Decision No. 85790

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for a revised tariff for SG-1 Private Branch Exchange Service.	Application No. 55527 (Filed February 28, 1975; amended September 24, 1975)

Roger P. Downes, Attorney at Law, for applicant.
Joel Effron, for Scott-Buttner Communications, Inc.; protestant.

OPINION

Proceeding

After due notice public hearing in this matter was held in San Francisco on October 6, 7, and 8, 1975 before Examiner Coffey. The matter was submitted upon the receipt of briefs on October 30, 1975.

On October 24, 1973, The Pacific Telephone and Telegraph Company (Pacific) filed Advice Letter No. 11165, which sought provisional rates for a Private Branch Exchange (PBX) Service designated as the SG-1. The rates were "provisional", in that the offering was to expire on May 24, 1975, unless sooner cancelled, changed, or extended.

On November 14, 1973, the Business Telephone Systems Division of Litton Systems, Inc. (BTS) filed a letter of protest against the proposed charges set forth in Advice Letter No. 11165. In addition to several other allegations, BTS stated "The rates proposed are too low, in view of the evidence available" and "The proposed rates are below the revenue requirements indicated on the

GE100's (prepared by BTS as part of their protest letter) by from 18 percent at 20 stations to 22 percent at 40 stations. As also shown, the degree of non-coverage increases with the size of the system." Pacific's provisional SG-1 rates were authorized by Commission Resolution No. T-8281, and became effective on November 24, 1973.

On May 16, 1974, Scott-Buttner Communications, Inc. (SBC) filed a complaint against Pacific (Case No. 9737) alleging among other things that the SG-1 rates were priced unjustifiably below reasonable costs associated with furnishing SG-1 equipment. Hearings on the SBC complaint were held on December 19, 1974 in San Francisco. After one day of direct testimony by complainant, who alleged that Pacific's authorized rates were lower than its reasonably justifiable costs, the case was removed from the calendar by mutual request with the understanding that Pacific would file an application requesting higher rates.

Some 15 months later, Pacific filed Application No. 55527 with the Commission on February 28, 1975. This application sought permanent rates, and an approximate 7 percent increase in rates for SG-1 PBX service. The application was alleged to reflect Pacific's actual cost experience with SG-1 installations.

The provisional rates were extended by Commission Resolution No. T-8935 on May 20, 1975. On August 19, 1975, Pacific filed Advice Letter No. 11696, asking for authorization to offer a new larger capacity model of the SG-1 at provisional rates. These provisional rates became effective on October 8, 1975. On September 24, 1975, Pacific filed its amendment to Application No. 55527. The amended application, which seeks permanent rates for both models of the SG-1 and increases of approximately 18 percent over 1973 provisional rates, was the subject of the Commission hearings on October 6, 7, and 8, 1975.

Case No. 9737 was dismissed on October 7, 1975, at complainant's request since it preferred to participate in this proceeding.

None of Pacific's approximately 1,350 SG-1 customers appeared at the hearing but a number wrote letters protesting the increased proposed rates. However, one of Pacific's competitors, SBC through the president of its ComPath division, appeared to cross-examine and produce evidence.

Relief Requested

Pacific seeks an order authorizing permanent rates for the SG-1 Dial PBX at a level approximately 18 percent higher than the existing provisional rates.

SBC seeks to have the Commission set the permanent rates for the SG-1 service at a level which is consistent with the reasonably justifiable costs related to the service.

Issues

Pacific's proposed rates are supported by cost studies set forth in Exhibit B to the amended application. The two interrelated issues raised at the hearing were (1) whether the Exhibit B studies fairly represent the costs of the SG-1 PBX service and (2) whether the rates proposed fully recover those costs.

By cross-examination, SBC inquired into the following cost study areas:

(a) The estimated depreciation reserve factor of 79 percent.

(b) The treatment of installation charges.

(c) The rates used to estimate installation and removal expense.

(d) The factor used to estimate administrative expense.

(e) The estimated location life.

(f) The estimated revenue producing life of the equipment.

SBC's direct presentation relates only to items (e) and (f), the estimates of location and revenue producing lives, or "market life".

SBC's Position

SBC concedes that there is ample evidence in the record to justify the requested rate increase but maintains that the requested increase is unrealistically low and therefore noncompetitive.

Based on cross-examination and testimony by Professor Hodges, professor of electrical engineering and computer sciences at the University of California, Berkeley, SBC argues that:

1. Pacific failed to provide quantitative market analysis to support use of a revenue producing life of 15 years.
2. The evidence will support a revenue producing life of no more than 5 to 7 years.
   (a) Absent competition Pacific would employ an unrealistic price structure to support a revenue producing life of up to 15 years.
   (b) Current electronic technology will render obsolete the SG-1 in five years if Pacific is prohibited from maintaining an unrealistic price structure.
   (c) Modern concepts of capital employment and competition will further hasten obsolescence.
   (d) It is reasonable to presume that competitors of Pacific will have a product superior to the SG-1 available in two years at a price reduction of up to 20 percent.
3. The evidence submitted by the parties supports an increase of as much as 40 percent at the SG-1 tariff.
4. No showing has been made in the record that the public interest will be served by Pacific's introducing the SG-1A.

Pacific's Position

Since no direct presentation was made by SBC on the first five questions delineated in the above "Issues" section, Pacific assumed that SBC was satisfied by Pacific's direct presentation and answers to cross-examination.

Pacific maintains that on the remaining issue the evidence shows that an informed engineering and market determination of an estimated 15-year revenue producing life is reasonable for the SG-1 PBX system.

Pacific introduced the testimony of both engineering and marketing experts on the source of the revenue producing life estimate. Pacific's witness Rock testified that the 15-year life estimate was reasonable from a technical point of view. This estimate of ultimate possible physical life was supported by SBC's witnesses Hodges and Howard. (We note, however, that the issue here is not how long the equipment might be expected to render service until it falls apart like the proverbial "one-hoss shay".)

Pacific's witness Sullivan testified on the market implications which were evaluated. Among other things, the witness noted that recent studies showed an actual average revenue producing life of 16 years on step-by-step PBX's. Inasmuch as the SG-1 is of a different technology than step-by-step, a further market analysis was required and was made. The marketing witness testified:

> "It (SG-1) is different and more modern, but of the same solid state characteristic as the 800 series PBX's introduced by Pacific in the last four years or so.
>
> "It is not too unlike equipment that is coming into the marketplace. The consideration I gave to its technology was simply that it would serve a market of inward movement for perhaps the next couple of years. And as such, would it do the things in the right way, at the right place for those customers, so that they would keep it.

> "And there would be some after market, at least enough to take care of the anticipated outward movement.
>
> "And after evaluating those things, in a subjective way, obviously, because it is future that we are looking at, I concluded that the revenue producing life was reasonable."

Among the SG-1 market factors evaluated were: Future equipment regulatory environment, expectation of good maintenance performance, ease of repair, fundamental intercommunication features, customer expectations, outward movement and an SG-1 after market, product and pricing management in the after market, unavailability of a competitive PBX to offer, and no indication that outward movement is going to accelerate.

The analysis of the market factors by Mr. Sullivan led to his acceptance of 15 years as a reasonable estimate of the revenue producing life for the SG-1 PBX.

Discussion

Here we have conflicting estimates by highly qualified witnesses of how long into the future the SG-1 PBX equipment will on the average be used to render service and produce revenue. These estimates range from about 5 to 15 years. We are impressed with the expertise and the arguments of both parties but unfortunately the record contains neither a certified crystal ball nor any other non-arbitrary means of resolving the views of the parties.

We are aware of the competitive interests of the parties. Testimony by SBC's witness indicates that Pacific's prices have to be 10 to 15 percent higher than its competitors for them to market their products in competition with Pacific. SBC argues that by adopting a revenue producing life of 15 years, Pacific's prices are too low by 22 percent.

Pacific, unlike its non-public utility competitors, bears the disadvantage of having to fix its prices for service figuratively in a fish bowl. However, it does have the advantage in ratemaking proceedings that the total amount of its reasonable earnings is determined before spreading the increases to be authorized to rates and charges for service. Thus, if Pacific rates should not recover all the costs of any particular service, Pacific's total earnings are not affected since losses incurred in rendering one service will be recouped by rates and charges for other services that are profitable.

Without in any way impugning the views and arguments of the parties in this proceeding, there exists in this record a wide range of reasonable variation in the estimates of the parties. Pacific's competitive position will be improved to the extent its estimates can result in low rates and charges for its PBX services. If these rates and charges should perchance ultimately prove to be so low as not to recover the costs of service, Pacific's investors will not be hurt under current regulatory procedures.

On the other hand SBC's competitive position will be improved to the extent its estimates will result in increases in the rates and charges for Pacific's PBX services.

Our concerns are that Pacific does not use its position as a public utility and utility regulatory procedures as means to gain undue competitive advantages and that unreasonable discrimination between Pacific's customers does not result from offsetting losses on competitive services with excessive profits on others. We are convinced that the free enterprise system will result in maximizing subscriber benefits whenever free competition can be injected into the framework of utility regulation.

All of our concerns would be satisfied, the parties would be fairly treated, and competition between the parties would be price-fair if we could with certainty prescribe rates and charges which will recover actual future costs of service. This we cannot do. If we should inadvertently set Pacific's prices above cost, Pacific's competitors will have an undue competitive advantage. Likewise, prices below cost will give Pacific an undue competitive advantage and result in discrimination between Pacific's customers. The solution to the dilemma paradoxically appears to permit Pacific to use its own best judgment as to what it should charge for its SG-1 PBX service so long as the rates and charges do not exceed reasonable levels. Therefore, we shall authorize the rates and charges proposed by Pacific. However, we shall require Pacific to keep separate accounts of the revenues, expenses, and plant involved in SG-1 service and we shall not permit Pacific in future Pacific rate proceedings to recoup from its non-SG-1 subscribers any excess of SG-1 costs of service above SG-1 revenues. Thus Pacific will be authorized to file the rates and charges for SG-1 service it proposes herein to recover costs and to meet the competition. Subscribers to SG-1 service may accept SG-1 service from Pacific or utilize equipment from Pacific's competitors, whichever is to the subscriber's economic advantage. Competitors of Pacific will be able to compete with Pacific with the assurance that Pacific will not be permitted to utilize its regulated monopoly position to unfairly compete in the open market.

Pacific may after a showing of reasonableness, be permitted in the future to raise its rates and charges for SG-1. However, we propose in future general rate proceedings to reduce the total amount of net income found reasonable by any amount the costs exceed the revenues associated with SG-1 service. This procedure, while it may not be to the advantage of all individual competitors of Pacific, will perform the more important functions of preserving fair competition and preventing discrimination between Pacific's subscribers.

Findings

1. On October 24, 1973, Pacific filed Advice Letter No. 11165 seeking provisional rates for the SG-1 PBX system. The Advice Letter No. 11165 rates became effective November 24, 1973 and were to expire on May 24, 1975, unless sooner cancelled, changed, or extended.

2. The above provisional rates were extended by Commission Resolution No. T-8935 on May 20, 1975, and will expire on May 24, 1976.

3. On August 19, 1975, Pacific filed Advice Letter No. 11696 seeking provisional rates for a larger capacity model of the SG-1. These rates became effective on October 8, 1975, and will expire on May 24, 1976.

4. Pacific filed Application No. 55527 on February 28, 1975. The application relied upon cost studies reflecting Pacific's cost experience with SG-1 installations.

5. Pacific filed amended Application No. 55527 on September 24, 1975, to reflect more current cost data.

6. The SG-1 rates sought by Pacific in the amended application seek to recover the costs of the service as reflected in the GE100 cost studies attached as Exhibit B to the amended application.

7. The revenue producing life used by Pacific in its GE100 cost studies was reviewed by both engineering and marketing personnel.

8. The labor rates and the labor hours used in Pacific's GE100 cost studies reflect information derived from Pacific's tracking procedures and recent historical data updated for the amended application.

9. The GE100 cost studies as found in Exhibit B to the amended application present Pacific's estimates of the costs of the SG-1 PBX system.

10. Current electronic technology and increased competition may reduce the revenue producing life of the SG-1.

11. Pacific's witnesses estimated SG-1 revenue producing life to be 15 years.

12. SBC's witness supported an SG-1 revenue producing life of no more than 5 to 7 years.

13. Utilization for ratemaking purposes of a revenue producing life for the SG-1 in excess of that which may actually be experienced will produce rates and charges which will produce less revenue than the costs associated with the SG-1 equipment.

14. This record does not contain persuasive evidence of the expected revenue producing life of SG-1 equipment.

15. The level of rates and charges proposed by Pacific is less than that advocated by SBC.

16. The rates and charges proposed by Pacific will not recover revenues in excess of reasonable costs of service.

17. The rates proposed for the SG-1 PBX system as found in Exhibit C to the amended application fully recover the costs as identified in Pacific's GE100 cost studies.

18. Subscribers to other than SG-1 service will not be burdened if Pacific is not permitted to recover from them costs of SG-1 service which might exceed revenues.

19. Competition between Pacific and SBC will be preserved by permitting Pacific to freely compete on price in the market place so long as Pacific does not render service below cost.

20. This record does not contain persuasive evidence that Pacific will be rendering SG-1 service at or below cost.

21. It is reasonable that Pacific be required to establish that costs of rendering SG-1 service do not exceed its revenues.

22. Based upon the record herein, the increases in SG-1 rates and charges authorized herein are justified; the SG-1 rates and charges authorized herein do not exceed reasonable levels and are not unreasonable; and the present SG-1 rates and charges insofar as they differ from those prescribed herein, are for the future unjust and unreasonable.

Conclusions

1. Pacific's application for SG-1 rate increases should be granted.

2. Pacific should be required to set up and maintain separate accounts for revenues derived from, expenses incurred in, and plant used in rendering SG-1 service.

3. As a part of its showing in support of any future requests for authorization to generally increase rates, Pacific should be required to report the annual amounts by which the costs of rendering SG-1 service exceed the revenues derived from rendering the service.

4. Pacific should be required to set up and maintain separate accounts and supporting data for depreciation expense and reserve accruals for the SG-1 system.

O R D E R

IT IS ORDERED that:

1. On or after the effective date of this order, The Pacific Telephone and Telegraph Company (Pacific) is authorized to file the revised rate schedule attached to the amended application as Exhibit C. The effective date of the revised schedule shall be the date of filing. The revised schedule shall apply only to service rendered on and after the effective date.

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2. On or before June 30, 1976, Pacific shall install and thereafter maintain until further order of this Commission, separate accounts in which shall be recorded revenues derived from, expenses incurred in, and plant used in rendering SG-1 PBX service subsequent to the effective date of this order. Memorandum accounts shall be developed and maintained for SG-1 revenues, expenses, and plant prior to the effective date of this order.

3. In addition to the data required by Rule 23 of the Commission's Rules of Practice and Procedure for a rate increase application, Pacific shall include as an exhibit annexed to future general rate increase applications the annual amounts by which the costs of rendering SG-1 PBX service exceed its revenues.

4. On or before June 30, 1976, Pacific shall install, and thereafter maintain, separate accounts and supporting data for depreciation expense and reserve accruals for the SG-1 system. Pacific shall be prepared at all times to report until further order the annual actual depreciation accruals for the SG-1 PBX plant and the amounts which would result from applying the lives estimated in the GE100 cost studies attached as Exhibit B to the amended application in this proceeding.

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

Dated at San Francisco, California, this 11th day of MAY, 1976.

I will file a written dissent
Leonard Ross

I will file a written dissent
Robert Batinovich

[signature] President
William Symons Jr.
Vernon L. Sturgeon

Commissioners

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COMMISSIONERS BATINOVICH AND ROSS DISSENTING:

The resolution of the service life issue is entirely unsatisfactory. The uncertainty of the evidence is recited in the decision. On that uncertain evidence the Commission somehow makes its finding, not that the rates are reasonable (because it cannot), but that the rates are not unreasonable. The result is illogical and illegal.

Logically, the decision is deficient because it overlooks the one standard that offers a reasonable approach to the service life question: the IRS depreciation life. The ten year depreciation life should control because it is so material to the business decision whether to buy the equipment or lease from Pacific.

Legally, the decision is deficient because it disregards the Commission's obligation to consider effects on competition. If the rate is non-compensatory, competition will be suppressed. This Commission cannot postpone its obligation for several years while Pacific gathers data that it should have provided with the qpplication.

At the very least the decision should guarantee Pacific's customers who rely on these original rates that their rates won't later be raised to reflect a shorter service life.

May 11, 1976
San Francisco, California

Robert Batinovich

Robert Batinovich, Commissioner

Leonard Ross

Leonard Ross, Commissioner