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Decision 87 12 070 DEC 22 1987

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of General Telephone Company of California, a California corporation (U 1002 C), for authority to increase and/or restructure certain intrastate rates and charges for telephone services.	Application 87-01-002 (Filed January 5, 1987)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs separations practices, contracts, service and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a California Corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	I.87-02-025 (Filed February 11, 1987)

(See Decision 87-08-051 for appearances.)

Additional Appearances

Harold L. Jackson, Attorney at Law, and James B. Gordon, Jr., for Communications Workers of America; Robert T. Morris, for Consumers Coalition; Marc Titel, Mayor, for City of Lakewood; Whitaker McKenzie, Attorney at Law (D.C.), for the Department of Defense and Federal Executive Agencies; and Shelley Ilene Rosenfield, Assistant City Attorney, City of Los Angeles; interested parties.

INTERIM OPINION

I. Synopsis of Decision

This order sets a rate of return for General Telephone Company of California (General) during test year 1988 and adopts those revenue reductions for operational cost reductions that have been agreed to by General and the Commission's Public Staff Division (renamed Division of Ratepayer Advocates (DRA)). This order does not address the disputed reductions still at issue in the case which will be decided in the first half of 1988.

This is an interim decision. It provides for a decrease in customer billings of $122.7 million on an annual basis effective January 1, 1988.

The decrease reflects stipulated results of operation data and our adopted 1988 test year rate of return of 10.90%.

In addition, on November 20, 1987, General filed Advice Letter (AL) 5110, in compliance with Decision (D.) 85-06-115 as modified by D.87-11-022, to shift nontraffic-sensitive (NTS) cost allocation based on subscriber plant factor (SPF) to one based on subscriber line usage (SLU), resulting in a revenue shift for 1988 of $54.071 million. The resulting changes in billing surcharges are an incremental decrease in surcharge of 0.28% for access services and an incremental increase of 3.59% for services other than access. We are consolidating General's AL 5110 filing with this interim decision so that there will be only one tariff revision to the billing surcharges on January 1, 1988.

The decision authorizes General to earn a return on equity of 12.75% which will provide an intrastate rate of return of 10.90%. Such a return will provide an after-tax interest coverage of 2.91 times and a pre-tax coverage of 3.94 times. These ratios indicate that General will have the financial capability to operate successfully, maintain its financial integrity, and attract capital.

As set forth in the section on rate design, the $122.7 million reduction results from a reduction of the present billing surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 which are collected on a "bill and keep" basis not subject to intercompany settlement. The apportionment of any additional decreases will be determined subsequent to the final submission of this matter.

II. Procedural Background

General requests authority in this application to increase and/or restructure certain of its intrastate rates and charges. The effect of the proposed changes will be to reduce its test year revenue requirement by approximately $114 million to provide a rate of return of 11.90% on General's intrastate rate base.

To enlarge the scope of these proceedings to cover essentially all aspects of General's public utility operations, this Commission issued Order Instituting Investigation (I.) 87-02-025 into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, services, and facilities of Pacific Bell and all of the California telephone utilities that interconnect with General. In addition, we opened I.87-01-019 into the rate of return for General's 1987 attrition year. Decision (D.) 87-08-051 as corrected by D.87-09-001 dated September 1, 1987 on that matter reduced General's revenue requirement for 1987 by approximately $50,626,000.

After due notice, more than 80 days of hearing have been held before Administrative Law Judges (ALJ) N. R. Johnson, K. Tomita, or M. J. Galvin in Los Angeles, San Francisco, or at the public participation hearings throughout General's service territory. Additional days of hearing are scheduled for January 1988.

The hearings on rate of return were held in San Francisco before ALJ Tomita and that phase of the matter was submitted permitting the issuance of this interim decision for a rate reduction.

The other phases of the matter will be briefed after the conclusion of the hearings and the final decision will issue subsequent thereto.

General presented 15 witnesses during its initial presentation and has a total of 32 rebuttal witnesses. DRA made its presentation through 35 witnesses, sponsoring 22 exhibits. In addition, testimony and exhibits were presented by Consumers Coalition of California on quality of service and rate design, by the Department of Defense and Federal Executive Agencies (FEA), and the City of Los Angeles (City) on rate of return, and by AT&T Communications of California (AT&T-C), API Alarm Systems (API), Western Burglar & Fire Alarm Association (Western), FEA, and Toward Utility Rate Normalization (TURN) on rate design.

Public participation hearings were held in Long Beach on June 15, 1987, in Santa Barbara on June 17, 1987, in San Fernando on June 18, 1987, in Santa Monica on June 19, 1987, in San Bernardino on June 22, 1987, in Palm Springs on June 23, 1987, in West Covina on June 24, 1987, and in Los Gatos on June 25, 1987. Statements and/or testimony were presented by 72 witnesses at these hearings. These statements covered a wide range of subject matters with the most frequent subject matters listed in order of descending frequency:

1. The 95¢ per month for "insurance" for inside wiring.
2. The "temporary" surcharge on monthly bills.
3. The physical size of the bill.
4. Zone Usage Measurement boundaries.

5. The quality of service.
6. Rate increase for residential customers in face of over-all decrease in revenues.
7. Directory assistance charges.
8. The monthly access charge.
9. The surcharge for handicapped equipment.
10. Pay phone availability and operational condition.
11. The number and cost of phone books.
12. The monthly charge for unlisted numbers.
13. The charge for the installation of equipment.
14. The 13-second time limit for dialing.

The individual service complaints were investigated and a summary of each investigation was forwarded DRA for review. The above subjects will be further addressed in the final decision.

III. General's Present Operations

General is the largest independent (non-Bell) operating telephone company in the United States and a member of the General Telephone and Electronics Corporation (GTE) system. GTE, General's parent company, holds all of the common but none of the preferred stock of General. GTE which was incorporated under the laws of the State of New York on February 25, 1935 is the parent company of more than 60 communications, products, research, and service subsidiaries with operations in 40 states and 19 countries abroad. The GTE system had combined revenues and sales of over $15.7 billion in 1985, consolidated net income from operations of a negative $161.0 million, including a nonrecurring after-tax charge of $1.3 billion (excluding this charge, the 1985 net income amounted to $1,131 million), 180,000 employees, and more than 475,000 shareowners.

General had an average of 25,903 equivalent employees in 1985. Wage payments applicable to operations in 1985 amounted to $766,152,085 of which $167,880,944 or 21.9% was charged to construction.

General operates within approximately 10,600 square miles serving approximately 330 communities and locations in portions of 20 California counties: Fresno, Imperial, Kern, Los Angeles, Marin, Orange, Riverside, Sacramento, San Bernardino, San Diego, San Joaquin, San Luis Obispo, Santa Barbara, Santa Clara, Santa Cruz, Solano, Sonoma, Tulare, Ventura, and Yolo. At the close of 1985, General operated 182 central offices in 86 exchanges. Customer lines totaled 2,689,746, of which 2,016,681 or 75% were residential and 673,065 or 25% were business.

IV. Rate of Return

Introduction

The rate of return phase of Application 87-01-002 was assigned to ALJ Tomita and all other issues to ALJ Johnson. Five days of hearings were held on rate of return issues between August 20 and 26, 1987. General, City, FEA, and DRA were the active participants in this phase of the proceeding.

At the conclusion of the hearings, the rate of return phase was taken under submission subject to the filing of concurrent briefs on September 30, 1987. Briefs were filed by General, City, and DRA.

General's Position

1. Capital Structure and Cost of Debt

General and DRA are recommending capital structures for the 1988 test year that are substantially the same. A summary of rates of return recommended by General, City, and DRA for test year 1988 follows.

Capital Structure	Avg. 1988 Cap. Ratios	Cost Factors	Weighted Cost
	General Telephone Company of California		
Long-term debt	41.20%	9.01	3.71%
Short-term debt	2.47	8.00	0.20
Preferred stock	2.77	6.42	0.18
Common equity	53.56	14.50	7.77
Totals	100.00%		11.86%
	Public Staff Division		
Long-term debt	41.50%	8.98	3.73%
Short-term debt	2.50	6.50	0.16
Preferred stock	2.50	6.41	0.16
Common stock	53.50	12-12.50	6.42 - 6.69
Totals	100.00%		10.47 - 10.74%
	City of Los Angeles		
Long-term debt	41.70%	8.986	3.747%
Short-term debt	2.50	7.000	0.175
Preferred stock	2.80	6.414	0.180
Common stock	53.00	12.500	6.625
Totals	100.00%		10.727%

The above tabulation shows that there is little difference in the capital ratios and capital costs considered reasonable by General, City, and DRA except for the cost of short-term debt and return on common equity. General as well as the other parties requested that the Commission consider the actual cost of General's long-term debt offering in 1987, if available at decision time, plus the general trend of bond and short-term debt rates in existence at that time in determining the reasonable long-term debt and short-term debt rate to adopt for test year 1988.

The only difference in long-term debt cost resulted from the fact that General estimated a 10% interest rate on new debt issues while DRA and City both used a 9.5% interest rate. For short-term debt cost General used an 8% cost for the test year, while DRA used a 6.5% interest rate and City a 7% interest rate.

2. Return on Equity

The principal area of dispute on rate of return revolves around the reasonable return on common equity (ROE) to be allowed. General requests that the Commission adopt a ROE of 14.5% for the 1988 test year. General states that this is 100 basis points less than the 15.5% ROE adopted in D.84-07-108 for its 1984 test year. It is, however, higher than the 13.75% ROE adopted by the Commission in D.87-08-051 for General's 1987 attrition year in I.87-01-019. General argues that the dramatic increase in interest rates that has occurred since the record was closed in I.87-01-019 supports an increase in General's ROE from the 13.75% authorized for 1987 to the 14.5% requested for test year 1988.

Joseph F. Brennan, President of Associated Utility Services, was General's ROE witness. He testified that the Commission should approve an ROE of at least 14%, and that an ROE of up to 14.5% would also be reasonable. Mr. Brennan gave consideration to the Discounted Cash Flow (DCF) model and the risk premium model as tools in arriving at what he believes investors require in the way of a return on their common equity investments. The witness testified that the results derived from the financial models should not be applied dogmatically but with the exercise of judgment to give consideration to the financial differences between General and the proxy group of companies used in the analysis.

Since General's common stock is not publicly traded, being a wholly owned subsidiary of GTE, it is not possible to obtain specific market information regarding General to determine the return to which investors in General's common stock are entitled. It was therefore necessary for Mr. Brennan as well as the other rate of return witnesses to use a proxy group of companies in undertaking their respective analyses.

Mr. Brennan selected 18 companies for use in his DCF analysis. The list includes three Independent Telephone Companies (Independents), seven Regional Holding Companies (RHC) (formerly AT&T subsidiaries), and eight gas distribution companies (GDC). Mr. Brennan included the GDCs in his study because of the limited number of telecommunications companies that are comparable to General and which have stock that is publicly traded, and also because the gas distribution industry is undergoing a transformation from a monopoly to a competitive environment, not unlike the telephone industry.

Brennan testified that in order to offset its increased business risk, General, like other telecommunications companies in his study increased the amount of common equity in its capital structure. While the percentage of equity in General's capital structure for 1988 is still significantly below the levels achieved by the RHCs and the three Independents in 1986, General has closed the gap.

Brennan stated that the greater investment risk associated with a telecommunications company or a GDC is reflected in the bond rating criteria published by Standard & Poors (S&P). According to the witness the two most important rating criteria used by S&P are the debt ratio and pre-tax times interest coverage. The pre-tax coverage for an AA-rated telephone utility is 4.5 to 6.5 times while the range for electrics is substantially lower at 3.5 to 5.0 times. These criteria differences indicate the telephone industry is considered to be substantially more risky than electric utilities by the investment community.

Brennan testified with respect to the DCF model that it is a technique which utilizes the market price, reported earnings per share and dividend payments per share in a calculation to determine the implicit return required by the investor, which is reflected in the market price of the stock. Brennan considers the DCF model as a useful tool to help the analyst come to an informed judgment. He further stated that for the past several years the DCF model seriously understates investor expected returns because factors other than earnings and dividend growth have influenced stock prices and are not considered in a DCF model. Factors that have impacted stock prices include mergers and acquisitions, the tremendous influx of foreign capital into the United States security market, and the change in investor expectations regarding increases in the price/earnings multiples of stocks which are not covered in the DCF analysis and thereby understate the investor-expected returns.

After completing his DCF study for each of his barometer companies, Mr. Brennan developed a DCF-derived ROE for each of the three utility categories within his barometer group. For the three Independents, the DCF cost rate was 12.4%; for the seven RHCs, the DCF cost rate was 12.2%; and for the eight GDC's, the DCF cost rate was 13%.

In addition to the DCF analysis Mr. Brennan made a risk premium analysis. The risk premium model is based on the fundamental principle of finance that equity investors expect a higher return on their investments than purchases of long-term debt. Brennan determined his equity risk premium by comparing equity returns over the yields of long-term utility bonds. He selected long-term bond yields because the DCF methodology also determines the expected return based on the assumption of an infinite holding period. This would make a comparison of equity yields under the risk premium analysis more appropriate to compare with a DCF-derived ROE. Brennan testified that a risk premium analysis based on a comparison of equity yields with the yields on intermediate or short-term debt would result in an inappropriate comparison with a DCF-derived ROE.

Brennan concluded that based on his review of the historical data that the appropriate risk premium for determining General's investor-required ROE is 4.7% when AAA and AA bonds yields are in the 9.0 to 9.5% range. He further testified that the risk premium spreads moves inversely with interest rates and that when interest rates for AA bonds yielded 12.6%, the equity risk premium is 4.0%.

The investor-expected ROEs for the three categories of utilities in Mr. Brennan's barometer group, giving equal weight to the results of his DCF and risk premium analyses, are 13.1% for the the three Independents, 13.2% for the seven RHCs, and 13.6% for the eight GDCs. Brennan then took the additional step to review the investment risk differences between General and the barometer group. He noted that General is rated as a weak AA by both Moody's and S&P while the seven RHCs and three Independents are on the average rated strong AA, and that over the five-year period ending in 1985, one investment grade differential equates to a debt cost difference of approximately 60 basis points. He further testified that each percentage point difference in the equity component of a utility's capital structure equates to a 10 basis point difference in the cost of debt. He further noted that General's average equity ratio of 53.5% was substantially below the average of the seven RHCs or the three Independents.

In recognition of these differences, Mr. Brennan increased the ROE derived from the average of his DCF and risk premium analyses by 70 basis points to arrive at his minimum investor-required ROE of 14%. Brennan further testified that the cost rate could even be 14.5% if less than equal weight is given to his DCF analysis for reasons stated above. General argues that Mr. Brennan's recommended ROE is consistent with recent decisions by other regulatory commissions. General believes Mr. Brennan's recommended cost of equity of at least 14% is very conservative and that a 14.5% return is more representative of today's market conditions.

General's Treasurer, Charles O'Rourke, testified on the projected capital structure for test year 1988, 1989, and 1990 and the projected cost of long-term debt and preferred stock for 1988, 1989, and 1990. He also estimated the cost of short-term debt for 1988. He also testified that the overall rate of return on rate base of 11.86% requested for test year 1988 using a 14.5% cost of common equity assumes that General will be afforded the opportunity to seek relief for financial attrition in 1989 and 1990.

DRA's Position

DRA is recommending a cost of common equity capital in the range of 12.00% to 12.50%. Using DRA's recommended capital structure and costs of long-term debt, short-term debt, and preferred stock, the recommended rate of return ranges between 10.47% to 10.74% for test year 1988, and is 10.60% using the midpoint 12.25% return on common equity recommended by DRA. Such rate of return produces an after-tax times interest coverage of 2.85 times for 1988, excluding short-term debt. DRA believes a rate of return within its recommended range will enable General to earn a fair return and balance the interest of General's investors and ratepayers.

DRA witness C.J. Blunt was responsible for the Report on the Cost of Capital and Rate of Return. Witness Blunt presented his estimate of recommended capital structures for the three-year test period 1988-1990. The witness stated that although DRA has made capital structure and capital cost recommendations for 1989 and 1990, he recommends that these should be updated with Attrition Rate Adjustment (ARA) mechanism reviews in 1989 and 1990. These ARA reviews were mandated by D.85-12-076, and were further refined by D.86-12-099 according to the witness.

DRA's witness testified that he was guided by the standards set forth by the U. S. Supreme Court decisions in the

Bluefield and Hope cases in determining a fair and reasonable return on common equity. The two standards which emerged from the two cases are: (1) a standard of capital attraction and (2) a standard of comparable earnings. The capital attraction standard focuses on investors' return requirements and is applied using market value methods in the DCF, capital asset pricing model (CAPM), and risk premium analyses. The comparable earnings standard uses the return earned on the equity investment by companies of comparable risks as a measure in setting a fair return.

DRA's witness selected 22 telecommunications and gas distribution companies which he considered encountered similar business risks to General and used this group as a surrogate for a common stock equity investment in General. On the basis of financial risk, the witness selected telecommunications and gas distribution companies with similar bond ratings and comparable betas. The four independent telecommunications companies and the seven RHCs were selected because they are engaged in similar business pursuits as General and are regulated or have subsidiaries that are regulated. The gas distribution companies were selected because they are experiencing similar business risks (due to deregulation) as the telecommunications industry.

The witness compared General's recorded earnings on common equity with that of his 22 comparison companies for the period 1982 through 1986 and concluded that General's earnings have exceeded the group in every year, except 1984, with a five-year average of 15.77%. He further noted that General's return on total capital and dividend payout ratio was higher than his comparison group. Furthermore, General has increased its common equity ratio substantially more than his comparison group. DRA's witness stated that the above facts demonstrate a highly improved financial picture for General which is supported by the upgrading of General's bond ratings by both Moody's and S&P to Aa3 and AA-respectively in December 1986. In addition, the fact that General's major construction programs are nearing completion thereby reducing the need for future external financing there were other factors given which reduces General's financial risks and justifies reducing the authorized return on common equity.

DRA's DCF analysis indicated a 11.98% to 12.17% cost of common equity for the test period depending on whether an April 1987 or a three-month average dividend yield rate is used. In addition DRA's witness performed a risk premium analysis and a CAPM analysis to assist him in developing his recommended cost of common equity. The risk premium analysis produced a required return on common equity for the test period of 12.43% to 12.76% depending on the type of security used. The CAPM analysis indicated that the investors expected return on common equity for the comparison group ranges from 11.97% to 12.31% depending on whether the DRI or Blue Chip Financial's forecast for three-month Treasury Bills are used. DRA's recommended ROE range of 12.00% to 12.50% is based primarily upon the DCF analysis. DRA recommends that the Commission adopt its recommended capital structure for 1988, a cost of long-term debt of 8.98%, short-term debt cost of 6.50%, an embedded cost of preferred stock of 6.41%, and a cost of common equity in the range of 12.0% to 12.5%. The resulting overall rate of return for General would be in the range of 10.47% and 10.74% for test year 1988.

City of Los Angeles' (City) Position

City contends that General's requested return on common equity of 14.50% and an overall rate of return of 11.86% are excessively high, particularly in light of the significant decrease in the cost of money since General's last general rate case in 1984. D.84-07-108 adopted a 12.74% rate of return with an allowance for common equity of 15.50% as reasonable. The City states that the Commission recognized this striking decrease in the cost of money in D.87-08-051 by adopting a lower rate of return of

11.36% with a 13.75% return on common equity capital as reasonable for General for attrition year 1987.

City's rate of return witness, M. Kroman, testified that he found the use of the DCF, risk premium, and other formula methodologies for determining the investor required return on equity unsatisfactory. He stated that the outcome achieved by using these methodologies is largely dependent on the assumptions of the person who uses these tools in arriving at his results. He further testified that it is impossible to estimate an investor's expectations or requirements.

Witness Kroman used a differential cost of money analysis in arriving at his recommended return on common equity and return on rate base. Under this methodology, the witness used as a benchmark the last authorized return on common equity found reasonable by the Commission in 1984 in D.84-07-108 and determined that based on his study (Exhibit 198, Tables 14 through 19) a 300 basis point decline in the cost of money was fairly representative. He recommends that a fair rate of return on common equity would be 15.50% less 3.00% or 12.50%. He further noted that the 12.50% return was conservative since General's common equity ratio has increased by nearly 10 percentage points since D. 84-07-108. He further testified that a comparable earnings analysis, including electric utilities, strongly suggests that a return on common equity in the mid 12% area would be appropriate for General.

Mr. Kroman used General's estimated capital structure, substituted a 9.5% cost for new long-term debt issues in place of General's 10% estimate, used a 7% cost for short-term debt for 1988, and substituted his recommended 12.5% return on common equity in arriving at his recommended rate of return of 10.727%. He concludes that this rate of return will produce a pre-tax interest coverage of 3.63 times, which should provide the basis for a solid investment grade bond rating.

The witness further testified that General's argument that it should be granted earnings sufficiently high to move it toward a double A bond rating should be rejected since the cost to ratepayers is much higher than the benefits to be derived from lower interest costs resulting from the higher bond ratings. He stated that utilities in general carry a single A bond rating and, absent extraordinary circumstances, have demonstrated no disability in raising new capital at market rates. In Exhibit 198, Table 2, the witness set forth hypothetical examples to show the cost of increasing a utility's bond ratings from A to AA.

Federal Executive Agencies (FEA)

FEA did not make a specific rate of return recommendation in this proceeding. FEA's witness, Dr. Charles A. McCormick, testified that General's rate of return witnesses failed to give recognition to the decline in capital costs during 1986 and the first quarter of 1987 or make any adjustments to its equity costs to reflect these trends. He stated that increasing General's equity ratio to increase its bond ratings must be placed in proper perspective and given the current economic conditions and nothing to reflect a return to the disastrous economic conditions of the early 1980's, an increase in the equity ratio is not justified. He further testified that General's witness, Mr. Brennan, has failed to justify the 0.6 to 0.7% adjustment he made to the estimated cost of common equity of 13.1%-13.2% for the comparable group of telephone companies to generate his 14.0% cost of common equity for General.

Discussion

1. Capital Structure

Although DRA recommends that both the capital structure and capital costs should be updated in conjunction with ARA reviews for the 1989 and 1990 attrition years, Ordering Paragraph 9 of D.87-04-078, dated April 22, 1987, an order modifying D.86-12-099 and denying rehearing, states:

"9. Finding of Fact No. 5 is modified to read:

> "5. Based on D.86-01-026 (See Finding of Fact 3) and our present policy of considering revision of the Return on Equity (ROE) and capital structure of California's two major local exchange telephone utilities every three years, we decline to review PacBell's ROE for 1987, but we will review PacBell's embedded debt costs and monitor PacBell's capital structure, consistent with the discussion on page 6 of this opinion."

The above ordering paragraph indicates that we have adopted a policy of considering revision of the ROE and capital structure for the two major local exchange telephone utilities every three years. The evidence in this record indicates that there is very little difference in the estimate of capital structure among the parties for test year 1988 and attrition years 1989 and 1990. However, events occurring in the financial markets in October indicates that we should reconsider our plan and have General's capital structure, interest costs, ROE, and financing plans reviewed in the attrition years. We will require a review of these items in the ARA reviews for 1989 and 1990.

In our full review of our regulatory process in I.87-11-033, we will reexamine the attrition mechanism for local exchange telephone utilities. This order should not be construed as prejudging the results of our investigation. The entire attrition process, including those parameters laid out for General in this decision, may be altered fundamentally by I.87-11-033.

Since we will be updating the capital structure in each of the attrition years, we will only adopt a capital structure for the test year in this order. As stated previously, there is little difference in the estimated capital structures between the parties. For the purposes of this proceeding we will adopt as reasonable the DRA recommended capital structure for test year 1988, as follows:

Components	1988
Long-Term Debt	41.50%
Short-Term Debt	2.50
Preferred Stock	2.50
Common Stock Equity	53.50
Total	100.00%

2. Debt Costs and Preferred Stock Costs

Although there was little difference in the estimated cost of long-term debt between General and DRA, there was disagreement as to the cost of new long-term and short-term debt. The parties were in agreement that the Commission should consider the current and forecasted interest rates at the time of making its decision in this matter. Our review of current interest rates and forecasted interest rates indicates that the cost of both long-term and short-term interest rates have climbed since the time the parties prepared their respective exhibits; also, we again note the uncertainty created by the recent stock market upheavals in October 1987. Giving due consideration to the various positions in the record, we will adopt as reasonable a 10% interest rate for both the 1987 and 1988 forecasted long-term debt issues and a 9.01% cost of long-term debt for 1988. We will adopt as reasonable a 7% cost rate for short-term debt for test year 1988.

In the ARA financial attrition review, we will require General to use the embedded cost of debt plus the interest rate on long-term AA utility bonds forecasted by DRI in September modified, if appropriate, by 50 basis points for a whole grade difference in bond ratings and 25 basis points for a split rating for any long-term bonds to be issued in the attrition year. We will further require the use of the Blue Chip Financial Forecast consensus one-month commercial paper projection as of October 1 for the attrition year short-term debt cost.

While we have considered but not directly adopted the most recent forecasts in arriving at our estimated cost of long- and short-term debt, the use of these popularly used forecasts will eliminate any controversy on the interest rates to be used for the attrition years.

General does not propose any new preferred stock issues in the test or attrition years. We will adopt as reasonable a 6.41% preferred stock cost rate for test year 1988. The gradual redemption of the highest cost preferred stock issues outstanding results in the declining preferred stock cost rate.

3. Cost of Common Stock Equity

The recommended ROEs range from 12%, the bottom of DRA's range to 14.50% requested by General. City's 12.50% ROE is also the top of DRA's recommended range of ROE. Both DRA and General rely on the DCF and risk premium methodologies to support their respective recommended returns on equity. However, DRA places greater emphasis on DCF than General since DRA uses the risk premium analysis and also the CAPM analysis as a test of the reasonableness of the DCF analysis. General's witness, on the other hand, averages the results of the DCF and risk premium analyses as his starting point before applying his adjustment for differences between General and his proxy group of companies. The following is a summary of the results of the various models:

ROE Model Results

Party	Model	ROE
General	DCF	11.1-13.1% Ind. Telcos 12.4% avg Ind. Telcos 11.8-12.7% RHCs 12.2% avg RHCs 12.0-14.8% GDCs 13.0% avg GDCs
	Risk Premium	13.7% Ind. Telcos 14.2% RHCs 14.2% GDCs
DRA	DCF	10.29-13.80% 12.08% avg
	Risk Premium	12.43-12.76% 12.54% avg
	CAPM	11.97-12.31% 12.14% avg
City	Differential Cost of Money Analysis	12.50%

The use of different assumptions made as to investor's currently expected dividend yield rates and investor's expected growth rates in the respective DCF analyses provided different investor expected cost of common equity rates for the test period. Because the results can vary depending on these subjective inputs, we have stated in the past that we have always relied more on judgment than on any singular formula approach to establish the reasonable return on common equity. The exercise of such judgment involves forecasts of overall economic conditions, range of returns earned by comparable companies, and an assessment of the relative risk inherent with the particular utility under consideration.

In the case of General where it is not possible to calculate a company-specific market related cost rate for General's common equity it is even more critical to exercise judgment rather than rely on any formula approach. While the money market derived cost of equity based on a proxy or group of companies may be useful as a guide it cannot be directly used in determining a reasonable cost of equity for ratemaking purposes. Judgment must be exercised to consider all the various factors which may differentiate the specific company from the proxy or group of companies being used in the study. Moreover, judgment must be exercised in using the results of a formula because the formulas may fail to take into consideration various factors that may influence the investor required return on common equity.

As recognized in D.87-08-051 in I.87-01-019, an investigation on the appropriate rate of return for attrition year 1987, there has been a substantial reduction in interest rates since the last general rate case. However, there has been a reversal of this trend in declining interest rates in the past few months. We note that the parties recognized that the level of interest rates could change and recommended that the Commission should take into consideration the actual debt costs incurred by General in 1987, and the trends in capital costs at the time it issues its decision. In arriving at our adopted ROE we will take into consideration the change in money market rates from the time the parties prepared their respective rate of return studies.

We believe that inflation during the three-year period will be in the 4% range and that interest rates while higher than the levels experienced in 1986 and early 1987 will tend to fluctuate around the current levels.

After consideration of all the evidence in this proceeding and the arguments advanced by the various parties, we adopt as reasonable a return on common equity of 12.75% for test year 1988. This is below the return on equity we found reasonable for General for test year 1987 in D.87-08-051 in August 1987. We note that this figure is higher than the average results from the various DCF models although within the high range of the companies studied. We also note that the adopted result in at the high end of the DRA's risk premium analysis. The average result of DRA's CAPM analysis is below the adopted figure. On the other hand, General's risk premium analysis shows a much higher cost rate. The variations in the results obtained from these models clearly indicate that these models should be used only as a guide and that we must rely on judgment rather than any particular methodology in determining the cost of common equity. In the case of General it becomes even more critical, since a company-specific market related cost rate can not be calculated and a proxy group of companies must be used to determine the market required cost of common equity for General.

Although it was originally our plan to review capital structure and ROE for the major local exchange telephone companies once every three years, we now believe that an annual review is necessary under the current turbulent financial market conditions. This annual review will substantially reduce the risk that the return authorized for General will become outdated due to changes which inevitably occur between General rate cases.

We believe a 12.75% ROE is reasonable for test year 1988. The 12.75% return on common equity applied to our previously adopted capital structure and costs translates to a rate of return 10.40% developed as follows:

Item	Capital Structure	Cost Factor	Weighted Cost
Long-term debt	41.5%	9.01%	3.74%
Short-term debt	2.5	7.00	.18
Preferred stock	2.5	6.41	.16
Common equity	53.50	12.75	6.82
Total	100.00%		10.90%

The after-tax coverage of the above 10.90% rate of return is 2.91 times and the pre-tax coverage is approximately 3.94 times excluding short-term debt. Such a return is fair and reasonable and balances the interests of both the investors and ratepayers and is comparable to returns earned by other investments of comparable risks.

V. Results of Operation

Comprehensive results of operations testimony and exhibits were presented by General and DRA. Substantial differences exist in all categories, i.e. revenues, expenses, and rate base. On October 20, 1987, General presented Exhibit 231 setting forth its updated estimates reflecting the impact of the 1987 attrition decision, D.87-08-051 dated August 26, 1987, inside wire on a business-as-usual basis, revisions made to date, and federal income tax calculated assuming a 34% tax rate and new definition of FIT income adjustments. Also included were Uniform System of Accounts (USOA) changes reflecting the capital to expense shift in Part 32 on the basis of its understanding that a rate recovery mechanism would not be included in the USOA proceeding I.87-02-023. At this juncture, the contents of a decision on this matter is pure speculation. Consequently we will eliminate the effects of this adjustment in General's showing. The following tabulations set forth General's latest showing without the USOA adjustment, together with DRA's results of operations as presented by its witness' exhibits and testimony on both total company and intrastate bases. For the purposes of this interim decision, we will use General's showing for the computation of the revenue reduction to yield a 10.90% rate of return. The difference between the revenue reduction of $122.7 million and the total revenue reduction of $657.2 million at issue or $534.5 million will not be made subject to refund pending our final resolution of the differences which we expect to complete in the first half of 1988. This will further reduce the risk that General will face in 1988, a reduction which is reflected in our adopted return on equity.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Intrastate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	DRA*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Operating Revenues:				
Local Revenues	$ 776,370	$ 772,308	$ (4,062)	(0.52)%
Toll Service	874,331	814,847	(59,484)	(6.80)
Access Revenues	273,146	233,482	(39,664)	(14.52)
Miscellaneous Rev.	282,311	244,855	(37,456)	(13.27)
Surcharge	202,202	186,274	(15,928)	(7.88)
1987 Attrition	(54,450)	(52,978)	1,472	(2.70)
Less Uncollectibles	18,950	23,168	4,218	22.26
Total	2,334,960	2,175,620	(159,340)	(6.82)
Operating Expenses				
Maintenance	310,667	382,898	72,231	23.25
Traffic	55,902	66,550	10,648	19.05
Commercial	204,032	228,087	24,055	11.79
Gen. Off. Sal. & Exp.	150,776	166,494	15,718	10.42
Other Oper. Exp.	134,546	164,336	29,790	22.14
Subtotal	855,923	1,008,365	152,442	17.81
Depreciation	404,347	440,979	36,632	9.06
Taxes Other than Inc.	70,522	89,899	19,377	27.48
State Income Tax	79,168	54,851	(24,317)	(30.72)
Federal Income Tax	252,942	149,030	(103,912)	(41.08)
Total	1,662,903	1,743,124	80,221	4.82
Net Oper. Income	672,057	432,496	(239,561)	(35.65)
Adj. to Net Income				
Gain on Sale of Prop.	5,898	-	(5,898)	(100.00)
GTE Telecom Adj.	1,123	-	(1,123)	(100.00)
Calif. Corp. Fr. Tax	-	(2,435)	(2,435)	
Communications Systems	704	704	0	0
GTE Directories	5,430	4,021	(1,409)	(25.95)
GTE Data Service	6,479	-	(6,479)	(100.00)
GTEL Adjustment	10,846	-	(10,846)	(100.00)
Compensation Levels	26,097	-	(26,097)	(100.00)
Total Adjustments	56,577	2,290	(54,287)	(95.95)
Adjusted Net Income	728,634	434,786	(293,848)	(40.33)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA revenue requirement.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Intrastate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	DRA*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Adj. Net Oper. Income	$ 727,930	$ 434,786	$(293,144)	(40.27)%
Rate Base				
100.1 Telephone Plant	4,902,633	5,418,720	516,087	10.53
100.2 Tel. Plant Under Construction	-	-	-	-
100.3 Property Held for Future Use	62	62	-	-
Materials & Supplies	12,738	18,888	6,150	48.28
Working Cash Allowance	14,534	3,862	(10,672)	(73.43)
Less: Deprec. Reserve	1,595,425	1,630,960	35,535	2.23
Less: Deferred Taxes	513,322	545,834	32,512	6.33
Total Rate Base	2,821,220	3,264,738	443,518	15.72
Adj. to Rate Base Communication Sys.	(2,686)	(2,686)	0	0.00
Net Adj. Rate Base	2,818,534	3,262,052	443,518	15.74
Rate of Return				
ROR - Present Rates	25.85	13.33		
ROR - Authorized	10.90	10.90		
Difference	-14.95	-2.43		
REVENUE REQUIREMENT Difference x Rate Base x N/G	(657,170)	(122,691)		

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA revenue requirement.

Net-to Gross Calculation

	1.00000
Uncollectible rate	0.00215
Difference	0.99785
CCFT @ an incremental rate of 0.018993	0.01895
Difference	0.97890
FIT @ 34%	0.33283
Difference	0.64607
Net-to-Gross Multiplier	1.54781

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Company Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	DRA*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Operating Revenues:				
Local Revenues	$ 776,370	$ 772,308	$ (4,062)	(0.52)%
Toll Service	874,331	814,847	(59,484)	(6.80)
Access Revenues	753,571	713,907	(39,664)	(5.26)
Miscellaneous Rev.	306,130	268,674	(37,456)	(12.24)
Surcharge	202,202	186,274	(15,928)	(7.88)
1987 Attrition	(54,450)	(52,978)	1,472	(2.70)
Less Uncollectibles	20,150	24,368	4,218	20.93
Total	2,838,004	2,678,664	(159,340)	(5.61)
Operating Expenses				
Maintenance	397,893	491,676	93,783	23.57
Traffic	62,632	74,563	11,931	19.05
Commercial	242,686	275,725	33,039	13.61
Gen. Off. Sal. & Exp.	178,640	197,636	18,996	10.63
Other Oper. Exp.	164,974	200,560	35,586	21.57
Subtotal	1,046,825	1,240,160	193,335	18.47
Depreciation	496,133	539,288	43,155	8.70
Taxes Other than Inc.	88,964	113,506	24,542	27.59
State Income Tax	94,562	65,342	(29,220)	(30.90)
Federal Income Tax	296,489	182,473	(114,016)	(38.46)
Total	2,022,974	2,140,769	117,795	5.82
Net Oper. Income	815,030	537,895	(277,135)	(34.00)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA revenue requirement.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Company Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	DRA*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Net Operating Income	$ 815,030	$ 537,895	$(277,135)	(34.00)%
Adjustments to Net Inc.				
Gain on Sale of Property	6,396	-	(6,396)	100.00
GTE Telecom Adj.	1,218	-	(1,218)	100.00
Calif. Corp. Fr. Tax	-	(2,802)	(2,802)	
Communications Systems	865	865	0	0.00
GTE Directories	5,579	4,131	(1,448)	(25.95)
GTE Data Service	6,656	-	(6,656)	(100.00)
GTEL Adjustment	11,143	-	(11,143)	(100.00)
Compensation Levels	31,917	-	(31,917)	(100.00)
Total Adj. to Income	63,774	2,194	(61,580)	(96.56)
Adj. Net Oper. Income	878,804	540,089	(338,715)	(38.54)
Rate Base				
100.1 Telephone Plant	6,199,312	6,832,892	633,580	10.22
100.2 Tel. Plant Under Construction	-	48,112	48,112	
100.3 Property Held for Future Use	79	79	-	-
Materials & Supplies	16,874	25,021	8,147	48.28
Working Cash Allowance	17,775	4,726	(13,049)	(73.41)
Less: Deprec. Reserve	2,013,214	2,051,951	38,737	1.92
Less: Deferred Taxes	649,306	695,140	45,834	7.06
Total Rate Base	3,571,520	4,163,739	592,219	16.58
Adj. to Rate Base Communication Sys.	(3,416)	(3,416)	0	0.00
Net Adj. Rate Base	3,568,104	4,160,323	592,219	16.60
Rate of Return	24.63	12.98%	(11.65)	(47.29)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA revenue requirement.

In its application, General requested represcription of depreciation rates for test year 1988. General estimated depreciation accruals for test year 1988 based on these requested rates. DRA recommendations used different rates to which General stipulated. The depreciation accruals shown in Exhibit 231 are based on DRA-recommended rates. We will want General to accrue depreciation expense using the new depreciation rates tabulated in Appendix B of this decision.

General also submitted testimony and exhibits on depreciation methodology and requested changes in the present methodology. DRA opposed these changes. The final determination on depreciation methodology issues will be forthcoming in the final decision.

On November 20, 1987, General filed AL 5110 to reduce rates for access services in 1988 and correspondingly increase the surcharge on other than access services. The filing is in compliance of D.85-06-115, as modified by D.87-11-022, which addressed the phased shift in revenue due to the shift in the use of a NTS cost allocator based on SPF to one based on SLU. General quantifies the total intrastate revenue shift for 1988 as $54.071 million which results in an incremental change of -0.28% for the surcharge applicable to access services and an incremental change of 3.59% for the surcharge applicable to services other than access. We will consolidate General's AL 5110 with this interim decision so that there will be one tariff revision to the billing surcharges on January 1, 1988.

VI. Rate Design

As previously stated, testimony and exhibits on rate design were submitted by General, DRA, AT&T, API, Western, FEA, and TURN. DRA submitted proposed rate designs reflecting revenue reductions of $115, $250, $500, and $750 million and General submitted proposed rate designs reflecting revenue reductions of $115, $250, and $500 million.

The final rates will be forthcoming in our final decision after this matter has been briefed and submitted and the final revenue requirement determined. For this interim decision, our adopted revenue reduction of $122.7 million will be derived from a reduction in the billing surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 of 6.78%. D.87-08-051 as corrected by D.87-09-001 indicated that effective January 1, 1988, the surcharge should be 5.47% for access services and 8.74% for other than access services. Deducting the above 6.78% from the 5.47% surcharge for access services and the previously discussed -0.28% SPF to SLU reduction results in a surcharge for access services of -1.59%. Deducting the 6.78% from the surcharge for other than access services and adding the 3.59% SPF to SLU increment results in a surcharge for other than access services of 5.55%, which we will adopt for this proceeding.

In D.85-06-113, dated June 12, 1985, we ordered that Ordering Paragraph 3 of D.85-03-056 is modified to read in full as follows:

> "3. Any reduction in AT&T-C's expense stemming from reductions in local exchange utilities' access charges shall be concurrently passed on to AT&T-C's customers through a corresponding incremental reduction in the billing surcharge. The tariff filings by AT&T-C to comply with this order shall be filed so that they are effective within 14 days after local exchange utilities have made the advice letter filings required to reduce their local access charges."

In accordance with D.87-07-017, we have recently received an application for rate flexibility from AT&T-C. We are also aware of several pending rate matters that will affect AT&T-C's access charge expenses. For now, we will order AT&T-C to accumulate the access charge reduction ordered here in a memorandum account, with interest, commencing on January 1, 1988. We will issue a further order describing how the entire amount of this savings is to be consolidated with other changes in access charge expenses for full pass-through to AT&T-C's customers.

VII. Comments on Proposed Decision

General

As provided in Section 311 of the Public Utilities Code, ALJs Johnson and Tomita prepared a Proposed Decision which was filed with the Commission and served on all parties on November 13, 1987. Rules 77.1 through 77.5 of this Commission's Rules of Practice and Procedure permit parties to file comments on such a Proposed Decision within 20 days of its date of mailing (December 3, 1987). Rule 77.3 provides in part:

> "Comments shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record. Comments which merely reargue positions taken in briefs will be accorded no weight and are not to be filed."

Comments and reply comments were received from General and DRA.

Comments of General

General submitted the following comments:

1. The proposed 13.25% ROE is unreasonably low.

2. There is no evidence in the record to support a reduction in General's ROE below the 13.75% authorized for attrition year 1987.

3. The estimated cost of new long-term debt and the estimated cost of short-term debt for the 1988 test year are too low.

4. The method for determining the cost of long-term debt for attrition years 1989 and 1990 should be revised.

5. The Commission must approve General's 1988 depreciation rates so that General can begin booking the new level of expense as of the start of the test year.

In its reply comments, General alleges that:

1. The DRA's 12.50% return on equity is unrealistically low in today's environment, and

2. DRA's proposed revision to the billing surcharge calculation in the decision is not supported on the record.

We concur with General's comments relating to determination of long-term debt interest costs for the 1989 and 1990 attrition years and have modified our discussion and Finding of Fact 4 to use the interest rate on long-term AA utility bonds forecasted by DRI in September modified, if appropriate, by 50 basis points for a whole grade difference in bond ratings and 25 basis points for a split rating.

General notes that part of the revenue reduction provided for in this decision is based on the use of new depreciation rates in the test year which have been stipulated to by both General and DRA, and that before General can begin booking the new depreciation rates, they must be approved by this Commission. General proposes the following finding of fact and conclusion of law to support an ordering paragraph authorizing General to begin booking the new rates effective January 1, 1988. General's position is well taken and will be adopted.

"Finding of Fact No. 12

"The depreciation rates proposed by the PSD [DRA], to which General has stipulated, are reasonable and should be authorized effective January 1, 1988."

"Conclusion of Law 6

"General may begin booking the new depreciation rates approved in this decision effective January 1, 1988."

General notes that on pages 7 and 8 of its comments DRA proposes a billing base of $1,639.403 million rather than the billing base discussed in the proposed decision. According to General, there is no support in the record for the $1,639.403 million proposed by DRA whereas the billing base reflected in the proposed decision is the most current billing base in the record. Consequently General believes no change should be made to the billing base. We agree and will not modify the proposed decision in this respect.

Comments by DRA

DRA submitted the following comments:

1. The appropriate return on equity to adopt for test year 1988 is 12.50%.

2. General should use only DRI forecasts for the ARA financial review and not both DRI and Blue Chip forecasts as set forth in the proposed order.

3. A customer billing base of $1,639.403 million should be used in computing the surcharge rather than the DRA's estimate of $1,809.000 million.

4. Finding of Fact should be amended and an ordering paragraph be added authorizing DRA's depreciation rates stipulated to by General.

5. "Test Year Adjustments" should be modified to reflect estimated loss associated with employee store operation of $600,000 and refund of protective connection arrangement balance of $2,200,000.

6. Reconciliation of figures included in the summary of earnings with figures in the Staff Report on Affiliated Relationship of General should be made as follows:

   a. Change DRA amounts to reflect adjustments for GTE Communications Systems Rate Base of $3,416,000 and expenses of $1,370,000.

b. Change DRA amounts to reflect its Directory Company expense adjustment of $9,149,000 instead of showing erroneous figures set forth in the summary of earnings.

7. An adjustment for the Thousand Oaks Relocation of $69.3 million to rate base and $21.5 million to expense should be made.

In its reply comments, DRA supports its assertion that a proper return on equity for General for test year 1988 is 12.5%.

We are not persuaded that it would be advantageous to use only DRI forecasts for the ARA financial review instead of both DRI and Blue Chip forecasts as set forth in the Proposed Decision.

As discussed under General's comments, we will not modify the Proposed Decision to reflect a billing base of $1,639.403 million instead of the billing base of $1,809.000 million set forth in the Proposed Decision.

In our discussion of depreciation rates set forth in the section on General's comments, we adopted a finding of fact and conclusion of law relating to stipulated depreciation rates. We will also adopt an implementing ordering paragraph reflecting DRA's proposal.

In the summary of earnings appearing on page 26 of the Proposed Decision, it is noted that the figures shown do not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA's revenue requirement.

DRA's proposed adjustments to reflect losses associated with employee's store operation, the refund of protective connection arrangement balance, and the Thousand Oaks relocation adjustment appear to be covered by this disclaimer. We believe we have more than ample latitude in the revenue requirement differentials set forth in the proposed decision to obviate the necessity of the further adjustments proposed by DRA.

DRA's directory company expense adjustment of $9,149,000 is properly reflected in the summary of earnings set forth in the Proposed Decision. The $9,149,000 figure is a gross figure which reduces to a $5,579,000 net income adjustment. The $5,579,000 amount is total company and reduces to $5,430,000 for General's intrastate operations. Similar computations apply to the figures shown for General's directory company expense adjustments.

We agree with DRA's position relating to the amount of adjustments for GTE Communications system. These adjustments should be $3,416,000 to rate base for both DRA and General, $865,000 to expense for both General and DRA on a companywide basis, and $2,686,000 and $704,000, respectively, for General's intrastate operations. Appropriate changes will be made to the summary of earnings tabulation.

We have carefully considered the comments made by the parties on return on equity and having evaluated them together with the record before us, conclude that a reduction in the return on equity set forth in the proposed decision is warranted. As set forth in our discussion on rate of return, we believe that a return on equity of 12.75% balances the interests of both investors and ratepayers, is comparable to returns earned by other investments of similar risk and is reasonable for 1988.

VIII. Findings and Conclusions

Findings of Fact

1. Unlike the major energy utilities, the Commission in D.87-04-078 stated that it will review capital structure and ROE for the major local exchange telephone utilities once every three years. However, the existing turmoil in the financial markets now justifies a further review of capital structures, interest rates and ROE in the attrition years.

2. There was no substantial difference in the capital structures estimated by DRA and General for test year 1988. We will adopt as reasonable DRA's estimate for 1988 as follows:

Components	1988
Long-Term Debt	41.50%
Short-Term Debt	2.50
Preferred Stock	2.50
Common Stock Equity	53.50
Total	100.00%

3. The reasonable costs for long-term debt and short-term debt for test year 1988 are 9.01% and 7.00%, respectively.

4. For attrition years 1989 and 1990 the reasonable cost for long-term debt is the embedded cost of debt plus the interest rate on long-term AA utility bonds forecasted by DRI in September modified, if appropriate, by 50 basis points for a whole grade difference in bond ratings and 25 basis points for a split rating for any long-term bonds to be issued in the attrition year. The reasonable short-term debt cost is the Blue Chip Financial Forecast consensus one-month commercial paper projection as of October 1 for the attrition year.

5. The reasonable preferred stock cost for test year 1988 is 6.41%.

6. A ROE of 12.75% is reasonable and should be adopted for test year 1988. A 12.75% ROE is sufficient to attract capital and reasonably compensate investors during 1988.

7. Adopting the above capital ratio and cost factors will provide a return on rate base of 10.90% for test year 1988. Such rate of return will provide a pre-tax coverage of 3.94 times and an after tax coverage of 2.91 times excluding short-term debt.

8. A revenue requirement reduction of $122.7 million is appropriate for test year 1988 on an interim basis.

9. To effect the revenue reduction of $122.7 million, the surcharge applicable to access services and services other than access should be decreased by an increment of 6.78%.

10. D.85-06-113 dated June 12, 1985 directs AT&T-C to flow through any reduction in its access expense stemming from reductions in local exchange utilities' access charges to its customers.

11. It is reasonable for General to accrue 1988 depreciation expense using new rates as shown in Appendix B.

12. We should consolidate General's AL 5110 with this interim decision so that there will be one tariff revision to the billing surcharges. In AL 5110, to reflect its 1988 SPF to SLU shift, General requested an incremental change in billing surcharge of -0.28% for access services and 3.59% for services other than access to be effective on January 1, 1988.

Conclusions of Law

1. A reduction in the revenue requirement of $122.7 million for General for the test year 1988 is reasonable on an interim basis.

2. Effective January 1, 1988, the surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 should be -1.59% for access services and 5.55% for other than access services, reflecting the $122.7 million revenue requirement reduction adopted in today's decision and General's AL 5110.

3. The rates described in Conclusion 3 are reasonable and other rates applied after the effective date of such rates are unreasonable.

4. Because of time constraints in effecting these rates by January 1, 1988, this order should be effective today.

5. Effective January 1, 1988, General should be authorized depreciation rates as shown in Appendix B.

INTERIM ORDER

IT IS ORDERED that:

1. Five days of the effective date of this order General Telephone Company of California (General) shall file revised Schedule Cal. P.U.C. No. A-38 to reflect the revisions shown in Appendix A of this decision and revised tariff sheets to reflect its 1988 SPF to SLU transition. The effective date of the ordered revisions shall be January 1, 1988. Such filing shall comply with General Order Series 96.

2. AT&T Communications of California (AT&T-C) is ordered to collect the access charge reductions it receives as a result of this decision into a memorandum account with interest at the three-month commerical phase appropriate short-term rate. These reductions will be passed through to AT&T-C's customers by a further order of the Commission.

3. Authority is granted to make effective January 1, 1988 the depreciation rates shown in Appendix B for calendar year 1988 and subsequent years until General files with the Commission a new depreciation study.

This order is effective today.

Dated DEC 22 1987, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser, Executive Director

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APPENDIX A
Sheet 1 of 2

SCHEDULE CAL. P.U.C. NO.-38
BILLING ADJUSTMENT

APPLICABILITY

Applicable to intrastate billing on each customer's and/or carrier's bill for services rendered on and after the effective date of these revisions, as ordered by the Public Utilities Commission. General shall not backbill any customer in the event it cannot because of billing limitations impose the revised billing adjustment as ordered by the Commission.

TERRITORY

Within the exchange areas of all exchanges as said areas are defined on maps filed as part of the tariff schedules.

RATES	Monthly Percentage
Adjustment Factor (See Special Condition 1)	(1.59)
Adjustment Factor (See Special Condition 2)	5.55

SPECIAL CONDITIONS

1. The monthly percentage factor applies to all services provided under Tariff Schedule C-1, Facilities for Intrastate Access.

2. The monthly percentage factor applies to all recurring and nonrecurring rates and charges for service or equipment provided under all of the Utility's Tariff Schedules except the following:

   a. A-1 - Semipublic Message Rate - RATES 7.a.

   b. A-21 - Public Telephone Service - All

   c. A-38a - Surcharge to Fund Public Utilities Commission Reimbursement

   d. B-1 - Message Toll Telephone Service - Coin-Sent Paid

   e. L-2 - Cellular Radio Telephone Service - All

   f. C-1 - Facilities for Intrastate Access - All

SCHEDULE CAL. P.U.C. NO. A-38
BILLING ADJUSTMENT

SPECIAL CONDITIONS - Continued

3. The billing adjustment amount on each bill shall be designated "Billing Surcharge".

4. The monthly percentage factor applies to each customer's/carrier's bill for the total recurring and nonrecurring rates and charges except those items excluded under Special Conditions 1 and 2, above, exclusive of federal and local excise taxes.

APPENDIX B

GENERAL TELEPHONE COMPANY OF CALIFORNIA
AUTHORIZED CAPITAL RECOVERY RATES FOR T.Y. 1988

ACCOUNT NO. FCC	ACCOUNT NO. GTC	CLASS OF PLANT	AUTHORIZED CAPITAL RECOVERY RATE, %
212.0	121	BUILDINGS	3.58
221.1	201	COE ELECTRONIC TOLL SW.	6.94
221.2	202	COE MANUAL SW. EQUIP.	18.42
221.3	203	COE AUTOMATIC SW. SXS	38.13
221.4	204	COE MESSAGE RECORD. EQUIP.	13.87
221.5	205	COE CIRCUIT EQUIPMENT	9.79
221.6	206	COE RADIO EQUIPMENT	10.80
221.7	207	COE ELECTRONIC SW.- ANALOG	16.83
221.9	209	COE ELECTRONIC SW.- DIGITAL	5.94
231.1	401	TELEPHONE STATION APPAR.	14.27
231.2	404	TELETYPEWRITER EQUIPMENT	0.00
232.0	450	STA. COMM.- INSIDE WIRES	10.00
235.0	470	PUB. TELEPHONE EQUIP.	8.90
234.0	300	LARGE PRIV. BRANCH EXCH.	0.00
241.0	601	POLE LINES	4.96
242.1	602	AERIAL CABLE	5.51
242.2	603	UNDERGROUND CABLE	4.35
242.3	604	BURIED CABLE	5.14
242.4	605	SUBMARINE CABLE	4.00
243.0	606	AERIAL WIRE	10.83
244.0	607	UNDERGROUND CONDUIT	2.02
261.0	811	FURNITURE & OFFICE EQUIP.	12.90
262.1	320	COMPANY EQUIP.- LPBX	13.96
262.2	430	COMPANY EQUIP.- STA. APPAR.	13.61
262.3	434	COMPANY EQUIP.- TTY	8.85
262.4	437	COMPANY EQUIP.- RADIO	21.27
264.0	870	AMORTIZATION - MINOR TOOLS	20.00
264.1	821	MOTOR VEHICLES	8.30
264.2	831	MOTOR VEHICLE SHOP EQUIP.	5.29
264.3	841	TOOLS & OTHER WORK EQUIP.	4.64
264.4	842	TRAIL & OTHER MOBILE TLS	3.49

Decision PROPOSED DECISION OF ALJs JOHNSON AND TOMITA

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of General Telephone Company of California, a California corporation (U 1002 C), for authority to increase and/or restructure certain intrastate rates and charges for telephone services.	Application 87-01-002 (Filed January 5, 1987)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs separations practices, contracts, service and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a California Corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	I.87-02-025 (Filed February 11, 1987)

(See Decision 87-08-051 for appearances.)

Additional Appearances

Harold L. Jackson, Attorney at Law, and James B. Gordon, Jr., for Communications Workers of America; Robert T. Morris, for Consumers Coalition; Marc Titel, Mayor, for City of Lakewood; Whitaker McKenzie, Attorney at Law (D.C.), for the Department of Defense and Federal Executive Agencies; and Shelley Ilene Rosenfield, Assistant City Attorney, City of Los Angeles; interested parties.

INTERIM OPINION

I. Synopsis of Decision

This order sets a rate of return for General Telephone Company of California (General) during test year 1988 and adopts those revenue reductions for operational cost reductions that have been agreed to by General and the Commission's Public Staff Division (PSD). This order does not address the disputed reductions still at issue in the case; however, it does set enough of General's rates subject to refund to permit full-year 1988 implementation of any such reductions found appropriate in the Commission's final order in this case.

This is an interim decision. It provides for a decrease in customer billings of $109.0 million on an annual basis with an additional $534.7 million of total revenues subject to refund with interest.

The decrease reflects stipulated results of operation data and our adopted 1988 test year rate of return of 11.17%. The amount collected subject to refund is based on cost differentials between the estimated results of operation data presented by General and PSD as detailed on the following tabulations for General's total operations and its intrastate operations.

The decision authorizes General to earn a return on equity of 13.25% which will provide an intrastate rate of return of 11.17%. Such a return will provide an after-tax interest coverage of 2.99 times and a pre-tax coverage of 4.05 times. These ratios indicate that General will have the financial capability to operate successfully, maintain its financial integrity, and attract capital.

As set forth in the section on rate design, the $109 million reduction results from a reduction of the present billing surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 which are collected on a "bill and keep" basis not subject to intercompany settlement. The apportionment of any additional decreases will be determined subsequent to the final submission of this matter.

II. Procedural Background

General requests authority in this application to increase and/or restructure certain of its intrastate rates and charges. The effect of the proposed changes will be to reduce its test year revenue requirement by approximately $114 million to provide a rate of return of 11.90% on General's intrastate rate base.

To enlarge the scope of these proceedings to cover essentially all aspects of General's public utility operations, this Commission issued Order Instituting Investigation (I.) 87-02-025 into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, services, and facilities and Pacific Bell and all of the California telephone utilities that interconnect with General. In addition, we opened I.87-01-019 into the rate of return for General's 1987 attrition year. Decision (D.) 87-08-051 as corrected by D.87-09-001 dated September 1, 1987 on that matter reduced General's revenue requirement for 1987 by approximately $50,626,000.

After due notice, 85 days of hearing have been held before Administrative Law Judges (ALJ) N. R. Johnson, K. Tomita, or M. J. Galvin in Los Angeles, San Francisco, or at the public participation hearings throughout General's service territory. Additional days of hearing are to be scheduled in the near future.

The hearings on rate of return were held in San Francisco before ALJ Tomita and that phase of the matter was submitted permitting the issuance of this interim decision for a rate reduction.

The other phases of the matter will be briefed after the conclusion of the hearings and the final decision will issue subsequent thereto.

General presented 15 witnesses during its initial presentation and have a total of 32 rebuttal witnesses. PSD made its presentation through 35 witnesses, sponsoring 22 exhibits. In addition, testimony and exhibits were presented by Consumers Coalition of California on quality of service and rate design, by the Department of Defense and Federal Executive Agencies (FEA), and the City of Los Angeles (City) on rate of return, and by AT&T Communications of California (AT&T-C), API Alarm Systems (API), Western Burglar & Fire Alarm Association (Western), FEA, and Toward Utility Rate Normalization (TURN) on rate design.

Public participation hearings were held in Long Beach on June 15, 1987, in Santa Barbara on June 17, 1987, in San Fernando on June 18, 1987, in Santa Monica on June 19, 1987, in San Bernardino on June 22, 1987, in Palm Springs on June 23, 1987, in West Covina on June 24, 1987, and in Los Gatos on June 25, 1987. Statements and/or testimony were presented by 72 witnesses at these hearings. These statements covered a wide range of subject matters with the most frequent subject matters listed in order of descending frequency:

1. The 95¢ per month for "insurance" for inside wiring.
2. The "temporary" surcharge on monthly bills.
3. The physical size of the bill.
4. Zone Usage Measurement boundaries.
5. The quality of service.
6. Rate increase for residential customers in face of over-all decrease in revenues.
7. Directory assistance charges.
8. The monthly access charge.

9. The surcharge for handicapped equipment.

10. Pay phone availability and operational condition.

11. The number and cost of phone books.

12. The monthly charge for unlisted numbers.

13. The charge for the installation of equipment.

14. The 13-second time limit for dialing.

The individual service complaints were investigated and a summary of each investigation was included in an exhibit to be entered into evidence during the hearings.

III. General's Present Operations

General is the largest independent (non-Bell) operating telephone company in the United States and a member of the General Telephone and Electronics Corporation (GTE) system. GTE, General's parent company, holds all of the common but none of the preferred stock of General. GTE which was incorporated under the laws of the State of New York on February 25, 1935 is the parent company of more than 60 communications, products, research, and service subsidiaries with operations in 40 states and 19 countries abroad. The GTE system had combined revenues and sales of over $15.7 billion in 1985, consolidated net income from operations of a negative $161.0 million, including a nonrecurring after-tax charge of $1.3 billion (excluding this charge, the 1985 net income amounted to $1,131 million), 180,000 employees, and more than 475,000 shareowners.

General had an average of 25,903 equivalent employees in 1985. Wage payments applicable to operations in 1985 amounted to $766,152,085 of which $167,880,944 or 21.9% was charged to construction.

General operates within approximately 10,600 square miles serving approximately 330 communities and locations in portions of 20 California counties: Fresno, Imperial, Kern, Los Angeles, Marin, Orange, Riverside, Sacramento, San Bernardino, San Diego, San Joaquin, San Luis Obispo, Santa Barbara, Santa Clara, Santa Cruz, Solano, Sonoma, Tulare, Ventura, and Yolo. At the close of 1985, General operated 182 central offices in 86 exchanges. Customer lines totaled 2,689,746, of which 2,016,681 or 75% were residential and 673,065 or 25% were business.

IV. Rate of Return

Introduction

The rate of return phase of Application 87-01-002 was assigned to ALJ Tomita and all other issues to ALJ Johnson. Five days of hearings were held on rate of return issues between August 20 and 26, 1987. General, City, FEA, and PSD were the active participants in this phase of the proceeding.

At the conclusion of the hearings, the rate of return phase was taken under submission subject to the filing of concurrent briefs on September 30, 1987. Briefs were filed by General, City, and PSD.

General's Position

1. Capital Structure and Cost of Debt

General and PSD are recommending capital structures for the 1988 test year that are substantially the same. A summary of rates of return recommended by General, City, and PSD for test year 1988 follows.

Capital Structure	Avg. 1988 Cap. Ratios	Cost Factors	Weighted Cost
General Telephone Company of California			
Long-term debt	41.20%	9.01	3.71%
Short-term debt	2.47	8.00	0.20
Preferred stock	2.77	6.42	0.18
Common equity	53.56	14.50	7.77
Totals	100.00%		11.86%
Public Staff Division			
Long-term debt	41.50%	8.98	3.73%
Short-term debt	2.50	6.50	0.16
Preferred stock	2.50	6.41	0.16
Common stock	53.50	12-12.50	6.42 - 6.69
Totals	100.00%		10.47 - 10.74%
City of Los Angeles			
Long-term debt	41.70%	8.986	3.747%
Short-term debt	2.50	7.000	0.175
Preferred stock	2.80	6.414	0.180
Common stock	53.00	12.500	6.625
Totals	100.00%		10.727%

The above tabulation shows that there is little difference in the capital ratios and capital costs considered reasonable by General, City, and PSD except for the cost of short-term debt and return on common equity. General as well as the other parties requested that the Commission consider the actual cost of General's long-term debt offering in 1987, if available at decision time, plus the general trend of bond and short-term debt rates in existence at that time in determining the reasonable long-term debt and short-term debt rate to adopt for test year 1988. The only difference in long-term debt cost resulted from the fact that General estimated a 10% interest rate on new debt issues while

PSD and City both used a 9.5% interest rate. For short-term debt cost General used an 8% cost for the test year, while PSD used a 6.5% interest rate and City a 7% interest rate.

2. Return on Equity

The principal area of dispute on rate of return revolves around the reasonable return on common equity (ROE) to be allowed. General requests that the Commission adopt a ROE of 14.5% for the 1988 test year. General states that this is 100 basis points less than the 15.5% ROE adopted in D.84-07-108 for its 1984 test year. It is, however, higher than the 13.75% ROE adopted by the Commission in D.87-08-051 for General's 1987 attrition year in I.87-01-019. General argues that the dramatic increase in interest rates that has occurred since the record was closed in I.87-01-019 supports an increase in General's ROE from the 13.75% authorized for 1987 to the 14.5% requested for test year 1988.

Joseph F. Brennan, President of Associated Utility Services, was General's ROE witness. He testified that the Commission should approve an ROE of at least 14%, and that an ROE of up to 14.5% would also be reasonable. Mr. Brennan gave consideration to the Discounted Cash Flow (DCF) model and the risk premium model as tools in arriving at what he believes investors require in the way of a return on their common equity investments. The witness testified that the results derived from the financial models should not be applied dogmatically but with the exercise of judgment to give consideration to the financial differences between General and the proxy group of companies used in the analysis.

Since General's common stock is not publicly traded, being a wholly owned subsidiary of GTE, it is not possible to obtain specific market information regarding General to determine the return to which investors in General's common stock are entitled. It was therefore necessary for Mr. Brennan as well as the other rate of return witnesses to use a proxy group of companies in undertaking their respective analyses.

Mr. Brennan selected 18 companies for use in his DCF analysis. The list includes three Independent Telephone Companies (Independents), seven Regional Holding Companies (RHC) (formerly AT&T subsidiaries), and eight gas distribution companies (GDC). Mr. Brennan included the GDCs in his study because of the limited number of telecommunications companies that are comparable to General and which have stock that is publicly traded, and also because the gas distribution industry is undergoing a transformation from a monopoly to a competitive environment, not unlike the telephone industry.

Brennan testified that in order to offset its increased business risk, General, like other telecommunications companies in his study increased the amount of common equity in its capital structure. While the percentage of equity in General's capital structure for 1988 is still significantly below the levels achieved by the RHCs and the three Independents in 1986, General has closed the gap.

Brennan stated that the greater investment risk associated with a telecommunications company or a GDC is reflected in the bond rating criteria published by Standard & Poors (S&P). According to the witness the two most important rating criteria used by S&P are the debt ratio and pre-tax times interest coverage. The pre-tax coverage for an AA rated telephone utility is 4.5 to 6.5 times while the range for electrics is substantially lower at 3.5 to 5.0 times. These criteria differences indicate the telephone industry is considered to be substantially more risky than electric utilities by the investment community.

Brennan testified with respect to the DCF model that it is a technique which utilizes the market price, reported earnings per share and dividend payments per share in a calculation to determine the implicit return required by the investor, which is reflected in the market price of the stock. Brennan considers the DCF model as a useful tool to help the analyst come to an informed judgment. He further stated that for the past several years the DCF model seriously understates investor expected returns because factors other than earnings and dividend growth have influenced stock prices and are not considered in a DCF model. Factors that have impacted stock prices include mergers and acquisitions, the tremendous influx of foreign capital into the United States security market, and the change in investor expectations regarding increases in the price/earnings multiples of stocks which are not covered in the DCF analysis and thereby understate the investor-expected returns.

After completing his DCF study for each of his barometer companies, Mr. Brennan developed a DCF-derived ROE for each of the three utility categories within his barometer group. For the three Independents, the DCF cost rate was 12.4%; for the seven RHCs, the DCF cost rate was 12.2%; and for the eight GDC's, the DCF cost rate was 13%.

In addition to the DCF analysis Mr. Brennan made a risk premium analysis. The risk premium model is based on the fundamental principle of finance that equity investors expect a higher return on their investments than purchases of long-term debt. Brennan determined his equity risk premium by comparing equity returns over the yields of long-term utility bonds. He selected long-term bond yields because the DCF methodology also determines the expected return based on the assumption of an infinite holding period. This would make a comparison of equity yields under the risk premium analysis more appropriate to compare with a DCF-derived ROE. Brennan testified that a risk premium analysis based on a comparison of equity yields with the yields on intermediate or short-term debt would result in an inappropriate comparison with a DCF-derived ROE.

Brennan concluded that based on his review of the historical data that the appropriate risk premium for determining General's investor-required ROE is 4.7% when AAA and AA bonds yields are in the 9.0 to 9.5% range. He further testified that the risk premium spreads moves inversely with interest rates and that when interest rates for AA bonds yielded 12.6%, the equity risk premium is 4.0%.

The investor-expected ROEs for the three categories of utilities in Mr. Brennan's barometer group, giving equal weight to the results of his DCF and risk premium analyses, are 13.1% for the the three Independents, 13.2% for the seven RHCs, and 13.6% for the eight GDCs. Brennan then took the additional step to review the investment risk differences between General and the barometer group. He noted that General is rated as a weak AA by both Moody's and S&P while the seven RHCs and three Independents are on the average rated strong AA, and that over the five-year period ending in 1985, one investment grade differential equates to a debt cost difference of approximately 60 basis points. He further testified that each percentage point difference in the equity component of a utility's capital structure equates to a 10 basis point difference in the cost of debt. He further noted that General's average equity ratio of 53.5% was substantially below the average of the seven RHCs or the three Independents.

In recognition of these differences, Mr. Brennan increased the ROE derived from the average of his DCF and risk premium analyses by 70 basis points to arrive at his minimum investor-required ROE of 14%. Brennan further testified that the cost rate could even be 14.5% if less than equal weight is given to his DCF analysis for reasons stated above. General argues that Mr. Brennan's recommended ROE is consistent with recent decisions by other regulatory commissions. General believes Mr. Brennan's recommended cost of equity of at least 14% is very conservative and that a 14.5% return is more representative of today's market conditions.

General's Treasurer, Charles O'Rourke, testified on the projected capital structure for test year 1988, 1989, and 1990 and the projected cost of long-term debt and preferred stock for 1988, 1989, and 1990. He also estimated the cost of short-term debt for 1988. He also testified that the overall rate of return on rate base of 11.86% requested for test year 1988 using a 14.5% cost of common equity assumes that General will be afforded the opportunity to seek relief for financial attrition in 1989 and 1990.

PSD's Position

PSD is recommending a cost of common equity capital in the range of 12.00% to 12.50%. Using PSD's recommended capital structure and costs of long-term debt, short-term debt, and preferred stock, the recommended rate of return ranges between 10.47% to 10.74% for test year 1988, and is 10.60% using the midpoint 12.25% return on common equity recommended by PSD. Such rate of return produces an after-tax times interest coverage of 2.85 times for 1988, excluding short-term debt. PSD believes a rate of return within its recommended range will enable General to earn a fair return and balance the interest of General's investors and ratepayers.

PSD witness C.J. Blunt was responsible for the Report on the Cost of Capital and Rate of Return. Witness Blunt presented his estimate of recommended capital structures for the three-year test period 1988-1990. The witness stated that although PSD has made capital structure and capital cost recommendations for 1989 and 1990, he recommends that these should be updated with Attrition Rate Adjustment (ARA) mechanism reviews in 1989 and 1990. These ARA reviews were mandated by D.85-12-076, and were further refined by D.86-12-099 according to the witness.

PSD's witness testified that he was guided by the standards set forth by the U. S. Supreme Court decisions in the Bluefield and Hope cases in determining a fair and reasonable return on common equity. The two standards which emerged from the two cases are: (1) a standard of capital attraction and (2) a standard of comparable earnings. The capital attraction standard focuses on investors' return requirements and is applied using market value methods in the DCF, capital asset pricing model (CAPM), and risk premium analyses. The comparable earnings standard uses the return earned on the equity investment by companies of comparable risks as a measure in setting a fair return.

PSD's witness selected 22 telecommunications and gas distribution companies which he considered encountered similar business risks to General and used this group as a surrogate for a common stock equity investment in General. On the basis of financial risk, the witness selected telecommunications and gas distribution companies with similar bond ratings and comparable betas. The four independent telecommunications companies and the seven RHCs were selected because they are engaged in similar business pursuits as General and are regulated or have subsidiaries that are regulated. The gas distribution companies were selected because they are experiencing similar business risks (due to deregulation) as the telecommunications industry.

The witness compared General's recorded earnings on common equity with that of his 22 comparison companies for the period 1982 through 1986 and concluded that General's earnings have exceeded the group in every year, except 1984, with a five-year average of 15.77%. He further noted that General's return on total capital and dividend payout ratio was higher than his comparison group. Furthermore, General has increased its common equity ratio substantially more than his comparison group. PSD's witness stated that the above facts demonstrate a highly improved financial picture for General which is supported by the upgrading of General's bond ratings by both Moody's and S&P to Aa3 and AA- respectively in December 1986. In addition, the fact that General's major construction programs are nearing completion thereby reducing the need for future external financing there were other factors given which reduces General's financial risks and justifies reducing the authorized return on common equity.

PSD's DCF analysis indicated a 11.98% to 12.17% cost of common equity for the test period depending on whether an April 1987 or a three-month average dividend yield rate is used. In addition PSD's witness performed a risk premium analysis and a CAPM analysis to assist him in developing his recommended cost of common equity. The risk premium analysis produced a required return on common equity for the test period of 12.43% to 12.76% depending on the type of security used. The CAPM analysis indicated that the investors expected return on common equity for the comparison group ranges from 11.97% to 12.31% depending on whether the DRI or Blue Chip Financial's forecast for three-month Treasury Bills are used. PSD's recommended ROE range of 12.00% to 12.50% is based primarily upon the DCF analysis. PSD recommends that the Commission adopt its recommended capital structure for 1988, a cost of long-term debt of 8.98%, short-term debt cost of 6.50%, an embedded cost of preferred stock of 6.41%, and a cost of common equity in the range of 12.0% to 12.5%. The resulting overall rate of return for General would be in the range of 10.47% and 10.74% for test year 1988.

<u>City of Los Angeles' (City) Position</u>

City contends that General's requested return on common equity of 14.50% and an overall rate of return of 11.86% are excessively high, particularly in light of the significant decrease in the cost of money since General's last general rate case in 1984. D.84-07-108 adopted a 12.74% rate of return with an allowance for common equity of 15.50% as reasonable. The City states that the Commission recognized this striking decrease in the cost of money in D.87-08-051 by adopting a lower rate of return of 11.36% with a 13.75% return on common equity capital as reasonable for General for attrition year 1987.

City's rate of return witness, M. Kroman, testified that he found the use of the DCF, risk premium, and other formula methodologies for determining the investor required return on equity unsatisfactory. He stated that the outcome achieved by using these methodologies is largely dependent on the assumptions of the person who uses these tools in arriving at his results. He further testified that it is impossible to estimate an investor's expectations or requirements.

Witness Kroman used a differential cost of money analysis in arriving at his recommended return on common equity and return on rate base. Under this methodology, the witness used as a benchmark the last authorized return on common equity found reasonable by the Commission in 1984 in D.84-07-108 and determined that based on his study (Exhibit 198, Tables 14 through 19) a 300 basis point decline in the cost of money was fairly representative. He recommends that a fair rate of return on common equity would be 15.50% less 3.00% or 12.50%. He further noted that the 12.50% return was conservative since General's common equity ratio has increased by nearly 10 percentage points since D. 84-07-108. He further testified that a comparable earnings analysis, including electric utilities, strongly suggests that a return on common equity in the mid 12% area would be appropriate for General.

Mr. Kroman used General's estimated capital structure, substituted a 9.5% cost for new long-term debt issues in place of General's 10% estimate, used a 7% cost for short-term debt for 1988, and substituted his recommended 12.5% return on common equity in arriving at his recommended rate of return of 10.727%. He concludes that this rate of return will produce a pre-tax interest coverage of 3.63 times, which should provide the basis for a solid investment grade bond rating.

The witness further testified that General's argument that it should be granted earnings sufficiently high to move it toward a double A bond rating should be rejected since the cost to ratepayers is much higher than the benefits to be derived from lower interest costs resulting from the higher bond ratings. He stated that utilities in general carry a single A bond rating and, absent extraordinary circumstances, have demonstrated no disability in raising new capital at market rates. In Exhibit 198, Table 2, the witness set forth hypothetical examples to show the cost of increasing a utility's bond ratings from A to AA.

Federal Executive Agencies (FEA)

FEA did not make a specific rate of return recommendation in this proceeding. FEA's witness, Dr. Charles A. McCormick, testified that General's rate of return witnesses failed to give recognition to the decline in capital costs during 1986 and the first quarter of 1987 or make any adjustments to its equity costs to reflect these trends. He stated that increasing General's equity ratio to increase its bond ratings must be placed in proper perspective and given the current economic conditions and nothing to reflect a return to the disastrous economic conditions of the early 1980's, an increase in the equity ratio is not justified. He further testified that General's witness, Mr. Brennan, has failed to justify the 0.6 to 0.7% adjustment he made to the estimated cost of common equity of 13.1%-13.2% for the comparable group of telephone companies to generate his 14.0% cost of common equity for General.

Discussion

1. Capital Structure

Although PSD recommends that both the capital structure and capital costs should be updated in conjunction with ARA reviews for the 1989 and 1990 attrition years, Ordering Paragraph 9 of D.87-04-078, dated April 22, 1987, an order modifying D.86-12-099 and denying rehearing, states:

> "9. Finding of Fact No. 5 is modified to read:
>
> "5. Based on D.86-01-026 (See Finding of Fact 3) and our present policy of considering revision of the Return on

> Equity (ROE) and capital structure of California's two major local exchange telephone utilities every three years, we decline to review PacBell's ROE for 1987, but we will review PacBell's embedded debt costs and monitor PacBell's capital structure, consistent with the discussion on page 6 of this opinion."

The above ordering paragraph indicates that we have adopted a policy of considering revision of the ROE and capital structure for the two major local exchange telephone utilities every three years. The evidence in this record indicates that there is very little difference in the estimate of capital structure among the parties for test year 1988 and attrition years 1989 and 1990. However, events occurring in the financial markets in October indicates that we should reconsider our plan and have General's capital structure, interest costs, ROE, and financing plans reviewed in the attrition years. We will require a review of these items in the ARA reviews for 1989 and 1990.

Assuming that we proceed with our full review of our regulatory process (following from our September 24 and 25, 1987 en banc hearings and Commissioner Wilk's October 28, 1987 Commissioner's Report proposing an OII) we will reconsider whether or how to use an attrition mechanism for local exchange telephone utilities. This order should not be construed as prejudging the results of such an investigation. The entire attrition process, including those parameters laid out for General in this decision, may be altered fundamentally by the upcoming OII.

Since we will be updating the capital structure in each of the attrition years, we will only adopt a capital structure for the test year in this order. As stated previously, there is little difference in the estimated capital structures between the parties. For the purposes of this proceeding we will adopt as reasonable the PSD recommended capital structure for test year 1988, as follows:

"9. Finding of Fact No. 5 is modified to read:

"5. Based on D.86-01-026 (See Finding of Fact 3) and our present policy of considering revision of the Return on Equity (ROE) and capital structure of California's two major local exchange telephone utilities every three years, we decline to review PacBell's ROE for 1987, but we will review PacBell's embedded debt costs and monitor PacBell's capital structure, consistent with the discussion on page 6 of this opinion."

The above ordering paragraph indicates that we have adopted a policy of considering revision of the ROE and capital structure for the two major local exchange telephone utilities every three years. The evidence in this record indicates that there is very little difference in the estimate of capital structure among the parties for test year 1988 and attrition years 1989 and 1990. However, events occurring in the financial markets in October indicates that we should reconsider our plan and have General's capital structure, interest costs, ROE, and financing plans reviewed in the attrition years. We will require a review of these items in the ARA reviews for 1989 and 1990.

Assuming that we proceed with our full review of our regulatory process (following from our September 24 and 25, 1987 en banc hearings and Commissioner Wilk's October 28, 1987 Commissioner's Report, and the institution of I.87-10-033 into rate flexibility for local exchange carriers), we will reconsider whether or how to use an attrition mechanism for local exchange telephone utilities. This order should not be construed as prejudging the results of our investigation. The entire attrition process, including those parameters laid out for General in this decision, may be altered fundamentally by I.87-11-033.

Since we will be updating the capital structure in each of the attrition years, we will only adopt a capital structure for the test year in this order. As stated previously, there is little

Components	1988
Long-Term Debt	41.50%
Short-Term Debt	2.50
Preferred Stock	2.50
Common Stock Equity	53.50
Total	100.00%

2. Debt Costs and Preferred Stock Costs

Although there was little difference in the estimated cost of long-term debt between General and PSD, there was disagreement as to the cost of new long-term and short-term debt. The parties were in agreement that the Commission should consider the current and forecasted interest rates at the time of making its decision in this matter. Our review of current interest rates and forecasted interest rates indicates that the cost of both long-term and short-term interest rates have climbed since the time the parties prepared their respective exhibits; also, we again note the uncertainty created by the recent stock market upheavals in October 1987. Giving due consideration to the various positions in the record, we will adopt as reasonable a 10% interest rate for both the 1987 and 1988 forecasted long-term debt issues and a 9.01% cost of long-term debt for 1988. We will adopt as reasonable a 7% cost rate for short-term debt for test year 1988.

In the ARA financial attrition review, we will require General to use the embedded cost of debt plus the interest rate on long-term AA utility bonds forecasted by DRI in September for any long-term bonds to be issued in the attrition year and the Blue Chip Financial Forecasts consensus one-month commercial paper projection as of October 1 for the attrition year short-term debt cost. While we have considered but not directly adopted the most recent forecasts in arriving at our estimated cost of long- and short-term debt, the use of these popularly used forecasts will eliminate any controversy on the interest rates to be used for the attrition years.

General does not propose any new preferred stock issues in the test or attrition years. We will adopt as reasonable a 6.41% preferred stock cost rate for test year 1988. The gradual redemption of the highest cost preferred stock issues outstanding results in the declining preferred stock cost rate.

3. Cost of Common Stock Equity

The recommended ROEs range from 12%, the bottom of PSD's range to 14.50% requested by General. City's 12.50% ROE is also the top of PSD's recommended range of ROE. Both PSD and General rely on the DCF and risk premium methodologies to support their respective recommended returns on equity. However, PSD places greater emphasis on DCF than General since PSD uses the risk premium analysis and also the CAPM analysis as a test of the reasonableness of the DCF analysis. General's witness, on the other hand, averages the results of the DCF and risk premium analyses as his starting point before applying his adjustment for differences between General and his proxy group of companies. The following is a summary of the results of the various models:

ROE Model Results

Party	Model	ROE
General	DCF	11.1-13.1% Ind. Telcos 12.4% avg Ind. Telcos 11.8-12.7% RHCs 12.2% avg RHCs 12.0-14.8% GDCs 13.0% avg GDCs
	Risk Premium	13.7% Ind. Telcos 14.2% RHCs 14.2% GDCs
PSD	DCF	10.29-13.80% 12.08% avg
	Risk Premium	12.43-12.76% 12.54% avg
	CAPM	11.97-12.31% 12.14% avg
City	Differential Cost of Money Analysis	12.50%

The use of different assumptions made as to investor's currently expected dividend yield rates and investor's expected growth rates in the respective DCF analyses provided different investor expected cost of common equity rates for the test period. Because the results can vary depending on these subjective inputs, we have stated in the past that we have always relied more on judgment than on any singular formula approach to establish the reasonable return on common equity. The exercise of such judgment involves forecasts of overall economic conditions, range of returns earned by comparable companies, and an assessment of the relative risk inherent with the particular utility under consideration.

In the case of General where it is not possible to calculate a company-specific market related cost rate for General's common equity it is even more critical to exercise judgment rather than rely on any formula approach. While the money market derived cost of equity based on a proxy or group of companies may be useful as a guide it cannot be directly used in determining a reasonable cost of equity for ratemaking purposes. Judgment must be exercised to consider all the various factors which may differentiate the specific company from the proxy or group of companies being used in the study. Moreover, judgment must be exercised in using the results of a formula because the formulas may fail to take into consideration various factors that may influence the investor required return on common equity.

As recognized in D.87-08-051 in I.87-01-019, an investigation on the appropriate rate of return for attrition year 1987, there has been a substantial reduction in interest rates since the last general rate case. However, there has been a reversal of this trend in declining interest rates in the past few months. We note that the parties recognized that the level of interest rates could change and recommended that the Commission should take into consideration the actual debt costs incurred by General in 1987, and the trends in capital costs at the time it issues its decision. In arriving at our adopted ROE we will take into consideration the change in money market rates from the time the parties prepared their respective rate of return studies.

We believe that inflation during the three-year period will be in the 4% range and that interest rates while higher than the levels experienced in 1986 and early 1987 will tend to fluctuate around the current levels.

After consideration of all the evidence in this proceeding and the arguments advanced by the various parties, we adopt as reasonable a return on common equity of 13.25% for test year 1988. This is below the return on equity we found reasonable for General for test year 1987 in D.87-08-051 in August 1987. We note that this figure is higher than the average results from the various DCF models although within the high range of the companies studied. We also note that the result of the PSD's risk premium analysis as well as the average result of PSD's CAPM analysis are below the adopted figure. On the other hand, General's risk premium analysis shows a higher cost rate. The variations in the results obtained from these models clearly indicate that these models should be used as a guide and that we must rely on judgment rather than any particular methodology in determining the cost of common equity. In the case of General it becomes even more critical, since a company-specific market related cost rate can not be calculated and a proxy group of companies must be used to determine the market required cost of common equity for General.

Although it was originally our plan to review capital structure and ROE for the major local exchange telephone companies once every three years, we now believe that an annual review is necessary under the current turbulent financial market conditions. We believe a 13.25% ROE is reasonable for test year 1988. The 13.25% return on common equity applied to our previously adopted capital structure and costs translates to a rate of return 11.17% developed as follows:

Item	Capital Structure	Cost Factor	Weighted Cost
Long-term debt	41.5%	9.01%	3.74%
Short-term debt	2.5	7.00	.18
Preferred stock	2.5	6.41	.16
Common equity	53.50	13.25	7.09
Total	100.00%		11.17%

The after-tax coverage of the above 11.17% rate of return is 2.99 times and the pre-tax coverage is approximately 4.05 times excluding short-term debt. Such a return is fair and reasonable and balances the interests of both the investors and ratepayers and is comparable to returns earned by other investments of comparable risks.

V. Results of Operation

Comprehensive results of operations testimony and exhibits were presented by General and PSD. Substantial differences exist in all categories, i.e. revenues, expenses, and rate base. On October 20, 1987, General presented Exhibit 231 setting forth its updated estimates reflecting the impact of the 1987 attrition decision, D.87-08-051 dated August 26, 1987, inside wire on a business-as-usual basis, revisions made to date, and federal income tax calculated assuming a 34% tax rate and new definition of FIT income adjustments. Also included were Uniform System of Accounts (USOA) changes reflecting the capital to expense shift in Part 32 on the basis of its understanding that a rate recovery mechanism would not be included in the USOA proceeding I.87-02-023. At this juncture, the contents of a decision on this matter is pure speculation. Consequently we will eliminate the effects of this adjustment in General's showing. The following tabulations set forth General's latest showing without the USOA adjustment, together with PSD's results of operations as presented by its witness' exhibits and testimony on both total company and intrastate bases. For the purposes of this interim decision, we will use General's showing for the computation of the revenue reduction to yield a 11.17% rate of return. The difference between the revenue reduction derived from General's figures of $109.0 million and the revenue reduction derived from PSD's showing of $643.7 million or $534.7 million will be subject to refund plus interest, pending our final resolution of the differences.

is comparable to returns earned by other investments of comparable risks.

V. Results of Operation

Comprehensive results of operations testimony and exhibits were presented by General and DRA. Substantial differences exist in all categories, i.e. revenues, expenses, and rate base. On October 20, 1987, General presented Exhibit 231 setting forth its updated estimates reflecting the impact of the 1987 attrition decision, D.87-08-051 dated August 26, 1987, inside wire on a business-as-usual basis, revisions made to date, and federal income tax calculated assuming a 34% tax rate and new definition of FIT income adjustments. Also included were Uniform System of Accounts (USOA) changes reflecting the capital to expense shift in Part 32 on the basis of its understanding that a rate recovery mechanism would not be included in the USOA proceeding I.87-02-023. At this juncture, the contents of a decision on this matter is pure speculation. Consequently we will eliminate the effects of this adjustment in General's showing. The following tabulations set forth General's latest showing without the USOA adjustment, together with DRA's results of operations as presented by its witness' exhibits and testimony on both total company and intrastate bases. For the purposes of this interim decision, we will use General's showing for the computation of the revenue reduction to yield a 10.90% rate of return. The difference between the revenue reduction of $122.7 million and the total revenue reduction of $657.2 at issue or $534.5 million will not be made subject to refund pending our final resolution of the differences which we expect to complete in the first half of 1988. This will further reduce the risk that General will face in 1988, a reduction which is reflected in our adopted return on equity.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Intrastate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	PSD*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Operating Revenues:				
Local Revenues	$ 776,370	$ 772,308	$ (4,062)	(0.52)
Toll Service	874,331	814,847	(59,484)	(6.80)
Access Revenues	273,146	233,482	(39,664)	(14.52)
Miscellaneous Rev.	282,311	244,855	(37,456)	(13.27)
Surcharge	202,202	186,274	(15,928)	(7.88)
1987 Attrition	(54,450)	(52,978)	1,472	(2.70)
Less Uncollectibles	18,950	23,168	4,218	22.26
Total	2,334,960	2,175,620	(159,340)	(6.82)
Operating Expenses				
Maintenance	310,667	382,898	72,231	23.25
Traffic	55,902	66,550	10,648	19.05
Commercial	204,032	228,087	24,055	11.79
Gen. Off. Sal. & Exp.	150,776	166,494	15,718	10.42
Other Oper. Exp.	134,546	164,336	29,790	22.14
Subtotal	855,923	1,008,365	152,442	17.81
Depreciation	404,347	440,979	36,632	9.06
Taxes Other than Inc.	70,522	89,899	19,377	27.48
State Income Tax	79,168	54,851	(24,317)	(30.72)
Federal Income Tax	252,942	149,030	(103,912)	(41.08)
Total	1,662,903	1,743,124	80,221	4.82
Net Oper. Income	672,057	432,496	(239,561)	(35.65)
Adj. to Net Income				
Gain on Sale of Prop.	5,898	-	(5,898)	(100.00)
GTE Telecom Adj.	1,123	-	(1,123)	(100.00)
Calif. Corp. Fr. Tax	-	(2,435)	(2,435)	
Communications Systems	-	704	704	
GTE Directories	5,430	4,021	(1,409)	(25.95)
GTE Data Service	6,479	-	(6,479)	(100.00)
GTEL Adjustment	10,846	-	(10,846)	(100.00)
Compensation Levels	26,097	-	(26,097)	(100.00)
Total Adjustments	55,873	2,290	(53,583)	(95.90)
Adjusted Net Income	727,930	434,786	(293,144)	(40.27)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact PSD revenue requirement.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Intrastate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	DRA*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Adj. Net Oper. Income	$ 727,930	$ 434,786	$(293,144)	(40.27)%
Rate Base				
100.1 Telephone Plant	4,902,633	5,418,720	516,087	10.53
100.2 Tel. Plant Under Construction	-	-	-	-
100.3 Property Held for Future Use	62	62	-	-
Materials & Supplies	12,738	18,888	6,150	48.28
Working Cash Allowance	14,534	3,862	(10,672)	(73.43)
Less: Deprec. Reserve	1,595,425	1,630,960	35,535	2.23
Less: Deferred Taxes	513,322	545,834	32,512	6.33
Total Rate Base	2,821,220	3,264,738	443,518	15.72
Adj. to Rate Base Communication Sys.	(2,686)	(2,686)	0	0.00
Net Adj. Rate Base	2,818,534	3,262,052	443,518	15.74
Rate of Return				
ROR - Present Rates	25.85	13.33		
ROR - Authorized	10.90	10.90		
Difference	-14.95	-2.43		
REVENUE REQUIREMENT Difference x Rate Base x N/G	(657,170)	(122,691)		

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA/SPF to SLU which will impact DRA revenue requirement.

Net-to Gross Calculation

	1.00000
Uncollectible rate	0.00215
Difference	0.99785
CCFT @ an incremental rate of 0.018993	0.018952
Difference	0.97890
FIT @ 34%	0.33283
Difference	0.64607
Net-to-Gross Multiplier	1.54781

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Intrastate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	PSD*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Adj. Net Oper. Income	$ 727,930	$ 434,786	$(293,144)	(40.27)
Rate Base				
100.1 Telephone Plant	4,902,633	5,418,720	516,087	10.53
100.2 Tel. Plant Under Construction	-	-	-	-
100.3 Property Held for Future Use	62	62	-	-
Materials & Supplies	12,738	18,888	6,150	48.28
Working Cash Allowance	14,534	3,862	(10,672)	(73.43)
Less: Deprec. Reserve	1,595,425	1,630,960	35,535	2.23
Less: Deferred Taxes	513,322	545,834	32,512	6.33
Total Rate Base	2,821,220	3,264,738	443,518	15.72
Adj. to Rate Base Communication Sys.	-	(2,686)	(2,686)	
Net Adj. Rate Base	2,821,220	3,262,052	440,832	15.63
Rate of Return				
ROR - Present Rates	25.80	13.33		
ROR - Authorized	11.17	11.17		
Difference	14.63	2.16		
REVENUE REQUIREMENT Difference x Rate Base x N/G	(643,716)	(109,058)		

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact PSD revenue requirement.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Company Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	PSD*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Operating Revenues:				
Local Revenues	$ 776,370	$ 772,308	$ (4,062)	(0.52)
Toll Service	874,331	814,847	(59,484)	(6.80)
Access Revenues	753,571	713,907	(39,664)	(5.26)
Miscellaneous Rev.	306,130	268,674	(37,456)	(12.24)
Surcharge	202,202	186,274	(15,928)	(7.88)
1987 Attrition	(54,450)	(52,978)	1,472	(2.70)
Less Uncollectibles	20,150	24,368	4,218	20.93
Total	2,838,004	2,678,664	(159,340)	(5.61)
Operating Expenses				
Maintenance	397,893	491,676	93,783	23.57
Traffic	62,632	74,563	11,931	19.05
Commercial	242,686	275,725	33,039	13.61
Gen. Off. Sal. & Exp.	178,640	197,636	18,996	10.63
Other Oper. Exp.	164,974	200,560	35,586	21.57
Subtotal	1,046,825	1,240,160	193,335	18.47
Depreciation	496,133	539,288	43,155	8.70
Taxes Other than Inc.	88,964	113,506	24,542	27.59
State Income Tax	94,562	65,342	(29,220)	(30.90)
Federal Income Tax	296,489	182,473	(114,016)	(38.46)
Total	2,022,974	2,140,769	117,795	5.82
Net Oper. Income	815,030	537,895	(277,135)	(34.00)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact PSD revenue requirement.

GENERAL TELEPHONE COMPANY OF CALIFORNIA
Total Interstate Summary of Earnings at Present Rates
Test Year 1988
(Thousand of Dollars)

Item	PSD*	General	General Exceeds Staff Amount	General Exceeds Staff Percent
Net Operating Income	$ 815,030	$ 537,895	$(277,135)	(34.00)
Adjustments to Net Inc.				
Gain on Sale of Property	6,396	-	(6,396)	100.00
GTE Telecom Adj.	1,218	-	(1,218)	100.00
Calif. Corp. Fr. Tax	-	(2,802)	(2,802)	
Communications Systems	-	865	865	
GTE Directories	5,579	4,131	(1,448)	(25.95)
GTE Data Service	6,656	-	(6,656)	(100.00)
GTEL Adjustment	11,143	-	(11,143)	(100.00)
Compensation Levels	31,917	-	(31,917)	(100.00)
Total Adj. to Income	62,909	2,194	(60,715)	(96.51)
Adj. Net Oper. Income	877,939	540,089	(337,850)	(38.48)
Rate Base				
100.1 Telephone Plant	6,199,312	6,832,892	633,580	10.22
100.2 Tel. Plant Under Construction	-	48,112	48,112	
100.3 Property Held for Future Use	79	79	-	-
Materials & Supplies	16,874	25,021	8,147	48.28
Working Cash Allowance	17,775	4,726	(13,049)	(73.41)
Less: Deprec. Reserve	2,013,214	2,051,951	38,737	1.92
Less: Deferred Taxes	649,306	695,140	45,834	7.06
Total Rate Base	3,571,520	4,163,739	592,219	16.58
Adj. to Rate Base Communication Sys.	-	(3,416)	(3,416)	
Net Adj. Rate Base	3,571,520	4,160,323	588,803	16.49
Rate of Return	24.58	12.98%	(11.60)	(47.19)

(Red Figure)

*Does not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact PSD revenue requirement.

VI. Rate Design

As previously stated, testimony and exhibits on rate design were submitted by General, PSD, AT&T, API, Western, FEA, and TURN. PSD submitted proposed rate designs reflecting revenue reductions of $115, $250, $500, and $750 million and General submitted proposed rate designs reflecting revenue reductions of $115, $250, and $500 million. The final rates will be forthcoming in our final decision after this matter has been briefed and submitted and the final revenue requirement determined. For this interim decision, our adopted revenue reduction of $109.0 million will be derived from a reduction in the billing surcharges set forth in General's Schedule Cal. P.U.C. No. A-38. D.87-08-051 as corrected by D.87-09-001 indicated that effective January 1, 1988, the surcharge should be 5.47% for access services and 8.74% for other than access services. A reduction of 6.03% to the above surcharges, or a negative 0.56% for access services and a positive 2.71% for other than access services, will yield approximately the $109.0 million reduction adopted for this interim decision.

In D.85-06-113, dated June 12, 1985, we ordered that Ordering Paragraph 3 of D.85-03-056 is modified to read in full as follows:

> "3. Any reduction in AT&T-C's expense stemming from reductions in local exchange utilities' access charges shall be concurrently passed on to AT&T-C's customers through a corresponding incremental reduction in the billing surcharge. The tariff filings by AT&T-C to comply with this order shall be filed so that they are effective within 14 days after local exchange utilities have made the advice letter filings required to reduce their local access charges."

In accordance with D.87-07-017, we have recently received an application for rate flexibility from AT&T-C. We are also aware of several pending rate matters that will affect AT&T-C's access charge expenses. For now, we will order AT&T-C to accumulate the access charge reduction ordered here in a memorandum account, with interest, commencing on the effective date of this decision. We will issue a further order describing how the entire amount of this savings is to be consolidated with other changes in access charge expenses for full pass-through to AT&T-C's customers.

VII. Findings and Conclusions

Findings of Fact

1. Unlike the major energy utilities, the Commission in D.87-04-078 stated that it will review capital structure and ROE for the major local exchange telephone utilities once every three years. However, the existing turmoil in the financial markets now justifies a further review of capital structures, interest rates and ROE in the attrition years.

2. There was no substantial difference in the capital structures estimated by PSD and General for test year 1988. We will adopt as reasonable PSD's estimate for 1988 as follows:

Components	1988
Long-Term Debt	41.50%
Short-Term Debt	2.50
Preferred Stock	2.50
Common Stock Equity	53.50
Total	100.00%

3. The reasonable costs for long-term debt and short-term debt for test year 1988 are 9.01% and 7.00%, respectively.

4. For attrition years 1989 and 1990 the reasonable cost for long-term debt is the embedded cost of debt plus the interest rate on long-term AA utility bonds forecasted by DRI in September for any long-term bonds to be issued in the attrition year and the reasonable short-term debt cost is the Blue Chip Financial

The final rates will be forthcoming in our final decision after this matter has been briefed and submitted and the final revenue requirement determined. For this interim decision, our adopted revenue reduction of $122.7 million will be derived from a reduction in the billing surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 of 6.03%. D.87-08-051 as corrected by D.87-09-001 indicated that effective January 1, 1988, the surcharge should be 5.47% for access services and 8.74% for other than access services. Deducting the above 6.78% from the 5.47% surcharge for access services and the previously discussed -0.28% SPF to SLU reduction results in a surcharge for access services of -1.59%. Deducting the 6.78% from the surcharge for other than access services and adding the 3.59% SPF to SLU increment results in a surcharge for other than access services of 5.55%, which we will adopt for this proceeding.

In D.85-06-113, dated June 12, 1985, we ordered that Ordering Paragraph 3 of D.85-03-056 is modified to read in full as follows:

> "3. Any reduction in AT&T-C's expense stemming from reductions in local exchange utilities' access charges shall be concurrently passed on to AT&T-C's customers through a corresponding incremental reduction in the billing surcharge. The tariff filings by AT&T-C to comply with this order shall be filed so that they are effective within 14 days after local exchange utilities have made the advice letter filings required to reduce their local access charges."

In accordance with D.87-07-017, we have recently received an application for rate flexibility from AT&T-C. We are also aware of several pending rate matters that will affect AT&T-C's access charge expenses. For now, we will order AT&T-C to accumulate the access charge reduction ordered here in a memorandum account, with interest, commencing on January 1, 1988. We will issue a further order describing how the entire amount of this savings is to be consolidated with other changes in access charge expenses for full pass-through to AT&T-C's customers.

Forecasts consensus one month commercial paper projection as of October 1 for the attrition year.

5. The reasonable preferred stock cost for test year 1988 is 6.41%.

6. A ROE of 13.25% is reasonable and should be adopted for test year 1988. A 13.25% ROE is sufficient to attract capital and reasonably compensate investors during 1988.

7. Adopting the above capital ratio and cost factors will provide a return on rate base of 11.17% for test year 1988. Such rate of return will provide a pre-tax coverage of 4.05 times and an after tax coverage of 2.99 times excluding short-term debt.

8. A revenue requirement reduction of $109.0 million is appropriate for test year 1988 on an interim basis.

9. It is reasonable to require General to collect $534.7 million subject to refund with interest pending our final decision in this matter.

10. To effect the above revenue reduction, the surcharge applicable to access services should be a negative 0.56% for access services and a positive 2.71% for other than access services.

11. D.85-06-113 dated June 12, 1985 directs AT&T-C to flow through any reduction in its access expense stemming from reductions in local exchange utilities' access charges to its customers.

Conclusions of Law

1. A reduction in the revenue requirement of $109.0 million for General for the test year 1988 is reasonable on an interim basis.

2. It is reasonable to have General collect $534.7 million subject to refund plus interest pending our final decision in this matter.

3. Effective January 1, 1988, the surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 should be -0.56% for access services and 2.71% for other than access services.

In its reply comments, General alleges that:

1. The DRA's 12.50% return on equity is unrealistically low in today's environment, and

2. DRA's proposed revision to the billing surcharge calculation in the decision is not supported on the record.

We concur with General's comments relating to determination of long-term debt interest costs for the 1989 and 1990 attrition years and have modified our discussion and Finding of Fact 4 to use the interest rate on long-term AA utility bonds forecasted by DRI in September modified, if appropriate, by 50 basis points for a whole grade difference in bond ratings and 25 basis points for a split rating.

General notes that part of the revenue reduction provided for in this decision is based on the use of new depreciation rates in the test year which have been stipulated to by both General and DRA, and that before General can begin booking the new depreciation rates, they must be approved by this Commission. General proposes the following finding of fact and conclusion of law to support an ordering paragraph authorizing General to begin booking the new rates effective January 1, 1988. General's position is well taken and will be adopted.

"Finding of Fact No. 12

"The depreciation rates proposed by the PSD [DRA], to which General has stipulated, are reasonable and should be authorized effective January 1, 1988."

"Conclusion of Law 6

"General may begin booking the new depreciation rates approved in this decision effective January 1, 1988."

General notes that on pages 7 and 8 of its comments DRA proposes a billing base of $1,639.403 M rather than the billing base discussed in the proposed decision. According to General, there is no support in the record for the $1,639.403 M proposed by DRA whereas the billing base reflected in the proposed decision is the most current billing base in the record. Consequently General believes no change should be made to the billing base. We agree and will not modify the proposed decision in this respect.

Comments by DRA

DRA submitted the following comments:

1. The appropriate return on equity to adopt for test year 1988 is 12.50%.

2. General should use only DRI forecasts for the ARA financial review and not both DRI and Blue Chip forecasts as set forth in the proposed order.

3. A customer billing base of $1,639.403 M should be used in computing the surcharge rather than the DRA's estimate of $1,809,000.

4. Finding of Fact should be amended and an ordering paragraph be added authorizing DRA's depreciation rates stipulated to by General.

5. "Test Year Adjustments" should be modified to reflect estimated loss associated with employee store operation of $600,000 and refund of protective connection arrangement balance of $2,200,000.

6. Reconciliation of figures included in the summary of earnings with figures in the Staff Report on Affiliated Relationship of General should be made as follows:

    a. Change DRA amounts to reflect adjustments for GTE Communications Systems Rate Base of $3,416,000 and expenses of $1,370,000.

    b. Change DRA amounts to reflect its Directory Company expense adjustment of $9,149,000 instead of showing erroneous figures set forth in the summary of earnings.

7. An adjustment for the Thousand Oaks Relocation of $69.3 million to rate base and $21.5 million to expense should be made.

In its reply comments, DRA supports its assertion that a proper return on equity for General for test year 1988 is 12.5%.

We are not persuaded that it would be advantageous to use only DRI forecasts for the ARA financial review instead of both DRI and Blue Chip forecasts as set forth in the Proposed Decision.

As discussed under General's comments, we will not modify the Proposed Decision to reflect a billing base of $1,639.403 M instead of the billing base of $1,809.000 M set forth in the Proposed Decision.

In our discussion of depreciation rates set forth in the section on General's comments, we adopted a finding of fact and conclusion of law relating to stipulated depreciation rates. We will also adopt an implementing ordering paragraph reflecting DRA's proposal.

In the summary of earnings appearing on page 26 of the Proposed Decision, it is noted that the figures shown do not reflect corrections and updates and the effects of intraLATA SPF to SLU which will impact DRA's revenue requirement.

DRA's proposed adjustments to reflect losses associated with employee's store operation, the refund of protective connection arrangement balance, and the Thousand Oaks relocation adjustment appear to be covered by this disclaimer. We believe we have more than ample latitude in the revenue requirement differentials set forth in the proposed decision to obviate the necessity of the further adjustments proposed by DRA.

DRA's directory company expense adjustment of $9,149,000 is properly reflected in the summary of earnings set forth in the

Proposed Decision. The $9,149,000 figure is a gross figure which reduces to a $5,579,000 net income adjustment. The $5,579,000 amount is total company and reduces to $5,430,000 for General's intrastate operations. Similar computations apply to the figures shown for General's directory company expense adjustments.

We agree with DRA's position relating to the amount of adjustments for GTE Communications system. These adjustments should be $3,416,000 to rate base for both DRA and General, $865,000 to expense for both General and DRA on a companywide basis, and $2,686,000 and $704,000, respectively, for General's intrastate operations. Appropriate changes will be made to the summary of earnings tabulation.

We have carefully considered the comments made by the parties on return on equity and having evaluated them together with the record before us, conclude that a reduction in the return on equity set forth in the proposed decision is warranted. As set forth in our discussion on rate of return, we believe that a return on equity of 12.75% balances the interests of both investors and ratepayers, is comparable to returns earned by other investments of similar risk and is reasonable for 1988.

VIII. Findings and Conclusions

Findings of Fact

1. Unlike the major energy utilities, the Commission in D.87-04-078 stated that it will review capital structure and ROE for the major local exchange telephone utilities once every three years. However, the existing turmoil in the financial markets now justifies a further review of capital structures, interest rates and ROE in the attrition years.

2. There was no substantial difference in the capital structures estimated by DRA and General for test year 1988. We will adopt as reasonable DRA's estimate for 1988 as follows:

Components	1988
Long-Term Debt	41.50%
Short-Term Debt	2.50
Preferred Stock	2.50
Common Stock Equity	53.50
Total	100.00%

3. The reasonable costs for long-term debt and short-term debt for test year 1988 are 9.01% and 7.00%, respectively.

4. For attrition years 1989 and 1990 the reasonable cost for long-term debt is the embedded cost of debt plus the interest rate on long-term AA utility bonds forecasted by DRI in September modified, if appropriate, by 50 basis points for a whole grade difference in bond ratings and 25 basis points for a split rating for any long-term bonds to be issued in the attrition year. The reasonable short-term debt cost is the Blue Chip Financial Forecast consensus one-month commercial paper projection as of October 1 for the attrition year.

5. The reasonable preferred stock cost for test year 1988 is 6.41%.

6. A ROE of 12.75% is reasonable and should be adopted for test year 1988. A 12.75% ROE is sufficient to attract capital and reasonably compensate investors during 1988.

7. Adopting the above capital ratio and cost factors will provide a return on rate base of 10.90% for test year 1988. Such rate of return will provide a pre-tax coverage of 3.94 times and an after tax coverage of 2.91 times excluding short-term debt.

8. A revenue requirement reduction of $122.7 million is appropriate for test year 1988 on an interim basis.

9. To effect the revenue reduction of $122.7 million, the surcharge applicable to access services and services other than access should be decreased by an increment of 6.78%.

10. D.85-06-113 dated June 12, 1985 directs AT&T-C to flow through any reduction in its access expense stemming from reductions in local exchange utilities' access charges to its customers.

11. It is reasonable for General to accrue 1988 depreciation expense using new rates as shown in Appendix B.

12. We should consolidate General's AL 5110 with this interim decision so that there will be one tariff revision to the billing surcharges. In AL 5110, to reflect its 1988 SPF to SLU shift, General requested an incremental change in billing surcharge of -0.28% for access services and 3.59% for services other than access to be effective on January 1, 1988.

Conclusions of Law

1. A reduction in the revenue requirement of $122.7 million for General for the test year 1988 is reasonable on an interim basis.

2. Effective January 1, 1988, the surcharges set forth in General's Schedule Cal. P.U.C. No. A-38 should be -1.59% for access services and 5.55% for other than access services, reflecting the $122.7 million revenue requirement reduction adopted in today's decision and General's AL 5110.

3. The rates described in Conclusion 3 are reasonable and other rates applied after the effective date of such rates are unreasonable.

4. Because of time constraints in effecting these rates by January 1, 1988, this order should be effective today.

5. Effective January 1, 1988, General should be authorized depreciation rates as shown in Appendix B.

4. The rates described in Conclusion 1 are reasonable and other rates applied after the effective date of such rates are unreasonable.

5. Because of time constraints in effecting these rates by January 1, 1988, this order should be effective today.

INTERIM ORDER

IT IS ORDERED that:

1. Five days of the effective date of this order General Telephone Company of California (General) shall file revised Schedule Cal. P.U.C. No. A-38 to reflect the revisions shown in Appendix A of this decision. The effective date of the ordered revisions shall be January 1, 1988. Such filing shall comply with General Order Series 96.

2. AT&T Communications of California (AT&T-C) is ordered to collect the access charge reductions it receives as a result of this decision into a memorandum account with interest at the appropriate short-term rate. These reductions will be passed through to AT&T-C's customers by a further order of the Commission.

This order is effective today.

Dated ________________, at San Francisco, California.

APPENDIX A
Sheet 1 of 2

SCHEDULE CAL. P.U.C. NO.-38
BILLING ADJUSTMENT

APPLICABILITY

Applicable to intrastate billing on each customer's and/or carrier's bill for services rendered on and after the effective date of these revisions, as ordered by the Public Utilities Commission. General shall not backbill any customer in the event it cannot because of billing limitations impose the revised billing adjustment as ordered by the Commission.

TERRITORY

Within the exchange areas of all exchanges as said areas are defined on maps filed as part of the tariff schedules.

RATES	Monthly Percentage
Adjustment Factor (See Special Condition 1)	(0.56)
Adjustment Factor (See Special Condition 2)	2.71

SPECIAL CONDITIONS

1. The monthly percentage factor applies to all services provided under Tariff Schedule C-1, Facilities for Intrastate Access.

2. The monthly percentage factor applies to all recurring and nonrecurring rates and charges for service or equipment provided under all of the Utility's Tariff Schedules except the following:

   a. A-1 - Semipublic Message Rate - RATES 7.a.

   b. A-21 - Public Telephone Service - All

   c. A-38a - Surcharge to Fund Public Utilities Commission Reimbursement

   d. B-1 - Message Toll Telephone Service - Coin-Sent Paid

   e. L-2 - Cellular Radio Telephone Service - All

   f. C-1 - Facilities for Intrastate Access - All

APPENDIX A
Sheet 2 of 2

SCHEDULE CAL. P.U.C. NO. A-38
BILLING ADJUSTMENT

SPECIAL CONDITIONS - Continued

3. The billing adjustment amount on each bill shall be designated "Billing Surcharge".

4. The monthly percentage factor applies to each customer's/carrier's bill for the total recurring and nonrecurring rates and charges except those items excluded under Special Conditions 1 and 2, above, exclusive of federal and local excise taxes.