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ORIGINAL

Decision No. 79367

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.	Application No. 51904 (Filed May 15, 1970) (Amended July 17, 1970)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Company of California.	Case No. 9100 (Filed August 4, 1970)

(Appearances Are Listed In Appendix A)

OPINION

General Telephone Company of California (General) seeks authority to increase its intrastate rates and charges for telephone service so as to produce approximately a $60 million increase in annual gross revenues, inclusive of $7.1 million of interim relief provided by Decision No. 78133 dated December 22, 1970, in these matters, on a test year 1970 basis.

The additional revenue requirement contended for by General would come, in part, from multi-message unit service in the Los Angeles Metropolitan Area and intrastate toll service. Rates for these services, however, have been increased, after the above-entitled matters were taken under submission, as a result of the decision[1/] issued on June 22, 1971 in the general rate proceeding on The Pacific Telephone and Telegraph Company (Pacific). Such increases in Pacific's rates apply to General

1/ Decision No. 78851 in Application No. 51774 and, among others, Case No. 9045.

since Pacific's intrastate toll rates are adopted by all other California telephone utilities and its multi-message unit rates apply to General as well as Pacific in the Los Angeles Extended Area.

Public Hearing

After due notice, 43 days of public hearings, in addition to the public hearings held earlier on the interim relief aspect of these consolidated proceedings, were held before Commissioner Symons and/or Examiner Main during the period October 19, 1970 and April 23, 1971 in Los Angeles and eight other cities in Southern California. Testimony and exhibits were presented by witnesses for General, the City of Los Angeles, several organizations, and the Commission's staff. Eleven of the hearing days were reserved specifically for the presentation of testimony by members of the general public. Concurrent opening briefs were filed on June 7, 1971 and concurrent reply briefs were filed on June 21, 1971, and the matter stands submitted as of the latter date.

Nature of the Company

General is a member of the General System, of which the domestic telephone operating subsidiaries comprise the largest independent (non-Bell) telephone system in the United States. General Telephone and Electronics Corporation (GT&E) is the parent company with communications, manufacturing and research subsidiaries.

General, which is by far GT&E's largest telephone subsidiary, operates in approximately a 10,000-square-mile area in Central and Southern California, serving 250 communities in portions of 16 counties. Its intrastate operations were last analyzed by the Commission in Application No. 49835, and related cases, on a test year 1968 basis. Following sixty days of hearing the Commission issued Decision No. 75873 therein on July 31, 1969. Principal issues in the present proceeding parallel closely the ones in the prior proceeding. Reasonable level of rate of return, affiliated interest adjustments, operating results under present rates, and quality and adequacy of service are contested elements within an overall determination of intrastate revenue requirements.

Rate of Return

A public utility is constitutionally entitled to an opportunity to earn a reasonable return on its investment which is lawfully devoted to the public use. Within this context, a fair and reasonable rate of return applied to an appropriately derived rate base quantifies the earnings opportunity available to the enterprise after recovery of operating expenses, depreciation allowances and taxes.

Ultimately, the rate of return determination in this proceeding must represent the exercise of informed and impartial judgment by the Commission, which must necessarily give equal weight to subscriber and investor interests in deciding what constitutes a fair and reasonable rate of return. Such balancing of interests is directed toward providing subscribers with the lowest rates practicable, consistent with the protection of the utility's capacity to function and progress in furnishing the public with satisfactory, efficient service and to maintain its financial integrity, attract capital on reasonable terms and compensate its stockholders appropriately for the use of their money. After considering all of the evidence, the Commission concludes that a rate of return ranging from 8.1 to 8.5 percent is fair and reasonable for General.

The Commission is seriously concerned with the preponderance of debt in General's capital structure and the concomitant effect upon interest coverage of continually increasing debt costs. Issuance of debt in the past has been the cheapest financing alternative; nevertheless, the impact of the existing high debt ratio upon interest coverage in the future will undoubtedly create undesirable financial consequences, particularly in light of anticipated increments in imbedded costs due to higher interest rates. In fulfilling its future requirements for substantial amounts of additional funds from external sources, General should consider carefully the alternatives which may be available with respect to issuing more equity securities, the objectives being to reduce the debt ratio and to improve interest coverage.

We will proceed now to a consideration of the evidence which assisted us in arriving at the rate of return we judge to be fair and reasonable.

Testimony and exhibits concerning the fair rate of return for General were presented by Witness Christensen of General, Witness Deal of the Commission's staff, and Witness Kroman of the City of Los Angeles. General also sponsored Witness Bjurman who presented rebuttal testimony from his viewpoint as a member of the investment community.

Two basic sets of capital ratios were presented. While they are not significantly different, the set used by the staff witness has the advantage of including both debt and equity securities planned for issuance in 1971. We adopt the following capital ratios for the purposes of this proceeding: debt, 55.58 percent; preferred stock, 3.42 percent; and common equity, 41 percent.

It appears that applicant's embedded debt cost as of December 31, 1971, will be at least 6.28 percent, a level originally estimated by the staff witness. The cost factor for preferred stock is equal to the effective dividend rate of 4.91 percent. A weighted aggregate cost of these two capital components of 3.66 percent results and is adopted.

Concerning the third capital component, each witness differs as to a proper allowance. In Mr. Christensen's judgment a proper allowance for return on common equity should be in the range of 11.5 percent to 14 percent; in Mr. Deal's judgment the range should cover from 10 percent to 10.5 percent; in Mr. Kroman's judgment the proper allowance for a return on common equity is 10.3 percent.

Based on its evidence of intrastate operating results, the $60 million increase in annual gross revenues proposed by General equates to an 8.5 percent rate of return, which yields an 11.8 percent return on common equity upon application of the adopted capital ratios and cost factors for debt and preferred stock. However, in Mr. Christensen's presentation the 8.5 percent rate of return corresponds to a 12.3 percent return on common equity, using slightly different capital ratios than those adopted herein and a lower embedded debt cost which does not reflect the anticipated issuance of debt securities in 1971.

In settling upon a 12.3 percent return on common equity, Mr. Christensen applied a comparable earnings approach in the following manner: He listed 33 electric, gas and telephone companies which issued mortgage bonds rated "A", (the same rating as General's mortgage bonds) by both Moody's and Standard and Poor's during 1969. For each company, he determined and set forth the average return on average common equity for the five-year period, 1964-1968, and the 1968 average capitalization. From this he determined that the 1964-1968 average return on average common equity of these 33 companies was 12.3 percent and that for 12 of them, those having common equity ratios in 1968 within a range of 35 to 45 percent, the average percent return on average common equity was 12.06 percent.

In fixing an 11.5 percent lower limit to his recommended range of return on common equity, Mr. Christensen compared the earnings of five GT&E telephone operating companies issuing mortgage bonds rated "A". The 11.5 percent represents the average of common equity returns in the 1964-1968 period for these five companies. At the upper limit of the range, the 14 percent return on common equity was computed as being the return necessary to produce the 2.7 times interest coverage referred to by the Commission in Decision No. 75873 as sufficient under then existing conditions to enable applicant to continue financing satisfactorily.

The Commission's staff witness on rate of return did not use a comparable earnings approach in determining his recommendations, stating that the method involves the measurement of risk between companies or groups of companies and that there is no known formula by which risk can be measured. However, the witness did examine the earnings of 14 other GT&E system companies, 23 Bell companies, and 5 telephone holding companies, because in his opinion there are elements of comparability between such companies and General. In addition, he testified that he exercised his informed judgment in view of the needs, circumstances and risks peculiar to General, considering many items, some of which influenced his judgment positively (higher return) and some of which influenced his judgment negatively (lower return).

Those items which he considered positively include: (1) General's capital structure; (2) the trend towards higher debt cost; (3) General's continuing need for large amounts of external financing; (4) the effects of continued inflation; and (5) the trend of General's earnings.

Those items which he considered negatively include: (1) the size of General; (2) competition as compared to a captive market; (3) essentiality of the service to the public; (4) physical area of General's operations; and (5) General's affiliation with GT&E and the control exercised by the parent company.

The staff witness testified that he had not assigned any specific quantitative values to the various positive and negative factors in arriving at his recommendations. As an over-all judgment, his conclusion was that a rate of return on common equity within the range of 10.0 to 10.5 percent is reasonable. The corresponding range of return on rate base would be 7.75 percent to 8.00 percent using his original set of capital ratios and embedded debt cost of 6.28 percent which have been adopted herein.

The witness for the City of Los Angeles recommended a rate of return of 7.70 percent, based primarily on an updating of the 7.2 percent rate of return allowed in Decision No. 75873. His recommendation equates to a 10.30 percent return on common equity under a slightly different set of capital ratios than the one adopted herein and with cost factors of 5.95 percent for long-term debt, 7 percent for short-term debt, and 4.91 percent for preferred stock. Such an allowance on equity represents in his judgment a fair and reasonable amount based upon several analyses and considerations, including

(1) the increases in earnings on equity which have been experienced by Bell System companies, and General Telephone system companies, and representative gas and electric companies; (2) returns on equity of other major utilities allowed recently by the Commission; and (3) the fact that the 10.3 percent return on common equity is near the top of the range found reasonable by Decision No. 75873.

Mr. Christensen and Mr. Kroman have shown a declining trend in interest coverages. Mr. Christensen contends that a reasonable rate of return for General should provide at least 2.5 times interest coverage. Mr. Kroman, in recomputing interest coverages for the 33 utility companies selected and used by Mr. Christensen in his presentation, arrived at median interest coverages for the 1964-1968 period and for 1969 of 2.89 and 2.30, respectively.

Of course, declining interest coverage can be one of the many reasons that a utility may cite when seeking rate increases in order to improve earnings and thereby endeavor to protect its bond ratings. The ability to determine precisely a specific optimum level of interest coverage in each situation for the purpose of maintaining a given bond rating would be remarkable; moreover, there could be no assurance that such a level, if determinable, would be compatible with a proper allowance for return on equity. Thus, the fair rate of return, in striking the desired balance of rate payer and investor interests while maintaining a financially sound, operationally effective utility, provides, through its return on equity component, appropriate, but only coincidentally optimum, interest coverage.

The principal presentations on rate of return and the critiques in the record have been of assistance to the Commission in making an informed and impartial judgment determination of reasonable rate of return. As previously stated, the resultant fair and reasonable rate of return for General is in the range of 8.1 to 8.5 percent. Such a range of return should produce earnings on common equity of 10.8 percent to 11.8 percent, and times interest coverages, after income taxes, ranging from 2.3 to 2.4. General's related common equity ratio is 41 percent and its mortgage bonds presently carry an "A" rating.

Before leaving this very important element of the rate making process, we would observe that the fair rate of return for General exceeds the returns upon which rates were set in the very recent general rate proceedings of Southern California Edison Company and The Pacific Telephone & Telegraph Company. Rates for Edison were set in Decision No. 78802 dated June 15, 1971, to yield a 7.9 percent rate of return. At this level Edison's return on a 37 percent common equity ratio is about 11.9 percent and the interest coverage for its Aa-rated debt securities is 2.9. In Decision No. 78851 dated June 22, 1971, rates for Pacific were set on a 7.85 percent rate of return to yield common equity earnings of 9.5 percent and approximate interest coverage of 3.1. Pacific's equity ratio is about 56 percent and its debt securities presently carry an "Aaa" rating.

From these ultimate results, we would further observe that the computed rates of return of General, Edison and Pacific, while not, of course, directly comparable any more than the companies themselves, are within the scope of a rational pattern, one which reflects an inverse relationship of return on common equity with equity ratio, on the one hand, and of interest coverages moving in the direction of security ratings, on the other. Similarly, there is reasonable consistency in the consumer burden, as indicated by the combined effect of return and income taxes, imposed by the several levels of rate of return.

Affiliated Interests

As a holding company, GT&E controls, in addition to telephone operating companies and other interests, GTE Automatic Electric Incorporated, General Telephone Directory Company, GTE Service Corporation, and GTE Data Services Incorporated, which transact a substantial amount of business with General.

GTE Automatic Electric Incorporated (Automatic or Automatic Electric) and its subsidiaries are the developing, manufacturing, supply and distributing companies for the telephone operating companies controlled by GT&E. Automatic is the largest non-Bell manufacturer of telephone equipment in the United States. In addition to products of its own manufacture, termed "equipment", Automatic purchases products manufactured by others, termed "supplies", for sale to its customers.

General Telephone Directory Company (Directory Company) performs directory service for the telephone operating companies controlled by GT&E as well as for a number of other non-Bell telephone operating companies. This service includes the sale of directory advertising, the compilation of the alphabetical and classified sections of the directory, and the printing of two-column directories.

GTE Service Corporation (Service Company) renders advisory assistance in legal, financial and operational matters and other services to GT&E and its subsidiaries. Service Company furnishes its services to affiliates on a cost-of-service basis.

GTE Data Services Incorporated (GTEDS) was formed in 1967 to provide data processing services to the General System telephone companies as well as to other organizations outside the General System. General has not transferred its data processing operations to GTEDS. GTEDS, however, is developing for General and other telephone operating companies of the General System a Business Information System, commonly known as BIS. A six- to ten-year program is contemplated for the BIS project at a cost of at least $12 million to General, and the staff has made appropriate recommendations concerning the surveillance of the project.

With respect to both the Service Company and GTEDS, there is only one basic difference between applicant and staff in the treatment of General's transactions with these affiliates. This difference is in allocation methods and has only a minor effect at present, i.e., a net expense effect of $167,000 on General's intrastate operating results for test year 1970. Appropriate resolution of this issue can provide an opportunity for General and its affiliates to move together toward a more equitable but still uniform allocation method.

Applicant's allocation method is consistent with actual billing procedures under which its share of the total billing is determined according to the ratio the customer's total operating expenses and taxes bears to the total of operating expenses and taxes of all participating General System telephone companies. The staff's method requires the use of four factors for the allocation and has long been accepted by the Commission for allocating common or general office expenses among operating districts or departments of California utilities. The four factors are number of main stations, number of employees, direct expenses and plant in service.

The advisory assistance and other services rendered by the Service Company are diverse, encompassing many utility functions. BIS will comprise the following five major application groups or "modules": Customer Service Module; Employee

Module; Financial Module; Materials Management Module; Property Module.

While it thus may appear that the four-factor method achieves a more equitable allocation of the costs associated with these activities among the participating telephone companies, we decline to accept either method at this time. Instead, we have settled on a middle-ground approach which results in a net expense reduction of $84,000, as the Service Company and BIS part of an adjustment for affiliated interests, in General's intrastate operating results for test year 1970.

Automatic Electric Adjustment

In this proceeding General again asserts that the prices it pays Automatic Electric are reasonable. Its evidence in support of this contention concerns prices of Automatic Electric to affiliates and non-affiliates, retention by Automatic Electric of a share of the telecommunication equipment business of non-affiliates, and prices quoted to General by Automatic Electric's competitors.

Such evidence tends to confirm that Automatic Electric enjoys the advantages of a privileged position in the manufacture and distribution of equipment and supplies for the independent telephone industry market, a market not generally available to Western Electric, but fails to establish that Automatic Electric's prices to General are reasonable. In essence, such evidence points to the aptness of the view expressed by the Wisconsin Commission in rejecting an analogous price comparison test:

> ". . . that for all practical purposes the prices involved here are 'administered prices'. The level of prices is not determined by the costs incurred by the largest and most efficient producer in a competitive market but rather are determined at a level which will permit smaller and less efficient producers to stay in business." (General Tel. Co. of Wis. (Wisc. PSL 1960) 34 PUR 3d 497, 512, 513.)

Automatic relies, and increasingly so, on business with its affiliated telephone companies. These companies operate about 46 percent of the telephones of the independent (non-Bell) telephone companies in the United States. Of the remaining 54 percent, 18 percent is accounted for by operations of United Utilities, Inc., and Continental Telephone Corporation, which are affiliated with telecommunication equipment manufacturers, North Electric Company and Superior Continental Corporation, respectively.

Automatic's total sales have increased from $192 million in 1959 to $566 million in 1969 and its sales to all independent (non-Bell) domestic telephone companies have been fluctuating around 85 percent of its total sales. With reference to the independents, the share of sales to Automatic's affiliated domestic telephone companies has increased from 66.5 percent in 1959 to 85.8 percent in 1969 or, conversely, sales to other non-Bell telephone companies have dropped from 33.5 percent to 14.2 percent. Moreover, while it is true that the telephone companies unallied with GT&E represent a smaller percentage of the independent telephone industry than they did 11 years ago (the companies unallied with GT&E operated about 64 percent of the total number of "independent" telephones in 1959 and 54 percent in 1969), Automatic's business with its affiliates appears to be increasing by substantially more than the relative growth of these affiliates within the independent telephone industry.

On its total sales of $565.7 million in 1969, Automatic realized a profit margin of 7.5 percent. A breakdown of this result by purchasers follows:

1969 Total Sales of Automatic Electric

Purchaser	Equipment	Supplies	Total	Profit Margin
	(Dollars in Millions)			
General Tel. of Calif.	$ 62.3	$ 39.9	$102.2	8.4%
Other GT&E Domestic Telephone Companies	178.8	137.7	316.5	7.6%
Non-GT&E-Affiliated Domestic Telephone Companies	57.8	11.3	69.1	10.7%
All Other	70.0	7.9	77.9	3.1%
Total	$368.9	$196.8	$565.7	7.5%

With the exception of sales made to "All Other" purchasers, where perhaps there is exposure to vigorous competition, Automatic Electric's profit margin on equipment sales (products of its own manufacture) is roughly double that on supplies sales. It charges the same or, for a number of important items, lower prices to its affiliates than to non-GT&E domestic telephone companies. On purchases of items by affiliates which are capitalized, credits are received from GT&E. In General's case such credits amounted to $7.8 million in 1969. The credits are in response to, and reflect, the elimination of intercompany profits in the General System consolidated federal income tax return.

General's purchases from Automatic, in reaching $102.2 million in 1969, represent 21 percent of all sales to domestic (non-Bell) telephone companies by Automatic, or 18.1 percent of total sales.

In Decision No. 75873 we held that Automatic's prices to General are unreasonable to the extent they provide more than a reasonable return on GT&E's investment in Automatic allocable to transactions with General. In light of substantially the same record before us in this proceeding and of the below enumerated considerations, we are convinced that no change is in order and that our holding in that decision should be, and is, reaffirmed:

(1) The size of the captive market -- GT&E system telephone companies provide nearly one-half of the independent or non-Bell telephone service in the United States.

(2) The less-than- arm's-length bargaining in affiliated transactions.

(3) The ambit in setting prices by virtue of the captive market and of being the major manufacturer of telephone equipment for the independent telephone operating companies.

(4) The tendency toward administered prices which can produce excessive profit margins and permit smaller and less efficient manufacturers to retain or increase their share of business with the non-GT&E controlled independent telephone companies.

(5) The most objective and fair standard available for use in determining the amount of payments to Automatic Electric which may be allowed to be recovered through General's rates appears to be cost inclusive of a reasonable return on investment.

In Decision No. 75873 we determined that for rate making purposes GT&E's investment in Automatic and adjustments in General's payments to Automatic should be based on the following criteria:

(a) Valuation of GT&E's shares of stock exchanged for shares of stock of Theodore Gary and Company and other acquired companies on the basis of the average of market prices for GT&E stock over the 12-month period immediately preceding each acquisition.

(b) Allocation of the market price determined in (a) above between domestic telephone equipment manufacturing and all other activities on the basis of net investment (book value).

(c) Allocation to General of GT&E's investment in Automatic Electric allocated to domestic telephone equipment manufacturing based on the investment method.

(d) Allowing Automatic Electric to earn a 12 percent return on equity in the form of GT&E's net investment in Automatic Electric and in effect applicable to the portion of such investment devoted to serving General.

With respect to the determination of GT&E's investment in Automatic, two opinions were issued recently by the Accounting Principles Board of the American Institute of Certified Public Accountants which have some pertinency. In fact, Opinion No. 16, Business Combinations, and Opinion No. 17, Intangible Assets, can be used to reassess our criteria for determining GT&E's investment in Automatic, which resulted in an upvaluation for rate making purposes over book value, and the pertinent allocation to General. These opinions cannot be applied retroactively in any way for accounting purposes.

Opinion No. 16 provides, among other things, guidelines concerning the values of shares exchanged in acquiring a company or group of companies and concerning the apportionment between companies of an acquired group. Opinion No. 17 prescribes that the cost above original cost should be amortized over a period of not more than 40 years. We consider that the guidelines laid down in Opinion No. 16 are sufficiently broad to include well within their purview, as contended for by the Commission's staff, all of the criteria and procedures we adopted in Decision No. 75873 to determine GT&E's investment in Automatic Electric. After their further testing on this record, we view those criteria and procedures, except to the extent modification is in order to reflect Opinion No. 17 considerations, as still being both appropriate and reasonable. They will be substantially followed, after modification to reflect Opinion No. 17 considerations, in developing the Automatic Electric adjustment.

Opinion No. 17 specifically requires the amortization of intangibles including goodwill. This was not done in Decision No. 75873, but now it will be.

Neither General nor the Commission staff provided on this record an in-depth study to determine the appropriate amortization periods for the various elements comprising the intangibles including goodwill. Perhaps adequate records necessary to developing such periods are not available.

Without such a study, the use of the maximum amortization period permitted of 40 years advocated by General appears to be less suitable than the 25-year period advocated by the staff. In some respects, the selection of a 40-year amortization period appears indicative of replacing, in part, the acquired intangibles including goodwill with those which have been developed since the acquisition of Automatic Electric by GT&E.

Any such replacement of intangibles including goodwill would hardly be consistent with Opinion No. 17 and historical cost accounting.

Quite clearly, General has failed to adequately meet the burden of proof as to the reasonableness of using the maximum amortization period permitted. Under the circumstances, we find the 40-year amortization period advanced by General to be unreasonable and the 25-year amortization period recommended by the Commission's staff not to be unreasonable. The staff recommendation is adopted.

We turn now to the matter of a reasonable return on GT&E's net investment in Automatic Electric. As we observed in Decision No. 75873, there appears to be somewhat greater risk in Automatic Electric's manufacturing operations, even with a substantially captive market, than exists in a utility operation. To quantify in some way this difference in risk and reflect it in a reasonable return continues to pose a difficult and complex problem.

We accord little weight to the comparable earnings test as applied by General because the selection of manufacturing companies and the array of data used does not allow for the substantially captive market enjoyed by Automatic Electric. We reject the staff recommendation to the extent it recommends the use of an 11 percent return on Automatic's common equity for years 1969 and 1970, observing the higher costs of money experienced generally since the proceeding in Application No. 49835 and the prevalence in the 1959-1969 period of the earnings pattern of a broad spectrum of American industry developed in that proceeding for the 1959-1966 period.

An examination of all of the evidence on the reasonable level of return on GT&E's net investment in Automatic Electric convinces us that no departure is warranted at this time from Decision No. 75873 wherein we said,". . . We are cognizant of the economic necessity for allowing Automatic a reasonable return on its investment to compensate for the risks undertaken and the need to attract capital. Accordingly, we conclude that Automatic would be treated fairly if it earned a return on its common equity approximating the return on common equity of a broad spectrum of American industry. . . . This reasoning leads us to conclude that a range of 10 to 12 percent on common equity of Automatic would be appropriate. Because of the uncertainties hithertofore discussed in our determination of a precise rate of return, which are complicated here because we are considering a manufacturing firm, albeit with a substantially captive market, we select the 12 percent return on equity, a return which may be slightly generous."

Automatic Electric's actual earnings on its book equity ranged from 17.7 percent to 37.1 percent, with a median of 22.4 percent over the period 1959 through 1969. Over the same period, its pro forma earnings on equity, in the form of GT&E's net investment as determined by the procedures adopted herein, ranged from 12.4 percent to 24.4 percent, with a median of 16.2 percent. Restricting Automatic Electric's return on equity (i.e., on GT&E's net investment in Automatic Electric) to 12 percent for the portion of its investment devoted to serving General prevents, for the rate-making purposes of this proceeding, Automatic Electric from making an unreasonable and excessive profit on sales to General; it results in a decrease of General's intrastate rate base of $19,806,000 and a net intrastate expense reduction of $1,244,000 for test year 1970.

General did not present evidence concerning Automatic's progress, if any, in increasing its productivity, objectives for future increases, or justify Automatic's underlying costs. It is not sufficient merely to point to Automatic's profitable share of the telecommunications equipment requirements of independent domestic telephone companies unallied with the GT&E system. In future proceedings we shall expect General to make a comprehensive showing covering such aspects of Automatic Electric's operations, including cost controls. In our determinations concerning the reasonableness of payments by General to Automatic Electric, exceptional increases in productivity, efficiency of management, and the like, which are clearly demonstrable, should redound to the benefit of Automatic Electric and of General and its rate payers.

Directory Company Adjustment

General is the major customer of the Directory Company. It furnishes approximately one-third of all of the Directory Company's domestic telephone directory revenues.

The Directory Company receives slightly over 80 percent of its total revenues from GT&E-affiliated telephone companies, about 10 percent from non-GT&E-affiliated telephone companies, and the remainder from other sources. In comparison with other telephone companies doing business with the Directory Company, General provides approximately three times the revenue of all of the nonaffiliates and also about three times the revenue of the next largest affiliated company. Most of General's directories are printed under contract with commercial printers.

General entered into a new contract with the Directory Company to be effective for all directories published on and after January 1, 1970. The old contract provided for payments to the Directory Company based on a step scale related to the level of advertising revenue per telephone. There was also a provision for annual adjustments depending on the magnitude of the Directory Company's net profits. The new contract provides for a split of directory advertising revenue, after certain advertising adjustments and uncollectibles, on the basis of 57 percent to General and 43 percent to Directory Company. The new contract may be terminated at the end of any year by either party upon one hundred twenty days' written notice being furnished before the end of that year.

General contends that the performance of Directory Company has minimized the rates General must secure from its subscribers to a greater extent than has the performance of the directory department of The Pacific Telephone and Telegraph Company (Pacific) for Pacific's subscribers. It further contends that payments by General to Directory Company are reasonable, that the benefits received by General and its subscribers from Directory Company's operation are substantial, and that application of a utility rate of return to a directory business is unrealistic and results in an inadequate return.

While it is true that the net directory revenue per average main station of General exceeds that of Pacific in 1968 and 1969, we would not venture an attempt to determine relative efficiencies of the two directory operations from the comparative results presented by General in its Exhibit 14. Such a determination is not undertaken because of the substantial effect of differences in rate levels for classified advertising, on the one hand, and in subscriber "mix", on the other, as between

General and Pacific, neither of which has been adequately evaluated on the record before us, and because other pertinent factors probably exist which have not been disclosed.

Under the new contract between the Directory Company and General the high profit levels the Directory Company has been earning in its business with General would continue. In fact, when 1970 is analyzed on a pro forma basis, the Directory Company's earnings from its business with General, as estimated by the staff, reach a high of 44.19 percent on net investment.

The tabulation below presents a comparison between General and other GT&E-affiliated companies of the advertising revenue produced per telephone in service at the beginning of the year. On a unit basis, such as the cost of putting a salesman in the field for a day or of compiling a listing, the costs of sales, publishing and printing should be approximately the same, whatever the size of the directory.

Advertising Revenue Per Telephone

Year	General	Other Affiliated Telephone Companies	General Exceeds Other Ratio
1965	$ 9.06	$5.27	71.9%
1966	9.68	5.49	76.3%
1967	9.91	5.95	66.6%
1968	8.52	6.00	42.0%
1969	9.09	6.07	49.8%
1970 (Est.)	10.71	6.43	66.6%
*	12.37	6.43	92.4%

*Pro Forma Basis for full-year effect of General's latest directory rates.

Because of its size, we would expect General on its own to have been, and to be, capable of developing an efficient directory operation serving its needs and perhaps those of other telephone companies which could inure to the benefit of General's subscribers. We can see, however, how a directory operation developed to handle all of the business of the GT&E system telephone companies probably provides system-wide benefits as presumably the GTE Service Corporation does in carrying out its functions on a cost-of-service basis.

At this point, certain portions of Decision No. 75873, which apply equally well to this proceeding, warrant repeating:

". . . We accept the staff position that the Directory Company should not be allowed a greater return on business with General than the latter is allowed on its other utility business.

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

(Mimeo. p. 73)

> ". . . 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."

(Mimeo. pps. 76, 77)

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

(Mimeo. p. 134)

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

"9. General and the Directory Company do not bargain at arms-length over the division of directory revenues. The Directory Company is used by GT&E to syphon profits from General . . ."

(Mimeo. p. 135)

For the rate-making purposes of this proceeding we will make a net reduction of $1,779,000 in General's expenses for test year 1970 to disallow Directory Company's making an unreasonable and excessive profit on its business with General. This adjustment is computed on the basis of limiting Directory Company's return on business with General to the level of return the latter is allowed on its other utility business.

Results of Intrastate Operation

Both applicant and the staff of the Commission presented results of operation of General for test year 1970.

For the jurisdictional separation, both used the Ozark Plan to reach separated intrastate from total results of operation and their final intrastate results, after revisions which occurred during the course of the proceeding, are set forth in Exhibit 84. In addition in Exhibit 84, individual differences in the operating results reached, together with their rate of return effects, are shown. In the aggregate these differences account for the total difference in rate of return under present rates of 6.01 percent as determined by applicant, and 6.78 percent as determined by staff.

In Table 1 below, the comparative results of applicant's intrastate operation for test year 1970, as set forth in Exhibit 84, are summarized and the intrastate operating results we adopt for test year 1970 under "present rates" are shown. "Present rates" exclude the interim supplemental billing charge made effective pursuant to Decision No. 78133, dated December 22, 1970, in this application and changes in state toll and multi-message unit rates pursuant to Decision No. 78851, dated June 22, 1971, in Application No. 51774 and, among others, Case No. 9045.

Table 1

Results of Intrastate Operation
Under Present Rates - Test Year 1970

Item	Staff Estimated & Adjusted	Difference Cols. 1 & 4 Accounted for by: Adjustments*	Other	Applicant Recorded & Adjusted	Adopted
	(Dollars in Thousands)				
	(1)	(2)	(3)	(4)	(5)
Operating Revenues	$ 364,733	$ 4,309	$3,663	$ 372,705	$ 370,973
Operating Expenses					
Expenses Other Than Taxes	222,768	2,146	2,885	227,799	227,252
Income Taxes	24,418	4,055	1,104	29,577	25,953
Other Taxes	44,978	359	(240)	45,337	45,337
Total Operating Expenses	292,164	6,800	3,749	302,713	298,542
Affiliates Adjustment	(3,286)	3,286	-	-	(3,107)
Net Revenues	75,855	(5,777)	(86)	69,992	75,538
Rate Base	1,118,028	47,005	(262)	1,164,771	1,142,635
Rate of Return	6.78%	(0.76%)*	(0.01%)	6.01%	6.61%

*Breakdown

Affiliated Interest	(0.41%)
Director Modification Program	(0.23%)
Interest Expense Adjustment	(0.13%)
Investment Tax Credit	(0.11%)
Decision No. 77947 Effects	0.10%
Other	0.02%

( ) Red Figure

As shown in Column 2 of the above table, the difference in ultimate results reached by applicant and staff, i.e., 6.01 percent rate of return vs. 6.78 percent rate of return, is for practical purposes attributable to adjustments accounting for 0.76 percent in rate of return. The remaining .01 percent of rate of return difference is a result of applicant's developing its operating results from recorded 1970 figures and the staff's developing operating results on an estimated year 1970 basis. The composition of the adjustment entries in Column 2 of Table 1 is shown in the following tabulation:

Composition of Column 2 of Table 1

	Operating Revenues	Operating Expenses	Affiliates Adjustment	Net Revenues	Rate Base
	(Dollars in Thousands)				
Decision No. 77947 Effects	$2,409	$1,244	$ -	$1,165	$ -
Director Modification Program	326	1,482	-	(1,156)	24,340
Interest Expense Adjustment	880	2,351	-	(1,471)	-
Investment Tax Credit	-	1,330	-	(1,330)	-
Working Cash Allowance	-	-	-	-	2,330
Ten-cent Toll to Extended Area Service & Other Items	694	393	-	301	-
Affiliated Interest	-	-	3,286	(3,286)	20,335
Total	$4,309	$6,800	$3,286	($5,777)	$47,005

( ) Red Figure

The first two items, Decision No. 77947 Effects and Director Modification Program, are pro forma adjustments made by the applicant and not the staff. The third item, Interest Expense Adjustment, is a pro forma adjustment made by the staff to place the deduction of interest expense for income tax purposes on a level commensurate with the embedded cost of debt as of the end of year 1971 which was used by the staff witness on fair rate of return. The fourth item, Investment Tax Credit, was excluded from the test period by applicant but not the staff. The next two items, Working Cash Allowance and Ten-cent Toll Conversion to Extended Area Service, reflect largely differences in methodology or procedures between applicant and staff in determining the amounts for these items. The last item, Affiliated Interest, encompasses staff adjustment for rate making purposes of General's business with its affiliates, Automatic Electric, Directory Company, Service Company and GTEDS.

Our adopted operating results in Table 1 reflect the company's basis of developing its operating results from 1970 recorded figures, some of the adjustments which account for the aforesaid 0.76 percent rate of return difference, and certain other considerations. We will now proceed to a discussion of such adjustments and considerations.

Inclusion, on a pro forma basis of the full-year effect in the test period, of the increase in rate levels resulting from Decision No. 77947 is not really an issue between the applicant and the staff. It is an identifiable difference in their presentations and the full-year effect is properly includable in the test year 1970.

The director modification program is an issue and has a substantial impact on ultimate results, i.e., 0.23 percent in rate of return. The program will result in an equipment rearrangement which is necessary to make more telephone numbers available in the Los Angeles metropolitan area. It will permit the use of additional three-digit central office codes not now available.

According to applicant, the present telephone numbering plan in the Los Angeles metropolitan area will exhaust about mid-1974 and the industry has scheduled cut-over to the new dialing plan, the metropolitan dialing plan, for completion by mid-1973, so as to allow adequate time to intercept misdialed calls prior to the introduction of numbering plan area codes as central office codes in mid-1974. Applicant's present schedule provides, however, for completion of the director modification program early in 1972.

The initial step commences in late 1971 with an interim plan that will be applicable to the Long Beach, Huntington Beach, Westminister and Downey central offices having extended area service to or from Orange County, which comprise 17 of General's total of 55 central offices in the 213 numbering plan area. Scheduling the director modification program for completion in 1972 evolved from several considerations including the conversion of 2-MMU routes to extended area service, the relief of the tandem network in the Los Angeles extended area by the use of multi-frequency signalling inherent in the director modification and adding of touch calling equipment made possible by director modification.

As of the end of 1970, applicant had spent on the program a total of $14,593,000 which reposed primarily in plant under construction. Applicant has adjusted its intrastate operating results for the test year 1970 to include the total cost of the director modification program. The pro forma adjustment attributable to the program amounts to an increase of $24,340,000 in rate base and a decrease of $1,156,000 in net operating income.

General contends that it is proper to make a pro forma adjustment for the entire cost of the director modification program in the test year because significant amounts have already been spent, its completion is near term, and the program constitutes a necessary increase in plant without offsetting revenue increase.

The staff contends that the director modification program should be considered as a growth item. Because of growth, new exchange prefixes in the 213 area are necessary and additional subscribers in that area means additional revenue. In essence, it is the staff's position that the plant is necessary to meet projected growth; that said growth will produce additional revenues and that if the plant is considered for rate making purposes, so should be the revenues. Applicant counters that the only thing the director modification allows is the signalling of additional central office codes on existing equipment by existing customers. The modification, of itself, does not allow applicant to handle any more traffic or to provide any further services to its subscribers.

Thus, while the ultimate aim of the program is made necessary by anticipated future growth in the Los Angeles metropolitan area, we agree with applicant that the director modification will serve existing customers and is not directly related to revenues to be received from future additional customers. It provides an ancillary type function and in that sense is essentially non-revenue producing in comparison with the expansion of central offices, the stringing of cable, or the installation of telephones to serve additional customers.

In the circumstances and upon consideration of the substantial delay in applicant's receiving rate relief making 1972 the first full year the new rates would be in effect, it is appropriate for rate making purposes to include in our adopted operating results the pro forma adjustment made by applicant for the director modification program.

Concerning the interest expense adjustment, the pro forma treatment used by the staff places on a consistent basis the deduction for interest in the computation of income taxes and the effective interest rate on debt used as part of a fair rate of return determination. In this way, income taxes and rate of return become closer coordinated elements of the total cost of service or revenue requirements.

Placing them on such a coordinated basis within operating results at present rates has the practical advantage of facilitating the determination of the revenue deficiency or additional revenue requirement upon a comparison with the rate of return upon which new rates will be set. This procedure does, however, distort earnings at present rates, as applicant contends, but so do other pro forma adjustments. The staff adjustment increases net operating income by $1,471,000 and relates to an effective interest rate of 6.13 percent on debt as of December 31, 1971. The comparable adjustment in our adopted operating results increases net operating income by $1,873,000 and relates to an effective interest rate of 6.28 percent on debt as of December 31, 1971.

The investment tax credit should be included in the test period operating results only if this credit will be available to applicant in the immediate subsequent periods. Under federal income tax law, the investment credit was repealed except as to purchase commitments made on or before April 18, 1969. Applicant's entitlement to claim further investment credits on its tax return was expected to exhaust in 1970. There are now, however, compelling indications that such credit, perhaps under a different set of plant eligibility requirements and rates, will be restored.

The staff based its computation of the investment tax credit for test year 1970 on its estimate of the amount of qualifying plant additions to April 18, 1969. This resulted in an investment tax credit of $1,493,000 for the total company and $1,330,000 for General's intrastate operation. Annual Reports of General for years 1967 through 1969, filed with the Commission, disclose that the investment tax credit amounted to $3,297,682, $3,957,951, and $3,387,460, respectively.

Our adopted operating results as set forth in Table 1 exclude an allowance for investment tax credit. Thus, this application should be kept open for the limited purpose of giving appropriate disposition to the effect of the investment credit if it is in fact restored in federal tax law by not later than six months after the effective date of the order herein. However, in the event General files a new application which would also serve this purpose or if the investment credit is not restored within said six-month period, the present application should be considered closed.

As to working cash allowance, the staff's figure, which is $2,330,000 less than applicant's -- giving rise to only a 0.01 percent rate of return difference, was arrived at by the same method of calculating working cash as the staff used in the most recent major rate proceedings before the Commission. It is an appropriate method on the basis of this record and we see no reason here for a departure from our actions in those proceedings. The staff's estimate in the negative amount of $218,000 as an allowance for working cash is adopted.

As required by ordering paragraph 4 of Decision No. 75873, the conversion of ten-cent toll to extended area service is to be made during 1971. The related conversion of 2-MMU routes to extended area service is also to be completed by December 31, 1971. The effects of eliminating ten-cent toll and 2-MMU routes have been "proformed" into 1970 operations by both applicant and staff. The staff's pro forma treatment increases the cost of service more than the applicant's and the difference between them, which equates to about 0.02 percent in rate of return, is caused primarily by the staff using the so-called satellite plan and applicant the "toll continuation method" as the method of settlement with Pacific.

Pacific's offer of settlement is based on the satellite plan and has been accepted by all independent telephone companies except General. The staff's pro forma adjustment to reflect the elimination of ten-cent toll and 2-MMU routes is included in our adopted operating results.

With respect to Affiliated Interest, the last item in the tabulation setting forth the composition of adjustment entries in Column 2 of Table 1, the pertinent affiliates (Automatic Electric, Directory Company, Service Company and GTEDS) and the development of our adopted adjustments have already been discussed at some length. The adjustments result in a net expense reduction, or conversely, a net revenue increase, of $3,107,000 and a reduction of $19,806,000 in rate base.

Apart from the matter of the adjustments accounting for the difference in ultimate results between applicant and staff, there are several expenditures included in operating expenses as developed by applicant from 1970 recorded expenses that are significant from a regulatory viewpoint while having only a minor impact on cost of service or revenue requirements. The expenditures are for certain television advertising and for legislative advocacy, dues and donations. Consonant with the pertinent staff disallowances, our adopted operating results exclude $455,000 in television advertising expense, which was directed principally toward improving the company image, and $20,000 for legislative advocacy, dues and donations.

Based on the intrastate revenues and expenses, other than income taxes, adopted herein, we compute and adopt as reasonable for the test year an amount of $25,953,000 for income taxes, which is the amount shown in Table 1. In the computation, accelerated depreciation with normalization was used to determine both federal and state income taxes.

This was also done by the staff and applicant in Exhibit 84 and is in conformity with the treatment specified in Interim Decision No. 77984, dated November 24, 1970, in Application No. 51774, et al, and made applicable to this case by Interim Decision No. 78133, dated December 22, 1970, herein, for federal income taxes. The adoption in Decision No. 77984 of the normalization basis for federal income taxes is based upon changes in the federal laws.

Concerning accelerated depreciation for state income tax purposes, we stated in Decision No. 78851 in Application No. 51774, et al, and it applies equally well here, as follows:

> "If Pacific were to adopt "flow-through" accounting for state income taxes using accelerated depreciation, it would not appear to be in compliance with the prerequisite in the Internal Revenue Code that a taxpayer such as Pacific must use the "normalization method of accounting" to qualify for the use of accelerated depreciation for federal income tax purposes. In any event, the state income taxes are a relatively small portion of total income taxes paid by Pacific. Under these circumstances it is not warranted to consider different accounting and rate-making treatment for state than for federal taxes. We find that the staff was correct in basing its determination of revenue requirement in Exhibit No. 66 on the use of normalization for both state and federal income taxes. This avoids the possibility of jeopardizing the much larger federal income tax deferrals."

Revenue Requirement

We find that the levels of revenues, expenses and rate base as set forth in Column 5 of Table 1 hereinabove, which reflect essential rate making modifications and comprise our adopted intrastate operating results, are appropriate, and should be used, to determine General's gross revenue deficiency under "present rates".

As shown in these results, the net operating income of $75,538,000 equates to a 6.61 percent rate of return on the rate base of $1,142,635,000. This is less than a fair return for General which, as found in a previous section of this Opinion, ranges from 8.1 to 8.5 percent.

Rates for applicant will be set to yield the midpoint rate of return of 8.3 percent. Thus, a deficiency in net revenues under "present rates" of $19,301,000 results and there is required additional gross revenues (net-to-gross multiplier of 2.087) of $40,281,000 per year. However, because of practical limitations in translating the additional revenue requirement into rates, the adopted rate spread, as set forth in the next section of this Opinion, yields revenue increases of $40,288,000, which represents a 10.9 percent increase in gross revenues.

The adopted intrastate results at rates being authorized herein may be summarized as follows:

Adopted Intrastate Results
At Authorized Rates

Operating Revenues	$ 411,261,000
Operating Expenses	316,419,000
Net Revenue	94,842,000
Rate Base	1,142,635,000
Rate of Return	8.3%

As discussed in a later section of this Opinion, General appears to be rendering an acceptable level of service. Continuation of a penalty in rate of return for inadequate service is neither warranted nor would it be conducive to maintaining General's capacity to meet service standards systemwide in light of the heavy capital requirements of its construction program over the next several years to meet system growth and other needs.

Rate Spread

A proper spread of the additional gross revenue requirement to the various types of telephone services provided by General is influenced in large measure by Decision No. 78851 issued on June 22, 1971, in the general rate proceeding on Pacific and related matters (Application No. 51774 and, among others, Case No. 9045). In fact, a revenue increase of $16,335,000 to General has been predetermined by that decision and a revenue increase of $17,113,000 ensues upon reflecting a consideration of parity in basic rates for Pacific's and General's exchanges in the Los Angeles Extended Area and other appropriate relationships. Our adopted rate spread yielding an annual gross revenue increase of $40,288,000 is set forth on the next page.

Adopted Rate Spread
Yielding Annual Gross Revenue Increase
of $40,288,000

Item	Billing Increase	Settlement Effect	Revenue Increase
	(Dollars in Thousands)		
Revenues Derived from D. 78851			
Message Toll Telephone Rates, Including 7, 8 MU Conversion			$ 5,700
Message Unit Service (MMU)			6,635
Extended Area Service Settlement Increase			4,000
Subtotal	-	-	16,335
Basic Exchange Rates			
Los Angeles Extended Area	$12,559	$(2,198)	$10,361
Other L. A. Metropolitan Area	2,506	-	2,506
Outside L. A. Metropolitan Area	4,089	-	4,089
Subtotal	19,154	(2,198)	16,956
Basic Formula Revisions			
Extended Area Service Rate Increment	$ 127	-	$ 127
Eliminate Differential - Courtland, Isleton and Walnut Grove	30	-	30
Subtotal	157	-	157
Other Services			
Pushbutton Telephone Service	$ 17	$ (2)	$ 15
Foreign Exchange Service	1,135	(162)	973
Message Rate Service @ 4.7¢	150	(26)	124
Supplemental Services	248	(27)	221
Move and Change	725	(71)	654
Service Connection	2,666	(260)	2,406
PBX Service	2,735	(288)	2,447
Subtotal	7,676	(836)	6,840
TOTAL	-	-	$40,288

( ) Red Figure

Basic Exchange Rates

As one of our continuing rate spread objectives, consonant with Section 728 of the Public Utilities Code, we seek to maintain parity or near parity in basic rates of General's and Pacific's exchanges in the Los Angeles Metropolitan Area. For General's exchanges outside the LA Metro Area, uniform basic rates for local service are desirable and warranted. Such rates are maintained generally at a higher level than basic rates in the LA Metro Area consistent with existing rate relationships and the objective of minimizing rate disparities between General and Pacific in the LA Metro Area.

Basic Exchange Monthly Rates, Primary Service

	Extended Service LA Metropolitan Exchanges		Local Service Courtland, Isleton Walnut Grove (1)		All Other Exchanges (2)	
Residence	Present	Authorized Herein	Present	Authorized Herein	Present	Authorized Herein
1-Party Flat Rate	$ 4.80	$ 5.75	$ 4.25	$5.95	$ 5.25	$ 5.95
1-Party Message Rate ("Lifeline")	2.40-30 (3)	2.95-20 (3)	-	-	-	-
2-Party Flat Rate	3.85	5.05	3.20	5.25	3.95	5.25
4-Party Flat Rate	3.05	4.15	2.55	4.25	3.30	4.25
Suburban (SUB-R)	3.65	4.75	3.05	4.85	3.80	4.85
PBX-Trunk	7.70	8.45	6.25	8.85	7.75	8.85
Business						
1-Party Flat Rate	10.60	12.60	9.55	13.20	11.80	13.20
1-Party Message Rate	5.75-80	7.65-80	-	-	-	-
2-Party Flat Rate	8.50	10.50	6.75	10.50	8.25	10.50
Suburban (SUB-B)	6.75	9.30	5.75	9.30	6.75	9.30
Semi-Public Coin Box	5.50	7.65	4.75	6.60	6.00	6.60
PBX-Trunk Flat Rate	15.75	18.90	14.25	19.80	17.50	19.80
PBX-Trunk Message Rate	2.75	3.85	-	-	-	-

(1) The present differential in rates for Courtland, Isleton and Walnut Grove exchanges is no longer justified. Service in these exchanges has been upgraded and they will benefit from the conversion of 10-cent toll routes to extended service.

(2) Excludes rate increments for Extended Area Service where applicable. Increases in such rate increments, in accordance with basic formula revisions as reflected in Exhibit 70, are also being authorized herein.

(3) Service to be offered in LA Metro Area Exchanges concurrently with the withdrawal of residence 2- and 4-party flat rate service by July 1, 1974, pursuant to Decision No. 75873.

Other Services

The adopted spread of rate increases to other services produce revenue increases meeting the remaining additional gross revenue requirement of $6,840,000.

Push-Button Telephone Service. Applicant proposes a new form of pricing arrangement and rate changes producing an increase in revenues of $1,270,000. The staff also advocates the new pricing procedure which includes replacing the extension charge and the key-in-lieu of extension charge, as presently applied, with a line appearance charge as set forth in Exhibit 81. The staff recommends rate changes producing a decrease in revenues of $531,000 however. We find reasonable and will authorize the new form of pricing arrangement and rates which produce only a minimal change in revenues from this service. In addition, non-illuminated key systems, which are not the standard type equipment used in applicant's packaged offerings, will become a closed tariff offering as proposed by applicant.

Foreign Exchange Service. Applicant's proposal to increase business foreign exchange service rates by $973,000 appears reasonable and is adopted. Its proposal for a 60 percent increase in residence rates for this service, which are already higher than Pacific's, would further widen the difference in rates between the two companies and is rejected.

Message Rate Service. A 4.7-cent rate was authorized in Decision No. 78851 for Pacific's message rate and message unit services. Consistent with this, the rate for calls in excess of the allowance under General's message rate service also will be increased to 4.7 cents.

Supplemental Services. Applicant's proposal to increase rates for some supplemental equipment is supported by the staff. It will generate a revenue increase of $221,000, appears reasonable, and will be authorized.

Service Connection and Move-and-Change Charges. Applicant proposes to increase charges for these services to yield a $3,060,000 revenue increase. The changes proposed include an increase in the basic business service connection charge from the present $15 to $18, an increase in the residence connection charge from $10 to $12 and an increase in the business move-and-change charge from $6.50 to $10. The proposed increases, which include a consideration of cost, appear reasonable and will be authorized.

Private Branch Exchange Service. The staff recommended changes in rates for this service, as set forth in Exhibits 70 and 70A, are more suited than applicant's to the level of revenue increases required at this time. Such rate changes, which produce a revenue increase of $2,447,000, appear reasonable and will be authorized. Concerning applicant's proposal to eliminate the present requirement for PBX basic termination charges, the tendency for such elimination to increase capital risk and to introduce potential inequities between existing and new subscribers would be undesirable. While the proposal does offer some advantages, including improved tariff administration, on balance we deem it prudent on the basis of the present record to reject it.

We have considered applicant's proposal to increase rates for extension stations and the staff's recommendation to increase rates for optional residence telephone service. Such increases would result in either a further departure or a departure from the level of Pacific's rates for the same services and do not appear to be warranted at this time.

Service Quality

General has had a history of rendering poor service and dissatisfaction with General's service by some subscribers, especially among those with heavy usage, still exists.

In some measure this history of poor service was attributable to rapid growth, strikes and acquisition and integration of systems of other companies. But in other respects it resulted from deficient management and deliberate neglect as evidenced during the late 1950's and early 1960's by limiting maintenance of central office equipment to repairs after deterioration or failure of equipment. As a result of the inadequate maintenance, equipment deteriorated and malfunctioned.

In the mid-1960's General adopted a preventive maintenance program and a number of other programs to improve service. By the time of the proceeding in Application No. 49835 (Decision No. 75873, dated July 1, 1969), service had improved substantially but was below the quality of service provided by Pacific in adjoining areas. In the proceeding in 1st Supplemental Application No. 49835, the Commission, in Decision No. 77947, dated November 10, 1970, found service to have undergone significant further improvement and to be adequate on the basis of service index plan results but less than adequate on the basis of a market survey. By Decision No. 79310, upon limited rehearing in 1st Supplemental Application No. 49835, the Commission further found "that the analysis of trends in service indices tends to be inherently a more reliable measure of service quality than market surveys."

In the present proceeding, General has shown a continuation of further improvement in its service, as measured by the service index plans, to the point where the objective level is now being met on a total company basis for each plan. Service indices of 96 to 98 for each plan are the objective and represent service standards which are among the highest in the nation.

Notwithstanding this over-all or company-wide attainment of service objectives, there still are local weak spots. In the case of the exchange maintenance service index, several service offices, which were of concern in the Application No. 49835 proceedings, show further improvement but remain slightly below the objective level. Similarly, with respect to the dial central office service index, the West Los Angeles Central Office shows slight improvement in reaching an average index of 94.3 for the eight-month period June 1970-January 1971. Programs designed to eliminate these few remaining weak spots have been improving service quality and are being continued, with modifications as required, to attain the service objectives.

By its nature, an electro-mechanical system is not troublefree. Thus, some telephone service problems can and do occur. As discussed at some length in Exhibits X and Y, General relies upon a number of continuing comprehensive programs designed to detect, eliminate and prevent service problems and to achieve and maintain its service objectives.

The Commission staff and the City of Los Angeles contend that a second market survey is indispensable to an evaluation of General's service performance and that the service penalty should continue. As set forth in Decision No. 79310, the Commission considers service index plans to be more reliable than market surveys to evaluate such performance.

In that light, a second market survey can and will serve only an ancillary role to provide, among other things, an imprecise confirmation of service index plans results.

The expert witness on service matters for the Commission staff disagrees with the above-stated staff position. Based on continuing surveillance of service rendered by General and Pacific in Southern California over the past six to eight years, he concludes that General's service performance is no longer inferior to Pacific's and in some respects is currently better than Pacific's.

In our opinion, based on a careful consideration of the record, a penalty in rate of return for service inadequacies has served its purpose and is not only no longer warranted, but it also would tend to impair General's capacity to continue to meet the service standards.

To ensure elimination of local weak spots and continuance of meeting service objectives on a total company basis, General will be required to verify quarterly the results of service index plans substantially in the manner prescribed in Appendix C hereto. In this connection, we said in Decision No. 79310:

> "To further buttress the reliability of the input data for the service index plans on an on-going, long-term basis, we plan to require in our forthcoming decision in Application No. 51904 that the service index plan results be verified quarterly by an officer of General who will attest to the procedures and controls used in obtaining and compiling the data and who will direct attention to areas of potential service deficiencies, i.e., those areas identified down to the smallest reporting unit (central office, service center, exchange, etc.) by which the several indices are developed, which

> fall below the 96 percent objective or fully satisfactory level for two or more consecutive months. He will also set forth the corrective measures being taken for such areas. Verification may be made before a notary public or by certification or declaration under the penalty of perjury."

In addition, should performance of central offices by Area (Eastern, Central, Northern and Southern) or on a company-wide basis -- as measured on the Dial Central Office Service Index Plan but exclusive of events beyond General's control (earthquakes, fires, floods, etc.) -- fail to reach a 95.5 index (1) in more than 40 percent of the Area/Total Company central offices for two or more consecutive months, (2) in more than 25 percent of the Area/Total Company central offices for four or more out of six consecutive months, or (3) in ten or more out of twelve consecutive months at the same Area/Total Company central offices comprising 10 percent or more of the Area/Total Company central offices, it will warrant reestablishment of the Central Office Audit Program, on an area or total company basis, whichever may result under the foregoing criteria, manned by maintenance audit teams under the plant director's control. This was formerly a routine program, which provided a central control and an independent audit of maintenance performance on central offices. It was developed and used regularly during the period of General's conversion to a preventive maintenance approach. Currently, the plant director requires such audits only in special cases, presumably upon certain deficiencies arising and continuing in equipment performance.

Before proceeding to our findings and conclusions and the order herein, we should point out that it is not practicable in a proceeding as extensive as this one to rule individually on all the various points brought before us for consideration. Our objective has been to discuss and rule on those matters which seemed of major importance in deciding the validity of applicant's request. However, broad consideration has been given to all requests though each may not be specifically treated herein.

Findings

1. General seeks authority to increase its intrastate rates and charges for telephone service so as to produce approximately a $60 million increase in annual gross revenues on a test year 1970 basis.

2. Prior to this proceeding General's intrastate operations were last exhaustively analyzed by the Commission in Application No. 49835 and related cases. Decision No. 75873 therein was issued on July 31, 1969. The test year used was 1968.

3. General's earnings under "present rates" from its intrastate operations during the 1970 test year produce a rate of return of 6.61 percent on a rate base of $1,142,635,000, as shown in Table 1 herein. The adopted intrastate operating results in Table 1 reflect essential rate making modifications including an affiliated interest adjustment.

4. General is controlled by GT&E, the parent company to communications, manufacturing and research subsidiaries. GT&E's domestic telephone operating subsidiaries comprise the largest independent (non-Bell) telephone system in the United States with General being by far its largest such subsidiary.

5. General, as a member of the General System, transacts a substantial amount of business with Automatic Electric, Directory Company, Service Company, and GTEDS which warrants the affiliated interest adjustment, consisting in the aggregate of a net expense reduction of $3,107,000 and a reduction of $19,806,000 in rate base, made in our adopted intrastate operating results.

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

(a) In light of the leading position held by Automatic Electric in manufacturing equipment for the independent telephone industry, the absence of arms-length bargaining between Automatic Electric and its affiliated telephone companies which provide almost one-half of the independent (non-Bell) telephone service in the United States and the tendency in such circumstances toward administered prices, Automatic Electric's prices to General are deemed unreasonable to the extent they provide more than a reasonable return on GT&E's investment in Automatic Electric allocable to transactions with General.

(b) After modification to reflect the amortization of intangibles, the procedures used in Decision No. 75873 to determine GT&E's investment in Automatic Electric and ultimately the latter's investment devoted to serving General should be followed substantially in determining such investments.

(c) A fair earnings requirement for Automatic Electric on equity, in the form of GT&E's net investment allocable to transactions with General and applicable to General's intrastate operations, is at the rate of 12 percent over the 12-year period 1959 through 1970.

(d) Restricting Automatic Electric's return on such equity to 12 percent results in a decrease of General's intrastate rate base of $19,806,000 and a net intrastate expense reduction of $1,244,000 for test year 1970. This is a fair and reasonable adjustment which prevents, for the rate making purposes of this proceeding, Automatic Electric from making an unreasonable and excessive profit on sales to General.

7. Directory Company, 100 percent owned by GT&E, performs directory service for the telephone operating companies controlled by GT&E as well as for a number of other non-Bell telephone operating companies.

(a) Directory service is an intrinsic part of General's operations.

(b) Our findings in Decision No. 75873 to the ultimate effect that the Directory Company should be treated for rate making purposes, with respect to its business with General, as an equivalent to a functioning department of the latter apply equally well to the record before us in this proceeding.

(c) Consistent with such findings, a net reduction in General's expenses of $1,779,000 is made for the test year to reduce the Directory Company's return on business with General to the level of return the latter is allowed on its other utility business. Such downward adjustment is fair and reasonable.

8. A reasonable range for the rate of return for General is 8.1 to 8.5 percent. Such a range of return should produce returns on common equity of 10.8 to 11.8 percent.

9. The level of return to be adopted as reasonable for purposes of authorizing rates herein should be 8.3 percent on General's intrastate rate base of $1,142,635,000 in the test year.

10. General is entitled to increased net revenues of $19,304,000, an amount sufficient to raise its 1970 test year rate of return to the 8.3 percent level. The corresponding increase in annual gross revenues is $40,288,000, a portion of which in the amount of $16,335,000 corresponds in turn to revenue increases General derives from Decision No. 78851. General should be authorized to increase its rates for intrastate telephone service to the extent provided for in Appendix B hereto. The rates authorized by this Commission, as set forth in Appendix B hereto, are fair, just and reasonable.

11. General has had a history of rendering inadequate service and dissatisfaction with General's service by some subscribers, especially among those with heavy usage, still exists.

12. General has followed diligently for the last several years comprehensive programs to improve service.

13. On a telephone system of this size, localized service problems can and do occur. General has the obligation and resources to take the necessary remedial actions.

14. General is now rendering satisfactory telephone service based on results of its service index plans which show that the objective levels are being met on a total company basis for each plan. These service objectives are among the highest in use by telephone companies in the United States.

15. Continuation of a penalty in rate of return for inadequate service neither is warranted any longer nor would it be conducive to maintaining General's capacity to meet service standards systemwide in light of the heavy capital requirements of its construction program over the next several years to meet system growth and other needs.

16. Consistent with Decision No. 79310, dated November 9, 1971, in 1st Supplemental Application No. 49835, the executive vice-president of General in charge of operations or a suitable alternate should be required to verify quarterly the results of service index plans substantially in the manner prescribed in Appendix C hereto.

17. Should performance of central offices by Area (Eastern, Central, Northern and Southern) or on a company-wide basis -- as measured on the Dial Central Office Service Index Plan but exclusive of events beyond General's control (earthquakes, fires, floods, etc.) -- fail to reach a

95.5 index (1) in more than 40 percent of the Area/Total Company central offices for two or more consecutive months, (2) in more than 25 percent of the Area/Total Company central offices for four or more out of six consecutive months, or (3) in ten or more out of twelve consecutive months at the same Area/Total Company central offices comprising 10 percent or more of the Area/Total Company central offices, it will warrant reestablishment of the Central Office Audit Program, on an area or total company basis, whichever may result under the foregoing criteria, manned by maintenance audit teams under the plant director's control.

18. The conversion to message rate service of 50 percent of business primary service in certain exchanges within the Los Angeles Metropolitan Area will not occur until after mid-1973. Upon such conversion certain changes in rates, charges and conditions would be authorized pursuant to Appendix D of Decision No. 75873. However, as a result of the present proceedings, such tariff changes have been rendered to be of questionable suitability. Not only would they no longer be incremental to the specific rate levels they were designed from, but, more fundamentally, the impact of the conversion to measured service on revenues and expenses is not known. If needed, appropriate rate relief may be sought by General as the conversion proceeds. Appendix D of Decision No. 75873 should be vacated.

19. The BIS project being developed by GTEDS for the General System telephone operating companies under a contemplated six- to ten-year program requires substantial expenditures by General. Continuing surveillance of the project by General should be such as to provide an on-going evaluation of total costs of the project, including both actual and

estimated remaining costs, in relation to benefits to be realized from the project. Such evaluations in summary form should be submitted to the Commission semi-annually.

Based upon consideration of the record and the foregoing findings, the Commission concludes as follows:

1. The application herein should be granted to the extent set forth in the preceding findings and in the following order and in all other respects should be denied.

2. The temporary supplemental billing charge established pursuant to Interim Decision No. 78133 herein should be terminated.

3. The increases in rates and charges authorized herein are justified.

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

5. Appendix D of Decision No. 75873, dated July 1, 1969, in Application No. 49835 should be vacated.

6. Surveillance of the BIS project, verification of Service Index Plans results, and potential implementation of the Central Office Audit program should be required as prescribed in the following order.

7. All motions consistent with these findings and conclusions should be granted and those inconsistent therewith should be denied.

The Investment Tax Credit may be restored in federal tax law soon and be applicable to General. If this occurs not later than six months after the effective date of the order herein, this proceeding will not be considered closed unless General files a new application suitable for giving appropriate disposition to the effect of the investment credit on its revenue requirement.

General applied for an increase in rates on May 15, 1970. Although the matter was submitted for decision on June 21, 1971, final disposition of its request was necessarily deferred during the pendency of the President's 90-day wage and price freeze which ended on November 13, 1971. We have carefully reviewed this order in relation to the regulations issued November 13, 1971 on Price and Rent Stabilization. In our opinion, the action taken herein and the increases authorized are in accordance with the Stabilization Act of 1970, as amended.

The rates authorized herein will do no more than maintain applicant's financial integrity and enable it to raise from external sources, at a reasonable cost, the substantial amount of new capital it will require to finance its construction program.

The rates herein authorized are estimated to result in an 8.3 percent rate of return on the rate base found reasonable in this proceeding, are estimated to produce earnings on common equity of approximately 11.3 percent and times interest coverage after taxes of approximately 2.3 times. Such a rate of earnings is, in our opinion, within the zone of reasonableness for this applicant considering its heavy reliance on debt and preferred stock as the sources of funds to finance its construction program.

Applicant is, of course, expected to comply with the requirements of the Price Commission's regulations relating to the stabilization of prices and rents after November 13, 1971.

O R D E R

IT IS ORDERED that:

1. General Telephone Company of California is authorized to file with this Commission, on or after the effective date of this order, revised tariff schedules with changes in rates, charges and conditions as set forth in Appendix B attached hereto. Such filing shall comply with General Order No. 96-A. The effective date of the revised schedules shall be five days after the date of filing. The revised rate schedules shall apply only to service rendered on and after the effective date thereof and concomitantly the temporary supplemental billing charge established pursuant to Interim Decision No. 78133 shall be terminated.

2. General Telephone Company of California shall maintain a continuing surveillance of the BIS project in such manner as to provide an on-going evaluation of total costs of the project, including both actual and estimated remaining costs, in relation to benefits to be realized from the project. Such evaluations in summary form shall be filed with the Commission semi-annually, on or before February 28 and August 31 of each year, until completion of the project.

3. Within forty-five days after each calendar quarter commencing with year 1972, General shall file with the Commission a verified report on the Service Index Plans and their results and on anticipated service affecting problems. The report and its verification shall be made substantially in the manner prescribed in Appendix C attached hereto.

4. In the event its performance, as measured by the Dial Central Office Service Index Plan, falls within the criteria prescribed in finding 17 hereinabove, General shall reestablish its Central Office Audit Program which thereafter shall remain in effect until pertinent further order of the Commission.

A. 51904, C. 9100 KB * *

Upon such reactivation, the program shall be structured to require not less than one primary audit of each central office in the Area or Areas, or in the Total Company, per year whichever results under said criteria, and shall conform to aforesaid finding 17 in all substantive respects. Further, General shall develop and file with the Commission, within ninety days after the effective date of this order, its plan for the potential implementation of the Central Office Audit Program.

5. Appendix D of Decision No. 75873, dated July 31, 1969, in Application No. 49835 is vacated.

6. All motions consistent with the findings and conclusions set forth above in this decision are granted and those inconsistent therewith are denied.

This proceeding will be kept open to the extent indicated in the statement concerning the Investment Tax Credit immediately following the findings and conclusions of the foregoing opinion.

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

Dated at San Francisco, California, this 22nd day of NOVEMBER, 1971.

Chairman

Commissioners

I will file a concurring opinion.
Thomas Moran

Appendix A

APPEARANCES

Albert M. Hart, H. Ralph Snyder, Jr., Walter Rook and John Robert Jones, Attorneys at Law, for applicant.

Alexander Googooian, Attorney at Law, for City of Bellflower; L. David Fox, for National Businessman's Association; Joan H. Martin, Attorney at Law, for Senior Citizens of Los Angeles County; Royal C. Younger, for Senior Citizens Movement; and Shirley Goldinger, for Association of California Consumers, protestants.

Roger Arnebergh, City Attorney of Los Angeles, by Charles E. Mattson, Deputy City Attorney; Louis Possner, for City of Long Beach; R. W. Russell, Chief Engineer and General Manager, by Manuel Kroman, K. D. Walpert and Kenneth E. Cude, Department of Public Utilities & Transportation, for City of Los Angeles; Robert E. Burt, for California Manufacturers Association; Carl Weissburg, Attorney at Law, for United Hospital Association; Ronald G. Travner, Attorney at Law, for California Hospital Association; John A. Van Ryn, Attorney at Law, City Attorney, for City of Santa Maria; Joseph R. Gallagher, in propria persona as a taxpayer and registered voter; and Morris M. Conklin, in propria persona, interested parties.

Janice E. Kerr and Leonard L. Snaider, Attorneys at Law, Colin Garrity and John Gibbons, for the Commission staff.

RATES

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

Schedule No. A-1
Individual and Party Line, Suburban, PBX Trunk and Semipublic Service--Authorized Rates

Class and Grade of Service	Rate Per Month: Extended Service: Los Angeles Metropolitan Exchanges (1)	Rate Per Month: All Other Exchanges (2)
Business Service		
Individual Line - Flat	$12.60	$13.20
Individual Line - Measured	7.65(80)	-
2-Party Flat	10.50	10.50
Suburban Business	9.30	9.30
Semipublic Coin Box	7.65	6.60
PBX Trunk - Flat	18.90	19.80
PBX Trunk - Message	3.80(0)	-
Residence Service		
Individual Line - Flat	5.75	5.95
Life-Line Measured	2.95(20)	-
2-Party Flat	5.05	5.25
4-Party Flat	4.15	4.25
Suburban Residence	4.75	4.85
PBX Trunk Residence Flat	8.45	8.85

(Message allowance shown in parenthesis)

NOTES

(1) Extended Service Exchanges.
Los Angeles Metropolitan Area

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

(2) Rates shown are for local service. Extended service,where offered, is offered at these rates plus extended service rate increments as set forth in Exhibit No. 70, Table 6.

RATES

Schedule No. A-1 - Continued

Message Rate

Class of Service	Rate Per Message
Message Rate Service - Each Message over Allowance	4.7¢
Semipublic Service - Each Exchange Message	10.0
Hotel Service - Each Exchange Message	5.0

Schedule No. A-6
Private Branch Exchange Service

The rates set forth in Exhibit No. 70, Table 7, Sheets 4, 5, 7 and 8, and Exhibit No. 70-A, Table 7, Sheets 2, 3, 6, 9 and 10 are authorized.

Schedule No. A-15
Supplemental Services

The rates set forth in Exhibit No. 11, page 24, are authorized.

Schedule No. A-19
Foreign Exchange Service

The rates set forth in Exhibit No. 70, Table 9, are authorized.

Schedule No. A-29
Move and Change Charges

The rates and charges set forth in Exhibit No. 11, page 26, are authorized.

Schedule No. A-30
Service Connection Charges

The rates set forth in Exhibit No. 11, pages 27 and 28, are authorized.

RATES

Schedule No. A-34
Pushbutton Telephone Service

The rates set forth in Exhibit No. 70, Table 11, are authorized except as follows:

Line Common Equipment

Each central office line, PBX station line or private line terminated in the system,
(1) Illuminated, rate per month $2.80
(2) Nonilluminated line - offering limited to service established or applied for prior to effective date of order.

Other Rates and Charges

Rates and charges for other related services shall be revised to the extent required by the above-authorized revisions.

APPENDIX C

Quarterly Verification of Service Index Plans

Preface

The proper application of the Service Index Plans and the results of the plans are to be verified, in conjunction with a quarterly Below Objective Report, by the officer of General in charge of operations, presently the Executive Vice-President - Operations, or a duly designated and authorized alternate in his absence. The quarterly report serves to set forth the reporting units which are below objective for two or more consecutive months, the reasons therefor and the corrective actions taken. In addition, the report directs attention to anticipated service affecting problems.

Below Objective Report

This quarterly report shall list each reporting unit which failed to meet the Company objective for any service index plan or component index thereof for two or more consecutive months in the four-month period ending with the last month in the calendar quarter.

The report shall include the following:

(a) Name of reporting unit and area (Eastern, Central, Northern or Southern) in which it is located.

(b) Service index results for each month.

(c) Analysis and description of causes of failure to meet objectives.

(d) Corrective actions taken or planned to be taken.

(e) Estimated date on which performance will meet or exceed Company objective.

In addition, the report shall identify anticipated serious service affecting problems and describe corrective actions planned or underway.

Appendix C (Continued)

Verification

I, the undersigned, an officer of the General Telephone Company of California, a corporation, certify under penalty of perjury that:

> I personally reviewed the procedures of index preparation, and am satisfied that the results are proper and unbiased.
>
> Based on my review of the indexes and personal knowledge of operation, the foregoing Below Objective Report is complete and there were no other existing or expected serious service affecting problems beyond those ennumerated or otherwise commented upon.
>
> All necessary steps have been taken, controls implemented, funds secured, and manpower provided to assure continued good service performance of the Company with the following exceptions:
> (Indicate "none" or specify the exceptions.)

Executive Vice-President - Operations

or

Duly designated and authorized alternate in his absence.

A. 51904
D. 79367

COMMISSIONER THOMAS MORAN, Concurring.

I concur with the majority in this decision despite the fact that in addition to granting rate increases, it constitutes a reversal of this Commission's historic practice. In all prior General Telephone rate cases until today the Commission has required General to "flow through" to its subscribers tax savings available by reason of the 1954 amendment of the U.S. Internal Revenue Code.

The Commission by this decision authorizes General Telephone to retain said tax savings rather than to flow them through to the subscribers - a practice euphemistically called normalization. As a consequence General Telephone will over the next ten years collect from its subscribers more than $100,000,000 over and above that provided by the rate of return herein authorized.

I shall not repeat herein my strong objections to this aspect of the decision as I set the same out in full in my dissent to this Commission's Decision No. 78851 dated June 22, 1971, in Application No. 51774, et al.

However the Commission has heretofore granted the same authorization to Pacific Telephone in Decision No. 78851, dated June 22, 1971, in Application No. 51774, et al., and it therefore would be inequitable if not indeed unlawful not to extend the same generous treatment to General Telephone and other utilities as this Commission extended to Pacific Telephone in the above cited decision.

Dated: November 22, 1971
San Francisco, California

Thomas Moran

Thomas Moran, Commissioner