applicant's stated goal respecting capital ratios, that the present mortgage will be replaced by a new mortgage rather than by issuance of common stock in an offsetting amount. It also has short-term debts of approximately \$175,000 for which the interest rate is

presently 7.25 percent and of \$99,500 for which no interest is charged by its parent. In the light of the necessity to soon refinance these items and in the light of present-day interest rates applicable to mortgages and bank loans, a rate of return of 7.75 percent, as sought by applicant, and as applicable to its particular operations, cannot be said to be unreasonable. Such will be used herein for the purpose of determining the amount of the intrastate revenue increase to which applicant is entitled. Applicant's proposed rates, however, would produce an unreasonably greater rate of return and such rates will not be authorized. The gross revenue increase authorized herein, to reflect the rate of return and rate base herein adopted as fair and reasonable, amounts to \$13,700 based upon the test year 1968. This is approximately 52 percent of that sought by applicant.

The subject of rate spread was an issue treated by both applicant and staff. Each proposal was predicated upon a spreading of their respectively recommended gross revenue increases (applicant \$26,457; staff \$4,400). Since the amount to be spread herein (\$13,700) differs from either we shall spread rates over the various exchange classes of service in the light of the respective positions of applicant and the staff as to the appropriateness of particular elements of exchange charges and after due consideration of rates for comparable service rendered in adjacent territories. By major classifications, the annual revenue increase to applicant will be as follows:

<u>Summary Classification</u>	<u>Revenue Increase</u>
Basic Exchange Service Rates ...	\$ 9,400
Auxiliary Items	1,700
Service Connection Charges	1,300
Move and Change Charges	100
Classified Directory Advertising	1,200
Total	<u>13,700</u>

We shall authorize the following basic exchange rates:

Authorized Basic Exchange Rates

Business Service

1-party	\$ 8.75
2-party*	6.75
Suburban 4-party	6.50
Suburban 10-party*	6.25
PBX Trunk	13.00

Residence Service

1-party	4.70
2-party	3.50
4-party*	3.00
Suburban 4-party	3.75
Suburban 10-party*	3.50

* To be withdrawn by not later than 12-31-70.

The evidence shows that applicant's tariffs are generally in need of a thorough revision and updating, both as to form and as to content. Applicant attempted to do this and offered Exhibit No. 6 for such purpose. A careful examination of these proffered tariff sheets discloses a number of deficiencies and a lack of coordination between existing tariffs and those proposed. The evidence is not sufficient to reconcile the differences herein, hence we shall leave the details thereof for handling through normal tariff filing procedures outside this proceeding. We are also of the opinion that the details of depreciation expense and reserve calculations are better left for routine technical-staff handling outside of this proceeding and in this connection we remind applicant that its normal filing schedule respecting depreciation studies must be followed, as heretofore directed by this Commission.

With respect to the quality of service being provided by applicant, one public witness presented testimony indicating deficiencies in the service being provided. The staff made a survey

consisting of 50 telephone calls to test the quality of service and to obtain subscribers' opinion of their telephone service. The results of this survey are included in Exhibit No. 3 and show that some of the subscribers contacted indicated problems with operator service, dialing of local and long distance calls, poor transmission, and billing errors. The staff recommended that the following service improvements be undertaken by applicant: (1) improvement of operator service; (2) improvement of maintenance, and trouble reporting, and trouble correcting procedures; and (3) upgrading suburban service to a maximum of four parties to a line. Applicant will be expected to take reasonable steps to make the recommended service improvements.

In view of the evidence and the foregoing discussion of its more important elements, the Commission makes the following findings of fact and conclusions of law:

Findings of Fact

1. After due notice, public hearings have been held, evidence has been adduced and the matter stands submitted.

2. Under existing rates and charges for service, applicant's intrastate earnings in the exchange category for the test year 1968 produced a rate of return of 4.67 percent on a depreciated rate base of \$293,100 and for applicant's total intrastate operations a rate of return of 6.35 percent on a rate base of \$469,100 was realized in such test year.

3. A rate of return of 7.75 percent on an intrastate rate base of \$469,100 is fair and reasonable.

4. Applicant is entitled to increase gross revenues of \$13,700, the same to be derivable from exchange operations, and such increase is justified when based upon the test year 1968.

Conclusions of Law

1. The application of California-Oregon Telephone Co. should be granted to the extent set forth in the following order and in all other respects denied.

2. The rates and charges herein authorized are just and reasonable and present rates, insofar as they differ therefrom, are for the future unjust and unreasonable.

O R D E R

IT IS ORDERED that:

1. Applicant herein is authorized to file with this Commission, on or after the effective date of this order and in conformance with the provisions of General Order No. 96-A, tariff sheets revised to reflect therein the rates set forth by Appendix A hereto and, on not less than five days' notice to the public and to this Commission, to make said rates effective for service rendered on and after March 15, 1970.

2. By not later than July 1, 1970, applicant shall file a complete set of tariffs, updated to fully reflect present-day operations, practices and relations with its patrons.

3. By not later than December 31, 1970, applicant shall have so arranged its plant and its operations as to upgrade its service

to the point that 2-party and suburban 10-party business services and 4-party and suburban 10-party residence services are withdrawn.

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

Dated at San Francisco, California, this 2nd day of MARCH, 1970.

William J. ...
President

[Signature]

[Signature]
[Signature]
Commissioners

Commissioner A. W. GATOV

Present but not participating.

APPENDIX A

RATES

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

<u>Basic Exchange Service</u>	<u>Rate Per Month</u>
<u>Business Service</u>	
1-Party	\$ 8.75
2-Party*	6.75
Suburban 4-Party	6.50
Suburban 10-Party*	6.25
PEX Trunk	13.00
Semipublic	4.50
Joint User	3.00
<u>Residence Service</u>	
1-Party	4.70
2-Party	3.50
4-Party*	3.00
Suburban 4-Party	3.75
Suburban 10-Party*	3.50

* To be withdrawn on or before December 31, 1970.

Auxiliary Items

Proposed rates set forth in Exhibit No. 1, Part 6.2, Auxiliary Items, except for the following:

<u>Suburban Mileage, Each One-Fourth Mile</u>	<u>Rate Per Month</u>
1-Party	\$0.65
2-Party	.35
4-Party	.25

Service Connection and Move and Change Charges

Proposed charges set forth in Exhibit No. 5.

Classified Directory Advertising

Proposed rates set forth in Exhibit No. 1, Part 6.1, Directory.