1mm

ORIGINAL

Decision No. 83162

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application No. 53587 (Filed September 19, 1972)
In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application No. 51774 (Filed March 17, 1970)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of all the telephone corporations listed in Appendix A, attached thereto.	Case No. 9504 (Filed January 30, 1973)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of The Pacific Telephone and Telegraph Company.	Case No. 9503 (Filed January 30, 1973)

(Appearances are listed in Appendix A)

TABLE OF CONTENTS

INDEX

O P I N I O N

By Application No. 53587 The Pacific Telephone and Telegraph Company (Pacific) seeks to increase its rates for intrastate telephone service by $289.8 million plus an additional $22.8 million to reflect the settlement effect of intrastate telephone service between Pacific and the independent telephone companies operating in California.

In conjunction with Pacific's application the Commission on its own motion instituted an investigation into Pacific's operations (Case No. 9503), and an investigation of all telephone companies in California other than Pacific (these telephone companies are known collectively as the "Independents", i.e., non-Bell telephone companies) for the purpose of investigating, in regard to the Independents, the following subjects: (1) separation procedures affecting toll and other settlements, (2) extended area rates, (3) intrastate toll rates, (4) exchange rates, multi-message unit rates, and conditions of service, and (5) earnings, capital structure, interest, and dividend rates (Case No. 9504). Cases Nos. 9503 and 9504 were consolidated for hearing with Application No. 53587. The Commission staff recommends that Pacific's rates be reduced by $114.8 million.

Also consolidated for hearing with Application No. 53587 was the accelerated depreciation issue of Application No. 51774 which has not yet been decided by the Commission. By Application No. 51774 Pacific, in 1970, sought to raise its rates by approximately $195 million. On January 2, 1971 in Application No. 51774, the Commission issued Interim Decision No. 77984 in which we held, based on our interpretation of the Tax Reform Act of 1969, that we would compute Pacific's federal income tax expense for ratemaking purposes on the basis of accelerated depreciation with normalization. That decision was annulled by the Supreme Court of California in City and County of San Francisco v PUC (1972) 6 C 3d 119, with directions to hold further hearings on the tax expense issue. All other issues in Application No. 51774 were determined by Decision No. 78851 dated June 22, 1971 (annulled by the Supreme Court of the State of California in City of Los Angeles v PUC (1972) 7 C 3d 331) and Decisions Nos. 80346, 80347, and 80348 dated August 8, 1972. The further hearings ordered by the Supreme Court on the tax expense issue were held on a consolidated record with Application No. 53587 and Cases Nos. 9503 and 9504. Hearings were held before Examiner Robert Barnett for 68 days between January 5, 1973 and November 1, 1973. On June 18, 1974 the proceedings were reopened for further briefs on the issue of the treatment of the reserve for deferred taxes; the entire proceedings were submitted July 3, 1974.

I

BACKGROUND

Pacific is one of 21 telephone operating subsidiaries of the American Telephone and Telegraph Company (American). American also owns the Western Electric Company which manufactures and installs equipment for the operating companies. American and Western Electric each own 50 percent of the outstanding capital stock of the Bell Telephone Laboratories which is a research and development organization. The operating companies, Western Electric, and the Bell Telephone Laboratories, together with American, form the Bell System.

As of December 31, 1972 American owned 89.72 percent of the voting securities of Pacific. The total voting power of all Pacific stockholders on that date was approximately 157 million votes, of which American had approximately 141 million votes.

Pacific operates throughout California. It is estimated that approximately 93,000 square miles of California's total area of 157,000 square miles are supplied with telephone service, and Pacific renders service in about 50,000 square miles of this area, with exchanges in 52 of the 58 counties in the State. The only counties not served by Pacific are: Mono, Alpine, Lassen, Modoc, Del Norte, and Santa Barbara. With approximately 11.3 million telephones out of the State total of about 14.3 million telephones at the end of 1972, it was estimated that Pacific served approximately 80 percent of the total population of the State. Pacific employs over 95,000 persons and had a wage bill in 1973 of over $1 billion.

Abbreviations for some parties are: the city of Los Angeles - Los Angeles; the city of San Diego - San Diego; the city and county of San Francisco - San Francisco; the Executive Agencies of the United States, General Services Administration - GSA.

II

RATE OF RETURN

Our observations concerning the importance of rate of return set forth in Re General Telephone Company (1969) 69 CPUC 601, 610, are worth repeating.

> "Rate of return in simplest terms is a percentage expression of the cost of capital utilized in providing service. It is just as real a cost as that paid for labor, material and supplies, or any other item necessary for the conduct of business. Generally, in public utility regulation, it is understood to be the measure of that amount of money, compensation, or return received by the owners of capital in the company over and above operating expenses and other

allowable revenue deductions. It is from this return that the different classes of capital are compensated. Stated in another way, the return comprehends the interest payable by the company on its long-term debt, dividends on preferred stock, and earnings on common equity. The amount of dollars that a utility is permitted to earn depends upon the amount of the rate base and the allowed rate of return. Any change in either of these factors has a substantial impact. Accuracy in determining a fair rate of return is much more important than accuracy in determining rate base because even the slightest variation in the rate of return counts much more, in terms of dollars, than a variation in rate base. For example, a change in the rate of return allowance of only 1 percent--from 5 to 6 percent--can have the same effect on the level of rates as a 20 percent increase in the value of the property. Thus, if the utility's rate base is $1,000,000, the return in dollars at 5 percent would be $50,000. If the rate of return were increased to 6 percent on the same rate base, the return in dollars would be $60,000. That would amount to a return of 5 percent on a rate base of $1,200,000, or 20 percent more than the original $1,000,000 rate base.

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

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

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

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

Pacific's Evidence

Pacific argues that it must have an increase in equity return if it is to continue to raise sufficient capital on reasonable terms to meet service demands of California consumers. Pacific's return on common equity as fixed by this Commission's most recent decision was approximately 9.5 percent. At the hearing Pacific sought an increase to 12.64 percent; in its brief Pacific requests "more than 12.5 percent". The increase is needed, in Pacific's opinion, to attract capital at reasonable cost so that Pacific may continue its construction program to provide adequate service to California ratepayers. Pacific estimates that its construction program will exceed $855 million in 1973 and will approach an annual level of $1 billion in the second half of the 1970's. Approximately 40 percent of this amount must be in the form of new capital. In order to attract this new capital, Pacific's equity return must meet the requirements of the marketplace. To meet these requirements Pacific must have earnings comparable to other companies of corresponding risk seeking funds in the marketplace. Pacific presented four approaches to comparable earnings all of which, in Pacific's opinion, result in a requirement of more than 12.5 percent return on common equity.

The first approach is to evaluate the business risks of industrials and electrics and estimate Pacific's required equity return with reference to the resulting range of returns. Pacific's rate of return witness, Robert M. Joses, concluded that the business risk of telephones was less than that of industrials and greater than that of electrics. He based this conclusion on the fact that Pacific now faces competition from other communications companies, such as Litton Industries, which provides various interconnecting devices, and similar companies, and the Southern Pacific Communication Company, which is presently engaged in constructing and offering services over a point-to-point microwave route stretching along the West Coast and into the southwestern United States. His analysis suggested the need for an equity return roughly equivalent to that earned by the electrics.

His second test was variability of return, which he explained as calculating the spread of the distribution of annual returns above their average for an appropriate period. The best measure of this spread is standard deviation. A firm with a high standard deviation reflects highly variable returns, while one with a low standard deviation is more stable. His analysis shows that, measured by the standard deviation of returns on total capital, the industrials have been subject to substantially greater risks than the telephones, and Pacific's risk exceeds that of the electrics.

Mr. Joses' third approach was based upon the market risk or Beta analysis, which he explained was an approach that simply measures the degree to which any security or group of securities is susceptible to economy-wide forces. The theory is that investors recognize the sensitivity of firms to economy-wide influences. They gauge their future expected returns on their judgment of future economic conditions which are, in turn, based on observations of past and present events. When investors expect favorable business conditions, they bid up the prices of stock in anticipation of future profits. When investors expect poor business conditions, they lower the price of stocks. The degree to which investors lower or raise stock prices depends on the sensitivity of the firm to economy-wide events--a firm highly sensitive to economic conditions will have highly volatile prices, while those with less sensitivity will have less movement. Beta is a measure of the relative sensitivity of a given security compared with a sensitivity of the average security in the market. As such, Beta is the market's evaluation of the risk of a firm's equity. This method permits the identification of equities which have risks which correspond to the equity risks of the utilities which the Commission regulates. The method cuts through the problems of evaluating business risk and it cuts through the problem of evaluating the degree to which equity ratios should be taken into account in identifying equities of corresponding risk.

By applying the Beta method Mr. Joses concluded that Pacific's Beta, and hence the risk associated with its common equity, was not significantly different from that of the major California energy utilities and the electrics generally. Thus, at the level at which the comparable earnings standard becomes critical--return on equity--the risks of electrics and of Pacific are corresponding and their equity returns therefore should be commensurate. As a check on this result Mr. Joses evaluated every company listed on the New York Stock Exchange to determine which companies had Beta factors, and hence equity risks, similar to that of Pacific. He found 111 companies, both industrials and utilities, having risks approximately equal to that of Pacific. The average return on equity of those firms was 12.41 percent for the period 1947-1971. The average for the industrials in the group was 12.67 percent and for the utilities 12.24 percent. Thus, Mr. Joses found confirmation of his recommendation that, if Pacific is to have a return on equity commensurate with the returns on equities of corresponding risk, that return must be more than 12.5 percent.

Finally, Mr. Joses measured risk by firms of comparable equity ratios, as shown in the following table:

PERCENT RETURN ON AVERAGE COMMON EQUITY

1966 - 1971

Year	Pacific Telephone	All Companies of Similar Beta*	50 Largest Telephones	50 Largest Electrics	50 Largest Industrials	Selected Industrials**
1966	7.05%	13.06%	10.52%	13.62%	14.22%	16.2%
1967	6.86	13.02	9.80	13.50	12.74	14.8
1968	7.18	12.32	9.48	12.98	12.54	15.4
1969	8.10	11.70	9.49	13.02	12.56	15.1
1970	7.68	12.07	9.44	12.53	10.33	12.3
1971	6.81	12.36	9.72	12.25	10.21	11.9
Average for 5-yr. period 1966-1970	7.37	12.43	9.75	13.13	12.48	14.8
Average for 5-yr. period 1967-1971	7.33	12.29	9.59	12.86	11.68	13.9

* All companies included on Line 4 of Exhibit 63.

** Of 425 Standard and Poors Industrials, all companies whose common equity percentages were in the range of 47 to 57 percent for the year 1971.

Utilizing this table Mr. Joses pointed out that a comprehensive group of industrials with common equity ratios similar to that of Pacific averaged 14.8 percent and 13.9 percent return on equity for the period 1966-1970 and 1967-1971, respectively, more than Pacific's sought 12.64 percent return. Second, the exhibit shows that every group except the telephones has earned returns averaging in excess of 12 percent with the single exception of the 50 largest industrials in the period 1967 through 1971 when average earnings were 11.68 percent on equity. Third, the exhibit shows that Pacific's equity returns have been far below those of any comparable group, including the telephones. The disparity between Pacific and the 50 largest telephones are substantial; the disparity between Pacific and the other comparable groups is enormous.

For all of the reasons stated above, and for many reasons that, for lack of space, are not set forth here, Pacific concludes that a return on equity of more than 12.5 percent is reasonable.

The staff's Evidence

The staff recommends that Pacific's return on equity should be 9.44 percent.[1/] The staff's recommendation was presented by Russell J. Leonard and was based upon a study consisting of 29 tables and 12 charts related to interest rates, earnings, capital structure, financing, and data pertaining to growth and net telephone plant investment. Trends in 5-year averages for the years 1967-1971 were utilized along with comparisons of Pacific's operating results with averages developed for 22 other Bell System operating companies, 16 General Telephone System operating companies, and 11 Independent telephone companies. Based upon those tables, charts, and comparisons, and applying his judgment and experience, he concluded that a rate of return of 7.9 percent applicable to Pacific's California intrastate

1/ This reduces to 9.37 percent under the stipulated costs and capital ratios.

rate base was reasonable. In his opinion, a 7.9 percent return was reasonable because it would provide adequate funds to cover Pacific's interest and preferred dividend requirements and would produce a common equity allowance sufficient to permit moderate increments to retained earnings after payment of a suitable dividend. He did not recommend a range in rate of return in view of the prevailing anti-inflationary objectives of the federal government.

He compared Pacific to other telephone companies because in his opinion telephone companies experience business and financial risks which are similar to those of Pacific. He did not compare Pacific to nontelephone utilities or to industrials because he felt that earnings comparisons which include other more risky utility groups and cyclical industries would probably result in requests for even higher returns by those relying solely on comparable earnings.

He pointed out that his 9.44 percent return on equity exceeds the average earnings rate on average common equity for the 22 Bell System companies for each year 1967-1971, exceeds the 5-year average for those companies, and exceeds the average for the 16 General Telephone companies for 1970 and 1971. He considered the fact that Pacific was a part of the Bell System and that Pacific, AT&T, Bell Laboratories, and Western Electric all have a community of interest which reduces the risk of each one because they are all acting in concert to produce profits. He believes Pacific is less risky than the California electric utilities primarily because of its affiliation with the Bell System and the community of interest of all companies involved in the Bell System.

Los Angeles's Evidence

Los Angeles, through its expert, Manuel Kroman, recommends that the return on equity should be approximately 9.5 percent. Mr. Kroman used three methods to arrive at his recommended return. The first method derives the allowance on common equity by updating the 9.47 percent common equity rate last authorized for Pacific in Decision No. 80347. He pointed out that although the decision states that 9.5 percent was the return on common equity, a more precise analysis shows that figure to be 9.47 percent. Mr. Kroman adjusted the 9.47 percent figure upward by 3.2 percent because Pacific's embedded cost increased 3.2 percent and, therefore, a similar increase in allowance on common equity is justified. He further increased it by .2 percent in recognition of the decrease in equity ratio from 55.10 percent in Decision No. 80347 to 52.07 percent currently. Because return on equity and equity ratio are inversely related, the slightly lower current ratio requires a slightly higher return. He then multiplied the resulting figure by 0.95 to reflect the fact that if the earnings on equity of the 250 largest companies presented for the Commission's consideration in Decision No. 80347 supported a return on equity of no more than 9.47 percent for Pacific, then the updated earnings of those companies, which show a downtrend, require a reduction downward by approximately 5 percent. The result of these three adjustments is 9.47 percent. He justifies this method because the California Supreme Court in reviewing the last authorized rate of return held that it was "satisfied that the Commission did not abuse its discretion in fixing the rate of return". (City of Los Angeles v PUC (1972) 7 C 3d 331, 348.)

Mr. Kroman's second method is to apply a comparable earnings approach adjusted to reflect the difference between Pacific's equity ratio of 52.1 percent and the median equity ratio of electric utilities of 34.2 percent. In his opinion this comparison supports an allowance of no more than 9.5 percent.

Mr. Kroman's third approach begins by postulating an after tax interest coverage of 2.75 times. He finds this interest coverage comparable to that for all the operating companies of the Bell System on a weighted basis. The resulting rate of return is 7.95 percent with an equivalent allowance on common equity of approximately 9.5 percent.

San Diego's Evidence

San Diego presented Manley Edwards who testified that a reasonable return on equity would be 8.76 percent based on the current price-earnings ratio of Pacific. In its brief San Diego adopts the staff's position.

Discussion

The parties stipulated to Pacific's capital ratios and to the cost of each capital ratio component except return on equity. For the reasons stated below we find that the return on equity should be 11.00 percent and that Pacific's fair rate of return should be 8.85 percent, as follows:

	Amount	Cost	Weighted Cost
Long-term debt	42.8%	6.06%	2.59%
Short-term debt*	3.8	11.8	.45
Preferred stock	1.3	6.00	.08
Equity	52.1	11.00	5.73
	100.0		8.85

* It was stipulated that the cost of short-term debt should be the prime rate prevailing at the time the Commission makes its determination. Obviously this can't be the date the decision is signed because of the substantive problem of spreading rates. We have selected June 25 as the determination date.

The position of the parties submitting briefs on return on equity is:

Pacific	more than 12.5%	San Diego	9.44%
Staff	9.44%	San Francisco	10.0%
Los Angeles	approximately 9.5%	Mrs. Siegel	9.44%
		GSA	9.44-9.5%

It would serve no useful purpose to analyze all of the rate of return testimony pointing out strong points and weak points. The parties agree only on the statement that there is no formula from which rate of return can be computed and informed judgment must be exercised on the evidence. The dollar difference in rate of return is approximately $140 million. In many cases we must decide important issues with less than full information; on this issue we are inundated with information.

We have examined the underlying data that supports the recommended rates of return of the rate experts. In our opinion these data do not support any of the experts to such an extent that we can accept his opinion and reject the opinions of the others.

Pacific asks too much. Pacific argues that its current equity return is dismally low, whether adequacy of return is measured by other California utilities, or by industrials, or by telephones, or by Bell System companies, or by utilities generally, or by all firms of corresponding risk. Pacific urges that a more than 12.5 percent return on equity will correct this imbalance. However, if the Commission were to authorize more than 12.5 percent Pacific's equity return would then be exceedingly high, whether adequacy of return is measured by other California utilities (Pacific's return would exceed every other major utility in the state), or by industrials (Pacific's return would equal or exceed the average return for the 50 largest industrials in every year since 1967), or by telephones (Pacific's return would exceed the average return of the 50 largest telephone companies for every year since 1965), or by Bell System companies (Pacific's return would exceed by over 300 basis points the average return earned by 22 Bell System companies since 1966), or by utilities generally (Pacific's return would almost equal the average return for the 50 largest electrics between 1967 and 1971, without regard to leverage), or by all firms of corresponding risk (Pacific's return would exceed the average return of all companies which Pacific considers to be of similar risk (Beta) for every year since 1967). In addition, Pacific's requested return on equity does not take into consideration, when comparing Pacific's financial situation with other companies, the fact that Pacific is the largest affiliated utility in the Bell System, that the Bell System is the largest utility system in the United States, that Pacific has an equity ratio higher than any of the electrics to which it compares itself and higher than most of the telephone companies to which it compares itself. Further, Pacific bases its request in part on the theory that telephones are more risky than electrics. This Commission has consistently held that we do not consider telephones to be more risky than electrics, and in the recent Southern California Edison rate case we pointed out that "electric utilities are required, by the circumstances that they find themselves to be in, to raise large amounts of capital in the face of a chronic fuel shortage, mandatory massive expenditures for new and sometimes untried equipment required to meet constantly more severe environmental requirements, difficulties and delay in siting power generation and transmission plant, and increasing demands for aesthetic considerations". (Re Southern California Edison Company, Decision No. 81919 dated September 25, 1973 in Application No. 53488, at pages 67-68.)

We have not been persuaded that the Beta factor is a useful tool in determining the fair rate of return. We do not agree that volatility of the performance of the stock of a regulated utility is equated to risk in the sense that we have traditionally used the term. We can understand risk within the context of competition from other businesses and we can understand risk in the sense that there must be sufficient interest coverage to protect the bondholders, but to measure the risk of regulated utilities on the basis that some stock prices fluctuate more than others seems to be insubstantial, somewhat on the level of a price-earnings ratio; it is evidence, but certainly not controlling.

When we examine the companies that have the same Beta factor as Pacific, we find that they cover the entire spectrum of the American business community. Setting Pacific's rate of return on average earnings of large industrials would indeed be a novel departure from traditional ratemaking.

But even if Beta does measure risk, we are not persuaded that Pacific should be given the average return on equity earned by other utilities having the same Beta as Pacific. To do so would abdicate regulation to the Beta factor. And, as the idea caught on, most large utilities would have the same return on equity no matter what their size, what their capital ratios, what service they provide, what part of the country they operate in, and no matter what other individual characteristics they may have that is thought to be important in determining return on equity. The argument that rejects Beta as a means of determining return on equity is the same argument that rejects any formula as a means of determining rate of return. The Commission is not ready to abdicate.

Nor do we find the staff recommendation persuasive. The staff witness originally recommended a 7.9 percent rate of return which would produce a return on equity of 9.54 percent and an interest coverage of 2.82 percent, which he considered to be "stringent coverage". When Pacific's 1973 estimated cost of debt increased substantially and had to be considered in the return equation, Mr. Leonard, instead of changing his rate of return recommendation, stated that it should remain the same, thereby reducing his recommended return on equity to 9.44 percent. The effect was that when Pacific's cost of debt rose, Mr. Leonard felt that it required a reduction in equity return. In addition, by adhering to a 7.9 percent rate of return under changed circumstances, the previously "stringent coverage" of 2.82 percent was reduced to 2.71 percent. Mr. Leonard worked backwards: He found the rate of return and then worked out its components; he should have determined the return on equity and then computed the overall rate of return. In our opinion Mr. Leonard's original recommendation of a 9.54 percent return on equity and a 2.82 percent debt coverage ratio has stronger support from the underlying data than his final recommendation.

The defect in the presentation of Los Angeles is that it is a formula approach. A formula that makes as its basic premise the last authorized decision of the Commission would end Commission discretion and would tie future Commissions to the rate of return found reasonable in Pacific's latest rate case. The method would foreclose the development of new methods of arriving at the fair rate of return. Despite the protestations of Los Angeles that Mr. Kroman did apply judgment to his formula, the result offered appears to us to be based solely on the formula, and we reject rates of return that are based on formula.

The evidence persuades us that Pacific is entitled to a substantial increase in return on equity, and this increase is essential if Pacific is to meet its construction program and give the public continuing good and improving service. Pacific's construction program is financed from earnings and borrowings. Of the more than $850 million required in 1974 about 40 percent will be financed through borrowing. Yet interest rates are spiraling, Pacific's bonds have been partially downrated, and its stock is selling below book value and at a 22-year low. (As to book value Pacific's position is comparable to many utilities.)

Pacific has been unable to increase its dividend for the last decade during which time other utilities have achieved substantial dividend increases. Investors are entitled to fair consideration just as are ratepayers. The Commission recognizes that we must fix a rate of return that is "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital" (FPC v Hope Natural Gas Co. (1944) 320 US 591, 603, 88 L ed 333, 345). In this regard we are concerned with interest coverage, a critical factor in the financial integrity of a utility. (See Re San Diego Gas & Electric Co., Decision No. 82279 dated December 18, 1973 in Application No. 53945.) If a utility's pretax interest coverage falls below 3.0, the Securities and Exchange Commission requires a special application for authority to issue new securities. If coverage falls below 2.0, many utilities cannot issue securities at all. When needed, as in this case, an increase in rates must be authorized to raise interest coverage to a sufficient level. Mr. Leonard testified that after-tax coverage of 2.82 was adequate. We have previously analysed his recommendation for rate of return and found it insufficient. So also is his recommended coverage of 2.82. In our opinion an after-tax interest coverage of about 3.0 is needed by Pacific in today's market, and our authorized return will provide it.

Starting with the return on equity found reasonable in Decision No. 80347, an increase is required in return on equity to reflect the increase in Pacific's embedded debt cost, and an additional increase is required to reflect the higher debt equity ratio. But no increase is required because of Pacific's Beta factor; nor merely because Pacific earns less than industrials, nor because Pacific earns less than electrics. Pacific is the largest operating utility of the Bell System. It is larger than any electric utility in the United States; it has a more conservative capital ratio than any major telephone utility outside of the Bell System or any electric utility that we have been considering. The factors of size and affiliation reduce Pacific's business risk; the factor of conservative debt equity ratio reduces Pacific's financial risk. Because of these factors none of the comparisons of earnings presented by Pacific compel us to increase Pacific's return on equity. On the other hand, the factors of large size, affiliation, and monopoly position would tend to lessen risk and have a restraining effect on return on equity.

To determine whether the increase in embedded cost and debt equity ratio would increase return on equity by the substantial amount requested by Pacific, or some lesser amount, we have considered, among other things, Pacific's experience in issuing bonds. Exhibit 62, page 5, shows that in 1969 Pacific issued bonds at 9.10 percent, four comparable Aaa utilities' bond issues at approximately the same time went out at lower yields to the public; in early 1970 Pacific issued bonds at 8.65 percent, of four comparable utility issues, two went out lower, one went out at the same rate, and one (AT&T) went out at 8.75 percent; in late 1970 Pacific issued bonds at 8.76 percent, of four comparable utility issues, three went out lower and one went out higher; in 1971 Pacific issued bonds at 7.80 percent, higher than four comparable utility issues; in 1972 Pacific issued bonds at 7.23 percent, <u>lower</u> than four comparable utility issues; and in 1973 Pacific issued bonds at 7.625 percent, of four comparable utility issues, two went out higher and two went out lower. The conclusion we draw from this is that in the marketplace, the "real world" that the Commission is so often accused of ignoring, Pacific holds its own with the best. Nevertheless, cost of debt for "the best" is soaring and Pacific must keep up. Pacific's reduced rating from Aaa to Aa by one bond-rating agency, while significant, does not have the significance for us that Pacific would have us place on it. In the first six months of 1973 the evidence shows (Exhibit 90, page 13) that the spread between yield averages of Aaa and Aa bonds ranged from .05 to .11. This spread is small and does not warrant an increase in return on equity to "more than 12.5 percent".

Of prime importance to us in determining return on equity is the prime rate. In rate cases prior to those of recent years, the prime rate was a minor consideration; in this rate case it is very important. A prime rate of 11.8 percent must have a strong upward effect on bond interest. As bond interest rises, not only must Pacific have increased earnings to pay the interest, but also it must have increased earnings, and the potential for increased dividends, to attract equity investors. All of these factors are interrelated. Every economic indicator that we have considered points to the need for a substantial increase in return on equity. For the reasons stated above, and based upon all the evidence, we find that a reasonable return on equity is 11 percent.

III

RESULTS OF OPERATIONS

The discussion of the estimating differences in revenues, commercial and traffic expense, maintenance expense, advertising, and pension expense includes the effect of wage annualization and wage offset. In addition, the issues of wage annualization and wage offset are discussed and resolved separately. Because of this overlapping it is extremely difficult to prepare a results of operations table that clearly reflects the differences between the parties. So as not to burden the opinion portion of this decision we have placed two results of operations tables, with appropriate footnotes, in Appendix B. The figures shown on the tables are on a California intrastate basis. The discussion in this opinion uses the numbers that the parties used in their briefs. Some issues were discussed on an intrastate basis and some on an interstate basis. It is not necessary for the purposes of discussing the issues to convert all numbers in the opinion to an intrastate basis. That conversion is done in Appendix B.

Table I of Appendix B shows the development of the adopted results of operations. Table II of Appendix B compares Pacific's and the staff's estimates with the adopted results.

Revenues

The staff's estimate of revenues for test year 1973 exceeds Pacific's estimate by $13.3 million. The staff's estimate was developed by reviewing Pacific's estimating and forecasting procedures. The staff witness then made independent estimates of the number of telephones and revenues, on an annual basis. Pacific's test year estimate, based on a month-by-month review, for the first five months of 1973 was within five one-hundreds of 1 percent, or less than $1 million, of the actual revenues for the same period. When estimating revenues, it is important to be as close to the mark as possible. We will adopt Pacific's estimate.

Commercial and Traffic Expense

The staff's estimates of commercial and traffic expense is $7.9 million less than Pacific's. The staff's estimates were developed using recorded expenses for the years 1967-72 and trending 12-month moving totals and averages to minimize seasonal variations.

Pacific based its estimates on a "bottoms-up" method. This method reflects estimates for the year in question made at the lowest operating level and then reviewed at the area level and finally approved at the company level, at which level any policy decisions which would affect the estimate are made.

The staff's estimated traffic operating expense for 1973 was based on an estimate per average company station (ACS) of $19.38. Recorded data through May 1973 on a 12-month moving basis give the same figure, $19.38 per ACS. The staff's 1973 estimate of commercial expense was based on an estimate of $7.72 per ACS, and of marketing expense on an estimate of $10.54 per ACS, a total of $18.26 per ACS. Recorded data through May 1973 on a 12-month basis shows commercial expense as $7.83 per ACS and marketing expense as $10.27 per ACS for a total of $18.10, or .16 cents less than the staff's estimated expense per ACS for the full year 1973. When determining the accuracy of expense estimates for a test year, we realize that the utility has very close control over its expenses as contrasted to a rather limited control over its revenues. The staff's estimate appears reasonable and we will adopt it.

Maintenance Expense

Pacific's estimate of maintenance expense exceeds the staff's estimate by approximately $3.8 million. Pacific estimated its maintenance expense in the same manner as it estimated its commercial and traffic expense. The staff derived its 1973 end of year total maintenance expense by trending the five recorded years 1968-1972. Pacific's maintenance expense estimate for the first five months of 1973 was $242.9 million; actual maintenance expense for the first five months of 1973 was $243.3 million. Considering the magnitude of the numbers involved the difference between Pacific's estimate and Pacific's recorded maintenance expense is de minimis. This reinforces our opinion that Pacific has extremely close control over its operating expenses. We will adopt Pacific's estimate, not so much because of its accuracy, but because 1972 maintenance expense was abnormally low and caused some distortion in the trend line from which the staff witness developed his 1973 estimate. And, most importantly, our continuing concern with adequacy of service causes us to be somewhat more generous in regard to maintenance expense.

Rate Base

The only significant difference between the staff and Pacific in their respective estimates of telephone plant and rate base relates to the percentage of construction expenditures which will be included in "Plant in Service" by the end of the 1973 test year. The staff's estimate is $54 million less than Pacific's.

The difference was explained by staff witness Houck as (1) the staff had available the recorded plant in service as of December 31, 1972, (2) based on the utility's experience dating back to 1965, the staff estimated that a smaller percentage of the estimated construction expenditures for 1973 would close as plant in service by the end of the year, and (3) again based on the utility's actual experience, the staff estimated that the weighted additions as a percentage of net additions to plant in service would be less by 2.7 percent than the utility's estimate. The staff witness made a substantial cut in rate base based upon his estimate that 67.6 percent of the 1973 construction program would go into service in the year, whereas Pacific had estimated 77.4 percent would become operative.

Pacific argues that the staff witness failed to take into account the reductions which have recently taken place in Pacific's construction program. The effect of reducing construction program expenditures is a substantial drop in construction work in progress (which is excluded from rate base) and a larger-than-average increase in the percentage of construction projects which are completed and go into service in the test year.

Not only is Pacific's estimate of plant in service closer to recorded amounts for 1973, but also its estimate of 77.4 percent of the construction program becoming operative in 1973 is not out of line with percentages of construction which became operative in prior years. We will adopt Pacific's estimate.

<u>Wage Annualization</u>

In July 1973 Pacific's wage expense was increased by 7 percent annually, or $70.4 million. By the end of 1973, $34.6 million of this increase will have been paid to Pacific's employees. The staff asserts that for test year 1973 only $34.6 million should be included as an expense; Pacific asserts that the entire $70.4 million should be included.

Pacific argues that if it is to have a chance to earn the return which the Commission finds reasonable, the 1973 wages must by annualized. In fact, it argues, annualization will still understate the actual impact of the wage increases. The wage increases in the labor contract are tied to the consumer price index, and because of the continued effects of inflation, the increase in the index was greater in 1973 than had been anticipated. In requesting this adjustment Pacific has taken into account the normal growth in investment, revenues, and expenses. The significant point is, it argues, that wages--particularly wages in a labor intensive company like Pacific--have increased, and continue to increase, out of proportion to the growth in revenues and other expenses. Moreover, when any rate relief authorized by this proceeding will become effective, Pacific will experience additional wage increases for which no offsetting rates are being requested in this proceeding.

Pacific asserts that the wage effective in July 1973 will not be offset by growth in revenues, by productivity increases in 1973 and 1974, or by anything else. Despite productivity gains averaging 5 percent and 6 percent a year and despite a productivity rate which, because of stringent budget controls, will approach 7 percent in the test period, Pacific has been unable to offset wage increases. This is so because increases in revenues and productivity have gone to offset the increases in other expenses. There are, moreover, no changes contemplated in Pacific's operations either now or in 1974 which will affect this trend.

Pacific argues that the wage increase is a known level change and "any item that is a known level change that distorts the relationship between revenues, expenses and investment that is not made up by productivity improvement or other factors, if you do not annualize those items, then you will not produce the allowed rate of return authorized by the Commission".

The staff argues that the Commission should not allow in the test year an item of expense that is nonexistent. Staff witness Norton's testimony clearly presents the staff's position. He said:

> "Any investigation of the results of operation of a utility must necessarily confine itself to a certain time frame. Usually this is a 12-month period in the future and is called a test year. For this test period the plans for operations of the utility are carefully scrutinized and weighed against past recorded performance and then estimates are made of the three basic elements--revenues, expenses, and rate base--from which is derived a rate of return. These three elements are so closely interrelated that each must be considered during the same time frame as the others. The exception is when a known extraordinary circumstance develops that would upset the normal interrelationship between the three elements, in which case adjustments may be made from outside or from within the test period. A utility that has a steady rate of growth without excessive fluctuations from year to year rarely would have need, if ever, for adjustments to the three basic elements outside of the test period. In other words, retention of the interrelationship within the test period is extremely important in the science of rate fixing.
>
> "But there is nothing sacred about selecting a test year to coincide with a calendar year. The test year could be any 12-month period. For example, in the current proceeding, conceivably the utility could have selected a test year period from July 15, 1973 to July 15, 1974. Had this been done, then the utility automatically would have included wage increases on an annual basis because that is when the actual expense occurred, and the staff would have agreed. It would not have been logical or reasonable to roll back into the test period any new wage increases that might be expected to be made subsequent to the end of the test period. Happily though, all other expenses, and the revenues, and the rate base estimates would have been made on the basis of the same time frame and the same test year, and all of the basic elements would be in harmony.

> "Similarly, the utility could change the date of effective wage increases to January 1 and thus put this annualized expense item in phase with other expense items and the other basic elements. In the utility's current showing, the wage increase expense is six months out of phase for annualization."

Mr. Norton testified that Pacific's employees over the past eight years have averaged wage increases in excess of 7 percent a year. Further, the evidence shows that Pacific has been averaging a 5-6 percent gain in productivity annually.

GSA argues that adjustments for changes outside the test year are fraught with danger, because any consideration of a _pro forma_ adjustment to the test year immediately gives rise to many other considerations such as the increase or decrease in revenues, productivity increases, the increase or decrease in expenses, etc. GSA takes exception to Pacific's statement that "The net effect of adopting the staff recommendation in refusing to annualize wages would be this: The company's expenses for the test period and for the future would be understated, and Pacific would never earn the return authorized by the Commission." GSA argues that refusal to annualize does not understate expenses for the test period but that annualization would overstate expenses for the test period. Also, GSA points out that if wages are annualized then revenues for the future would be understated unless revenues were also annualized.

San Diego asserts that Pacific's witness on the subject of wage annualization admitted that just as wage expenses could be annualized so could revenues and rate base be annualized to reflect the first half of 1974 in the 1973 test year. However, Pacific did not make such a computation. San Diego also points out that Pacific does not characterize the wage increase as "extraordinary". Rather, it is referred to as a "known level change".

In our opinion Pacific's argument is persuasive. Pacific has over 95,000 employees on the payroll and over 60,000 of those employees are represented by unions. The payroll for these employees is 60 percent of Pacific's total annual expenses and consumes over 1/3 of its revenues. This wage expense is the item most responsible for the continued upward spiral in Pacific's expenses. To ignore 1/2 of a 7 percent increase in annual wages is to ignore reality. The evidence shows, and we find, that Pacific's wage expense has increased, and continues to increase, out of proportion to the growth in revenues and other expenses. We have annualized wages for Pacific in Pacific's two most recent rate cases. (Decision No. 79873 dated April 4, 1972 in Application No. 52794, and Decision No. 80347 dated August 8, 1972 in Application No. 51774.) In Decision No. 80347 we held that Pacific's general wage increase effective July 1970 should be annualized for test year 1970 as the wage increase is "a known change unrelated to growth". (At page 23.) The 1973 wage level increases will be in effect during the future period for which we are fixing rates and they should, therefore, be recognized in full (City of Los Angeles v PUC (1972) 7 Cal 3d 331, 336).[2/] The effect of the wage annualization adjustment is to increase both intrastate expenses for test year 1973 and the revenue requirement by $19,089,000 (Appendix B, page 1).

2/ We recognize that the Commission has decided this issue in favor of the staff's position in recent cases.

Wage Increases in Excess of 5.5 Percent

Wage increases effective in 1972 increased expenses in test year 1973 by $81,152,000, or an increase of 8.36 percent. The staff adjusted this increase by reducing it by $27.8 million, which reduced the 8.36 percent to 5.5 percent. The staff also reduced Pacific's wage increase in 1973 of 6.99 percent to 5.5 percent, or by $7.4 million. The staff's total wage adjustment for test year 1973 is $35.2 million. The 5.5 percent limitation was selected by the staff because, "While it might not be the maximum allowable amount of increase, it is and has been the guideline maximum percentage under the Economic Stabilization Act[3/] and has been the Cost of Living Council's target for maximum increase per year. Most importantly, however, 5.5 percent was the policy guideline of the Price Commission which formed the basis for the Commission's Rules of Procedure 23.1, adopted by resolution on June 27, 1972 and continued in force and effect by Resolution No. A-4015 on April 17, 1973".

On August 21, 1973, by Resolution No. A-4157, this Commission rescinded Rule 23.1. The resolution included the following statement by the Commission:

3/ See discussion of Phase I and Phase II of the federal Economic Stabilization Act in Decision No. 79873 at p. 6, et seq. Phase III and Phase IV guidelines continued the 5.5 percent wage standard through the test year.

"BE IT FURTHER RESOLVED: That this Commission, in administering its responsibilities and duties in the establishment of just and reasonable rates and charges of public utilities and related transportation businesses shall adhere to the spirit and goals of the Economic Stabilization program in maintaining rate increases at the lowest level consistent with its constitutional and statutory mandate."

In July 1971, following a two-week strike, Pacific entered into tentative agreements with the unions representing Pacific's employees. The wage agreements, which were ratified on August 14, 1971, and became effective on dates in July 1971, called for specific wage increases in July 1972 and in July 1973, and provided for additional annual increases based upon the consumer price index.

In 1971, in Application No. 52794, Pacific applied for a wage offset increase based upon the first year effect of those labor contracts. The wage and salary increases which were involved in that proceeding were approximately 17.9 percent. The Commission, by Decision No. 79873 dated April 4, 1972, authorized an increase in rates based upon the full amount of those wage increases. The Price Commission rules then in effect required the Commission to find that the authorized rate increase was in accordance with Price Commission guidelines, and the Commission so found. And, in fact, the rate increase authorized in Decision No. 79873 had been submitted to the Price Commission and approved. The wage increase approved in Decision No. 79873 was based upon the same wage contracts which resulted in the 1972 and 1973 increases involved in this proceeding.

In the case at bar, the evidence shows that the 1972 wage increase had been approved by the Pay Board and the 1973 increase has been approved by the Cost of Living Council. Further, the Price Commission's policy in Phase I was to allow increases in excess of 5.5 percent if those increases resulted from agreements reached with the unions prior to the announcement of Phase I. Also, Phase II Pay

Board regulations, which are applicable in Phases II, III, and IV, apply only to contracts entered into after November 13, 1971.

The staff argues that regardless of the repeal of Rule 23.1, the federal guideline which states that the general wage and salary standard is a 5.5 percent increase per annum is still in effect, and the Commission should enforce this guideline. Despite the fact that Pacific's 1972 wage increase was approved by the Pay Board and by this Commission, the staff witness, in making his disallowance, stated: "But I am not following the Pay Board regulations. I am following the Price Commission regulations. . . . I am not questioning the legality of Pacific paying over 5-1/2 percent in wage increases in 1972. . . . But I am questioning the propriety of paying wages and salary in excess of 5-1/2 percent based on Price Commission guidance and Public Utilities Commission guidance of this state." The staff argues that although the Pay Board may have approved wage increases in excess of 5.5 percent, such approval did not authorize Pacific to raise its rates by the amount of the increases as an offsetting factor. In addition, the staff reduction is based upon expected and obtainable productivity gains keeping in mind the federal goals of holding inflationary trends to a cost-of-living increase of from 2-1/2 percent to 3 percent annually.

We see no reason to roll back wage increases paid in 1972 and 1973 to 5.5 percent. The staff would have us disallow $27.8 million of wage expense which Pacific was legally obligated to pay and did pay to its employees in 1972, and $7.4 million paid in 1973. The contract upon which these wage increases are based was entered into prior to any regulations limiting wage increases, was exempt from any limitations on wage increases, and the wages paid pursuant to that contract have been approved by the various federal and state agencies to which they were submitted. There has been no change in the law since Decision No. 79873, and there is no persuasive reason why Pacific should be prevented from recovering 1972 and 1973 wage increases arising from the same contract which was implemented in Decision No. 79873.[4/] In fact, since the wage offset decision, the federal price controls have become less stringent, not more so.

To accede to the staff position would require us to disallow some $35.2 million in wage expense which Pacific is lawfully obligated to pay under a contract heretofore found acceptable by the Commission: a contract, which violates no law, was approved by those empowered to enforce federal guidelines, was entered into after collective bargaining, and which raises no suspicion of imprudence on the part of Pacific.

Finally, the Commission has consistently rejected the staff position for a wage increase roll-back in those cases where the staff has advocated such a position. (See Continental Telephone Company of California, Decision No. 81896 dated September 25, 1973 in Application No. 52805, and Re Minimum Rate Tariff 4-B (Case No. 5330, Petition No. 72), Decision No. 82249 dated December 18, 1973.) In passing we note that the staff has not advocated this position in all cases before the Commission even though many cases involve wage increases substantially in excess of 5.5 percent.

Looking at the question from another perspective, the staff is requesting that we implement anti-inflation measures by prohibiting Pacific from passing on a wage increase, dollar-for-dollar, in price increases. In our view, in a general rate case the anti-inflation measures that we adopt should be reflected in rate of return; more specifically in return on equity.

4/ The staff makes no mention of Decision No. 79873 in its argument on this issue.

Pre-1973 Deferred Tax Reserve

Pacific asserts that its test year 1973 rate base should include approximately $62 million of deferred tax reserve accrued as a result of certain income tax computations during the years 1970, 1971, and 1972.

To understand this adjustment one requires a knowledge of recent cases of this Commission concerning Pacific and recent changes in the tax law. In 1968 the Commission granted Pacific a rate increase based upon test year 1967, with the increase to go into effect in 1969. (Re Pacific Tel. & Tel. (1968) 69 CPUC 53.) At the time of that rate case Pacific was paying its federal income tax on the basis of straight-line depreciation. It had done so in 1967 and would do so in 1968 and 1969. However, the Commission fixed rates on the basis of flow-through treatment of accelerated depreciation for federal income tax purposes. The impact of taking accelerated depreciation on a flow-through basis for 1967 was only a $2.9 million reduction in total company tax expense. Pacific switched to accelerated depreciation for the year 1970, after the changes made by the Tax Reform Act of 1969.[5/] The next Pacific rate case where the issue of federal income tax depreciation arose was in Application No. 51774. In that proceeding, on a 1970 test year, the Commission's first decision (No. 78851 dated June 22, 1971) fixed Pacific's rates on the basis of accelerated depreciation with normalization; that decision was reversed by the Supreme Court of the State of California, and on remand the Commission fixed Pacific's rates on the basis of accelerated depreciation with flow-through (Decision No. 80347 dated August 8, 1972). The 1972 decision had a 1970 test year.

5/ A detailed presentation of the Tax Reform Act of 1969 is set forth in the section of this opinion dealing with accelerated depreciation.

Pacific reasons that when a utility is using normalization, its federal income taxes are paid on the basis of accelerated tax depreciation, but its rates are computed on the basis of straight-line depreciation. The federal income tax that is deferred as a result of the use of accelerated tax depreciation is, in turn, transferred to a deferred tax reserve. The reserve, because it represents an interest-free loan to the utility from the United States government, is deducted from rate base. The purpose of deducting the reserve from the rate base is to pass the advantages of accelerated tax depreciation to the utility's customers.

But Pacific claims its situation is unique. It argues that from the standpoint of Pacific's customers, Pacific has been on flow-through since December 1968. The customers have not paid rates computed on a basis of straight-line depreciation; they have paid rates computed on the basis of accelerated tax depreciation and the tax deferrals (if there turn out to be any) have been flowed through in the form of reduced rates. Pacific asserts that there can be no justification for the deduction of the deferred tax reserve from rate base unless the cash flow to create that reserve was derived from customer rates in the first place.

Pacific offers the following analogy: "If, for example, PG&E were to receive permission from this Commission to switch from flow-through to normalization, no one would contend that its rates should be determined prospectively by deducting from rate base a hypothetical deferred tax reserve attributable to the ten years during which it had been a flow-through utility and during which the tax deferrals in their entirety have been passed to PG&E's customers. From the customers' standpoint, Pacific is in no different position. It has been on flow-through rates since 1969. In fixing rates for the future there is no more basis for deducting the deferred tax reserve attributable to 1970, 1971, or 1972 transactions than there is for deducting a hypothetical deferred tax reserve attributable to transactions in 1969. The customers have already received the full amount of the deferred tax reserve in the form of flow-through rates."

Pacific argues that because its rates to date have not reflected accruals to the deferred tax reserve as an expense, all plant which has been constructed in the period December 1968 to date has been constructed with invested capital. There can be no basis, therefore, for deducting the approximately $62 million from Pacific's rate base.

The staff argues that no part of the $62 million reserve should be included in rate base. GSA supports the staff. Alternately, the staff asserts that if any amount is included in rate base because of this adjustment it should be no more than approximately $15 million; computed on the basis of about $2.9 million for 1969 (when the 1968 case rates went into effect) and slightly increased amounts in 1970, 1971, and until mid-1972 when new rates were set on the 1970 test year, and for a further increased amount for the remainder of 1972 based on the new rates.

Replying to Pacific's claim that the Commission's use of flow-through in 1968 set Pacific's rates in concrete as far as treatment of Pacific's normalization reserve is concerned, GSA answers that Pacific has based its request for additional revenue in this case on a claimed inadequacy in rates; one reason for the inadequacy being that the rates do not reflect accruals to the deferred tax reserve. Presumably, GSA argues, Pacific would be making this claim had its realized rate of return been either 10 percent or 4 percent on rate base. Had its rate of return been 4 percent, then the question would be whether in light of inadequate earnings the deferred tax reserve should be deducted from rate base. Had its rate of return been 10 percent, the question would be whether in light of the more than adequate return, the reserve for deferred taxes should be deducted from rate base, for while earnings have been more than adequate, technically, there has been no provision for a deferred tax reserve as the original rates were not computed to allow for such a reserve. If the latter condition had been the case, GSA feels that Pacific's position would be given short-shrift. Nor should the first give longer pause. GSA argues that consideration of the past tempts one to disregard a cardinal rule of ratemaking: rates are set for the future, without consideration of the adequacy or inadequacy of earnings in the past; each rate case is a new case and each rests upon its own facts.

Looking at the problem from another point of view, GSA refers us to the testimony which has described the deferred tax reserve as either an advance of capital from the ratepayers or an interest-free loan from the Treasury. Pacific claims that this tax reserve is an interest-free loan from the Treasury. In any event, this reserve is not by any stretch of the imagination, stockholder money, because but for the tax laws it would have been paid in taxes. Again, citing hornbook law, GSA asserts that a utility is only entitled to earn on its investment devoted to public service, and since the deferred tax reserve in no way can be considered investor capital, it should be deducted from Pacific's rate base in its entirety.

Pacific disagrees with GSA's argument. Pacific argues that "GSA concedes neither the principal nor the amount, and has missed the issue. The question is not 'who should benefit,...the ratepayers or Pacific stockholders'. The ratepayers have already benefitted to the same extent as the customers of any flow-through utility. The question is whether some part of the deferred taxes which were accrued while Pacific's rates remained on flow-through should once again be flowed-through in the form of a rate base deduction."

We agree with GSA's argument. In our opinion Pacific misses the issue. The issue is not double flow-through, but is whether this Commission is going to permit Pacific to earn a return on what Pacific's own witnesses repeatedly testified was a loan from the Treasury of the United States (which, by the way, this Commission considers to be an advance of capital from the ratepayers; the effect is the same) in violation of the basic principal of regulatory law that investors earn a return on <u>their</u> investment, not on interest-free loans or advances from customers. In essence, Pacific asserts that this Commission erred in 1968 when it fixed Pacific's rates on the basis of accelerated depreciation with flow-through rather than on the basis of accelerated depreciation with normalization. Now Pacific wishes the Commission to correct that error by eliminating the normalization reserve. As pointed out by GSA we do not give added rates for the future to correct errors in the past anymore than we would reduce rates for the future in order to take away excess profits earned in the past.[6/]

6/ Pacific fares no better if it admits we were correct in 1968 on the flow-through issue because Pacific did not accede to our order by paying income taxes on an accelerated depreciation basis until the Tax Reform Act of 1969. It was then that the normalization reserve began to accrue, by operation of law.

Pacific's analogy to a putative PG&E situation is not apposite for the reason that it does not take into consideration the change in the tax law in 1969. The effect of the Tax Reform Act of 1969 was to preclude this Commission from imputing accelerated depreciation with flow-through to a company such as Pacific which at the time of the Tax Reform Act was not taking accelerated depreciation on its federal income tax return. When Pacific decided to take accelerated depreciation it had no choice but to normalize, to obey the law. That is the point when Pacific's normalization reserve began and that is the point from which we have computed the normalization reserve that we are deducting from rate base. (See Appendix B, page 2, Reserve for Deferred Taxes.) PG&E, because it had taken accelerated depreciation prior to the change in the tax law and because its rates were fixed on a flow-through basis was not, and is not, faced with a situation comparable to Pacific's.

Pension Expense

The staff's estimate of Pacific's contribution to its employees' pension plan in test year 1973 is $40 million less than Pacific's estimate.

Pacific described the operation of its pension plan through the testimony of Mr. William Smith, a consulting actuary. Mr. Smith has advised, among others, the State Department of Human Resources Development, the California Public Employees' Retirement System, the State Teachers' Retirement System, Standard Oil of California, and the Fireman's Fund.

Mr. Smith testified in substance as follows: Pacific makes contributions to a pension fund and a death benefit fund for its employees. The contributions are irrevocable and are paid monthly by check to the banks which act as trustees for the pension plans. The plans are funded by a method which actuaries call the "remaining cost method." This is one of several actuarial methods of determining the rate at which contributions must be made to a pension fund in order to assure that the fund will be adequate to pay the pensions of both active and retired employees. The remaining cost method is used to develop a contribution rate, technically called "an accrual rate." The accrual rate, which is recalculated each year, is a percent (12.85 percent in 1973) which is then applied against Pacific's actual payroll in the year. The resulting dollar amount is contributed to the pension fund.

Under the remaining cost method the accrual rate is determined at the beginning of each year based upon estimates or assumptions as to (1) the long-term rate of wage increases, (2) the long-term average rate of earnings on the pension fund, (3) service retirement rates, (4) mortality rates, (5) disability retirement rates, (6) separations rates, and (7) qualified beneficiary ratios.

If all of the assumptions were completely accurate and there were no improvements in pension benefits, the contributions to the fund, plus the earnings on the pension fund, would be just sufficient to pay the pensions of current and retired employees and the goal of the method would be achieved: To contribute to the pension fund a level percentage of basic payroll of current active employees during their working lives.

However, the assumptions or estimates of such items as future wage increases or future earnings on the fund can never be precisely accurate. Based on actual experience in each of the last twenty years, Pacific's accrual rates, and hence its contributions to the fund, have been somewhat low. In addition, pension improvements have caused increases in the accrual rate. When, as in Pacific's case, the assumptions are insufficient in a given year, the accrual rate to be applied over the remaining lives of the existing employees must be raised to fund the unanticipated increase in pension cost. The accrual rate, in other words, is recalculated each year to reflect the effects of actual experience in the preceding year.

It is essential that the composite of the assumptions be as accurate as possible. If there are large errors in the assumptions, there will be large deficits in contributions to the fund. If the deficits are large enough and continue long enough, or if the assumptions are deliberately manipulated to produce an unrealistically low accrual rate and hence an unrealistically low contribution, the fund could eventually fall short of the amount necessary to pay pensions.

Because pensions are based on the last five years of an employee's career, an assumption or estimate for future wage level increases is an essential part of any final salary plan if contributions are to be adequate to pay employee pensions. If the development of the accrual rate is based on the hypothetical assumption that wage levels will not increase, and there are wage level increases over the working life of the employee, his pension will be greater than assumed and the fund will be inadequate.

In earlier years, the wage increase assumption in Pacific's pension plan, like that in many plans, was implicit instead of being separately stated. Wage level increases were offset by deliberately underestimating the assumed long-term earnings of the fund. This has the effect of increasing the accrual rate to take account of wage level increases. The purpose of using an implicit assumption was to prevent the labor unions representing Pacific's employees from seizing upon Pacific's wage level assumption as a floor in future collective bargaining demands. Many companies do likewise and for the same reason.

However, in Decision No. 80347, although the Commission affirmed the reasonableness of Pacific's accrual rate for 1970, it directed Pacific to make all of its estimates and assumptions explicit. In other words, Decision No. 80347 foreclosed Pacific from continuing to account for wage level increases by making offsetting reductions in the assumed rate of interest on the fund. Instead, the Commission required that each estimate be set forth separately. Pacific responded to the Commission's decision by stating each assumption separately. The 3-1/2 percent wage level increase assumption was stated explicitly, and the interest assumption was increased from 3-1/2 percent to a realistic level of 5 percent.

Mr. Smith concluded that because Pacific had merely made explicit the assumptions which had previously been implicit, the separate statement of the assumption for future wage level increases and for future earnings on the fund did not materially affect the overall accrual rate and did not result in contributions to the fund or pension expense greater than would have resulted using the old assumptions. In fact, if the pension plan experience is recomputed for the years 1962 through 1971 using a 3-1/2 percent wage level assumption and a 5 percent interest assumption in place of the prior assumptions, the resulting shortfall is substantially unchanged.

The staff's estimate of pension expense is approximately $40 million less than Pacific's as a result of the staff's deletion of Pacific's assumption that future wages would increase by 3-1/2 percent a year. Both the staff's and Pacific's estimates reflect the same accrual assumptions for pension fund earnings and for future wage increases because of progression and promotion. The staff agrees with Pacific's 5 percent interest assumption for test year 1973, and recognizes that the interest assumption is based on considerations different from those of a possible wage increase assumption.

The staff's recommended disallowance is based upon a study made by the staff which, in the staff's opinion, shows that for a long period of time changes in pension plan provisions make up for more than the deficit in accruals to the pension plan. Wage level increases are not the cause of the deficit. Therefore, no wage level assumption is needed. In addition, the staff witness, Mr. John Quinley, said that the utility's use of a 3-1/2 percent annual wage increase assumption duplicates to some extent wage increases reflected in accruable payrolls. The accrual rates used in determining 1973 test year accruals reflect a 3-1/2 percent wage increase in 1972 and a 3-1/2 percent wage increase in 1973. The accruable payroll estimated by the company for 1973 reflects approximately 15 percent in wage increases during the years 1972 and 1973; while a measurement of the extent of duplication could not be obtained, it is clear that duplication exists. In summary, the staff position is that any deficiencies in Pacific's pension plans were caused by changes in the pension plan provisions, that yearly predictions of pension plan cost based on the remaining cost method will make up for any deficits, and that there is no need for a wage increase assumption.

On cross-examination, the staff witness admitted that Pacific's accrual rate has been too low in the majority of years since 1957; that Pacific has experienced continuing actuarial losses; that Pacific's contributions to the fund have been too small for almost every year of the last decade; that the fund has experienced a deficit in accruals; that if his method had been used in earlier years the pension contributions in those years would have been even less; and that if wage increases are not taken into account the pension plan will suffer adverse experience.

In response to the staff witness's argument that "one reason alone, changes in pension plan provisions, makes up for more than the deficit. Wage level increases are not the cause of the deficit", Pacific states "Mr. Quinley was right, but the reason for the absence of substantial losses as a result of wage increases in earlier years was so obvious that Mr. Quinley apparently could not see it. There were no substantial losses from wage level increases in earlier years because Pacific has always had an implicit wage increase assumption in the form of a low interest assumption. To eliminate that assumption starting in 1973, as Mr. Quinley proposes, would be to condemn the plan to ever-increasing underaccruals."

In our opinion, Pacific's assumptions are proper, its reasoning clear, and its estimate reasonable. We cannot understand the staff's position. In this case all Pacific is doing is following our direction in Decision No. 80347 where we said:

> "Pacific, in determining its accrual, assumes no future changes in the plan nor in wage levels. This would result in serious deficiencies if some means were not used to cover such contingencies. The assumption by Pacific of a low interest rate on the fund's earnings tends to provide for such contingencies, although for the past twenty years even this expedient has not proven sufficient to avoid deficiencies. For example, in Decision No. 74917, the Commission disallowed a portion of the accrual used by Pacific. Pacific continued to pay more into the pension fund than had been allowed as an operating expense. Despite this, the reserve has continued to be deficient.
>
> "In the current proceeding, the staff contends that each of the factors which go toward determining pension fund accruals should be evaluated as accurately as possible rather than to have offsetting infirmities cancel out to a reasonable end result. We agree and in future proceedings will expect Pacific to present its support for the pension

> accrual rate on the basis of more realistic interest rate assumptions and separately stated contingency provisions." (Page 24.)

In prior rate proceedings the wage increase assumption in Pacific's pension plan was implicit instead of being separately stated. Wage level increases were offset by deliberately underestimating the assumed long-term earnings on the fund. This had the effect of increasing the accrual rate to take account of wage level increases. Following our directions in Decision No. 80347, Pacific increased its interest assumption from 3-1/2 percent to a realistic 5 percent. It also explicitly stated its wage level increase assumption at 3-1/2 percent. Because Pacific has merely made explicit the assumptions which had previously been implicit, the separate statement of the assumption for future wage level increases and for future earnings on the fund does not materially affect the overall accrual rate and does not result in contributions to the fund or pension expense greater than would result from using only the old 3-1/2 percent interest assumption. Pacific's use of a 3-1/2 percent wage level assumption is based upon the fact that Pacific's wage level increases have substantially exceeded 3-1/2 percent a year for recent years. The 3-1/2 percent wage level increase assumption is reasonable.

<u>Advertising Expense</u>

The staff recommends that approximately $3.1 million of Pacific's $6.9 million advertising expense budget for 1973 be disallowed, as follows:

Item	Utility Budget	Staff Proposed Allowed	Staff Proposed Disallowed	Adopted
		(Dollars in Thousands)		
Ac. 642, Advertising				
A. Major Campaigns				
Mass Media				
Directory Assistance	$ 562	$ 562	$ -	$ 562
Dial Direct	1,012	1,012	-	1,012
Dial "1", Los Angeles	463	463	-	463
Business Marketing	197	-	197	197
Instructional - General	213	213	-	213
- Minority	158	158	-	158
Subtotal	2,605	2,408	197	2,605
Bell System TV	545	-	545	-
Regions - Newspapers and Periodicals	61	-	61	61
Total - Mass Media	3,211	2,408	803	2,666
Non-Mass Media				
Monthly Bill Inserts	225	225	-	225
Optional Residence Toll Service (ORTS)	99	99	-	99
Disneyland Exhibit	356	-	356	100
Total - Major Campaigns	3,891	2,732	1,159	3,090
B. Other Advertising				
Booklets, Leaflets, & Other Bill Inserts	217	-	217	192
Exhibits, Posters, & Window Displays	190	-	190	190
Motion Pictures	51	-	51	51
Other Advertising (Directory Fillers, Special Usage Promotion, & Fairs)	90	-	90	90
Salaries (Regular $385, Disneyland $212)	597	385	212	475
Other Expenses (House Service & Travel)	200	200	-	200
Subtotal - Other Advertising	1,345	585	760	1,198
Total Ac. 642, Advertising	5,236	3,317	1,919	4,288
Other Accounts				
C. Ac. 132, Prepaid Directory Advertising*	1,475	-	1,171*	1,171
D. Employment (Various Accounts)	153	153	-	153
E. Ac. 664, Legal	17	17	-	17
Total - All accounts	6,881	3,487	3,090	5,629

* Classified directory advertising expenditures are included in Ac. 132, Prepaid Directory Advertising, until charged off to Ac. 649, Directory Expenses. The utility estimated 1972 Ac. 132 charge of $1,171,000 is used as a disallowance to 1973 estimated commercial expenses.

Pacific's Evidence

Pacific's witness testified that Pacific itself was reducing its \$6.9 million advertising budget by \$505,000 in test year 1973 for ratemaking purposes because this sum was not directly, immediately, and significantly beneficial to the company and its customers. Of the remaining advertising expense, the witness testified that Pacific's advertising for 1973 would fall into three major areas:

(1) Instructional Informative Advertising.

This advertising has five major purposes. They are directory assistance, the use of DDD and area codes, the use of directory instruction pages, emergency call procedures, and the introduction of dialing changes and numbering plan conversions. This category of advertising also includes advertising dealing with malicious, obscene, or harassing telephone calls, the explanation of repair service, the explanation of means by which billing disputes may be resolved, and advertising designed to avoid damage to Pacific's facilities.

(2) Advertising Designed to Increase Pacific's Revenues.

This advertising is designed to promote those services which are more profitable and hence serve to subsidize basic exchange rates. This advertising is essential in order that Pacific may continue successfully to compete for the provision of services which, if they were lost to competition, would diminish the subsidy of basic exchange rates and force an increase in those rates.

(3) Advertising for Recruitment Purposes.

This advertising category costs \$153,000. Over the four years ended 1971, Pacific employed an average of almost 24,000 employees each year. It is necessary to advertise to attract those employees.

The witness testified that in 1973 Pacific's advertising expense will amount to only .26 percent of operating revenues, the smallest proportion of advertising expense to operating revenues in the last decade. In absolute dollars, Pacific's 1973 advertising expense is less than the $11.5 million which received both Commission and court approval in 1972. (City of Los Angeles v PUC (1972) 7 C 3d 331.) The witness testified that this reduction in advertising expense is in the face of newspaper advertising rates which are increasing at approximately 3 percent a year and television rates which are increasing by as much as 16 percent a year.

Regarding advertising to promote Yellow Page sales, the witness testified that this expense was just over $1 million whereas the revenues received from Yellow Page advertisers were approximately $112 million. If Yellow Page advertising were to diminish, the lost revenues would have to be retrieved from other services, including basic telephone rates. The witness estimated that if Pacific were to terminate the promotion of the Yellow Page directory advertising, revenues would immediately drop by an amount in excess of $10 million. Regarding Pacific's advertising at Disneyland, the witness testified that in his opinion the Disneyland exhibit was an informative exhibit which gave instruction on how to use the telephone, especially to young telephone users.

Pacific's 1973 test year advertising expense will be about one-half the $11.5 million advertising expense which was allowed by the Commission in Decisions Nos. 78851 and 80347. Finally, Pacific points out that its 1973 advertising expense is barely one-third of the 0.75 percent of operating revenue guideline which was laid down for Pacific in Re Pacific Telephone Co. (1954) 53 CPUC 275, 279.

The Staff's Evidence

The staff recommends that advertising expenses be allowed only if Pacific can demonstrate that its advertising is necessary for the continuing operation of the utility (such as to advertise job openings), that its advertising is required by law or by order of a regulatory authority, or that its expenditures for advertising produce substantial benefits for the ratepayers. There is no dispute over advertising that is necessary for the continuing operation of the utility or the advertising that is required by law.

To determine whether advertising that falls within the third category produces substantial benefits for the ratepayers, the staff developed the following criteria:

> "'Substantial benefits to the ratepayers' are assumed to include:
>
> "a. Substantial savings to the ratepayer.
>
> "b. Substantial reduction of expenses to the utility resulting in lower revenue requirements.
>
> "c. Promotion of safety in the home and to the family.
>
> "d. Announcement and instructions relative to new telephone procedures.
>
> "e. Safeguarding utility property to assure continued service.
>
> "f. Good telephone usage.
>
> "g. Instructions as to procedures in case of emergencies, misdialed toll calls, disputed bills, obscene phone calls, telephone-out-of-service, etc.
>
> "h. Distribution of calling which tends to lessen the busy hour loads and thereby increase efficiency of system."

On the other hand, advertising considered not to be of substantial benefit to ratepayers was assumed to include, among others:

> "a. Advertising products and services, the availability of which is common knowledge.
>
> "b. Institutional advertising - selling the use of telephones versus other methods of communication.
>
> "c. The provision for shows and entertainment which are localized.

> "d. Corporate image-building.
>
> "e. Advertising designed for the convenience of special groups, conventions, etc.
>
> "f. Advertising products and services which are beyond the means of the average ratepayer.
>
> "g. Routine insertion of advertising in local papers with messages inserted by local business offices.
>
> "h. Advertising simply to stimulate revenues when such revenues are already assured by the popularity of the service or product."

The staff criteria were devised in response to recent Commission criticism of advertising expenditures by utilities, and have resulted in a declining trend of such expenditures by California utilities and by disallowances of advertising expenses in rate proceedings. (See Re Southern California Edison Co., Decision No. 81919 dated September 25, 1973 in Application No. 53488; Re Pacific Gas and Electric Co. (1971) 72 CPUC 282, 302; Re General Telephone Co. (1971) 72 CPUC 652, 673; Re Southern California Edison Co. (1971) 71 CPUC 724, 752.) In addition the staff was influenced by the California Assembly House Resolution No. 56 adopted May 30, 1972, which states in part:

> "Resolved by the Assembly of the State of California, That the Public Utilities Commission is urged to continue its strict regulation of advertising by public utilities and particularly that the commission include explicit findings on advertising in its decision in every major rate case; and be it further
>
> "Resolved, That the commission is urged to continue the downward pressure evident in recent cases on the overall level of advertising expenditures by public utilities; and be it further
>
> "Resolved, That the commission is urged to adopt the following guideline in its examination of individual advertising campaigns and to set strict standards in its interpretation of the guidiline (sic); that advertising expenditures shall be allowed only

> if it is demonstrated, with the burden of demonstration on the public utility, that such expenditures produce substantial benefits for the ratepayers; and be it further
>
> "Resolved, That in its regulation of the advertising expenditures of public utilities the commission attempt to develop explicit guidelines and a consistent body of precedents on what constitutes a reasonable level of advertising expenditures and what constitutes advertising of substantial benefit to the ratepayers.
>
> "Resolution read, and referred by the Speaker pro Tempore to the Committee on Rules."

Discussion

The need for much of Pacific's advertising program is obvious. It is important that Pacific tell its customers how to use the telephone system. Improper use of the system overloads equipment, causes additional burdens on telephone operators and other personnel, requires added employees, causes ratepayers to overlook many of the benefits of modern telephony, and causes frustration in the ratepayer who cannot understand why a simple telephone call cannot be put through without problems. What is less understood is that advertising generates income to the company which is used to offset losses on those services which are rendered below cost, such as residential flat rate and lifeline service. The losses in these services are made up from profits on the remainder of the system. To the extent that advertising will increase revenues on other portions of the system, basic flat rate residence service and lifeline service will be priced so that millions can afford it. Although the staff criteria for determining the proper allowance to be accorded advertising expenses have merit, we must be careful when applying them to individual items of expense to consider the many kinds of telephone users and the uses, both good and bad, to which telephones are put.

As we look at advertising, the key factor is whether a particular advertisement is institutional advertising and goodwill, to be paid for by the owners of the utility, or whether it benefits the ratepayers, whereby it should be an expense for ratemaking purposes. And since all advertising which has Pacific's name on it is to some extent institutional and promotes goodwill, we must assure ourselves that, even though advertising is directed to informing customers of services and assisting customers, it is not used to such an extent that its promotion of goodwill obscures its promotion of ratepayer benefits.

We applaud Pacific's pruning of its advertising budget in conformity with prior Commission decisions, staff criteria, and legislative policy. Pacific's advertising budget of .26 percent of operating revenues is reasonable, but, nevertheless, we have disallowed some advertising expense as more properly belonging within the ambit of shareholder responsibility.

In only one aspect was Pacific criticized for failure to advertise, and that concerned its lifeline telephone service. This service is one party, 30-message residence service, at $2.25 a month. It is offered in most metropolitan areas. The service is tailored to meet the needs of persons on limited income, especially the elderly, but anyone may subscribe where offered. The only limitation is that it can be the only service on the premises. Concern for lifeline service occupied the majority of time used by public witnesses in testimony in this case. They came by the busload to testify. Their theme was constant: keep the rates low and advertise the service. We are sympathetic to the plight of low-income elderly persons and will keep a low, subsidized rate in effect, and we will order Pacific to advertise its lifeline service in appropriate media to inform those for whom it was especially designed.

We will discuss separately each item of advertising which has been recommended to be disallowed.

Business Marketing - $197,000 Recommended Disallowance

Pacific argues that this item is made up of advertising directed to businessmen primarily in relation to services for which Pacific is in direct competition with at least 26 of the manufacturers. The services involve business communication equipment such as PBX equipment. At least one competitor of Pacific presented evidence which showed the highly competitive nature of this kind of service. The staff disallowed this item of advertisement with the statement that "It is believed that any businessman having need of complicated communication facilities is aware of and will make use of communication consultation service offered by the utility without being reminded by advertisements". The Commission does not share this belief; we will allow the $197,000 of business marketing advertising expense.

Bell System TV - $545,000 Recommended Disallowance

Of this $545,000 disallowance Pacific agrees that $440,000 is well taken. Pacific argues that the $105,000 balance is actually nationwide business marketing expense similar to that discussed above. Although we have no doubt that some of this money is beneficial to sales, we are of the opinion that this entire category of Bell System TV is used to enhance the general corporate image of the Bell System and therefore properly belongs within the expenses that the shareholders should bear, just as charitable contributions do.

Regions - Newspapers and Periodicals -
$61,000 Recommended Disallowance

The staff disallowance is based opon the following statement in the staff's Exhibit 69. "The utility provided three samples of newspaper ads prepared in 1972 with subjects, 'What to do in case of fire', 'How to deal with an obscene phone call', and 'Making better use of information in the phone book'.

"The utility has not adequately identified this budget item either as to content or purpose. It is recommended that it be disallowed."

In our opinion it would be difficult to imagine to what better purpose telephone advertising could be put than the three examples cited above. We will allow the item but with the understanding that advertisements such as these not only are beneficial to the ratepayer, as well as to all citizens, but also enhance Pacific's image. If the advertising expense becomes too large, we will question the primary purpose of Pacific.

Disneyland Exhibit - $356,000 Recommended Disallowance

Of the $356,000 Pacific agrees that $119,000 should be disallowed. The balance, Pacific asserts, is devoted to educational and instructional material at the Disneyland Exhibit. We are familiar with the Disneyland Exhibit and agree that there is educational and instructional material presented at that exhibit. Although the exhibit is presented primarily to enhance the corporate image of Pacific and the Bell System, the educational and instructional material have substance, but not to the degree advocated by Pacific. Therefore, $100,000 will be allowed.

Other Advertising - $760,000 Recommended Disallowance

There are six categories in Other Advertising, and we will consider them as one. Of the $760,000, Pacific agrees that $25,000 should be disallowed. Of the balance, $212,000 is related to salaries paid at the Disneyland Exhibit; of this amount we will allow $90,000 in keeping with our holding on the educational and instructional material.

The reason the staff gives for disallowance of the other items appears to be that the utility has not shown the nature or amount of advertising to be purchased with these budgeted amounts. We do not expect the utility to give us a dollar-by-dollar account of each ad, nor do we expect the utility to provide us with copies of every ad they will use in the course of a year. There is a limit to the amount of detail that can be presented in any one rate case. However, Pacific's witness on the subject of advertising testified in detail that the categories in question were devoted principally to advertising that assists the customer in the use of the telephone.

As an example, the staff would disallow advertising expenditures designed to advertise telephone devices and procedures that would be of assistance to handicapped and blind people in the use of the telephone. The basis of the staff disallowance is "people so handicapped will either have assistance or would have discovered such devices; and if they are blind, I doubt if they would be reading advertising". Again we disagree with the staff. Such advertising by Pacific is not only permissible, but if Pacific did not so advertise we would order them to do so. Other than the $25,000 item agreed to by Pacific and $122,000 for Disneyland salaries, we will allow all other advertising expenses in Other Advertising.

Yellow Page Advertising - $1,171,000
Recommended Disallowance

The staff disallowance is based primarily on the belief "that advertising is not required to convince advertisers of the value of using the Yellow Pages to advertise products and services, that there is no indication that less revenue would be received from Yellow Page advertising if all efforts to sell that advertising were discontinued, and that revenues from directory advertising are based not so much on the cost but more on the value of such advertising to the advertisers. In 1972 the utility received revenues of $111,850,173 from directory advertising and sales, while directory expenses amounted to $51,276,029".

Pacific's witness on this subject testified that Yellow Page advertising was a necessity. That the fact that it derived $112,000,000 in revenues with only $51,000,000 in expenses shows that Yellow Page revenues support the loss in revenue in such services as residential flat rate and lifeline. He testified that if Pacific were to eliminate Yellow Page advertising there would be a substantial loss in Yellow Page revenues.

The staff position is without merit.[7/] The evidence is clear that Pacific's directory advertising costs relate directly to revenues from Yellow Page advertisers. If directory advertising was eliminated, Yellow Page revenues would drop substantially, more than the advertising costs saved. Perhaps the problem here is that the staff is looking at this advertising under the category of commercial expenses when, instead, they should be considering this item as part of directory expenses.

7/ However, we are accepting the staff estimate that only $1,171,000 will be expensed by Pacific for Yellow Page advertising in test year 1973.

Accelerated Tax Depreciation

The present proceedings on the issue of accelerated tax depreciation are a direct result of an earlier order of this Commission in November 1970 (Re Pacific Tel. & Tel. Co. (1970) 71 CPUC 590), which authorized Pacific to normalize accelerated tax depreciation, and the California Supreme Court's decision in City and County of San Francisco v PUC (1971) 6 C 3d 119, annulling the Commission's order. The Supreme Court stated:

> "For failure to consider lawful alternatives in calculation of federal income tax expense, the decision of the commission must be annulled. . . . Upon further consideration the commission should consider whether to adhere to the 1968 method of determining federal income tax expense and whether to adopt the accelerated depreciation and normalization method adopted by the decision before us. . . . The commission may also consider alternative approaches which strike a balance between these two extremes.
>
> "...although the method open to the nontelephone utilities is not open to Pacific, the commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in the light of current federal income tax statutes." (6 C 3d at 130.)

The normalization order annulled by the Supreme Court had been made as an interim order in Pacific's general rate increase Application No. 51774. Prior to the decision of the Supreme Court the Commission issued Decision No. 78851 dated June 22, 1971 in Application No. 51774 which increased Pacific's rates by some $143,000,000. That decision was also annulled by the California Supreme Court (City of Los Angeles v PUC (1972) 7 C 3d 331) partly because the Commission had computed Pacific's taxes on the basis of normalization.

After the decision annulling our normalization order, we reopened the proceedings in Application No. 51774 for the purpose of considering the various methods of accounting for tax depreciation. On January 5, 1973 the reopened proceedings on accelerated tax depreciation were consolidated with this current rate application. More than 19 days of hearing were devoted to the issue of accelerated tax depreciation.

In 1954 Congress enacted Section 167 of the Internal Revenue Code. That section gave taxpayers the right to elect between the straight-line method of depreciation and certain accelerated methods of depreciation for tax deduction purposes. Shortly after enactment of Section 167, a controversy arose over the appropriate ratemaking treatment for the tax deferrals resulting from the election of accelerated tax depreciation by public utilities. Basically. two ratemaking methods were advanced for the treatment of the tax deferrals. Under the first method, flow-through, the tax deferrals would be "flowed-through" to the utilities' net income. Under the second method, normalization, the tax deferrals would be credited to a reserve for deferred taxes and, in most instances, that reserve would be deducted from the utilities' rate base in setting rates.

In California several utilities elected accelerated depreciation. Some utilities elected flow-through and others, such as PG&E and Southern California Edison, elected to normalize. In 1958 this Commission instituted an investigation into the subject of the appropriate ratemaking treatment for accelerated tax depreciation. In that investigation the Commission determined that if a utility under its jurisdiction elected accelerated tax depreciation, it must also use the flow-through method for ratemaking. (Rate-fixing Treatment for Accelerated Amortization (1960) 57 CPUC 598.) The initial decision of whether to elect straight-line depreciation or accelerated depreciation was, however, left to the discretion of utility management.

Pacific continued to file its tax return using straight-line depreciation. In 1967 Pacific filed for a rate increase with its taxes computed on a straight-line basis. In our decision we found that a true tax saving would result from Pacific's use of accelerated depreciation, and we computed Pacific's income tax expense for the test year on the basis of the use of accelerated depreciation beginning with plant additions in the test year, and flowed the tax deferrals through to net income. (Re Pacific Tel. & Tel. Co. (1968) 69 CPUC 53, 61-64.)

Following the Commission's decision in 1968, Pacific had until September 1969 before filing its tax return for the tax year 1968, and making an election with respect to its method of depreciation. During this same time Congress was giving active consideration to drastic alteration or even complete withdrawal of the accelerated depreciation option as to utilities.

On December 30, 1969 Section 441 of the Tax Reform Act of 1969 became law. Section 441 declared that utilities such as Pacific which had been straight-line taxpayers prior to August 30, 1969 would not be allowed to take accelerated depreciation unless normalization was used to reflect operating results in the company's regulated books of account and for establishing the company's cost of service for ratemaking purposes. Pacific did not, prior to August 30, 1969, elect to take accelerated depreciation. After August 30, 1969 Pacific did so elect.

At the hearing in this application five methods of accounting for depreciation were presented: (1) straight-line, (2) accelerated depreciation with normalization, (3) accelerated depreciation with flow-through, (4) accelerated depreciation with normalization on a "pro forma" basis, and (5) an automatic adjustment clause. The first three alternatives are conventional and need no further definition. Pro forma normalization utilizes an estimated tax reserve for some point in the future. The rationale and method for determining the pro forma normalization reserve were described by the staff expert as follows:

> "Inasmuch as rates can be set only for the future, it is necessary to look beyond the test year to anticipate extraordinary changes in costs which are not to be accompanied by commensurate changes in revenues. As can be seen (in Exhibit 32) the rapid growth rate in the deferred tax reserve following the first year of normalization far exceeds in magnitude and character the growth rate anticipated for revenues, expenses, or rate base. While Pacific's revenues, expenses, and rate base may be expected to increase in a range of 5 to 10 percent per year, the end of year deferred tax reserve increases over the 1970 end of year reserve by approximately 400 percent in 1971; 860 percent in 1972; 1,500 percent in 1973; and 2,300 percent in 1974. Accordingly, the use of a future year deferred tax reserve is more nearly representative of conditions anticipated for future years than the initial year effect of the test year 1970.
>
> "A similar analysis relative to test year 1973 shows deferred tax reserve increases of 150 percent in 1974; 200 percent in 1975; 280 percent in 1976; and 360 percent in 1977. Selection of a future period during which rates established in this proceeding can be considered to have been in effect requires some informed judgment. I have chosen five years as a typical span of years over which rates may be in effect. I consider that rates may become effective early in the year following the test year and that an approximate weighted average of the deferred tax reserve over a five-year period is the reserve at the end of the third year. This means reflecting the reserve at the end of year 1973 in a 1970 test year or reflecting the reserve at the end of the year 1976 in a 1973 test year.
>
> "The use of a pro forma deferred tax reserve has an adjusting feature which can be applied in future rate proceedings. Should a general rate proceeding occur during or after the period assumed for the pro forma tax reserve, the ensuing rates can be developed in accordance with any underaccrual or overaccrual of the reserve."

The automatic adjustment clause method is comparable to the fuel or purchased gas adjustment clauses found in electric or gas company tariffs. If adopted, it would cause an automatic reduction in Pacific's rates each year. Pacific's rates would be reduced by the revenue requirement difference between the deferred tax reserve in the test period and the estimated reserve for the coming year.

We have considered the alternative of using straight-line depreciation accounting for tax purposes and reject it; no party advocated this method. Nor will we consider further the automatic adjustment clause. This method was proposed with the understanding that the Commission would consider it only if Pacific consented to its imposition; Pacific has not consented.

In our opinion we are precluded, as a practical matter, from imputing accelerated depreciation with flow-through to Pacific. Although the tax statutes seem to be very carefully drawn to avoid limiting the Commission's power, our interpretation of the applicable statutes is that if we were to impute flow-through to Pacific, the United States Treasury would assess taxes against Pacific on the basis of straight-line depreciation. Such a result would be a financial disaster to Pacific and would cause a substantial deterioration of service within a few years.

Section 167(l) of the Internal Revenue Code, as amended by Section 441 of the Tax Reform Act of 1969, makes it clear that Pacific cannot elect accelerated depreciation for tax purposes if flow-through is used to establish the Company's "cost of service for ratemaking purposes" (I.R.C. 1954, § 167(l)(3)(G)(i)). As to post-1969 property, i.e., property which became public utility property after December 31, 1969, Pacific may elect accelerated depreciation only if a normalization method of accounting is used. The phrase "normalization method of accounting" is defined in subsection (3)(G) of Section 167(l):

> "(G) NORMALIZATION METHOD OF ACCOUNTING - In order to use a normalization method of accounting with respect to any public utility property -
>
> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
>
> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

In FPC v Memphis Light, Gas & Water Div. (1973) 411 US 458, 36 L ed 2d 426, the United States Supreme Court explained the options available to regulated utilities following the Tax Reform Act of 1969:

> "With respect to post-1969 property, a utility may use (1) straight-line depreciation, (2) accelerated depreciation with normalization, or (3) accelerated depreciation with flow-through if the utility used flow-through prior to August, 1969 (§ 167(l)(2)). In addition, under § 167 (l)(4)(A), a utility may elect to abandon accelerated depreciation with flow-through with respect to post-1969 expansion property." (411 US 463, emphasis added.)

Pacific did not, prior to August 1969, elect accelerated depreciation with flow-through, and if Pacific's rates are established on that basis, it will lose its eligibility to use accelerated depreciation (Memphis Light, Gas & Water Div. v Federal Power Com'n (DC Cir 1972) 462 F 2d 853, 857). The California Supreme Court in its decision annulling Decision No. 77984 recognized that flow-through is no longer available to Pacific (City and County of San Francisco v PUC (1971) 6 C 3d 119, 124-125). The Court concluded that "the option to switch to accelerated depreciation and flow-through has been terminated", and that "the method open to the nontelephone utilities is not open to Pacific" (6 C 3d 119, 130).

Pacific characterizes its benefit from normalization as an "interest-free loan from the Treasury"; the ratepayers' benefit by having the normalization reserve subtracted from rate base thereby obtaining lower rates. The staff asserts that if the Commission does not wish to impute flow-through to Pacific, then the Commission should utilize the staff formula for pro forma normalization in determining Pacific's deferred tax reserve. All parties other than Pacific support the staff. Pacific asserts that if pro forma normalization is used to compute the reserve for deferred taxes, then the Treasury will find that pro forma normalization is not permitted by statute and will tax Pacific on the basis of straight-line depreciation.

The staff argues that nothing in the Internal Revenue Code prohibits the use of pro forma normalization. Subsection 167(1)(3)(G) of the Code directs itself to methods of depreciation prescribed to compute depreciation expense and tax expense as elements of cost of service for ratemaking. It is silent on rate base and says nothing on the treatment of the tax reserve. Furthermore, the staff argues that Pacific's regulated books of account are already based on estimates. The estimated tax reserve would simply be one more estimate. The pro forma treatment was recently used by the State of Washington Commission in a rate case involving a Bell Telephone company. (Washington Utilities and Transportation Commission v Pacific Northwest Bell Telephone Company (1971) 93 PUR 3d 275.)

GSA argues that while Congress legislated regarding the cost of service aspects of deferred taxes to prevent tax losses, it did not legislate regarding the rate base treatment to be accorded the deferred tax reserve. It did not do so, GSA argues, because legislation regarding rate base treatment would not only be a direct interference with state commissions but would open up a multitude of complications in light of the various methods of computing rate base in different regulatory jurisdictions. Finally, GSA points out that there are a number of rate base adjustments, all of which affect revenue, and which might cause an overzealous Treasury official to assume that by making these adjustments the Commission was doing indirectly what it could not do directly, that is, flow through part of the accelerated tax saving. The Western Electric adjustment might be so classified. Other adjustments to rate base made in this proceeding have been adjustments for pay TV and telephone plant acquisitions. Because of these rate base adjustments GSA argues that Congress, when it used the phrase "cost of service", was distinguishing between cost of service and rate base.

Pacific argues that to create a hypothetical reserve for ratemaking purposes using some other, larger amount which is not "the deferral of taxes resulting from the use of...different methods of depreciation", in order to cut the revenue requirement below the normalization level, would directly contravene the plain terms of the statute and would jeopardize eligibility. Pacific argues that those who would claim that cost of service excludes rate base are making assertions contrary to common sense. Pacific argues that it is impossible to make a cost of service determination without determining rate base at the same time, and cites staff witness Gardner to the effect that the California Commission determines a utility's cost of service for ratemaking purposes by compiling a results of operations study which "develops gross revenues using existing or assumed rates, deducts expenses, and compares the net income to a rate base in order to produce a resultant rate of return." Pacific concludes by asserting that if cost of service for ratemaking purposes is defined to exclude rate base, utility commissions could achieve full flow-through by the simple expedient of deducting a larger than actual deferred tax reserve from rate base in defiance of the statute and congressional intent.

Rate base is as much a part of cost of service as are revenues, expenses, and rate of return. Rate of return is a cost just as wage expenses are costs, but there is no way to determine rate of return without reference to a rate base. We agree with Pacific that the deferred tax reserve may be an estimate, and, if it is, it must be an estimate of the amount in the reserve for deferred taxes for the period used in determining the taxpayer's cost of service for ratemaking. Our results of operations study reflects this. (See Appendix B, page 2.) Up to this point, as a matter of interpreting federal tax statutes, we see no viable alternative to Pacific's position. The treatment of the deferred tax reserve as a tax problem is clear enough, but the regulatory effect of the consequences of accelerated depreciation must be considered. We turn to that in the next section.

<u>Adjustment for Extraordinary Item</u>

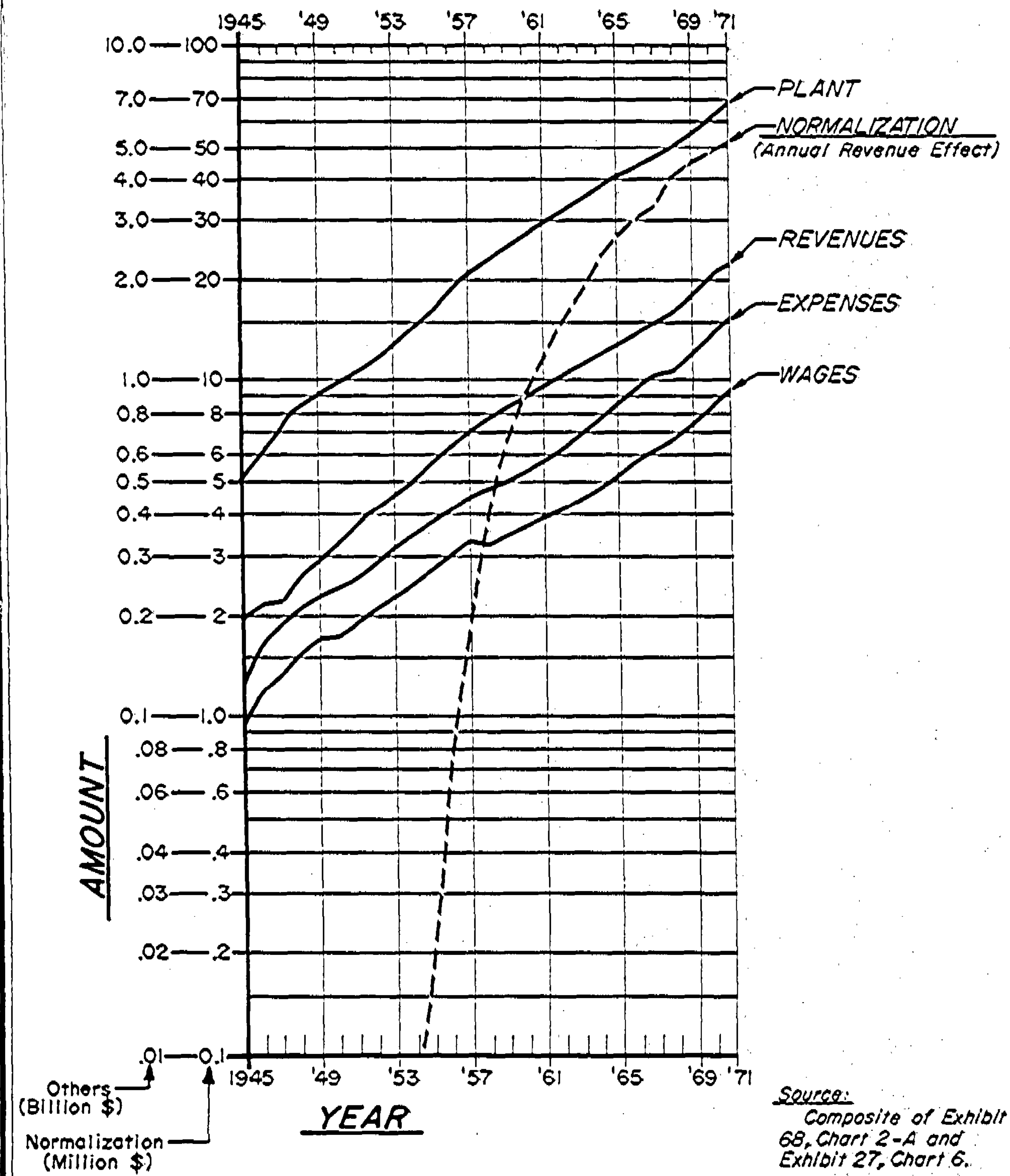
One consequence of the use of accelerated depreciation by Pacific is to create a rapidly growing reserve for deferred taxes that is totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base. This is shown graphically on the chart on page 65. This rapidly growing reserve is, in our opinion, an extraordinary item which, if not handled properly, will create a windfall for Pacific to the detriment of the ratepayers. The tax statute has created a regulatory problem with which the Commission must deal.

The staff's solution to this regulatory problem was the concept of pro forma normalization, as defined in the preceding section. The evidence submitted by the staff and the rebuttal of Pacific were framed in terms of pro forma normalization. In this section we will use the statistical data submitted on the pro forma issue to illustrate the extraordinary nature of this item and the fact that unless an adjustment is made ratepayers will lose much of the benefits of normalization. After illustrating the problem in terms of pro forma normalization, we will propose an answer in terms of traditional ratemaking concepts. However, because of the tax statute we feel that we are legally precluded from incorporating this ratemaking adjustment into Pacific's results of operations. We will set out the dollar effect of the adjustment so that if we are found to be wrong in our interpretation of the tax statute the correct adjustment can readily be made.

PACIFIC TELEPHONE AND TELEGRAPH COMPANY

STATE OF CALIFORNIA

GROWTH AND NORMALIZATION CURVES



Our analysis begins with the chart on page 65 which shows actual plant (rate base), revenues, expenses, and wages as plotted in Pacific's Exhibit 68 with, superimposed upon the graph, a curve (based on Exhibit 7, Chart 6) showing the growth of the normalization reserve if Pacific had been taking accelerated depreciation with normalization since 1954. In our opinion, for at least the first 18 years of normalization, the annual revenue effect of normalization is extraordinary. When such an extraordinary item appears in the test year, traditional ratemaking principles, approved by the Supreme Court of the State of California, require us to make an appropriate adjustment to keep the relationship of revenues, expenses, and rate base in balance.8/

When considering the issue in terms of dollars rather than as a curve on a chart, the result is the same, as might be expected, and the dollars are understandable. The following two tables are illustrative. They are presented for comparative purposes and are not intended to indicate the actual gross revenue reduction for each alternate but to show the impact of the differences between the various ratemaking alternates.

The following definitions and notes, together with the table footnotes, explain the comparisons:

8/ The principles are as old as the Commission. Extraordinary expenses should be distributed over a period of years intended to cover the period of their probable recurrence. (Citizens Water Co. (1919) 16 CRC 950, 954, review dismissed by stip. sub nom Frazee v Railroad Commission (1921) 185 Cal 690); an abnormal expense should be amortized over a period of years (Imperial Utilities Corp. (1928) 31 CRC 539, 542; abnormal expenses should be eliminated or normalized in using a test period for rate fixing purposes (Pacific Tel & Tel Co. (1958) 56 CPUC 277, 285). See cases collected Calif. Public Utilities Digest, Return, Secs. 100-106, 100-108. "...[T]he commission may adjust all figures, revenue, expense, and investment for anticipated changes but it may not adjust one side or part of the equation without adjusting the other unless there is a finding that the particular expenditure is extraordinary." (City of Los Angeles v PUC (1972) 7 C 3d 331, 347.)

1. Figures for flow-through and first year normalization are taken from Exhibit 27, Schedule 10 (Donovan). Pro forma normalization and October adjustment clause alternates were derived using data of Schedule 10, including an assumed tax rate of 50 percent and a revenue effect rate of 13.16 percent as shown in Schedule 10.

2. First year normalization and flow-through are shown as beginning in 1968.

3. Flow-through means that the difference between taxes that would have been due on a straight-line basis and those actually due using accelerated depreciation. This difference is reflected as additional income to the utility in the year of occurrence.

4. Normalization means that the utility's depreciation is determined on a straight-line method for its regulated books of account and for ratemaking purposes while its income taxes are computed by a faster method of depreciation and the difference between the taxes that would have been due under the straight-line method and those actually paid under the accelerated method are credited to a reserve.

5. Pro forma normalization is based on the staff's alternate method which uses the reserve at the end of the third year as an approximate weighted average of the deferred tax reserve over a five-year period, i.e., the reserve at the end of the year 1970 would be used for a 1968 test year.

6. The October adjustment clause alternate for each year is computed by weighting the average deferred tax reserve of the previous year with the current year to obtain a reserve applicable to October 1 of the current year. For example, the weighted reserve for 1973 of $131,639,000 is 3/4 of the 1972 reserve of $118,414,000 (Schedule 10) plus 1/4 of the 1973 reserve of $181,314,000 (Schedule 10). The adjustment amount of $17,324,000 is 13.16 percent times $131,639,000. This results in a nine-month lag.

TABLE I

The Pacific Telephone and Telegraph Company

ANNUAL GROSS REVENUE REDUCTION COMPARISONS
(Effect of the Use of Accelerated Depreciation)

Line No.	Year	5 Years Between Rate Proceedings				Annual Rate Proceeding	
			Normalization				
		Flow- 1/ Through	Pro 2/ Forma	First 3/ Year	Oct.Adj.4/ Clause	Flow- 5/ Through	First Yr. 6/ Normal.
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
		(Dollars in Thousands)					
1	1968	$ 14,258	$ 7,295	$ 469	$ 469	$ 14,258	$ 469
2	69	"	"	"	904	38,617	2,209
3	70	"	"	"	3,003	57,992	5,387
4	72	"	"	"	6,500	77,333	9,839
5	72	"	"	"	11,275	97,251	15,583
6	73	114,346	43,968	22,545	22,545	114,346	22,545
7	74	"	"	"	24,538	128,028	30,519
8	75	"	"	"	32,727	140,381	39,350
9	76	"	"	"	41,754	151,915	48,966
10	77	"	"	"	51,557	163,029	59,328
11	78	174,033	101,163	70,417	70,417	174,033	70,417
12	79	"	"	"	73,372	185,193	82,236
13	80	"	"	"	85,364	195,043	94,746
14	81	"	"	"	98,031	204,391	107,887
15	82	"	"	"	111,309	211,638	121,575
16	83	217,360	172,381	135,689	135,689	217,360	135,689
17	84	"	"	"	139,303	222,130	150,148

1/ Col. (b) Flow-through - The annual gross revenue reduction difference of flow-through accelerated depreciation over straight-line depreciation assuming five-year increments between utility rate changes.

2/ Col. (c) Pro Forma Normalization - The annual gross revenue reduction difference of pro forma normalization over straight-line depreciation assuming five-year increments between utility rate changes.

3/ Col. (d) First-Year Normalization - The annual gross revenue reduction difference of first-year normalization over straight-line depreciation assuming five-year increments between utility rate changes.

4/ Col. (e) October Adjustment Clause - The annual gross revenue reduction difference of the October adjustment clause normalization over straight-line depreciation as described in pages 2181-2182 of Transcript 20 and Exhibits 101 and 102.

5/ Col. (f) Flow-through - The annual gross revenue reduction difference of flow-through accelerated depreciation over straight-line depreciation assuming annual rate changes.

6/ Col. (g) First-Year Normalization - The annual gross revenue reduction difference of first-year normalization assuming annual rate changes.

TABLE II

The Pacific Telephone and Telegraph Company

CUMULATIVE GROSS REVENUE REDUCTION COMPARISONS
(Effect of the Use of Accelerated Depreciation)

		5 Years Between Rate Proceedings				Annual Rate Proceeding	
			Normalization				
Line No.	Year	Flow- 1/ Through	Pro 2/ Forma	First 3/ Year	Oct.Adj. 4/ Clause	Flow- 5/ Through	First Yr. 6/ Normal.
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
		(Dollars in Thousands)					
1	1968	$ 14258	$ 7295	$ 469	$ 469	$ 14258	$ 469
2	69	28516	14590	938	1373	52875	2678
3	70	42774	21885	1407	4376	110867	8065
4	71	57032	29180	1876	10876	188200	17904
5	72	71290	36475	2365	22151	285451	33487
6	73	185636	80443	24890	44696	399797	56032
7	74	299982	126411	47435	69234	527825	86551
8	75	414328	168379	69980	101961	668206	125901
9	76	528674	212347	92525	143715	820121	174867
10	77	643020	256315	115070	195272	983150	234195
11	78	817053	357478	185487	265689	1157183	304612
12	79	991086	453641	255904	339061	1342376	386848
13	80	1165119	559804	326321	424425	1537419	481594
14	81	1339152	660967	396738	522456	1741810	589481
15	82	1513185	762130	467155	633765	1953448	711056
16	83	1730545	934511	602844	769454	2170808	846745
17	84	1947905	1106892	738533	908757	2392938	996893

1/ Col. (b) Flow-through - The cumulative gross revenue reduction difference of flow-through accelerated depreciation over straight-line depreciation assuming five-year increments between utility rate changes.

2/ Col. (c) Pro Forma Normalization - The cumulative gross revenue reduction difference of pro forma normalization over straight-line depreciation assuming five-year increments between utility rate changes.

3/ Col. (d) First-Year Normalization - The cumulative gross revenue reduction difference of first-year normalization over straight-line depreciation assuming five-year increments between utility rate changes.

4/ Col. (e) October Adjustment Clause - The cumulative gross revenue reduction difference of the October adjustment clause normalization over straight-line depreciation as described in pages 2181-2182 of Transcript 20 and Exhibits 101 and 102.

5/ Col. (f) Flow-through - The cumulative gross revenue reduction difference of flow-through accelerated over straight-line depreciation assuming annual rate changes.

6/ Col. (g) First-Year Normalization - The cumulative gross revenue reduction difference of first-year normalization assuming annual rate changes.

The basic assumption of both tables is that a rate proceeding will occur once every five years. Discussions of the difference between the revenue reduction assuming flow-through compared to the revenue reduction assuming normalization are usually in terms of cumulative reductions after a period of years, for instance, in year 17 flow-through would have given rise to a $2.4 billion revenue reduction while first year normalization would have given rise only to $1 billion (Table II, Columns (f) and (g)). But this result will occur only if there is a rate case every year, practically a physical impossibility. If we assume a rate case every five years, then the difference between flow-through and first-year normalization is the difference between $1.9 billion and $738 million (Table II, Columns (b) and (d)). The inequity in using first-year normalization is shown in Table II, Column (d), as compared to Table II, Column (g). Assuming a test year every five years, in the first year of normalization there would be a revenue reduction of $469,000, and in the five years that those rates are in effect the total would be $2,345,000. But in the five-year period, if the ratepayer had been given the benefits of normalization on an annual basis, the cumulative effect would have been $33.5 million (Table II, Column (g)).

Pacific argues "normalization will give customers the full benefit of accelerated depreciation without the proven hazards of flow-through." Tables I and II show this argument to be false. The cumulative gross revenue reduction assuming an annual rate proceeding beginning in 1968 would be $33.5 million in 1972 (Table II, Column (g)). Under Pacific's proposal, assuming no rate case for five years, the actual accumulated gross revenue reduction by 1972 would be only $2.4 million (Table II, Column (d)). Clearly something more than Pacific's plan must be utilized to reflect into rates the extraordinary growth in this rate base reduction and thus give the ratepayers their share of the benefits of normalization. And there is more to the problem than this. We have been directed to seek a reasonable compromise between the flow-through adjustment and the normalization adjustment (City of San Francisco v PUC (1971) 6 C 3d 119, 130). Because the yearly additions to the deferred tax reserve are extraordinary and because setting rates annually is impractical, a method which averages the extraordinary accumulation in the deferred tax reserve over the period the rates are expected to be in effect is a reasonable ratemaking procedure. The method appropriate to the facts of this case is an adjustment to rate base which is equivalent to an average of the additions to the deferred tax reserve over a reasonable period. In this manner the ratepayers will not be deprived of their share of the benefits of normalization and Pacific's earnings will not include a return on a portion of the tax deferral reserve, contrary to good ratemaking, regardless of whether this reserve is viewed as capital contributed by ratepayers or as an interest-free loan from the federal government. This adjustment for an extraordinary item yields results fair to both the ratepayer and Pacific in light of current federal income tax statutes, and, over the period of the adjustment, does not reduce the Treasury's revenues.

In this inflationary period a prudent estimate of the next rate case is three years. Therefore, the extraordinary item adjustment will be the dollar equivalent to an average of the additions to the deferred tax reserve for 1974, 1975, and 1976. This amortizes the extraordinary item over the estimated period the rates are expected to be in effect, in conformity with Commission practice. In Pacific's next general rate case, assuming no changes in the tax law, we will repeat this procedure: estimate the years before another general rate case and amortize the projected reserve. For test year 1973, the difference in gross revenue requirement between accelerated depreciation with normalization and our adjustment for the extraordinary item is approximately $23 million. The difference in rate of return and rate base is shown in Appendix B, Table I, page 2.

Notwithstanding this discussion we are not making this extraordinary item adjustment for federal taxes. We have read the relevant tax statutes and the explanatory Treasury Regulations published June 7, 1974 (39 F.R. 20194, et seq.), plus the briefs submitted July 3, 1974. Our conclusions are: (1) from a tax viewpoint, treating the extraordinary item adjustment as part of the deferred tax reserve, the adjustment is improper; (2) from a regulatory viewpoint, as a ratemaking adjustment for an extraordinary item, the adjustment is proper, and (3) the Treasury Department is most likely to look at this matter from a tax viewpoint. If we make the adjustment and if the Department does what we expect them to do, they will disallow the accelerated depreciation treatment entirely, compute Pacific's taxes on a straight-line basis, and assess back taxes and penalties of more than $57 million for 1973. The Commission does not want this $57 million to flow to Washington; we want it in California where it will be used to provide service to the public. Further, a $57 million outflow will affect Pacific's current service, as well as its ability to finance, to maintain its credit, and to assure confidence in its financial integrity. These risks outweigh the $23 million gross revenue saving to the ratepayers that our adjustment would cause.

Our conclusion that our extraordinary item adjustment is proper is based on the following reasons: (1) We have established a rate base which has been reduced by an amount of deferred tax reserve determined on the basis of the test period which is used to determine Pacific's tax expense in arriving at cost of service (Appendix B, page 2, line "Reserve for Deferred Taxes"); (2) our extraordinary item adjustment is a conventional ratemaking adjustment (see footnote 10); (3) we have made other ratemaking adjustments to rate base, such as for pay TV and telephone plant acquisition, which no one asserts is improper; (4) our extraordinary item adjustment, being conventional, is not a subterfuge to evade the tax law; and (5) the loss of federal revenues, assertedly the reason for normalization (see Pacific's Supp. Brief, page 7), will not occur under the extraordinary item treatment during the amortization period or beyond. The fear of federal revenue loss is groundless. Yet, despite this reasoning, our concern for Pacific's ability to serve and the needs of the ratepayers for good service compels us to take the conservative position and not make the extraordinary item adjustment.

Job Development Investment Credit

The job development investment credit shall be computed in the same manner as the treatment accorded accelerated depreciation. The initial computation resulting in the 6.74 percent rate of return reflects only service life amortization at JDIC in test year 1973. The alternate calculation of the extraordinary expense item includes a three year average of the anticipated benefits from JDIC to Pacific in the years 1974, 1975, and 1976.

State Income Tax

In compliance with the Supreme Court's decision, state income taxes shall be computed on a flow-through basis. (City of Los Angeles v PUC (1972) 7 Cal 3d 331, 338-342.) Further, the reasons for an extraordinary item adjustment are equally applicable to state tax flow-through, and no tax statute prohibits this procedure. Therefore, we shall compute state tax expense using a projected three-year average flow-through for the years 1974-1975-1976. (See Note 11 to Table I in Appendix B.) This three-year adjustment is appropriate to Pacific's results of operations because Pacific has so recently begun to compute its tax depreciation on an accelerated basis as contrasted to other classes of utilities which have been utilizing accelerated depreciation for more than a decade.

Authorized Increase in Revenue

The determination of the additional revenue to produce the rate of return found reasonable is set forth in the calculation below:

Rate of return authorized	8.85%
Rate of return at present rates (Appendix B, Table I)	6.74
Increase in rate of return required	2.11
Adopted rate base (Appendix B, Table I)	$4,426,929,000
Net revenue increase	93,408,202
Gross-to-net multiplier	1.962 1/
Gross revenue increase	183,266,892
Use	183,300,000
Settlement provision	8,600,000
Gross revenue increase required 2/	199,400,000

1/ Exhibit 50, p. 7-2.

2/ Includes $7.5 million for annual charges for timing equipment.

IV
SERVICE

Testimony concerning service was presented by one witness for Pacific and some telephone users. Pacific's witness testified that Pacific's service was good but that there were certain areas which needed improvement. When rates were reduced as a result of the Supreme Court decision in June 1972, Pacific instituted measures to reduce operating expenses and construction. As a result of these reductions service deteriorated. The significant areas of deterioration were the availability of operators and of service representatives, and the interval customers had to wait for installation and repair of telephone service. After rate relief was granted in August 1972, service deterioration ceased and improvement began to be noticed. The witness emphasized that at no time did basic telephone service, that is, local and toll dialing ability, ever deteriorate. In the witness' opinion present service is adequate but can be improved in certain areas; Pacific is in the process of making those improvements.

The few telephone users who testified concerning service said that in some instances they had received poor service. This negligible amount of customer complaints in a proceeding that was widely publicized throughout the State and in which hearings were held in at least six separate locations shows that Pacific's service is, in the legal sense, adequate. In our opinion Pacific's service is superior.

V

RATE SPREAD

Basic Exchange Service

An understanding of rate spread begins with an understanding of the pricing of basic exchange service. Basic exchange service consists of the simple flat rate and measured rate residence and business telephone services, including 30-message residence service (the so-called "lifeline service"). The remaining exchange services include MMU, directory advertising, exchange private line, ORTS, and an enormous variety of special services such as key telephone (the "button" telephone which can handle multiple lines), PBX, and Centrex which go beyond basic telephone service but still fall within the exchange category.

The central fact, agreed upon by the staff and Pacific and not controverted by any other party, is that both business and residence basic exchange service are provided at a loss and that this loss must be made up in the rates for other services. Thus staff rate spread witness Andrego testified that "basic [exchange] services basically are not at the present rate levels at full cost"[9/] and that "each and every [basic exchange] service is deficient". Staff counsel stated the staff position in the same terms: "We recognize that there is an inadequacy in all of the [basic] exchange charges".

Pacific's rate spread witness Sullivan introduced evidence of the magnitude of the inadequacy in basic exchange rates. He testified that the cost to Pacific simply to keep the average telephone instrument in place and ready for use is $9.50 per month if the telephone is never lifted from the hook either to place or receive a call. This is in contrast to basic exchange rates which, in the metropolitan areas, range from $2.25 per month with 30 free local messages for basic residence service to $6 per month with 80 free messages for basic business service. If the telephone is never used, and hence no costs

9/ "Full cost" includes average company return on investment and associated income taxes. A utility rate may cover operating expenses but still be provided at a loss if the rate does not provide for return and taxes.

arise as a result of usage, Pacific's losses range from \$7.25 per month on the most inexpensive residence service to \$3.50 per month on business service.

Most telephones, of course, are used. And when the costs incurred as a result of usage are added to the costs of maintaining a telephone in place, the gap between costs and rates is magnified. The reason is obvious: Costs are incurred when every call is placed, but because no revenue is received for local calls placed over flat rate residential lines and because no additional revenue is received from local message service until the free call allowance is exceeded (which ranges from 30 to 80 local messages per month) the costs incurred in usage outrun the revenues received.

Pacific contends that the total cost of providing a basic exchange telephone, including the costs of local usage, averages \$15 per telephone per month. The total revenue received from the average residence telephone, including revenues from toll and MMU service, is \$8.03 in the case of lifeline service and \$15.69 for flat rate residence service.

The staff points out that, even assuming Pacific's costs are accurate, Pacific has made no allocation to toll or MMU service. For instance, the \$9.50 cost associated with readiness to use should not be considered solely as a basic exchange cost as that same instrument stands ready to be used in toll service and MMU service.

The evidence is not sufficient to make a finding on the precise cost of basic exchange service. Therefore we cannot say that flat rate service or business service is "X" dollars deficient. But the evidence is sufficient to find that each basic exchange service is being provided substantially below cost, and will continue to be at the rates authorized by this decision.

No one has suggested that basic telephone rates should be increased in an amount sufficient to make the service self-supporting. To do so would undoubtedly price telephone service out of the reach of some Californians. Reduced to its essentials, the issue is whether basic exchange service, which is now being furnished at a low return and is subsidized by other services, should be left as is, or whether basic exchange rates should be increased to make the service more nearly self-supporting. The staff would, to the extent possible, obtain necessary revenue increases from exchange services other than basic exchange service. Pacific would give first priority to basic exchange service, although even Pacific's proposed basic exchange rates are below cost.

Basic telephone service rates have not been increased since August 1972. It is only fair that these services should share in the burden of offsetting Pacific's increased costs since 1972. We will authorize an increase in all basic services: Residence - 90 cents for flat rate, 40 cents for 60-message rate, 25 cents for lifeline; business - $1.50 for 80-message rate.

Timing Local Messages

Both Pacific and the staff have joined in proposing that local messages be timed and that the charge for local messages be based upon five-minute periods. All parties support the principle of timing local messages and only Olan Mills, Inc., a chain of photography studios, opposes the use of five-minute periods and proposes that the period should be only one minute and that the charge should be two cents for the first minute and one cent for each minute thereafter. Each message unit would be worth one cent.10/

The reason for instituting the timing of local messages is that the present rate structure fails to make any allowance for the fact that a customer who makes a five-minute call is charged one message unit at 4.5 cents whereas another customer who makes a six-hour call over the same route is also charged one message unit at 4.5 cents. Business customers' holding times on a single call may in some cases last for an entire business day. Some residence customers also have extremely long duration calls. Under present pricing arrangements long duration calls cost only 4.5 cents on message rate service.

10/ In its brief Olan Mills suggests alternate combinations of minutes and rates, e.g., two- and three-minute minimums at varying rates.

Olan Mills gets its business by random telephone solicitation. According to studies which Olan Mills introduced, over 85 percent of its solicitation calls are timed at one minute or less. Under existing rates these calls cost 4.5 cents each, the rate for a single local message. Pacific's figures show that 88 percent of all California business single message unit calls are five minutes or less in length, the average length being less than three minutes. More than 60 percent of all California business single message unit calls are two minutes or less in length. Olan Mills asserts that its proposal would structure rates so as to encourage people not to use facilities longer than necessary. As an alternative Olan Mills proposed that only business messages be timed.

The Olan Mills scheme would substitute a new subsidy for an old one. It costs about 3.75 cents to set up a local call, even if that call lasts only ten seconds. The cost of a local call of average duration, about four minutes, is approximately five cents. Thus Olan Mills, which would pay only two cents each for the great bulk of its calls, would be able to make most of its calls at a price far below Pacific's cost, thus leaving the rest of the customers to pick up the difference. If the charge for the first minute is increased to cover full costs substantial changes in calling habits of both business and residence customers will occur. It is clear that Olan Mills would benefit. It is equally clear that most message-rate residence customers and a substantial number of business customers would suffer.

The Olan Mills proposal would substantially cut the local call allowance. For example, the message allowance for lifeline service is 30 local messages. Under the Olan Mills scheme, with two units being charged for the first one minute and one unit per minute thereafter, the call allowance would be cut from 30 calls to five or six calls of average duration. If more cost is loaded in the first minute or two, the call allowance is cut further. Olan Mills proposes too much, too soon. Experience under the staff and Pacific's proposal is needed before more drastic measures are implemented. Olan Mills' alternative suggestion, that only business services be timed, merely shifts the existing subsidy from long duration business callers to short duration business callers and ignores the problem of long duration residence calls.

The proposal of Pacific and the staff preserves existing rate relationships and message allowances while at the same time eliminates the abuses to which local message service has been subjected. We recognize that when rates are increased or new concepts are introduced some users will be financially harmed more than others, but we see no way to avoid this when dealing with millions of ratepayers. In this particular instance Olan Mills will not be harmed at all. It makes almost no calls of a duration of more than five minutes. It argues fairness to business users, but, except for a gluttonous few, business users will not be harmed by five-minute timing. We will adopt the proposal of Pacific and the staff.

The staff proposes that during off-peak periods charges should be made only for the number of calls and not for the duration of the call. Off-peak periods are defined as from 11:00 p.m. to 8:00 a.m. daily and 8:00 a.m. to 5:00 p.m. Sundays and holidays. This is expected to minimize Pacific's investment necessary to handle peak traffic. We do not agree with the staff proposal. Its reason is not sufficient to subsidize long duration calls.

Finally, the staff recommends that Pacific provide for optional detailed billing for local message unit service, but the staff does not recommend that Pacific be ordered to install the necessary equipment at this time because of the substantial costs involved. We find no need for detailed billing for local message unit service. Today most business service and a large percentage of residence service is on local message unit service, yet there is no evidence of any demand for detailed billing. However, Pacific should consider the possibility of public demand for optional detailed billing when it designs or selects a system for timed local message unit service.

We are aware of the virtue of off-peak pricing to reduce Pacific's peak loads. It is probable that eventually evening usage of message units will be provided at a lower price than day usage, just as now evening usage of toll is provided at a lower price. Because of this we expect that Pacific, when installing its timing equipment, will provide equipment that either has the capability of off-peak pricing, or can be adapted to provide off-peak pricing.

Exchange Message Unit Rate

The present exchange message unit rate is 4.5 cents. The evidence shows that the cost to Pacific of an average local message is approximately 5 cents for about 4 minutes. Message unit service is a losing proposition. Pacific has proposed varying amounts of increase depending upon the level of rates authorized by this decision. In our opinion message unit service should pay its way.

It is not part of basic exchange service which should be subsidized, as customers can control their local message usage. We will authorize a message unit rate of 5 cents. The message unit rate applies to single message units and multi-message units. Foreign Exchange single message units will be increased to 6 cents.

Multi-Message Unit Service

The staff proposes that the remaining three to six multi-message unit (MMU) routes be converted to toll. When MMU service was first introduced in 1940, it was designed to create economies of operation through bulk billing of calls at a time when all toll calls were handled by operators on a manually ticketed basis. The economies of MMU as compared to toll service have disappeared with the almost universal introduction of nationwide direct distance dialing and the provision of detailed billing on MMU service starting in 1967. These changes have resulted in two services indistinguishable from each other except for the method of stating the rate. The effect of the staff proposal would be an increase in revenue to Pacific of $39.5 million.

Pacific, Los Angeles, San Francisco, and Mrs. Siegel oppose the staff proposal. They argue that the record shows that under current uniform statewide basic rates subscribers in Los Angeles and San Francisco pay the same rates as most subscribers in the State for basic exchange service. However, Pacific's breakdown of costs and return in various areas in the State shows that the return from Los Angeles and San Francisco is higher than the return from other parts of the State. Los Angeles and San Francisco are subsidizing service in the remainder of the State. Because of this those opposed to the staff proposal argue that it would be unfair to impose an additional burden on Los Angeles and San Francisco ratepayers who are already contributing more to Pacific's return than other groups of ratepayers. The staff's proposal would increase the telephone bills of Los Angeles and San Francisco customers by an average of approximately 15 percent to 20 percent above whatever basic exchange rates are authorized in this proceeding.

As an alternative Pacific proposes to convert selected MMU and toll routes to exchange service. This would increase service by expanding local calling areas without requiring rate increases above those which have been proposed.

Both the staff's and Pacific's proposals are not feasible at this time. The staff's proposal would further burden Los Angeles and San Francisco subscribers who are already contributing more to Pacific's income than subscribers in other parts of the State. Pacific's proposal, contrary to its assertion, would reduce its revenues by $13.1 million which would have to be made up elsewhere. Further, Pacific's proposal would expand basic exchange areas, in effect increasing the subsidy to an already highly subsidized aspect of Pacific's operation. Both proposals are rejected. However, it is inevitable that MMU routes will be converted to toll. At this time Pacific's revenue requirement permits continuation of MMU, but in the near future when the message unit rate is increased again, when toll is increased, when changes in timing are made for toll service, MMU will be converted.

Wide Area Telephone Service (WATS)

WATS is a service designed to permit toll usage at a bulk rate without regard to distance. For example, at present rates the subscriber to outward WATS receives an access line through which he can make an unlimited number of toll calls within a specified geographical area (for example, northern California, or southern California, or the entire State) for a flat rate for the first 15 or 125 hours of usage and a specified hourly rate thereafter. Pacific asserts that outward WATS is advantageous because (1) it does away with the need for recording and billing the details of toll calls and the associated expense, and (2) it limits the load on the toll network because a customer for outward WATS service can only place one outgoing call at a time on a given WATS line and is, therefore, prevented from concentrating his calling at certain peak periods of the day.

Inward WATS service is a very different service with very different characteristics. The customer to inward WATS service cannot place calls over his line. Instead, he pays a bulk rate so that people can call him without charge. Like outward WATS, Pacific saves the expense associated with recording and billing toll call details, but in sharp contrast to outward WATS, Pacific must augment its facilities to prevent overloading as a result of a high volume of calls to the inward WATS customer. The net result is that the cost to Pacific of furnishing an inward WATS line is 68 percent higher than the cost of furnishing an outward WATS line.

WATS is in effect a simple discounted toll service for large customers. Presently, one tariff applies to inward WATS and outward WATS. Pacific proposes no increase for outward WATS and some increase for inward WATS. The staff proposes an increase for outward WATS and a higher increase for inward WATS. The staff has also recommended discounts for evening and night calls.

We will adopt the staff proposed increases without any reductions for evening or night calls. We recognize that WATS can be provided at somewhat lower costs than regular service because of the savings due to bulk billing. However, we are not convinced that WATS limits the load on the toll network to any substantial extent, and certainly not to the extent which permits a substantial wholesale rate. In Pacific's next rate case we will expect Pacific to present evidence which shows the saving to Pacific and the peak load shifting that supports the WATS discount.

Service Connection, Moves, and Changes

Pacific proposes an increase in service connection charges of $10 (from $25 to $35 for each new business line and from $15 to $25 for each new residence service) and an increase in the charge for simple moves and changes of telephone apparatus of $2 (from $10 to $12 for both business and residence services). The proposed increases in service connection charges are required because present charges do not come close to covering the expenses incurred in connecting new services. Even the proposed charges will, on the whole, fall short of the expense involved in service connections.

On the average, the expense incurred by Pacific in connecting a new business or residence service of the most simple variety is $37, exclusive of any visit to, or work at the premises of the customer. The $37 expense includes only the unavoidable work associated with the establishment of a new service such as making connection in the central office, assigning a telephone number, establishing billing records, preparation of service orders, revision of the telephone directory, and revision of directory assistance records. The $37 does not include the cost of sending an installer to the customer's location, which would average an additional $25.

The cost of the installer's trip to the customer's location and the work done there are capitalized and thus recovered through the return which Pacific realizes on its investment. The $37 expense, however, must be recovered in the form of a service connection charge if it is to be recovered at all. The proposed service connection charges will partially overcome the existing deficiency.

Pacific proposes to increase both business and residence service connection charges by the same amount, although the resulting charge for business connections will be $35 whereas that for residence services will be only $25. The reason for proposing a larger proportional increase for residence connections is that new residence connections outnumber business connections by two to one, but at the proposed rate level residence charges will still fall short of expenses by approximately 30 percent. For all but the most simple business services, moreover, there is a substantial additional installation charge which has no counterpart in the residence market.

There is no objection to Pacific's proposal except that the staff proposes that for residence service if the new customer accepts the existing telephone as installed or, if there is no instrument on the premises, accepts the inside wiring arrangement, then the customer shall receive a $10 credit. The reason is to save the customer a charge and Pacific the additional costs associated with its present policy of removing phones upon termination of service. The staff's proposed credit is unsound. The only purpose of the service connection charge is to recover the unavoidable expense in establishing a new service - not the capitalized cost of the installer's visit. Because the proposed service connection charge will not recover even the unavoidable expense incurred in a service connection whether or not an installer is needed, there is no basis upon which to offer a discount when an installer's visit is unnecessary. We will adopt Pacific's proposal.

There was considerable testimony on the issue of whether Pacific should leave all telephones in place rather than remove them when a customer terminates service. The evidence on this issue appears evenly balanced, therefore we will not change Pacific's practices.

<u>Private Lines, Services, and Channels</u>

Pacific recommends that these services be increased by approximately $2.8 million. The staff concurs and there are no objections. We will adopt Pacific's recommendation.

Classified Directory Advertising

The staff proposes a $7.7 million, or 7 percent, increase in classified directory advertising. This is the first increase since November 1968. Pacific does not object to this increase nor do any other parties. We will adopt it.

Optional Residence Telephone Service (ORTS)

Pacific proposes a 15 percent increase in its ORTS offering in order to maintain a rate relationship similar to that which currently exists between MMU and ORTS. The staff contends that this 15 percent increase would maintain only an earlier rate relationship with MMU and that an increase of at least 25 percent is necessary to maintain the present relationship with MMU. The staff analysis is reasonable. ORTS and MMU are cross-elastic services whose rates must be kept in relation to each other so as to avoid disproportionate shifts in service. We will adopt increases in ORTS proportionate to our adopted MMU rates.

PBX, Centrex, and Related Services

The staff proposes a 15 percent surcharge for these services. Although the proposed rates will not meet the full cost requirements for the various services the 15 percent increase is considered appropriate pending the completion of cost studies. Pacific concurs in this proposal and there are no objections; we will adopt the staff's proposal.

Telephone Answering Services

Pacific recommends that rates for telephone answering service switchboards should be increased by $400,000. The staff's original recommendation was that these rates should be increased by $800,000. The staff's recommendation would be an increase of 50 percent over current rates. Telephone Answering Systems of California, Inc. (TASC), representing approximately 105 telephone answering service companies operating in California with a clientele of about 100,000, protests both Pacific's and the staff's recommendations. TASC protests on the ground that telephone answering service switchboards are substantially the same as PBX switchboards to which Pacific and the staff are agreed that a 15 percent interim increase should be applied pending a thorough review and cost study of such equipment. TASC asserts that to price telephone answering switchboards differently from PBX switchboards would be discriminatory.

The staff rate spread expert conceded that PBX equipment is substantially the same as the equipment used by the telephone answering service industry. After this concession, the staff proposed an alternate rate spread for telephone answering services which consisted of an across-the-board 15 percent increase in all services. Since this increase included services in addition to switchboards, the total increase came to over $900,000. If a 15 percent increase were applied only to telephone answering switchboards, the increase to the telephone answering services would be approximately $340,000. Pacific presented exhibits which showed that telephone answering service switchboards are currently priced substantially below cost and that an increase of even $400,000 would not bring them up to cost.

In our opinion the $800,000 increase to the telephone answering services on switchboard equipment that is essentially the same as that being supplied to nontelephone answering services is unreasonable. The staff's proposal would increase telephone answering switchboard costs more than twice as much as it proposes to increase costs of other users of switchboard equipment; such an increase is discriminatory. The staff's alternate proposal of a flat 15 percent increase across-the-board for all telephone answering services has not been substantiated on this record. There is no evidence that the costs of nonswitchboard equipment to the telephone answering service industry should be raised by so substantial an amount. We are left with the choice between the $400,000 increase proposed by Pacific and the $340,000 increase that would be effective if a 15 percent surcharge were applied to telephone answering service switchboards. In our opinion Pacific's $400,000 increase recommendation is reasonable and will be adopted. Pacific's increase will increase only 5 tariff items, the 15 percent increase as proposed would increase approximately 21 tariff items. Simplicity of tariff construction has value in itself, and in this instance also because it permits a comparison of costs by telephone answering services of the offerings of different telephone companies. More important, the evidence of costs of telephone answering service switchboards that is in the record shows that an increase of $400,000 in rates will not be sufficient to cover the costs of the service. We expect the cost studies now being conducted by Pacific and the staff in the field of switchboard equipment to be completed in the near future. At that time Pacific's rates will be adjusted to reflect such updated information. TASC is invited to participate in that determination.

Key Equipment Services

Of the thousands of business equipment services offered by Pacific proposed rates were most strenously attacked for key telephones (COM PAK II and COM PAK III), keyless business extensions, and illuminated lines. Key telephones are the familiar "button" telephones which can handle multiple telephone lines. Keyless business extensions are simply plain telephone sets used as an extension by a business. And illuminated lines are telephone lines which terminate on lighted key telephone buttons. In all three of these services Pacific suggested either no change in the rates or only a nominal change. The staff suggested somewhat higher changes in more categories. And the most strenuous advocate of a change in rates, raising them substantially in seven out of nine categories, was the Business Telephone Systems division of Litton Systems, Inc. (BTS). BTS is engaged in manufacturing, selling, leasing, installing, and servicing telephone terminal equipment to customers within California for connection with the telephone lines and central office exchange system of Pacific. In this business BTS competes with Pacific. BTS's argument is simply that the rates proposed by Pacific and the staff for the three items in question will not fully cover the costs of providing the service, with the ultimate effect of transferring costs to other ratepayers and adversely affecting competition. BTS is interested in services other than the three discussed in this section of the opinion, and as to those services it concurs in the recommended rate increases proposed by Pacific and the staff. The following table shows the different rate proposals.

		Proposed Rates*		
	Present Rates	Pacific	Staff	BTS
COM PAK II				
Monthly Charge	$ 2.20	$ N/C	$ N/C	$ 5.10
Installation Charge	20.00	N/C	N/C	35.00
COM PAK III				
Monthly Charge	4.65	4.85	5.00	6.95
Installation Charge	50.00	N/C	N/C	N/C
Keyless Business Extension Phone				
Monthly Charge				
Measured	1.00	N/C	1.25	2.60
Flat Rate	1.75	N/C	2.00	2.60
Installation Charge (Measured and Flat Rate)	10.00	N/C	N/C	N/C
Illuminated Line				
Monthly Charge	2.60	2.80	3.00	3.85
Installation Charge	10.00	N/C	12.00	12.00

* N/C = No Change.

The preceding table sets forth BTS's proposal for the first year rates are in effect. BTS's original proposal was to raise rates by about 50 percent, which is twice the increase shown in the preceding table. However, BTS recognizes that such an increase would be intolerable for many businesses and suggests that the increase be made in two steps, one-half the first year and one-half the following year. The effects of BTS's proposal is that in the first year revenue is to increase by approximately $30.5 million with an additional $30.5 million increase in the second year.

Pacific's proposed increase for the three services plus additional key equipment services not discussed is $5 million. The staff's proposed rate increase for the three services plus additional key equipment services not discussed is $9.8 million.

Pacific's rate spread witness based his recommended increases by starting with a cost study which develops the incremental costs and resulting annual charges which Pacific would incur if it installed a new item of the particular equipment which is the subject of the cost study, using all new materials and at current labor rates for installation labor. Then the witness considered that these items of equipment have service lives of varying length with each year showing some items being retired, some items being installed new, and the majority of items being holdovers from previous years' installations. Thus, although current cost studies reflect the annual charges attributable to a new installation made today, the studies substantially overstate the annual charges attributable to earlier installations installed at lower labor rates and material costs.

For instance, for key telephone installations, Pacific's witness began by calculating the costs associated with 1972 key telephone installations using the new cost format and using actual 1972 installation, maintenance, and removal hours and actual 1972 labor rates, material costs, return, and taxes. Next he repeated the process year by year for installations made in 1971, 1970, and 1969. In each case he used 1972 rates of return, maintenance hours and rates, taxes and all other items which should be priced at current rates, together with the installation labor rates and material costs appropriate for the year when the equipment went into service. He did not analyze installations made prior to 1969 despite the fact that approximately 25 percent of key telephone installations went into service prior to that year.

BTS asserts that Pacific's cost analysis is wrong in a number of instances but particularly in its labor costs which BTS asserts are substantially understated for installation, removal, and maintenance. BTS presented a witness who testified to what he considered to be average times for doing various functions of installation, removal, and maintenance. This witness was a former Pacific installer who based his testimony solely upon his own experience during 12 years with Pacific. He gave details of his experience and his estimate of the hours and minutes associated with each function of installation, removal, and maintenance. Based on this testimony BTS concludes that labor costs are so substantially understated that Pacific should raise its rates for the three items in question by over $60 million in two yearly increases. This is more than six times the amount the staff recommends for a larger variety of items and more than 12 times the amount Pacific recommends for a larger group of items.

We cannot authorize an increase in revenue of upwards of $60 million based upon the testimony of one installer of Pacific relating his experience over the past 12 years. (BTS, in its brief, actually asserts that based upon its witness's testimony revenues should be increased over $110 million, but it did not ask for that amount.) BTS requests that we order Pacific to make detailed cost studies to include, among other things, "detailed cost information showing the labor investment to (a) installation, (b) maintenance and (c) removal by the specific categories of equipment: small PBX, large PBX, key, keyless, Centrex CO, Centrex CU as already stated. The installation labor investment should be detailed to show the types of installation occurring for each service, and the frequency of each type of installation occurring for each service." It would serve no useful purpose to continue this discussion. BTS would have us order Pacific to make incredibly complex cost studies taking years to complete, yet at the same time would have us raise rates by some $60 million annually based on the testimony of one telephone installer. This we will not do.

We have reviewed the cost studies placed in evidence by Pacific and have considered the evidence of the substantial increases in labor costs over the past three years that enter into the pricing of the key equipment services. In our opinion Pacific's proposed rate level does not adequately reflect these increases, but the staff rate level does. We will adopt the staff proposal.

Supplemental Equipment

The staff proposal is reasonable; we will adopt it.

Directory Assistance

The staff suggests that a charge be made, in certain circumstances, for persons calling the operator for directory assistance. We feel that this suggestion is premature.

Lifeline Service

We have discussed lifeline service in a number of parts of this opinion. Lifeline service is a one-party measured service for residence subscribers at a current rate of $2.25 a month with an allowance of 30 messages. This rate is well below the cost of service. Just the cost of providing the telephone in place is $9.50. In its original concept it was intended to be an economical way of providing necessary telephone service to those with low incomes. (Re General Telephone Company (1969) 69 CPUC 601, 676.) However, as presently offered, there is no income restriction; the only restriction on the service is that it be the only service in a particular residence. It has come to our attention that large numbers of persons subscribe to lifeline service who do not come within the definition of a low income person. A number of persons participating in a professional capacity in this rate case have stated for the record that they subscribe to lifeline service. Lifeline service, a highly subsidized service, is not meant for anyone other than a person or family living on a limited income. Therefore we shall order Pacific to require any person applying for lifeline service to certify that the combined annual income of all persons living in the residence where the service will be installed is less than $7,500. The certification shall be in the following form:

> I hereby apply for residence individual line 30-message service (lifeline service). I certify that the combined annual gross income of all persons living at the premises where lifeline service is requested is less than $7,500.

____
Applicant

The fact of certification by the applicant for lifeline service shall be sufficient for Pacific to install the service if all other conditions of telephone service are met. No recertification shall be required as long as the subscriber continuously subscribes to lifeline service on the premises where first installed. Persons presently subscribing to lifeline service shall fill out the certification to retain lifeline service. (See Appendix C, page 2.)

Toll Rates

Pacific's proposal for toll rates includes instituting a one minute initial period on daytime direct distance dialed (DDD) calls and increasing rates for all calls where customers request operator handling, including coin telephone calls. At present the intrastate toll system earns more than Pacific's overall rate of return and contributes to the deficit for basic services. Therefore, we are not adjusting toll rates in this proceeding.

Our primary reason is that we feel it is more important to bring basic telephone service rates closer to cost. Further, increases in toll affect other services so substantially that evidence in more detail than this record contains should be presented to assure informed consideration of all of the ramifications of increasing toll rates. Toll rates and MMU service are cross-elastic services. An increase in toll as proposed without changing the MMU routes would create undue discrimination. However, it is apparent that in the near future all MMU routes will be abolished and either extended area service or toll will be substituted. At that time it will be appropriate to reconsider the level of toll rates including the proposal for a one minute initial period on daytime DDD. Because operator handling and coin telephone rates are closely associated with toll, we will not authorize increases in these services.

We will authorize one minor change recommended by all parties which is to change the starting time of the evening rate from 6 p.m. to 5 p.m. This change will have a negligible effect on Pacific's revenue.

Other Changes

The staff has recommended other changes that have little or no cost associated with them. We will adopt all of the staff recommendations. These recommendations are:

1. For the exchanges of Bakersfield, Fresno, Modesto, Riverside, Santa Rosa, and Stockton business one-party measured, residence one-party measured with a 60 allowance, and residence one-party measured with a 30 allowance, shall be introduced within five years. Concurrently, business two-party flat and residence two-party and four-party flat rate services shall be withdrawn.

2. The Sacramento area shall be wholly converted to one-party residence service within five years offering 30- and 60-message service and flat rate service.

3. One-party flat rate FEX and measured residence FEX service shall be offered to new applicants, as well as suburban service where applicable.

4. All eight-party suburban service and four-party urban service shall be completely eliminated within five years.

5. Once a year Pacific shall enclose a bill insert to each residence customer showing a list of services and their costs as shown in the telephone directory.

6. For new connections, both business and residence, the initial bill shall contain a fully itemized list of each separate service item as well as a reference to the list of services in the directory.

SOURCES OF INCREASED REVENUE

Item	PT&T Revenue	Settlement	Billing Total
	Millions of Dollars		
Exchange			
Basic Exchange (Incl. FEX)	$ 80.4	$2.9	$ 83.3
Timing Local Messages *	7.3	.6	15.4 **
Local & FEX Message Rate	10.8	.4	11.2
MMU Rate	14.8	1.3	16.1
Service Conn., Moves, & Changes	23.3	.8	24.1
Classified Directory Advertising	7.7	.3	8.0
ORTS	2.1	-	2.1
PBX, Centrex, and Related Services	11.6	.4	12.0
Business Extensions	5.3	.2	5.5
Telephone Answering Services	.4	-	.4
Supplemental Equipment	2.2	.1	2.3
Key Equipment	9.8	.3	10.1
Private Line (Local)	3.9	-	3.9
Total Exchange	179.6	7.3	194.4
Toll			
WATS	4.8	1.7	6.5
Private Line (Interchange)	(1.1)	(.4)	(1.5)
Total Toll	3.7	1.3	5.0
Total Toll & Exchange	183.3	8.6 ***	199.4

* Effect at present rates.

** $7.5 million of this amount is offset by additional annual charges for timing equipment.

*** General Telephone's share of settlements:

Exchange	$7.3 million	
Toll	1.0 million	
Total	8.3 million	$.3 million to other Independents.

VI

FINDINGS OF FACT

1. Pacific's capital ratios, the cost of each capital ratio component, and the weighted cost of each capital ratio component are:

	Amount	Cost	Weighted Cost
Long-term debt	42.8%	6.06%	2.59%
Short-term debt*	3.8	11.8	.45
Preferred stock	1.3	6.00	.08
Equity	52.1	11.00	5.73
	100.0		8.85

* It was stipulated that the cost of short-term debt should be the prime rate prevailing at the time the Commission makes its determination. Obviously this can't be the date the decision is signed because of the substantive problem of spreading rates. We have selected June 25 as the determination date.

2. The reasonable results of intrastate operations under present rates for test year 1973 results in a 6.74 percent rate of return. The results are set forth in Column (c) in Appendix B, pages 1 and 2 and are adopted.

3. The wage increase granted in July 1973 should be annualized. This increase is a known level change unrelated to growth and will be in effect during the future period for which we are fixing rates.

4. Wage increases paid in 1972 and 1973 in excess of 5.5 percent should not be rolled back to 5.5 percent. The contract upon which these wage increases are based was entered into prior to any regulations limiting wage increases, was exempt from any limitations on wage increases, and the wages paid pursuant to that contract have been approved by the various federal and state agencies to which they were submitted.

5. The pre-1973 deferred tax reserve should not be included in Pacific's test year 1973 rate base. This normalization reserve can be characterized as either a loan from the Treasury of the United States or an advance of capital from the ratepayers. Investors earn a return on <u>their</u> investment, not on interest-free loans or advances from customers. The staff's deduction of the normalization reserve from rate base is correct.

6. In determining its accruals to its pension plan Pacific used an interest assumption of 5 percent and a wage level increase assumption of 3-1/2 percent. These assumptions are reasonable.

7. A reasonable allowance for advertising expenses is that shown in the table on page 44 in the "adopted" column. This allowed advertising produces substantial benefits to the ratepayers.

8. Pacific does not spend enough money on advertising its lifeline service. This service is designed for persons on limited incomes and Pacific should direct an appropriate portion of its advertising budget to reach this particular market.

9. Pacific began using accelerated depreciation with normalization in 1970. We interpret the Tax Reform Act of 1969 to the effect that if we were to impute flow-through to Pacific, the United States Treasury Department would assess taxes against Pacific on the basis of straight-line depreciation. Such a result would be a financial disaster to Pacific and would cause a substantial deterioration of service within a few years.

10. The normalization reserve for deferred taxes must be deducted from rate base. The reserve for deferred taxes is a rapidly growing reserve totally out of consonance with the roughly harmonious relationship between revenues, expenses, and rate base that is set forth on the chart on page 65.

11. Based upon the chart on page 65, for at least the first 18 years of normalization the annual revenue effect of normalization on Pacific's results of operations is extraordinary. Sound regulatory principles require an adjustment for this extraordinary item. If the adjustment were made Pacific would require $23 million less in gross revenue than we are authorizing. However, if the Treasury Department disallowed this expense and taxed Pacific on the basis of straight-line depreciation, Pacific would have to pay more than $57 million more to the Treasury. In our opinion the Treasury Department will not recognize our extraordinary item adjustment; therefore we will not make it.

12. JDIC and accelerated depreciation are subject to the same ratemaking considerations and must be treated in the same manner. If JDIC was subject to the extraordinary item adjustment the effect would be to reduce Pacific's gross revenue requirement by $1.9 million.

13. State income taxes shall be computed on a flow-through basis. We shall compute state tax expense using a projected 3-year average flow-through.

14. As to Application No. 51774 the proper ratemaking treatment of accelerated depreciation is normalization. In response to the Supreme Court's order in City and County of San Francisco v PUC (1971) 6 C 3d 119, we find that, in light of current federal income tax statutes, Pacific had properly computed its taxes for ratemaking purposes.

15. The additional revenue required by Pacific to produce the rate of return found reasonable is $183.3 million. When settlements and adjustments are included the revenue requirement is $199.4 million.

16. The increase in rates and charges authorized by this decision are justified and are reasonable; and the present rates and charges, insofar as they differ from those prescribed by this decision, are for the future unjust and unreasonable.

17. Pacific's service is adequate.

18. It costs Pacific approximately $9.50 a month to keep the average telephone instrument in place and ready to use on the customer's premises, if the telephone is never lifted from the hook either to place or receive a call.

19. Costs are incurred when every call is placed, but because no revenue is received for local calls placed over flat rate residential lines and because no additional revenue is received from local message service until the free call allowance is exceeded (which ranges from 30 to 80 local messages per month) the costs incurred in usage outrun the revenues received.

20. The total cost of providing a basic exchange telephone, including the costs of local usage, averages $15 a telephone a month. The total revenue received from the average residence telephone, including revenues from toll and MMU service, is $8.03 in the case of lifeline service and $15.69 for flat rate residence service.

21. Each basic exchange service is being provided substantially below cost, and will continue to be at the rates authorized by this decision.

22. Local messages should be timed in increments of one message unit for each five minutes or fraction thereof.

23. The current charge for a message unit is 4.5¢. The cost of an average local message is approximately 5¢ for about four minutes. A charge of 5¢ will cover the cost of the service. The message unit rate should be raised to 5¢ and should be applied to single message units and multi-message units. Foreign exchange single message units should be increased to 6¢.

24. Inward WATS service is a very different service from outward WATS with very different characteristics. Because of these differences the cost to Pacific of furnishing an inward WATS line is 68 percent higher than the cost of furnishing an outward WATS line. We will recognize this difference in our rate spread.

25. The expense incurred by Pacific in connecting a new business or residence service of the most simple variety is $37, exclusive of any visit to, or work, at the premises of the customer. The present service connection charges are $25 for business and $15 for residence. These services should each be increased by $10 to bring them closer to cost.

26. The staff's proposed rates for key telephones (COM PAK II and COM PAK III), keyless business extensions, and illuminated lines are reasonable. These rates cover the cost of providing the service plus a contribution to basic exchange rates.

27. The remaining rates set forth in Appendix C are reasonable and are adopted.

28. A large number of persons subscribing to lifeline service are not persons living on low incomes. Lifeline service is a highly subsidized service which should be limited to persons or families living on limited incomes. No person should receive lifeline service if the combined annual income of all persons living in the residence where the service will be installed is $7,500 or more. Pacific shall not furnish lifeline service to any subscriber who does not file a certification with Pacific, in the form set forth in Appendix C, to the effect that the combined annual gross income of all persons living at the premises where lifeline service is installed or requested is less than $7,500.

29. For the exchanges of Bakersfield, Fresno, Modesto, Riverside, Santa Rosa, and Stockton, Pacific shall introduce business one-party measured service, residence one-party measured service with a 60-message allowance, and residence one-party measured service with a 30-message allowance, within five years. Concurrently, business two-party flat and residence two-party and four-party flat rate services shall be withdrawn.

30. The Sacramento area shall be wholly converted to one-party residence service within five years offering 30- and 60-message service and flat rate service.

31. One-party flat rate FEX and measured residence FEX service shall be offered to new applicants, as well as suburban service where applicable.

32. All eight-party suburban service and four-party urban service shall be completely eliminated within five years.

33. Once a year Pacific shall enclose a bill insert to each residence customer showing a list of services and their costs as shown in the telephone directory.

34. For new connections, both business and residence, the initial bill shall contain a fully itemized list of each separate service item as well as a reference to the list of services in the directory.

VII

CONCLUSION OF LAW

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

O R D E R

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company is authorized to file with this Commission, on or after the effective date of this order and in conformity with the provisions of General Order No. 96-A, revised tariff schedules with rates, charges, and conditions modified as set forth in Appendix C. The effective date of the revised tariff sheets shall be five days after the date of filing. The revised tariff schedules shall apply only to service rendered on and after the effective date of the revised schedules.

2. Pacific shall modify its existing service as follows:

   a. For the exchanges of Bakersfield, Fresno, Modesto, Riverside, Santa Rosa, and Stockton business one-party measured service, residence one-party measured service with a 60-message allowance, and residence one-party measured service with a 30-message allowance, shall be introduced within five years. Concurrently, business two-party flat and residence two-party and four-party flat rate services shall be withdrawn.

b. The Sacramento area shall be wholly converted to one-party residence service within five years offering 30- and 60-message service and flat rate service.

c. One-party flat rate FEX and measured residence FEX service shall be offered to new applicants, as well as suburban service where applicable.

d. Eight-party suburban service and four-party urban service shall be completely eliminated within five years.

e. Once a year Pacific shall enclose a bill insert to each residence customer showing a list of services and their costs as shown in the telephone directory.

f. For new connections, both business and residence, the initial bill shall contain a fully itemized list of each separate service item as well as a reference to the list of services in the directory.

g. Pacific shall advertise its lifeline service in a manner to reach those most likely to be eligible for the service.

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

Dated at San Francisco, California, this 23rd day of MAY, 1974.

Vernon L. Sturgeon
President

William Symons Jr.

[illegible]

[illegible]

[illegible]

Commissioners

APPENDIX A
Page 1 of 2

LIST OF APPEARANCES

Applicant: Richard W. Odgers, Roger P. Downes, and James B. Young, Attorneys at Law, for The Pacific Telephone and Telegraph Company.

Protestants: William M. Bennett, Attorney at Law, for himself and for Consumers Arise Now; and Sylvia M. Siegel, for herself, Consumer Federation of Calif., Toward Utility Rate Normalization, S. F. Consumer Action, Alameda County Consumer Action, Diablo Valley Consumer Action, and Consumers United of Palo Alto.

Interested Parties: Bert Pines, City Attorney, by Charles E. Mattson and Charles W. Sullivan, Deputy City Attorneys, Manuel Kroman, and Robert W. Russell, for City of Los Angeles; Max P. Beere, for Tymshare, Inc.; Frederick Bolte, for Wilsey & Ham; Frederick W. Bray and Mel Sager, for California Public Interest Law Center; John K. Chapin, for General Services Administration; James F. Crafts, Jr., and Robert J. Gloistein, Attorneys at Law, for Continental Telephone Company of California and California-Pacific Utilities Co.; Richard D. Crowe and D. C. Williams, for Continental Telephone Company of California; Theodore F. Craver, Attorney at Law, and Larry L. Yetter, for Litton Industries, Inc.; Philip E. Decker, for Public Interest Research Center, Inc.; Frank J. Dorsey and Woodrow D. Wollesen, Attorneys at Law, for Executive Agencies of the U. S., General Services Administration; H. C. Dow and W. W. Weddell, Jr., Attorneys at Law, and Walter W. Long, for General Dynamics Corp.; John W. Witt, City Attorney, by Robert J. Logan, Deputy City Attorney, Manley W. Edwards, and Ronald L. Johnson, for City of San Diego; Max Factor III and Valerie Kantor, Attorneys at Law, for California Law Center; Lessing E. Gold, for Western Burglar and Fire Alarm Association and American District Telegraph; A. M. Hart, John Robert Jones, and H. Ralph Snyder, Jr., Attorneys at Law, for General Telephone Company of California; Neal C. Hasbrook, for California Independent Telephone Association; Carl Hilliard, Attorney at Law, and Ernest W. Watson, for Telephone Answering Services of California, Inc.; Ralph O. Hubbard, William L. Knecht, and William S. Marrs, for California Farm Bureau Federation; James P. Jackson, for City of Sacramento; Ballard Jamieson, Jr., Attorney at Law, for Citizens Utilities Company; Thomas M. O'Connor, City Attorney, by Milton H. Mares, Deputy City Attorney, and Robert Laughead, for City & County of San Francisco; R. L. Palmer and Ross Workman, Attorneys at Law, for California-Pacific Utilities Co.; Philips B. Patton, Attorney at Law, for Olan Mills, Inc.; Dick J. Van Aggelen, for S. F. Consumer Action;

APPENDIX A
Page 2 of 2

Francine K. Weiss, for Consumers Affairs Clinic, Loyola Law School; Lenard G. Weiss and John T. Weld, Attorneys at Law, for The Ponderosa Telephone Co., Foresthill Telephone Co., Inc., Hornitos Telephone Co., Livingston Telephone Company of California, The Siskiyou Telephone Company, Evans Telephone Company, Dorris Telephone Company, Ducor Telephone Company, Bryan Telephone Company, and William Butts Telephone Company; Jim Lipary, for San Pablo Tenants Council; Leonard J. Theberge, for Rohr Industries, Inc.; Jerry Allen and Don H. Hudson, for Consumer Behalf; and William C. O'Bryant, Claude N. Rosenberg, Attorney at Law, and D. A. Perigo, for themselves.

Commission Staff: Timothy E. Treacy and Richard D. Gravelle, Attorneys at Law, Kenneth K. Chew, Tedd F. Marvin, and James G. Shields.

TABLE I

Adopted Results of Intrastate Operations
Under Present Rates - Test Year 1973
(Dollars in Thousands)

	Total California (a)	Total Intrastate Operations: Estimated and Before Adjustments (b)	Adjustments (c)	Adopted (d) *
Operating Revenues 1/				
Local Service Revenues		$1,184,110	$ (779)	$1 183,331
Toll Service Revenues		761,307	(2,149)	759,158
Miscellaneous Revenues		127,190	-	127,190
Less: Uncollectibles		19,121	(28)	19,093
Total		2,053,486	(2,900)	2,050,586
Operating Expenses and Taxes Other Than Income				
Current Maintenance		460,815	(7,396)	-
Western Electric Adjust.		-	(1,440)	-
Adjusted 2/		460,815	(8,836)	451,979
Depr. & Amort. 3/		292,791	2,800	295,591
Traffic Expenses 4/		170,793	5,809	176,602
Commercial Expenses 5/				
Basic Estimate	211,206			
Advertising Disallowance	(948)			
Adjusted	210,258	179,813	-	179,813
Gen. Office Salaries & Expenses 6/		117,511	3,820	121,331
Operating Rents 7/		19,366	-	19,366
Gen. Services & Licenses 7/		20,000	-	20,000
Balance Other Operating Expenses 8/		152,874	(2,669)	150,205
Payroll Taxes 9/		40,459	666	41,125
Ad Valorem & Misc. Taxes 7/		136,389	-	136,389
Subtotal		1,590,811	1,590	1,592,401
Wage Annualization 10/				19,089
Total				1,611,490

* Footnotes on following pages.

TABLE I
(Continued)

Adopted Results of Intrastate Operations
Under Present Rates - Test Year 1973
(Dollars in Thousands)

	Total Intrastate Operations		
	Estimated and Before Adjustments (b)	Adjustments (c)	Adopted (d) *
Income Taxes			
State Income Tax 11/	$ -	$ -	$ 14,546
Federal Income Tax 12/	-	-	126,382
Total	-	-	140,928
Total Expenses and Taxes	-	-	1,752,418
Net Revenues	-	-	298,168
Average Rate Base 13/			
Telephone Plant	5,656,386	54,059	$5,710,445
Property Held for Future Use	1,997	-	1,997
Working Cash	77,984	-	77,984
Materials and Supplies	22,972	-	22,972
Depreciation Reserve	(1,263,749)	(12,077)	(1,275,826)
Reserve for Deferred Taxes	(54,859)	(55,784)	(110,643)
Total	4,440,731	(13,802)	4,426,929
Rate of Return			6.74%
Adjust expense for extraordinary item 14/			(933)
Adjusted expenses and taxes			1,751,435
Adjusted net revenue			299,151
Adjust Rate Base for extraordinary item 14/			(132,912)
Adjusted Rate Base			4,294,017
Adjusted Rate of Return			6.97%

*Footnotes on following pages.

TABLE I NOTES

Unless otherwise noted all references to an exhibit are to Exhibit 149, Part III.

NOTE

1. The adopted operating revenues are the utility's estimated revenues shown in column (b) [exhibit page 1 column (a)] less the revenue effects of wage annualization shown in column (c) [exhibit page 2, column (s)].

2. The adopted maintenance expense consists of the utility's estimate [exhibit page 1, column (a)] less the $7,396,000 wage annualization effect [exhibit page 2, column (s)] and then adjusted by adding the staff's estimate of the Western Electric Adjustment [exhibit page 2, column (p)].

3. The adopted depreciation and amortization expense is the staff's estimate of $292,791,000 [exhibit page 2, column (AA)] then increased by $2,800,000 to compensate for the adoption of the larger plant estimate of the utility.

4. The adopted traffic expenses are the staff's estimate $170,793,000 [exhibit page 2, column (AA)] and adjusted for the 5.5% wage restriction of $5,809,000 [exhibit page 2, column (u)].

5. The total California basic estimate of commercial expense shown in column (a) is the staff's estimate of $211,206,000 [Exhibit 42, Table 10-A, column (a), line 1] excluding wage adjustments. The total California advertising disallowance of $948,000 is explained in the opinion. The adopted intrastate expense of $179,813,000 in column (b) is developed by using the staff's total intrastate separation factor of 85.52% (work paper source) and applying it to total California operations.

6. The adopted General Office Salaries and Expenses are the staff's estimate of $117,511,000 [exhibit page 2, column (AA)] adjusted for the 5.5% wage restriction of $3,820,000 [exhibit page 2, column (u)].

7. The adopted Operating Rents Expense of $19,366,000, General Services and Licenses Expense of $20,000,000, and Ad Valorem and Miscellaneous Taxes of $136,389,000, are the staff's estimates taken from the exhibit on page 2, column (AA).

8. The adopted Balance Other Operating Expenses of $150,205,000 is the utility's estimate of $152,874,000 [exhibit page 1, column (a)] less the utility's estimate of the effects of wage annualization of $2,669,000 [exhibit page 2, column (s)].

NOTE

9. The adopted Payroll Taxes of $41,125,000 are the staff's estimate of $40,459,000 [exhibit page 2, column (AA)] adjusted for the 5.5% wage restriction of $666,000 [exhibit page 2, column (u)].

10. This restores the wage annualization expense which had been excluded in the above expense items involving payroll. It is the net of expense and revenue effects.

11. The adopted state tax based on income (SCFT) is made up as follows: $30,838,000 [exhibit page 3, column (BB)]; plus $25,000 to eliminate a duplication in the Western Electric Adjustment*; plus $38,000 [exhibit page 2, column (u)] to remove the 5.5% wage restriction; less $4,227,000 of taxes on the remaining differences between column (BB), page 3 of the exhibit, and the adopted revenues and expenses; plus ($8,101,000) [exhibit page 3, column (DD)] to convert from normalization to test year flow-through; less $4,056,000 to convert from test year flow-through to pro forma flow-through. The $4,056,000 is the difference between the 1973 state tax and the average for the years 1974, 1975, and 1976 as these are shown on Table II of Exhibit 32. Also included is the amount of $29,000 resulting from the inclusion of wage annualization expense described in Footnote 10.

Summary: $30,838,000 + $25,000 + $38,000 - $4,227,000 - $8,101,000 - $4,056,000 + $29,000 = $14,546,000

12. The adopted federal income taxes of $126,382,000 consists of the following: $162,769,000 [exhibit page 3, column (BB)]; plus $1,363,000 to eliminate duplication of the Western Electric Adjustment#; plus ($12,279,000) [exhibit page 2, column (u)], to remove the 5.5% wage restriction; less $21,990,000 of taxes on the remaining differences between column (BB), page 3 of the exhibit, and the adopted revenues and expenses; plus $3,888,000 which is the federal tax increase due to the decrease in state tax [exhibit page 3, column (DD)]; plus $1,947,000 to reflect

---

* Explained in Exhibit 101, the first sentence of A.26 on page 13-RDG. The net change of $30,000 is $25,000 on an intrastate basis. Revision was duplicated in the preparation of Exhibit 149 as noted in Exhibit 150.

\# Explained in Exhibit 101, the second sentence of A.26 on page 13-RDG. The net change of $1,711,000 is $1,363,000 on an intrastate basis. Revision was duplicated in the preparation of Exhibit 149 as noted in Exhibit 150.

NOTE

state income tax on a pro forma flow-through basis. Further, a reduction of $9,316,000 results from the inclusion of wage annualization expense described in Footnote 10.

Summary: $162,769,000 + $1,363,000 - $12,279,000 - $21,990,000 + $3,888,000 + $1,947,000 - $9,316,000 = $126,382,000.

13. The rate base of $4,426,929,000 consists of the following: $5,710,445,000 for telephone plant, which is the sum of the staff's estimate of $5,656,386,000 [exhibit page 3, column (BB)]; less ($54,059,000) [exhibit page 1, column (i)], which is the basic difference between staff and company plant estimates; the adopted amounts for property held for future telephone use, working cash, and materials and supplies, which are the staff's estimates shown in column (BB), page 3 of the exhibit; the adopted amount for depreciation reserve of $1,275,826,000, which is the staff's estimate of $1,263,749,000 [exhibit page 3, column (BB)] increased by $12,077,000 to properly adjust the reserve to reflect the $54,059,000 of plant referred to above; and the deferred tax reserve of $110,643,000 taken from page 6, recast column.

14. See text at page 63 to 73.

STATE OF CALIFORNIA
DEPARTMENT OF CORRECTIONS
PRISON INDUSTRY AUTHORITY

Certificate of Individual Microfilm or Other Photographic Reproduction

Section 14755, Government Code

I, the undersigned, hereby certify to the following in connection with the accompanying microfilm (photographic reproduction):

That I, Thomas Coupe', Industrial Supervisor, P.I.A. Micrographics or B#85186 an employee in the charge of Mr. Coupe', have been provided with access to the records, documents instruments, plans, books or papers (hereinafter referred to as "records") of C.P.U.C at C.M.F VACAVILLE CA., for the purpose of microfilming; that such access was provided with the consent of said person or entity; that such records are reproduced in the accompanying microfilm; and that each Department of Corrections P.I.A. of the State of California repoduction includes the following identifying symbol, roll number Vol#851.

That pursuant to delegation of the Department of Corrections P.I.A., I am authorized to direct and control the reproduction of documents and records of the Department or of other persons and entities in the manner authorized by Section 14756 of the Government Code, and Section 1551 of the Evidence Code; to execute certificates as required by Section 1531 and 1551 of the Evidence Code; and to certify under the official seal of the Department.

That this microfilm of the above described records was taken under my direction and control on the date hereof and that it is a complete, true and correct copy thereof;

That the microfilming or other photographic processes were accomplished in a manner and on film which meet with the standard specification of the United States National Bureau of Standards and A.N.S.I.

That this certificate was made at the time of the taking of this microfilm.

WITNESS my hand and the seal of the Department of Corrections Prison Industry Authority 10, day of DEC, 1985

Thomas R Coupe'
(name)

california
prison industry authority

TABLE II 1/

Results of Intrastate Operations Under Present Rates - Test Year 1973
(Dollars in Thousands)

	Pacific Estimated (a)	Staff Estimated (b)	Adopted (c)
Operating Revenues			
Local Service Revenues	$1,184,110	$1,184,965	$1,183,331
Toll Service Revenues	761,307	760,033	759,158
Miscellaneous Revenues	127,190	127,240	127,190
Less: Uncollectibles	19,121	18,016	19,093
Total	2,053,486	2,054,222	2,050,586
Operating Expenses and Taxes Other Than Income			
Current Maintenance	460,815	439,321	451,979
Depreciation & Amortization	297,228	292,791	295,591
Traffic Expenses	183,945	170,793	176,602
Commercial Expenses	189,387	173,231	179,813
Gen. Office Salaries & Expenses	124,311	117,511	121,331
Operating Rents	19,665	19,366	19,366
General Services & Licenses	21,635	20,000	20,000
Balance Other Operating Expenses	152,874	111,996	150,205
Payroll Taxes	42,573	40,457	41,125
Ad Valorem & Misc. Taxes	136,079	136,389	136,389
Subtotal	1,628,512	1,521,855	1,592,401
Wage Annualization			19,089
Total			1,611,490

1/ Column (a) is obtained from Exhibit 149, Part III, column (a) on page 1. Column (b) is from column (AA) on page 2 of Part III, Exhibit 149. Column (c) is obtained from Table I. Both column (b) and column (c) reflect corrections to Exhibit 149 relative to the staff's Western Electric Adjustment explained in the notes to Table I and shown in Exhibit 150.

APPENDIX B

TABLE II[1]
(Continued)

Results of Intrastate Operations Under Present Rates - Test Year 1973
(Dollars in Thousands)

	Pacific Estimated (a)	Staff Estimated (b)	Adopted (c)
Income Taxes			
State Income Tax	$ 24,308	$ 22,762	$ 14,546
Federal Income Tax	113,146	86,877	126,382
Total	137,454	109,639	140,928
Total Expenses and Taxes	1,765,966	1,631,494	1,752,418
Net Revenues	287,520	422,728	298,168
Average Rate Base			
Telephone Plant	5,715,648	5,656,386	5,710,445
Property Held for Future Use	2,480	1,997	1,997
Working Cash	83,991	77,984	77,984
Material and Supplies	24,851	22,972	22,972
Depreciation Reserve	(1,279,154)	(1,263,749)	(1,275,826)
Reserve for Deferred Taxes	(54,859)	-	(110,643)
Total	4,492,957	4,495,590	4,426,929
Rate of Return	6.40%	9.40%	6.74%
Adjust expenses for extraordinary item			(983)
Adjusted net revenue			299,151
Adjust rate base for extraordinary item			(132,912)
Adjusted rate base			4,294,017
Rate of Return			6.97%

1/ Column (a) is obtained from Exhibit 149, Part III, column (a) on page 1. Column (b) is from column (AA) on page 2 of Part III, Exhibit 149. Column (c) is obtained from Table I. Both column (b) and column (c) reflect corrections to Exhibit 149 relative to the staff's Western Electric Adjustment explained in the notes to Table I and shown in Exhibit 150.

APPENDIX C
Page 1 of 5

RATES

The rates, charges, and conditions of The Pacific Telephone and Telegraph Company are changed as set forth in this appendix.

Schedule Cal. P.U.C. No. 4-T, Individual and Party-Line Service

The following rates are authorized:

	Exchanges Outside Metropolitan Areas#	Metropolitan Extended Areas Los Angeles, Orange County Sacramento, San Diego San Francisco-East Bay
Business Service		
Individual Line		
Flat Rate	$ 14.55	$ -
Message Rate	7.50 (80)*	7.50(80)
2-Party Line	10.75	-
4-Party Suburban	11.00	-
8-Party Suburban	9.75	9.75
Semipublic Coin		
Flat Rate	6.80	-
Message Rate	7.50*	7.50
Residence Service		
Individual Line	5.70	5.70
Flat Rate	-	3.75(60)
Message Rate	-	2.50(30)
2-Party Line		
Flat Rate	4.75	4.75**
Message Rate	3.70(60)*	-
	2.50(30)*	-
4-Party Line	3.85	3.85**
4-Party Suburban	4.90	-
8-Party Suburban	4.35	4.35

\# Rates shown are for local service. Additional rate increments apply to certain extended area service (EAS) exchanges outside metropolitan areas pursuant to Decision No. 77311.

* Where offered.

** Sacramento EA only.

RATES (Continued)

Schedule Cal. P.U.C. No. 4-T, Individual Party Line Service (Cont'd.)

Certification by Present and New Lifeline Customers

In order to restrict lifeline service to those households with income below $7,500 a year, Pacific shall furnish the following certification statement to each present lifeline customer.

"The telephone service presently provided to you is one-party measured residence service with an allowance of 30 local calls per month. This service is commonly known as 'lifeline' telephone service and is intended for customers living on a limited income. By a recent order of the California Public Utilities Commission our company is directed to offer this service only to customers who certify that the combine annual income of all persons living at the premises where lifeline service is requested is less than $7,500. In conformance with the order of the Commission we are furnishing the following certification statement to each lifeline customer.

"If you qualify for lifeline service because the combined annual gross income of all persons living at the premises is less than $7,500 and wish to retain your lifeline service, please sign the statement below and return it to the company with your telephone bill payment. If you do not return the statement, your service will be converted to one-party measured residence service with an allowance of 60 calls per month at a monthly rate of $3.75. If you wish flat rate residence service at a monthly rate of $5.70, please contact our business office.

"CERTIFICATION

"I wish to retain my residence individual line 30-message service (lifeline service). I certify that the combined annual gross income of all persons living at the premises where lifeline service is installed is less than $7,500.

____
Customer"

For new subscribers to lifeline service the following certification is required:

"I hereby apply for residence individual line 30-message service (lifeline service). I certify that the combined annual gross income of all persons living at the premises where lifeline service is requested is less than $7,500.

____
Applicant"

RATES (Continued)

Schedule Cal. P.U.C. No. 9-T, Farmer Line Service

Rate per month for each station is increased by $1.85 for business and $1.00 for residence.

Schedule Cal. P.U.C. No. 13-T, PBX Trunk Line Service

Commercial and Hotel Manual and Dial PBX, Business Key Station Dial PBX and Order Receiving Equipment Services:

Where offered, the trunk rate for business flat rate service for each trunk line shall be 150% of the individual line primary station flat rate rounded to the lower 25-cent multiple. The trunk rate for business message rate services for each trunk line shall be one half the individual line primary station message rate with no message allowance rounded to the lower 5-cent multiple. When offered the trunk rate for residence flat rate service for each trunk line shall be 150% of the individual line primary station flat rate rounded to the lower 5-cent multiple.

Schedules Cal. P.U.C. Nos. 4-T, 6-T, 13-T, 34-T, and 121-T, Message Unit Service in San Francisco-East Bay Extended Area and Los Angeles Extended Area and Message Rate (Measured) Exchange Service in Other Exchanges Where Offered

Message Unit Rate	Each Message Unit
Foreign Exchange Service	6.0¢
Semipublic coin-box and public telephone	6.0¢
Other Services	5.0¢

Exchange Message Rate Exchange message units over the allowance for message rate services:	Each Exchange Message Unit
Foreign Exchange Service	6¢*
Other Services	5¢*

* The number of exchange message units applicable to exchange messages is one exchange message unit for an initial period of 5 minutes and one exchange message unit for each additional 5 minutes or fraction thereof.

RATES (Continued)

Schedule Cal. P.U.C. No. 22-T, Key Equipment Service

Proposed rates and charges as set forth in Exhibit No. 74, Section 6, are authorized.

Schedule Cal. P.U.C. No. 28-T, Service Connection Charges, Move and Change Charges, In Place Connection Charges

Proposed charges and conditions as set forth in Exhibit No. 74, Section 10 are authorized.

Schedule Cal. P.U.C. No. 32-T, Supplemental Equipment

Proposed rates and charges as set forth in Exhibit No. 74, Section 4, are authorized.

Schedule Cal. P.U.C. No. 34-T, Foreign Exchange Service

Business	Authorized Monthly Rate Increase
Individual Line Message Rate (200)	$2.85
PBX Trunk, First, Message Rate (300)	4.25
PBX Trunk, Each Additional, Message Rate (300)	4.25

Residence

Residence primary service rates for foreign exchange services are adjusted to the extent required by any changes in the basic exchange rates.

Foreign exchange service from exchanges having special rate areas will be priced at rates shown for the base rate area or special rate area, as appropriate.

In addition to the rates shown above, the appropriate mileage increment will apply. The increment for rate areas, A, B or C will apply in addition to the proposed rate for Los Angeles service in contiguous exchanges.

Schedule Cal. P.U.C. No. 39-T, Classified Telephone Directory Advertising

Proposed rates as set forth in Exhibit No. 74, Section 12, are authorized.

Schedule Cal. P.U.C. No. 50-T, Private Line Service and Channels - Supplemental Equipment

Proposed rates and charges as set forth in Exhibit No. 74, Section 4, are authorized.

RATES (Continued)

Schedule Cal. P.U.C. No. 83-T, Special Assemblies of Equipment

Proposed rates as set forth in Exhibit No. 74, Section 4, are authorized.

Schedule Cal. P.U.C. No. 128-T, Wide Area Telephone Service

Proposed rates and charges as set forth in Exhibit No. 74, Section 13, without evening or night "off-peak" discounts, are authorized.

Business Extensions and Related Services - All Affected Schedules

Proposed rates as set forth in Exhibit No. 74, Section 15, are authorized.

PBX, Centrex and Related Services - All Affected Schedules

A 15% surcharge, as proposed in Exhibit No. 74, Section 7, is authorized.

Local and Interexchange Private Line Services and Channels - All Affected Schedules

Proposed rates, charges and conditions as set forth in Exhibit No. 97, Section 4, are authorized.

Other Changes

Proposed revisions as set forth in Exhibit No. 74, Section 21, are authorized.