

ALJ/bg/vdl

Decision 83 12 025 December 7, 1983

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of
THE PACIFIC TELEPHONE AND TELEGRAPH
COMPANY, a corporation, for authority
to increase certain intrastate rates
and charges applicable to telephone
services furnished within the State
of California due to increased
depreciation expense.

Application 82-11-07
(Filed November 4, 1982)
WEST COAST TELEPHONE SERVICE
YUWACHOO

In the Matter of the Application of
THE PACIFIC TELEPHONE AND TELEGRAPH
COMPANY, a corporation, for authority
to increase certain intrastate rates
and charges applicable to telephone
services furnished within the State
of California.

Application 83-01-22
(Filed January 17, 1983)

Investigation on the Commission's
own motion into the rates, tolls,
rules, charges, operations, costs,
separations, inter-company settle-
ments, contracts, service, and
facilities of THE PACIFIC TELEPHONE
AND TELEGRAPH COMPANY, a California
corporation; and of all the telephone
corporations listed in Appendix A,
attached hereto.

OII 83-04-02
(Filed April 20, 1983)

In the Matter of the Application of
THE PACIFIC TELEPHONE AND TELEGRAPH
COMPANY, a corporation, for authority
to adopt intrastate access charge
tariffs applicable to telephone
services furnished within the State
of California.

Application 83-06-65
(Filed June 30, 1983)

10/10/82

Case 82-10-09 (Filed October 28, 1982)

TELEPHONE ANSWERING SERVICES OF CALIFORNIA,

Complainant,

vs. THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,

Defendant.

to be resolved and to return and all
associated and exchanged services and
other services and facilities of
Case 82-10-09 (Filed October 28, 1982) and
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(See Appendix A for Appearances.)
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I N D E X

<u>Subject</u>	<u>Page</u>
INTERIM OPINION	3
Summary	3
Nature of Proceeding	4
Description and Operations of Applicant	6a
Recent Organizational Developments	8
Regulatory Framework	10
Scope of This Decision	12
Separations and Settlements	13
Format of Estimates and Tables	16
Estimated 1983 Results of Operations	18
REVENUES	23
Revenue Estimates	23
EXPENSES	25
Expense Estimates	25
Maintenance Expense	28
Discussion of Maintenance Expenses	38
Depreciation Expense	41
Represcription	42
Depreciation Application A.82-11-07	44
Effect of D.83-08-031	46
Opposition to Represcription Results	46
TURN Depreciation	46
TCA Group's Depreciation Position	48
Gibbons' Comments on Depreciation	49
Staff Counsel's Position on Depreciation	50
Depreciation Discussion	51
Traffic Expenses	54
Commercial Expenses - Overview	56
Commercial Expenses, BAU and	58
CI-II Differences	58
Ac. 640, General Commercial Expenses	59
Ac. 643, Sales Expense	59
Ac. 645, Local Commercial Operations	60
Ratemaking Adjustments	62
Commercial Expenses, Rebuttal	63
and Surrebuttal	65
Discussion of Commercial Expenses	65
General Office Salaries and Expenses	65
Service Measurement	68
Operating Rents	70

I N D E X

<u>Subject</u>	<u>Page</u>
General Services and Licenses	76
Balance "Other Operating Expenses"	77
Antitrust Expenses	78
Business Information Systems	80
Relief and Pensions	81
Discussion of Pension Fund Penalty	83
Adopted "Balance Other Operating Expenses"	85
Early Retirement Incentive Plans	85
OPERATING TAXES	88
Tax Differences	88
California Corporation Franchise Tax	88
Proper CCFT Rate for 1983	89
Adopted Taxes	89
CUSTOMER PREMISE EQUIPMENT SALES	89
Nature of CPE Issue	89
Ordinary and Extraordinary Retirement Accounting	91
Tax Effects	93
Refurbishment	95
Nondisposition Material	96
Discussion of CPE Sales	96
TELEPHONE PLANT	98
Telephone Plant - Overview	98
PT&T's Plant in Service Estimate	99
Staff Plant in Service Estimate	103
Property Held for Future Telephone Use	110
Plant Estimate - Rebuttal, Rejoinder, and Briefs	114
Evaluation of Plant Estimates	113
Plant Underutilization Adjustment Proposal	118
Underutilized Plant - Discussion	123
RATE BASE	130
Rate Base Determination	130
Adopted Results of Operations	131
Background	133
Capital Structure	144
Six Percent Equity	145
Meyer for PT&T	146
Litzenberger for PT&T	152

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I N D E X

10/10/82

<u>Subject</u>	<u>Page</u>
Jones for PT&T	156
Mowrey of the Commission Staff	164
Kroman for the City of Los Angeles	173
Langsam for U.S. Government	178
Discussion - Rate of Return	179
NET-TO-GROSS MULTIPLIER	182
INCREASED REVENUE REQUIREMENT	182
Method of Determining Revenue	
Increase Required	182
Revenue Increase Required	182
Need for Rate Relief	184
Attrition	185a
OTHER MATTERS	186
Affirmative Action	186
The Service Employees	
International Union, Local 87	187
SURCHARGE DESIGN	188
Surcharge Design Considerations	188
Positions of the Parties	189
Discussion	191
FINDINGS AND CONCLUSIONS	196
Findings of Fact	196
Additional Findings of Fact	201
Conclusions of Law	202
THIRD ORDER	202
APPENDIX A	
APPENDIX B	

INTERIM OPINION

1 2 3 4 5

Summary

The Pacific Telephone and Telegraph Company (PT&T) is seeking an increase in rates of \$837.9 million. This proceeding was bifurcated into two phases, a "Business as Usual" Revenue Requirement phase and a Divestiture - Rate Design phase. The Commission finds that PT&T has demonstrated "overriding financial need for rate relief" and authorizes a revenue increase of \$445,450,000 through the imposition of surcharges to present rates in addition to the \$61 million already granted in D.83-08-21. The increase is based on a 16% return on common equity and a 12.7% rate of return on rate base.

The Commission accepts a staff contention that the rate base in the amount of \$483.5 million intrastate plant is underutilized. The order finds that the underutilization results partly from PT&T's imprudent management and partly from effects of the economy. We authorize only half of the normal rate of return on this plant, which results in a disallowance of about \$48 million.

Because a decision in the second phase of the proceeding is scheduled to be issued on May 30, 1984, no specific attrition mechanism is adopted in this phase although we find that the establishment of such a mechanism is reasonable. Consideration of female and minority business enterprise and custodial-janitorial questions is also deferred to the second phase.

PT&T is granted authority to use FCC-prescribed depreciation factors for California intrastate purposes, to use single decimal depreciation rates and to base depreciation rates on current year's depreciation data. The effect of the adopted depreciation rates is to increase PT&T's revenue requirement by about \$123 million including settlement effects.

Nature of Proceedings

PT&T is seeking an \$837.9 million increase in its telephone rates subject to the jurisdiction of this Commission. The procedural history of this request is complex. On August 30, 1982 PT&T tendered its "Notice of Intention to File an Application for General Rate Increase" (NOI) according to the Commission's then effective Regulatory Lag Plan (RLP).¹ The NOI was accepted for filing on November 17, 1982, as NOI No. 85. Application (A.) 83-01-22 was then filed on January 17, 1983. The application requested an annual general rate increase of \$819.2 million.

A.82-11-07 was filed by PT&T on November 4, 1982. This application requested an increase in annual revenues of \$165.9 million to offset increased depreciation expense resulting from rescription of depreciation rates. On March 3, 1983, A.82-11-07 was consolidated with PT&T's general rate case, A.83-01-22. NOI 85 and A.83-01-22 asked that the proceeding be bifurcated into a revenue requirement phase and a rate design phase. At a prehearing conference held on February 24, 1983, in San Francisco, counsel for PT&T declared that he would file a written motion to bifurcate the case into two phases and to seek rate relief upon completion of a revenue requirement phase and in advance of a rate spread phase. The motion was filed on March 4, 1983, and on April 6, 1983 the Commission, in Decision (D.) 83-04-02, bifurcated the case and established a schedule that was an acceleration of the Commission's Rate Case Plan (RCP)¹ schedule to accommodate the exigencies of the case. The first phase was to consider 1983 results of operations, an attrition mechanism, and an interim surcharge design. The second phase was to consider 1984 attrition, access charges, the effects of divestiture of PT&T by American Telephone and Telegraph Company (AT&T), and final rate design.

¹ The RCP is the Commission's standing plan and schedule for processing major utility general rate cases and has become a

Since the facilities of other California telephones and companies are interconnected with those of PT&T to provide an integrated communications network, any changes in PT&T's rates will affect the division of revenues between the independents and PT&T. It is customary therefore in PT&T's general rate increases for the Commission to issue an Order Instituting Investigation (OII) into the operations of PT&T and all other California telephone utilities so that adjustments occasioned by changes in PT&T's rates can be made to the rates of the interconnecting companies. Such an OII, designated OII 83-04-02, was issued in this case on April 20, 1983. The order differed from the usual OII issued in PT&T's general rate cases, however, in that it provided for an investigation of the actions of PT&T and the independents to adjust for the divestiture of PT&T by AT&T. Because it appeared that AT&T would be providing a form of intrastate toll service and terminal equipment rentals to California telephone customers, AT&T was named as respondent.

On April 8, 1983, PT&T distributed revised prepared testimony which it proposed to introduce at the first day of hearing, April 18.² In this testimony PT&T revised its combined increase of \$819.2 million and \$165.9 million (a total of \$985.1 million) set downwards to a combined total of \$837.9 million. The reduction in revenue requirement was brought about by a reduction in the combined settlement effects of the two applications, a lower interest expense, a reduction in the cost of equity money (from 19% to 17.5%), and a resulting decrease in required rate of return (from 14.31% to 13.49%), and the correction of errors.

On June 30, 1983 PT&T filed A.83-06-65 to establish intrastate access charges to recover from interexchange carriers and end users the costs associated with PT&T providing access to its local networks for the initiation and completion of intrastate calls.

² The RCP and its predecessor RLP require that prepared testimony be submitted with the NOI and again with the application when filed.

interexchange communications. PT&T propose to recover approximately \$1.3 billion in annual revenues through intrastate access charges, calculated to provide a level of contribution toward recovery of fixed local network costs comparable to that which has been provided in the past by PT&T's intrastate toll operations which are being transferred to AT&T in January 1984 in connection with the divestiture required by an antitrust consent decree.

On July 5, 1983, PT&T filed an amendment to A.83-01-22 to reflect effects of the divestiture of PT&T by AT&T and of attrition in PT&T's earnings in 1984 as compared to 1983, and to establish rates to reflect these changes in PT&T's operations. In this filing PT&T asked for an additional \$410 million in annual gross revenues.

On October 28, 1982, Telephone Answering Services of California (TASC) filed a complaint against PT&T, asserting that PT&T's rates for provision of direct inward dialing services and facilities to telephone answering services were unlawfully discriminatory. By an Administrative Law Judge's (ALJ) ruling of August 1, 1983, the TASC complaint was consolidated with A.83-01-22 and the associated matters.

On April 18, 1983 PT&T began presenting its case. On June 23, 1983, Phase I was submitted after 26 days of technical hearings and 105 exhibits. On June 27, 28, and 29 hearings were held on the surcharge methodology to spread any interim increase that might be granted. Phase I of the case now stands submitted with concurrent opening briefs filed on or before July 29, 1983. Oral replies were presented on August 5, 1983 pursuant to D.83-04-021. Four Commissioners were present for the oral replies. Notice of the hearings was provided to the public by bill inserts.

During the course of this proceeding, three separate series of public participation hearings, two sessions per day for a total of 15 days were publicly noticed and held at locations throughout PT&T's service area. Four days of public hearings were held in Los Angeles,

three in San Francisco, and one each in San Diego, Monterey, San Jose, Santa Rosa, Red Bluff, Sacramento, Stockton, and Fresno. In addition, approximately 2,700 letters have been received from California ratepayers concerning the requested increase.

Literally hundreds of PT&T ratepayers addressed their views to the Commission at the public hearings. Their predominant themes were concern for the maintenance of basic telephone service and its universal availability especially for the elderly, the poor, and the unemployed; opposition to the concentration of rate increases upon basic residential rates and to any increase in rates for lifeline service or any limitation of the lifeline calling allowance; and opposition to a rate increase of the magnitude proposed or to any rate increase whatever. Many speakers doubted the need for a rate increase, and expressed concern about inefficiency in PT&T's

operations and management.

Description and Operations of Applicant

At the present time PT&T is one of 21 telephone operating subsidiaries (OTCs) of AT&T. AT&T also owns Western Electric Company, Inc. (Western Electric) which manufactures and installs

equipment for AT&T and the OTCs. AT&T and Western Electric each own 50% of Bell Telephone Laboratories, Inc. (Bell Labs), which is the Bell System's research and development arm. AT&T, Western Electric, Bell Labs, and the OTCs form what is presently known as the Bell System. These arrangements will be restructured in the immediate future as divestiture of the OTCs by AT&T is implemented.

As of December 31, 1981, PT&T had approximately 10,275,000 main and equivalent main telephones in service out of a state total of approximately 12,783,000. PT&T estimates that it serves approximately 80% of the population in the State of California, having exchanges in 52 of the 58 counties in the state. The only counties not served by PT&T are Mono, Alpine, Lassen, Modoc, along the Nevada border; Del Norte, in the northwest corner; and Santa Barbara, in the southcentral coastal area. Pacific's telephone plant in service as of December 31, 1981 amounted to \$16,756,766,803.

PT&T has one subsidiary, Bell Telephone Company of Nevada, which renders telephone service only within the State of Nevada. All the outstanding capital stock of this company is owned by PT&T.

PT&T estimates that as of December 31, 1981, approximately 94,000 square miles of the State of California were supplied with telephone service. PT&T served about 51,000 square miles by means of 390 exchanges. The remaining area was served by 24 independent telephone companies with 238 exchanges. PT&T had 1,960 central offices, of which 803 were electronic.

The utility outside plant includes 59,088 miles of aerial wire and 93,121 miles of aerial cable, carried on 1,254,873 poles. The aerial cable contained approximately 28,268,369 miles of wire. There was also underground cable of 43,917 miles that contained 86,351,061 miles of wire; buried cable of 49,046 miles that contained 13,368,884 miles of wire; and submarine cable of 164 miles that contained 164,437 miles of wire. In addition, there were 15,109 miles of coaxial cable and 9,881 miles of radio relay system.

PT&T estimated, by means of periodic counts of total long distance originating calls, that in 1981 there were approximately 11.8 to 12.3 29,399,000,000 local calls, an average of 1,746 per telephone. There were also 3,232,560,480 completed toll calls and 2,113,905,486 uncompleted toll calls made for a total of 5,346,465,966 toll calls, an average of 329 calls per telephone. Recent Organizational Developments, 1981, p. 13.

On May 12, 1982, PT&T became a wholly owned subsidiary of AT&T. To accomplish this merger, 0.35 AT&T common shares were exchanged for each of the 49,159,707 PT&T common shares outstanding which were not owned by AT&T, and \$60 per share was paid for each of the 179,043 PT&T 6% voting preferred shares outstanding which were not owned by AT&T. As a result of the merger, all shares of PT&T except one were cancelled, and the single outstanding share became the only outstanding voting share of PT&T.

On January 8, 1982 AT&T announced it had agreed to a proposal by the Department of Justice (DOJ) in the DOJ's 1974 antitrust case against AT&T to modify an existing 1956 consent decree. As a result, both the DOJ and AT&T have stipulated to dismissal of the 1974 action. The terms of the new consent decree require that AT&T divest those parts of the Bell System OTCs that provide local exchange and exchange access services and also require termination of the license contracts between AT&T and OTCs and the standard supply contracts between Western Electric and OTCs. The interexchange facilities, including those currently owned by OTCs, would remain a part of AT&T, which would continue to own Western Electric and Bell Labs. AT&T's access to the services of the divested local exchange companies would eventually be on terms and conditions equal that of other interexchange carriers. Ownership of customer premises equipment (CPE) would remain with AT&T. The separated local exchange companies would be divested by a spin-off to AT&T's shareholders or by other disposition.

On August 11, 1982 Judge Harold H. Greene of the United States District Court for the District of Columbia issued an opinion in which he ruled that the court would approve the proposed consent decree agreed to by AT&T and the DOJ, provided that AT&T and the DOJ agreed to modifications. The modifications were permitting the divested local operating companies to provide, but not manufacture, CPE and to retain the directory advertising ("Yellow Pages") business, and to permit any divested company to engage in any other business upon a showing to the court that there would be no substantial possibility that the company could use its monopoly power to impede competition in the market it sought to enter. The modification would also require that, if the exchange access offered by a divested local operating company to an interexchange carrier is not equal in type and quality to that provided in AT&T, the tariffs filed for such access shall reflect the lesser cost, if any, of such access as compared to the access provided to AT&T. The modification also would require the assignment of jointly used facilities and other assets to a divested local operating company if the use by that company predominates over the use by AT&T. At the time of divestiture AT&T would have to assure that each divested local operating company would have a debt ratio of approximately 45% (except for a 50% debt ratio for PT&T) and that the quality of the debt of each company should be representative of the debt of AT&T and its subsidiaries at the time of divestiture.

On August 19, 1982 AT&T and the DOJ notified the judge that they would accept his modifications to the consent decree. On August 24, 1982 the court approved and entered the consent decree with the court's modification.

In addition to the upheaval caused by the settlement of the antitrust case, action by the Federal Communications Commission (FCC) has also had a profound impact on the telephone industry. In 1980, the FCC, by its D.80-628, in Docket 20828, ordered deregulation

of telephone terminal equipment and ordered AT&T and General Telephone and Electronics Corporation (GTE) to form fully separated terminal equipment subsidiaries (ESS) to handle the deregulated activities. This FCC decision is commonly known as the Computer Inquiry II decision (CI-II) although its greatest impact is on the ownership of plain old telephones.

Following the CI-II decision, the California Commission decided, in D.93367 dated August 4, 1981 in A.59849 et al. (the last previous general rate increase decision) that sale of terminal equipment by PT&T to its customers would be desirable. After further hearings in that proceeding, in D.82-08-017, dated August 4, 1982 (exactly a year later) the Commission ordered PT&T to file tariffs for, and to proceed with the sale of, single line terminal equipment to its customers; and by D.83-09-024 dated September 7, 1983, ordered PT&T to file tariffs for and to implement a comparable sale program for key telephone system which comprise a substantial portion of its multiline terminal equipment.

Regulatory Framework

Public utility rate setting in California generally follows the traditional American regulatory processes that have developed over the last one hundred years, in response to various pronouncements of the Supreme Court of the United States.

The first question to be answered in the traditional rate-making process is: What is a reasonable judgment of the utility company's results of operations? For the purpose of determining the results of operations, a test period is selected. The test period is usually the immediate future calendar year. Estimates of the future are thus involved. The test year does not simply reflect the expected results but instead represents the operations of the utility adjusted to reflect average conditions and reasonable levels of expenses and rate base.

See also California Public Utilities Code, Sections 386-388 and 389.

The final outcome of the results of operation is the realized rate of return for the test period at present rates. This realized rate of return indicates the amount of revenue change required to bring the rates of return to reasonable levels.

For the purpose of determining a rate of return, it is necessary to make reasonable allowances for operating expenses, depreciation expense, and taxes. These are subtracted from the estimated revenues to obtain the net revenue.

The net revenue is the numerator of the fraction representing the rate of return. The denominator is the rate base, or net valuation, which is the result of subtracting accrued depreciation from the gross valuation of utility property devoted to rendering public utility service.

The second question is: What is the reasonable rate of return that should be applied to rate base? Rate of return, while equally as important as rate base, depends much more heavily on judgment and is the subject of widely varying expert opinions.

The reasonable return is obtained by applying the adopted rate of return to rate base. The return is added to the reasonable allowance for expenses to determine the revenue requirement.

The third question to be asked is: How shall the revenue requirement be allocated to various classes of utility users? This allocation, often known as rate spread, also depends heavily on opinion and judgment and frequently involves the resolution of widely divergent expert testimony.

Under California law, it is presumed that the existing rates are reasonable and lawful (Public Utilities (PU) Code § 451); therefore, in order to raise rates, it is incumbent on the utility to justify the increase. (Northern California Power Company, Consolidated, D.134 dated July 13, 1912, in A.62, 1 CRC 315, 320.) This is so because the Commission cannot raise rates unless it is determined that such increase is just and reasonable (PU Code

§ 454). Accordingly, the utility seeking an increase in rates has the burden of showing by clear and convincing evidence that it is not entitled to such increase. If the utility does not sustain the burden of satisfying the Commission that the proposed increase is proper, justified, the application will be denied. (Pacific Telephone and Telegraph Company, D.90642, dated July 31, 1979 and A.58223; 2 CPUC 2nd 89, 1981). Scope of This Decision

This case is procedurally perhaps the most complex that the Commission has ever considered, coming as it does at the same time as PT&T is being divested by AT&T as part of the general dismantling of the Bell System pursuant to the Modified Final Judgment in the AT&T antitrust case (United States v American Telephone and Telegraph Co. Civil Nos. 74-1698 and 82-0192, 1982 F.3d Supp. 1000 (D.D.C. 1982)).

The Commission, in D.83-04-021, decided that the best way to cope with the complexity was to evaluate PT&T's results of current operations (R/O) as filed in A.83-01-22 to establish a 1983 rate base and revenue requirement. Adjustments would then be made in a second phase, for divestiture and for access charges to be effective in 1984. The Commission declared that only if the results of the proceeding warranted, would it consider adjusting present rates on an interim basis to take effect January 1, 1984. Any such interim adjustments would be on a surcharge basis.

This decision will confine itself to examination of results of operations aspects of A.82-11-07 and A.83-01-022 to determine what interim relief, if any, should be awarded. Should interim relief be found to be indicated, an interim surcharge will be established.

Revised 11-15-83 to 70-11-88.A

Separations and Settlements

Commonly a utility, for geographical or jurisdictional reasons, is subject to two or more regulatory authorities. When this is the case, it is necessary to segregate and allocate expenses, revenues and rate base components into those subject to the various regulatory bodies.

Almost all of the telephone utility plant of PT&T is physically located within California. Major portions of the plant, as well as associated expenses, reserves, and taxes, involve both intrastate and interstate operations. Intrastate services are regulated by this Commission and interstate services by the FCC. Some parts of the system are used for intrastate service only and therefore can be assigned directly to intrastate; other portions used exclusively for interstate can be assigned directly to interstate. The major portion is used for both services and therefore, for ratemaking purposes, must be allocated between jurisdictions, or "separated". This process, requiring the allocation of revenues, expenses, taxes, investments, and reserves, is called "separations".

In addition, the provision of telephone services often involves the use of more than one company's facilities. For example, a call between San Francisco and Santa Monica involves facilities of both PT&T and GTE. An interstate call could easily involve use of the facilities of two or even three companies. In these cases the costs of each of the utilities must be determined to permit a division of the revenues. This process is called "settlements" and its methods parallel separation procedures.

Also, separation procedures are used by some jurisdictions to allocate costs of a single company among its various types of services. For example, this Commission has historically examined the separation of intrastate operations between toll and exchange operations to assist it in ratemaking decisions.

The fundamental principles of separations were defined by the Minnesota Rate Cases (1913) 230 US 352 and Smith v Illinois Bell Tel. Co. (1930) 282 US 133. Minnesota Rate Cases involved railroad carriers and established the principle that investment and expenses used in common for interstate and intrastate should be apportioned among the services on the basis of the relative use made of facilities and personnel. The Illinois Bell case dealt with separations as related to the fixing of telephone service rates and established that separations are "essential to the appropriate recognition of the competent governmental authority in each field of regulation." It also established the principle of actual use or relative use as a proper basis for the separation of telephone plant.

In practice, separations require, as a first step, the assignment of telephone plant to categories and the determination of the costs of the assigned plant. The second step involves the allocation of the costs of the plant in each category between interstate and intrastate on the basis of direct assignment or the appropriate measure of use.

Within California, major settlements for interchanged toll service between PT&T and the various independents for both interstate and intrastate toll are essentially similar to the national division of revenues that takes place. Each participant receives its allocated toll expense from the pooled toll revenues and then shares in the remaining profits in proportion to its net investment in the statewide toll facilities.

The changes in separation procedures over the past 40 or 50 years have resulted in assignment of lesser expense and investment to intrastate and increased assignment to interstate. New technology, as well as economies of scale, has now reversed this trend and caused the cost per toll message-mile-minute to continually decrease, where local service facilities experienced only nominal benefits from the new techniques and economies.

Recognizing this reversal in the trend the FCC, in June 1980, established CC Docket 80-286 which convened a Federal/State Joint Board to address alleged disparities in the separations manual. The FCC directed the Joint Board to prepare a recommended decision dealing with any revisions that might be required to reflect changes in the telephone industry in the regulatory, competitive and technological areas.

Several areas of concern were specified for consideration by the Joint Board. These included the impact of the deregulation of telephone terminal equipment; the treatment of foreign exchange and common control switching arrangement access lines; the structuring of separations categories to support the determination of just and reasonable access charges; and a review of the factors used in determining the overall allocation level of exchange plant cost to the interstate jurisdiction.

In February 1982, the FCC took interim action in this Docket by adopting two proposals of the Joint Board modifying the treatment of nontraffic sensitive (NTS) exchange plant and "CPE cost" allocations. One of these modifications freezes the subscriber plant factor (SPF) at the 1981 average level. SPF is used to allocate jointly used NTS exchange plant costs. This change became effective April 2, 1981. The second of these modifications caps the level of CPE investment subject to the jurisdictional separations process at the December 31, 1982, level and progressively reduces this level by 1/60th each month for the following five years. The same treatment is applicable to the expenses directly related to this investment.

The first modification, the freezing of the SPF, was occasioned by the concern that the growing cost burden being placed in toll service by the then current separations procedures might cause large toll customers to "migrate" to "bypass facilities" and thereby could cause an increased burden on the other ratepayers.

The second modification, the capping of the CPE investment and its amortization over a five-year period, was made to recognize the expected deregulation of this service component. CC Docket 80-286 remains open and the Joint Board is presently engaged in the process of considering and developing further modifications to the separations manual.

In this proceeding PT&T's separations are done by employees Richard C. Bruins, district staff manager, separations and analysis. Brian M. Chang, senior utilities engineer in the Communications Division, was responsible for the staff's separations. There was no controversy concerning separations in this proceeding. Format of Estimates and Tables:

Events transpiring between the preparation of estimates for PT&T's NOI before its filing in August 1982, and the beginning of testimony on April 18, 1983 could have required a complex and confusing set of revisions to the data originally submitted. PT&T overcame this difficulty by retaining its original estimates and "recasting" them three times before presentation to the Commission as evidence at the beginning of the hearings. The sequence of revisions was:

- Business as Usual (BAU) - estimate of 1982 operations as if unaffected by the deregulation of telephone terminal equipment ordered
- CI-II
- Ratemaking Adjustments
- Recast #1 - Direct Sale of CPE
- Recast #2 - Triennial Represcription
- Tax Adjustment
- Rate of Return Adjustment
- Recast #3

These terms were defined by PT&T's vice president, M. E. King, Jr., as follows:

BAU - "Business as Usual" an estimate, as of 1982, of 1983 operations as if unaffected by the deregulation of telephone terminal equipment ordered

- by the FCC's CI-II D.80-628 in Docket 20828.
- CI-II - Changes that became effective because of CI-II and D.82-08-017. Includes transfers of assets and expenses to an unregulated subsidiary of AT&T and sale of CPE to customers.
- Ratemaking Adjustments - Adjustments of a type consistently made by the Commission in past decisions and which, in this proceeding, PT&T is not contesting.
- Recast #1 - BAU as modified by CI-II and "Ratemaking Adjustments."
- Direct Sale of CPE - The effect of sale of CPE as ordered by the California Commission's D.82-08-017.
- Recast #2 - Recast #1 as modified by "Direct Sale of CPE."
- Triennial Represcription - The depreciation changes proposed by A.82-11-07.
- Tax Adjustments - Correction of an error in taxes computed for BAU.
- Rate of Return Adjustment - The effect of the company's reduction, at the first day of hearing, of its requested rate of return. At present rates this reduced the magnitude of the Western Electric adjustment included in "Ratemaking Adjustments."
- Recast #3 - The final R/O estimate.

The staff accepted this format and its estimates were prepared consistent with PT&T's. Comparisons are therefore between the two "Recast #3" estimates.

The use of BAU allowed PT&T to budget on a basis consistent with past budgets, and then modify its budget for the drastic changes now being experienced. For this proceeding, PT&T is not contesting the ratemaking adjustments that the Commission has made in the past.

A final complication in the presentation and comparison of results was the issuance, on August 3, 1983, of D.83-08-031 in PT&T's previous general rate case A.59849 et al.

D.83-08-031 was signed out after the evidentiary hearings in Phase I had been completed. The effect of D.83-08-031 was to increase PT&T's 1983 estimated annualized revenues by \$61,006,000. Since no allowance had been made in this record to anticipate that increase, any final increase authorized by this decision must be reduced by \$61,006,000. This final adjustment in Phase I of the preceding is designated "Recast 4".

Estimated 1983 Results of Operations

Only PT&T and the Commission staff made complete estimates of California intrastate R/O for the year 1983.- Their final separated recommendations are shown below:

	PT&T	Staff	PT&T Exceeds Staff
		(\$000)	
Revenues	\$ 6,220,609	\$5,986,880	\$ 233,729
Expenses and Taxes	5,290,158	4,953,234	336,924
Net Revenues	930,451	1,033,646	(103,195)
Rate Base	10,166,415	9,932,863	233,552
Realized Rate of Return	9.15%	10.41%	(1.26%)

(Red Figures)

By applying the recommended rates of return and net-to-gross multipliers to provide for income taxes, uncollectibles, and franchise fees, the recommended increases in intrastate gross revenues are obtained. The staff's recommendation is after its recommendation that revenues be reduced to eliminate earnings on underutilized plant.

The utility's and staff's recommended California intrastate revenue requirements are shown as follows:

1.0000

MAINTENANCE ALTERNATE CAN KNOWLEDGE OVERDAS ENT

REVENUES ALTERNATE CANOT TO STUBBS

1.0000 1.0000 1.0000

	PT&T	Staff	PT&T Exceeds Staff
(Dollars in Millions)			

Estimated 1983 Intrastate Rate

Base Rate	\$10,166.4	\$9,932.9	\$ 233.5
Requested Rate of Return	0.1349	0.1258	0.0091
Net Revenues Required at Rate of Return	1,371.4	1,249.6	121.8
Estimated 1983 Net Revenues	930.4	1,033.6	(103.2)
Increase in Net Revenues Required	441.0	216.0	225.0
Net-to-Gross Multiplier	1.9000	1.9010	.0010
Increase in Gross Rev's Required	837.9	410.6	427.3
Underutilized Plant Adjustment	-	(93.7)	93.7
Proposed Gross Revenue Increase	837.9	316.9	521.0

(Red Figures)

The total California and separated California intrastate results at present rates are shown in Tables 1 and 2 which follow.

Effects of the overall categories on California intrastate operations are shown in Table 2. No such comparison is shown in Table 1 because of the absence of Commission control of interstate revenues.

1982	1983	1984	1985
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	441.0
1.9000	1.9000	1.9000	1.9000
837.9	837.9	837.9	837.9
-	-	-	-
837.9	837.9	837.9	837.9
10,166.4	10,166.4	10,166.4	10,166.4
0.1349	0.1349	0.1349	0.1349
1,371.4	1,371.4	1,371.4	1,371.4
930.4	930.4	930.4	930.4
441.0	441.0	441.0	

TABLE 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
RESULTS OF TOTAL CALIFORNIA OPERATIONS
A.83-01-22 ESTIMATED YEAR 1983
RECAST #3

	PT&T	Staff	Exceeds Staff
		(\$000)	
<u>Operating Revenues</u>			
Local Service Revenues	\$ 3,047,451	\$ 2,977,964	\$ 69,487
Toll Service Revenues	5,168,194	4,806,108	362,086
Miscellaneous Revenues	437,980	442,134	(4,154)
Uncollectibles	(116,902)	(110,164)	(6,738)
Total Operating Revenues	\$ 8,536,723	\$ 8,116,042	\$420,681
<u>Operating Expenses and Taxes</u>			
Current Maintenance	\$ 2,288,504	\$ 1,879,740	\$408,764
Depreciation & Amortization	1,227,013	1,217,998	9,015
Traffic Expenses	424,501	385,218	39,283
Commercial Expenses	808,990	711,778	97,212
Gen. Office Salaries & Expenses	473,733	456,959	16,774
Operating Rents	78,321	55,091	23,230
Gen. Services & Licenses	70,805	65,829	4,976
Other Oper. Expenses	825,106	751,860	73,246
Total Operating Expenses	\$ 6,196,973	\$ 5,524,473	\$672,500
Operating Taxes - Federal Income	430,940	539,081	(108,141)
- Cal. Corp. Franch.	186,473	296,161	(109,688)
- Social Security	190,323	185,351	4,972
- Other	175,819	166,080	9,739
CPE Gain After Net. Adj.	0	(47,199)	47,199
CPE Gain Tax Effect	0	14,651	(14,651)
Total Oper. Expenses & Taxes	\$ 7,180,528	\$ 6,678,598	\$501,930
Net Revenues	\$ 1,356,195	\$ 1,437,444	(\$81,249)
<u>Rate Base</u>			
Telephone Plant in Service	\$19,102,286	\$18,753,715	\$348,571
Property Held for Fut. Tel. Use	55,877	55,100	777
Working Cash	219,936	123,255	96,681
Materials and Supplies	148,369	103,930	44,439
Depreciation Reserve	(3,447,992)	(3,427,486)	(20,506)
Reserve for Deferred Taxes	(2,257,858)	(2,209,957)	(47,901)
Total Rate Base	\$13,820,618	\$13,398,557	\$422,061
Rate of Return	9.81%	10.73%	(0.92%)

(Red Figure)

TABLE 2 - INTRASTATE OPERATIONS

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
 RESULTS OF CALIFORNIA INTRASTATE OPERATIONS
 A.83-01-22 ESTIMATED YEAR 1983
 RECAST #3

	PT&T Estimates	Staff Estimates	PT&T Exceeds Staff	Rate of Return Effect
(\$000)				
<u>Operating Revenues</u>				
Local Service Revenues	\$3,045,051	\$2,974,384	\$70,667	
Toll Service Revenues	2,813,140	2,642,993	170,147	
Miscellaneous Revenues	437,980	442,134	(4,154)	
Uncollectibles	(75,562)	(72,631)	(2,931)	
Total Operating Revenues	\$ 6,220,609	\$ 5,986,880	\$233,729	2.35%
<u>Operating Expenses and Taxes</u>				
Current Maintenance	\$ 1,620,105	\$ 1,354,460	\$265,645	
Depreciation & Amortization	898,016	897,297	719	
Traffic Expenses	339,451	309,060	30,391	
Commercial Expenses	671,456	592,215	79,241	
Gen. Office Salaries & Expenses	367,682	355,773	11,909	
Operating Rents	60,717	42,767	17,950	
Gen. Services & Licenses	51,908	48,760	3,148	
Other Oper. Expenses	615,240	564,793	50,447	
Total Operating Expenses	\$ 4,624,575	\$ 4,165,125	\$459,450	
Operating Taxes - Federal Income	267,284	361,336	(94,052)	
- Cal. Corp. Franch.	126,778	196,976	(70,198)	
- Social Security	142,103	139,330	2,773	
- Other	129,418	123,015	6,403	
CPE Gain After Net Adj.	0	(47,199)	47,199	
CPE Gain Tax Effect	0	14,651	(14,651)	
Total Oper. Expenses & Taxes	\$ 5,290,158	\$ 4,953,234	\$336,924	(3.39%)
<u>Net Revenues</u>	\$ -930,451	\$ 1,033,646	(\$103,195)	
<u>Rate Base</u>				
Telephone Plant in Service	\$14,064,223	\$13,857,674	\$206,549	
Property Held for Fut. Tel. Use	44,210	40,967	3,243	
Working Cash	161,196	93,058	68,138	
Materials and Supplies	108,792	75,817	32,975	
Depreciation Reserve	(2,539,645)	(2,489,069)	(50,576)	
Reserve for Deferred Taxes	(1,672,361)	(1,645,584)	(26,777)	
Total Rate Base	\$10,166,415	\$ 9,932,863	\$233,552	0.22%
Rate of Return	9.15%	10.41%	(1.26%)	1.26%

(Red Figure)

UNITED STATES DEPARTMENT OF COMMERCE
BUREAU OF ECONOMIC ANALYSIS
WASHINGTON, D.C. 20540
OFFICE OF THE ATTORNEY GENERAL
WASHINGTON, D.C. 20540

From Table 3 it can be seen that the largest difference between PT&T and the staff is in the estimate of operating expenses. This difference is offset, to a significant degree, by the opposing difference in revenue estimates. Calculation of taxes based on income is almost entirely a function of net revenue differences. The effect of differences in rate of return recommendations and the staff underutilized plant adjustment were of relative lesser importance.

REVENUES

Revenue Estimates

PT&T's revenue estimate was presented by its Vice President King and the staff's by the Communications Division's Denise S. Mann, regulatory analyst, and Brian Chang, P.E., senior engineer.

Mann was responsible for the fundamental basis of the revenue estimate, the volumes. Chang made the actual revenue estimates, using Mann's volume estimate.

The differences between the PT&T and staff revenue estimates, at present rates and after Recast 3, are shown in the following table, Table 4.

	PT&T	Staff	Difference
Present Rates	\$1,000,000	\$1,000,000	\$0
Recast 3	\$1,000,000	\$1,000,000	\$0
Operating Expenses	\$1,000,000	\$1,000,000	\$0
Income	\$1,000,000	\$1,000,000	\$0
Taxes	\$1,000,000	\$1,000,000	\$0
Net Revenue	\$1,000,000	\$1,000,000	\$0
Plant Adjustment	\$1,000,000	\$1,000,000	\$0
Rate of Return	\$1,000,000	\$1,000,000	\$0
Total Revenue	\$1,000,000	\$1,000,000	\$0

TABLE 4

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

RESULTS OF TOTAL CALIFORNIA OPERATIONS

A.83-01-22 ESTIMATED YEAR 1983

OPERATING REVENUES THROUGH RECAST #3

(\$000)

Operating Revenues Through Recast #3 (Estimated Year 1983) (\$000)

Item	PT&T	Staff	Exceeds Staff
Local Revenues	\$3,210,766	\$3,104,250	\$106,516
Toll Revenues	5,074,122	4,827,280	246,842
Misc. Revenues	437,980	436,300	1,680
Uncollectible Revenues	116,713	111,442	5,271

BAU Total Before Adj. \$8,606,155 \$8,256,388 \$349,767

AdjustmentsLocal

CI-II (74,569) (55,031) (19,538)

Represcription

3,154 1,876 1,278

Toll

CI-II (7,972) (110,799) 102,827

Represcription

102,044 89,627 12,417

Miscellaneous

CI-II 0 5,834 (5,834)
(Inter-Entry)

Uncollectible

CI-II 1,101 2,408 (1,307)

Represcription

(1,290) (1,130) (160)

Subtotal CI-II

(81,440) (157,588) 76,148

Subtotal Represcription

103,908 90,373 13,535

Sale of CPE

(91,900) (73,131) (18,769)

Recast #3 Total Rev.
at Present Rates

\$8,536,723 \$8,116,042 \$420,681

PT&T's Requested Increase

\$ 837,900 \$ 837,900 0

Revenues at Proposed Rates

\$9,374,623 \$8,953,942 \$420,681

(Red Figure)

PT&T's revenues are higher than the staff's later estimates, primarily because of the use of a later look at a time when economic forecasts were not as optimistic as when PT&T made the NOI revenue estimates. The staff had available recorded data through 1982.

The staff's estimate is to PT&T's benefit, since a lower estimate requires a larger revenue augmentation. Should the economy revive to the level predicted by PT&T, the utility would then receive a larger increase than was intended.

PT&T did not contest the staff revenue estimate per se, but, in its brief, it complained that the methodologies used by the staff expense and plant witnesses were inconsistent with those used by Chang to estimate revenues. PT&T also stated that, given the unexpected delay in California's economic recovery, a reduction in revenues below the utility's mid-1982 projection is probably appropriate.

Considering the changed circumstances since preparation of the staff estimate the Commission will accept the staff Recast 3 total company revenue estimate, at present rates adjusted for settlement effects, in the amount of \$8,156,117,000 for use in this decision.

EXPENSES

Expense Estimates

The overall difference between PT&T and staff estimates of reasonable levels of expense for the test year 1983 is the largest area of disagreement in the proceeding, amounting to \$672,500,000 on a total California operations basis, as shown on Table 1. (As explained earlier, when studying the company, it must be examined as a unit and the results then separated to California jurisdictional operations.)

Of the \$672,500,000 difference \$408,764,000, or 61%, is in the maintenance expense estimates.

PT&T's expense estimate was based upon its expense budget and was presented by Vice President King.

In describing PT&T's budgetary process, King said that there are basically eight forecast components which are used as major drivers in the estimation of the resources that PT&T believes will be required to meet customer demand. These are: Main and Equivalent Main Gain (Access Line Gain), Main and Equivalent Main Inward Movement (Access Line Inward Movement), Main and Equivalent Main Outward Movement (Access Line Outward Movement), Total Telephone Inward Movement, Total Telephone Outward Movement, Total Telephones In Service, Average Telephones In Service, and Total Toll Messages.

PT&T's primary use of the Main and Equivalent Main Telephone Gain (Access Line Gain) forecast is as an incremental driver for many of its capital budget accounts. For example, this forecast is used to help determine requirements for additional central office equipment, subscriber and trunk cables, and land and buildings. The Average Telephones In Service forecast is fundamental to estimating the total force and expense required to maintain Plant in Service. The Main and Equivalent Main Inward and Outward Movement forecasts are used as resource planning tools to estimate capital and expense dollars for outside plant. The Telephone Inward and Outward Movement forecasts are estimates for the volume of work to be done and are fundamental resource planning tools of the customer contact and installation force groups.

In the capital budget process the Toll Message forecast is used as a reasonableness check on the forecast of message trunks. This forecast is also used to test the reasonableness of the independently generated revenue forecasts.

PT&T now develops its expense budget by function, according to the type of work activity being performed. PT&T sees two main advantages to using this method. Since the budget cuts across organizational lines, it is not sensitive to the changes brought by

reorganizations and further the utility believes that it accurately reflects business functions as they are today.

PT&T monitors its forecasts at the corporate office to assure their reasonableness. In summary, King said, five procedures are used to produce reasonable forecasts:

1. They are produced through the use of sophisticated techniques based on state of the art statistical methodology.
2. PT&T uses a "tops down" (Operations Administration) and "bottoms up" (Local Area) reconciliation technique on the Main Telephone Gain forecast.
3. The company tests independently developed volume and revenue forecasts against each other.
4. There are careful reviews of the recommended forecast levels by all levels of management, from 1st level to the President. All budgets are required to be consistent with these forecast levels once they are approved by the President.
5. Monthly reviews of actuals are studied and forecast changes are made when these results indicate such action is appropriate.

In developing the 1983 BAU expense budget, PT&T's corporate guidelines specified that the company would meet forecasted demand for quality telecommunications service in a cost effective manner. These guidelines were:

1. Maintain service levels.
2. Help offset inflation through productivity improvements.
3. Assure the minimum adequate force required to do the job.
4. Assume the organizational structure and framework in effect as of June 1, 1982.
5. Assume an annual inflation rate of 5.6% in 1983.

Since there were several staff expense witnesses, their methods are described under the various expense headings.

Maintenance Expense

Maintenance expense is the largest category of PT&T's operating expense and consists of salaries, wages, materials, and of administrative and other overhead and incidental costs incurred in the upkeep of the operating plant. The staff's estimate of basic maintenance expense is \$408.8 million, or 18% below PT&T. This is the single largest difference between PT&T and the staff and accounts for over two-thirds of the total difference in expense estimates.

An 18% difference in the cost of such a basic function as maintenance illustrates the turmoil that the communications industry is experiencing and the difficulty in making reasonable estimates under present day conditions.

A spread of the difference, by FCC accounts, is shown in the following table, Table 5.

Basic maintenance expense	1.0
Administrative and other overhead	1.0
Materials	1.0
Salaries and wages	1.0
Depreciation	1.0
Interest	1.0
Income taxes	1.0
Other	1.0
Total	1.0

Table 5
The Pacific Telephone and Telegraph Company
Results of Total California Operations
A.83-01-22 Estimated Years 1983
Maintenance Expenses Through Recast #3

Item	PT&T	Staff	Exceeds Staff
(\$000)			
Accounts			
602 Repairs of Outside Plant	\$ 303,830	\$ 302,574	\$ 1,256
603 Test Desk Work	371,771	308,487	63,284
604 Repairs of Central Ofc. Eq.	724,874	606,894	117,980
605 Repairs of Station Eq.	892,674	727,628	165,046
606 Repairs of Bldgs. & Grds.	62,199	59,123	3,076
610 Maintaining Xmission Power	44,600	31,434	13,166
612 Otr. Maintenance	31,213	31,213	0
Nevada Bldg. Adj.	(51)	(51)	0
Subtotal	2,431,110	2,067,302	363,808
C1-11	(100,555)	(106,210)	5,655
Subtotal	2,330,555	1,961,092	369,463
WECo	(31)	(31)	0
SL-RL	(1,209)	(1,209)	0
Recast #1 Subtotal	2,329,315	1,959,883	369,432
Sale of CPE	(38,100)	(30,756)	(7,344)
Recast #2 Subtotal	2,291,215	1,929,127	362,088
Construction Budget	0	(14,309)	14,309
L.L. Transfer	0	(19,029)	19,029
Cogeneration & Electrical Energy	0	(16,049)	16,049
Rate of Return	(2,711)	0	(2,711)
Recast #3 Total	2,288,504	1,879,740	408,764
SL - RL Adjustment added back	1,209	1,209	0
	1,880,949		
(Red Figures)			

The staff's estimate was presented by Hassan M. Mirza, P.E., a Senior Utilities Engineer of the Commission's Communications Division.

The staff explained that the \$363,808,000 difference (the first subtotal in the comparison table, Table 5) results mainly from staff estimates of lower work indicator volumes, higher productivity levels, and lower nonlabor expenses. Some of the difference was due to later available information than the utility had when it made its estimates. The utility only had five months of 1982 recorded data while the staff had actual data through November 1982.

The remaining \$44,956,000 represents difference in estimates of the effects of CI-II, the 1983 construction budget, transfer of utility personnel to AT&T Long Lines Department, cogeneration, electric energy costs, and sale of CPE.

The staff developed its maintenance expenses by estimating upkeep and changes for each maintenance expense account of the FCC Uniform System of Accounts. The upkeep and changes expense component estimates were made by estimating direct-labor and nonlabor expenses separately.

The direct labor expenses were made by multiplying total hours times the estimated labor rate per hour. The total hours were estimated by multiplying workload (workload indicator volumes) times productivity (total hours per workload indicator). The workload indicators were selected by correlating recorded total hours with the various related work indicator volumes, such as access lines, inward telephones, etc., for the last eight years. The work indicator with the highest correlation coefficient with total hours was selected. Productivity was determined by analyzing historical data, projects, etc., and using engineering judgment. The engineering judgment was based upon analyzing utility responses to staff data requests, project tracking reports and studies, field investigations, and meetings with knowledgeable utility personnel. The total hours used were normalized by the utility for accounting changes, AT&T Plant Cost Result Plan changes reflecting reorganization of work activities, and operational transfers of personnel and maintenance responsibilities from the utility to the AT&T Long Lines Department.

The staff 1983 labor rate per hour was based on the November 1982 actual amount increased by the Cost of Living and COLA Adjustment (COLA) forecast of the Revenue Requirements Division staff. This 1983 hourly rate was also adjusted to include estimates for merit salary increases and management bonuses. The major difference in the labor rate was due to the differences in COLA.

The staff's estimates for nonlabor expenses were also based on an analysis of the last eight years of recorded data. The nonlabor expense portion consists of Loadings on Labor, Motor Vehicles, Contract Billings (Measured as well as Unmeasured), Engineering, Western Electric Billings, Miscellaneous and Net Billings, and Other. Since most of the nonlabor expenses are proportional to direct labor, these expense estimates were made using historical ratios. Other methods were used for those nonlabor portions which are not directly related to labor. For example, to estimate Western Electric Billing and Engineering expenses for the change portion of maintenance, the staff used the construction budget because that budget is directly related to those nonlabor expense costs.

The staff witness testified that it used its method of estimating maintenance expenses because of deficiencies that the staff saw in PT&T's methodology. The staff maintains that the utility did not use consistent estimating procedures to estimate its maintenance expenses but that each organization developed its maintenance estimate differently. For example, the Distribution Services organization used the December 1981 Commitment View of 1982 as its initial base level estimate. The December 1981 Commitment View of 1982 was a "bottom up" approach with "top-down" adjustments to determine a funded level. Then this organization made further incremental adjustments based on April and July 1982 administrative views for volumes, cost of living, management salary increases, etc., to arrive at its final estimates. The April administrative view

adjusted the December 1981 view by analyzing the annualized first three months of recorded 1982. This was also adjusted for later, over volume, wage, and project impact estimates. Then the organization made adjustments in the July administrative view for wages, etc., but not volumes. On the other hand, the Business Services organization annualized five months of recorded 1982 expense by equivalent work days to make its estimate. This organization also incorporated administrative April and July top-down adjustments for volumes, cost of living, management salary parameters, and 1983 incremental impacts of projects. As a further contrast, the Network Services organization utilized 1981 reconstructed work units and hours, adjusted in April and July 1982 administrative views for volumes and other parameters changes including 1983 incremental project impacts. Other utility organization entities used even different methods than those described here.

As a further complication, the staff said that, at AT&T's request, PT&T switched in 1982 from a "terminating" concept of budgeting expenses, using the AT&T functional accounting system, to an "originating" concept. In the new "originating" concept, each organization is only accountable for its own expenses, not expenses charged to it by other organization entities. Therefore, there are no "cross-charges" between the organizations using "originating" concept accounting. The individual utility organization entities did not have actual 1981 or prior years' data in originating terms to make their 1982 and 1983 estimates. The Network Services organization did attempt, as best it could, to reconstruct the 1981 actual data from terminating to originating terms by eliminating cross-charges, however.

The staff also discovered that PT&T is having difficulties, including data base errors, with the new MR/IBPS system described by witness King. As with any new complex computer-based system, many problems are to be expected. In addition, there is not a direct or

translation between MR/IBPS and the FCC Uniform System of Accounts, so the utility had some difficulties in directly translating organization budgets to FCC Accounts.

Mizra also believed that the staff estimating methods were superior because the staff had the advantage of utilizing data going back to 1975 since the "terminating and originating" concept, as explained above, does not affect the FCC Uniform System of Accounts.

In rebuttal, King testified that Mirza, in general, ignored more recent data where the loadings on labor were a higher percentage of direct labor than they were in earlier years. Specifically, King claimed that in two of the nine maintenance functions, Mirza used the 1982 factor (Service Order Test) or the average of the 1981 and 1982 ratios (Truck Testing). In the remaining seven functions Mirza did not use the 1981 and 1982 ratios, though he should have done so. The 1981 and 1982 ratios for all functions reflect the reclassification of overheads, such as plant meal allowances, from direct labor to loadings on labor and an allocation of some additional training expenses to loadings on labor. King agreed that PT&T was unable to quantify the effects of these reclassifications, but it is also clear that those hours must be included somewhere, and Mirza had not done so, thereby understating expenses. Correcting this understatement by using the average of the 1981 and 1982 ratios would increase the staff's maintenance expense estimate by \$28.5 million, King said.

King disagreed with Mirza's estimate of the number of direct labor hours required for Subscriber Line Testing (part of the estimate for Account 603, Test Desk Work). Because Mirza used a derived trouble report rate based on a different number of access lines in service than was used by others in the staff, Mirza's calculation results in a reduction in trouble reports despite an increase in access lines. The 1983 estimate of trouble reports should be computed by calculating the ratio of 1982 customer trouble

reports to the staff's 1982 estimate of access lines and applying the resultant ratio to the staff's 1983 estimate of access lines, King said.

According to King, correcting for this apparently inadvertent error would result in an increase in Mirza's estimate of trouble reports for 1983 by 243,000. Applying Mirza's estimates of hours per trouble report and direct labor expense to this corrected customer trouble report rate would result in an increase in the staff's estimate of Subscriber Line Test expenses by \$3.2 million. Using the corrected loadings on labor and Mirza's other nonlabor expenses would result in an increase in the staff's estimate of this expense by another \$3.2 million, for a total increased estimate of \$6.4 million.

King claimed that Mirza's estimate of station upkeep hours in Account 605, Repairs of Station Equipment, is low because his estimate of trouble reports is too low. Also his estimate of station upkeep hours is also too low because it is based on a decrease in the number of hours required per trouble report. Finally, Mirza's estimate of station upkeep expense is too low because his estimates of nonlabor expenses for motor vehicles and miscellaneous and net billing are too low. Adjusting Mirza's estimate of station upkeep hours for both the understatement of trouble reports and the correction of hours per trouble report would increase the staff's estimate by \$27.2 million.

King disputed Mirza's estimate of the miscellaneous and net billing loadings on labor for Repairs of Station Equipment. King claimed that Mirza never requested 1981 or 1982 information on these items but the company did provide some information pertaining to these items although not so requested. Mirza proceeded to base his estimate on 1980 information, without regard for further detailed investigation, and therefore did not have a true "picture" on which to base an expense estimate.

According to King, the total effect of these three changes on the staff's estimate of Repairs of Station Equipment expenses would be an increase of \$54.8 million.

King challenged Mirza's computation of the Western Electric Billings and Engineering expense included in the station changes portion of Account 605, Repairs of Station Equipment.

Station changes include the cost of replacing, or relocating on the same customer's premises, station apparatus in good condition and also the cost of replacing station connections where service discontinuance is not involved. It also includes the costs associated with the connection, reconnection or reestablishment of service, and disconnection or deactivation of service for a customer at a particular location. Installation of station connections had been capitalized until November 28, 1981, the effective date of D.93728 which ordered expensing. Station changes also include the replacing of minor items of large private branch exchanges, the replacing of one small private branch exchange with another, modifications or improvements to public pay telephone, and the installing of jacks.

Station changes and station upkeep together comprise Account 605.

King said that Mirza's use of 1981 data did not accurately reflect the total effect of expensing station connections. The 1981 expenditures reflected 25% of expensing station connections, while 75% remained in capital from January 1 through November 28. Since the 1981 construction expenditures reflect only partial accounting for expensing station connections, the use of the 1982 budget and the 1983 BAU budget would be more appropriate. By using the 1982 budget and the 1983 BAU budget, the correction to the staff's estimate of station changes would result in adding \$40.9 million to Account 605, Repairs of Station Equipment.

Finally, King contested Mirza's estimate of the Central Office Equipment (COE) upkeep portion of Account 604, Repairs of Central Office Equipment. According to King, Mirza estimated a 15% improvement in productivity based on the implementation of electronic switching systems (ESS). King quoted Mirza as testifying that staff witness Weiss had accepted the utility's estimate of the modernization portion of plant to be added in 1983 (Tr. p. 1611 ff.). King said that Mirza's statement was not accurate. King pointed out that Weiss' estimate was actually lower than PT&T by 27% so, to be consistent, Mirza's 15% increase in productivity should be reduced by 27% to approximately 11%, and the staff's estimate for COE upkeep be increased by \$6.0 million.

In rejoinder to King, Mirza did not contest King's assertion that the staff's estimate of Account 605, Repairs of Station Equipment, was understated by \$40.9 million. He did defend all his other estimates.

Mirza denied that he had ignored recent data for loadings on labor. For two of the accounts staff estimates were higher than 1982 actual, and for a third, very nearly the same. To get them he used an average of 1980, 1981, and 1982 data or else 11 months' annualized data. For four of the seven accounts mentioned by King he did not use recent data because the utility did not provide the factual data requested. To the time of his rejoinder testimony, June 14, 1983, he still had not been provided the factual data he required.

Regarding King's contention that he had used inconsistent access line data, Mirza also said he had not been able to receive from the utility the exact difference between the access lines reported on PT&T's E-2700 report and the access lines used in the staff volume estimate. The utility indicated that it would take a considerable amount of time to get that information and Mirza was unable to verify what was included on the E-2700 and the staff volume

access line figures. Further, Mirza referred to the portion of King's rebuttal testimony, where King said that, in applying the ratio that King had derived, to the staff's 1983 estimate of access line gain, King had used a 1983 year-end figure. This tended to overstate the 1983 trouble report estimate because it assumes that the whole 1983 access line gain had occurred on the first day of 1983.

To question King's asserted correction of the staff's estimate of station upkeep hours for the understatement of both number of trouble reports and hours per trouble report, Mirza pointed out that the application of King's methodology would increase the utility's original NOI (and application) estimate by \$27.2 million (thus indicating a decline from PT&T's originally estimated productivity).

Mirza answered the contention that he had not followed up on the volunteered information concerning Account 605, Repairs of Station Equipment, for the reason that he had other data requests outstanding which he did not want to be delayed.

To King's final contention that Mirza's estimated 15% improvement in productivity attributable to ESS implementation should be reduced to 11%, Mirza said that the utility incorrectly assumed that he based the 15% productivity improvement on a direct relationship to number of access lines served by ESS in 1983. Actually, his 15% productivity improvement, which he considered to be a conservative estimate, was based upon engineering judgment plus considering three factors, a 20% increase in the number of access lines served by ESS in 1983, the estimated 12% increase in the number of ESS central offices in 1983, and the 10% annual historical decrease in the total hours per access line for the years 1975 to 1980.

Also, according to Mirza, the company misunderstood his use of the 1982 construction budget. He closed his rejoinder remarks by saying that in reducing his productivity improvement estimate to 11%,

the utility was only considering the modernization effect on central office upkeep and ignoring the effect on central office changes. With ESS modernization, the utility would not require the hours needed in the past to replace COE, nor would it require the engineering efforts associated with past replacements.

Discussion of Maintenance Expenses

In its brief, PT&T dwells upon Mirza's use of "engineering judgment" (PT&T's quotes) in evaluating trends in productivity, and states that in virtually every case the staff's 1983 estimates are completely off the historical trends shown in the staff's R/O report (Exhibit 28, pp. 8-41 thru 8-46). PT&T declares, at page 30:

"Thus the question of what is a proper estimate of maintenance expense for Pacific in 1983 becomes largely dependent upon whether the Commission accepts the staff's 'engineering judgment' as to the proper 'productivity level' that should be projected for 1983, rather than the estimates presented and supported by Pacific."

The Commission agrees with that assertion. The differences between the PT&T and staff estimates are the product of judgment of the expert witnesses making the estimates. It is incumbent upon the Commission to evaluate the quality of the estimates, and, where the estimates depend on "engineering judgment" the quality of such judgment.

Mirza's study of Maintenance Expense, Chapter 8 of Exhibit 28, of the staff R/O report, comprises 127 numbered paragraphs on 38 pages, plus 7 charts and 2 tables. He was cross-examined on his direct showing for approximately a day and a half.

The 127 paragraphs of Chapter 8 are not mere boiler plate, but are stocked full of detailed and meticulous justification of the staff position and its differences from the utility. PT&T, in its brief, correctly states that the staff estimates are completely off the trends shown on the seven charts "in virtually every case." Yet Chapter 8 identifies these differences and provides an explanation.

based on such information as the utility made available to the staff.

For example, regarding "loadings" Mirza reported:

"102. The staff requested the utility to justify with factual data the 55% increase in 1982 loading on labor expense (35% increase in 1981) from the 1980 level. The utility did not justify the total increase with the exception of one accounting classification change. On April 1, 1982, the utility reclassified tools and work equipment costing \$200 or less from Capital to Expense. The previous limit was \$50. The utility provided the impact for this reclassification.

"103. Because the utility did not completely justify the large 1981 and 1982 loadings on labor expense increases, the staff used the 1980 ratio of loadings to labor expense to direct labor expenses with an adjustment for the accounting reclassification. The staff believes that tremendous increase in loadings on labor expense in 1981 and 1982 may have also been impacted from the MATCH program. The 1983 loadings on labor expense was then derived by multiplying the 1983 direct labor expense times the adjusted 1980 loadings on labor ratio."

We believe that staff has made an excellent showing and has provided strong justification for its projected maintenance expense levels in nearly all cases. The staff expense levels are in general clearly more reasonable than those offered by Pacific.

We will adopt the staff position in all areas of maintenance expense with three exceptions. First, we will correct for the \$40.9 million understatement of Account #605 which both staff and the company agreed was in error. Second, we will adopt a more moderate productivity assumption for the direct labor component of Central Office Equipment Upkeep (Account #604). While

we agree with staff that the greater prevalence of ESS offices should allow increased productivity levels, we believe that the 15% productivity assumption for 1983 is too severe given recent experience, and we will instead adopt a 10% assumption, equivalent to the 1975-80 trend. Similarly, we believe that the staff productivity assumption of 18.5% in the direct labor component of Station Upkeep Repairs (Account #605) is too severe given recent experience in this area, and we will adopt 11.5% instead. The latter figure is half-way between the staff assumption of 18.5% and the utility assumption of 4.5%. The effect of these two additional adjustments in the staff maintenance expense forecast is to increase the maintenance expense level by \$29.255 million.

The maintenance expense level for the test year 1983 which the Commission finds reasonable is \$1,949,895,000 on a total California operations basis. This number is derived from the staff estimate of \$1,879,770,000 corrected for the three aforementioned changes. It is a proper estimate of expenditures given Pacific's service requirements and assuming reasonably efficient maintenance operations on the part of Pacific.

Pacific must strive to achieve the assumed maintenance efficiency levels if it is to earn its authorized rate of return. We note with alarm the staff's evidence, presented in Exhibit 28, of the recent decline in maintenance efficiency, particularly in the 1980-82 period. Implicit in our adopted maintenance expense levels is the assumption that Pacific will reverse this recent negative trend. To be successful in the increasingly competitive telecommunications marketplace, and to continue to provide service to its California ratepayers at reasonable cost, Pacific must improve its performance in this central part of its operations.

In re 70-17-88.1

Table 6

PACIFIC TELEPHONE & TELEGRAPH COMPANY
RESULTS OF TOTAL CALIFORNIA OPERATIONS

A.83-01-22 ESTIMATED YEAR 1983

DEPRECIATION EXPENSE THROUGH RECAST #3

(\$000)

Item	PT&T	Staff	PT&T Exceeds Staff
CI-II Depreciation Expense	\$ 977,255		
SL-RL Adjustment	29,942		
Triennial Represcription	241,957		
CI-II W/SL-RL and Triennial Represcription	1,249,154	\$1,241,000	\$8,154
Other Adjustments			
Ratemaking 'Vertical' SL-RL Adjustment	-	1,390	(1,390)
Western Electric Price	(9,839)	(12,473)	2,634
IDC Rate	(324)	(324)	0
IDC Short Term	5,233	5,233	0
ESC Phase-In	(2,412)	(2,412)	0
Subtotal Ratemaking Adj.	(7,342)	(8,586)	1,244
CPE Sales	(14,700)	(14,416)	(284)
Rate of Return	(99)	-	(99)
Total Adjustments	(22,141)	(23,002)	861
Depreciation Expense-Recast #3	1,227,013	1,217,998	9,015
Reconciliation:			
'Vertical' SL-RL Adj.		(1,390)	
Western Electric Price		12,473	
Depreciation Expense (Staff format)		\$1,229,081	

NOTE

Staff estimate reflected SL-RL adj. for Maintenance, Traffic, Commercial and Balance Other in Depreciation Expense. Staff report showed Western Electric Price adj. as a separate line on the Results of Operations:

Represcription

Pursuant to Section 220(b) of the Communications Act of 1934, as amended, the Federal Communications Commission (FCC) prescribes depreciation rates for the "carriers" subject to its

jurisdiction, including PT&T, and such rates must be used on the carriers' books.

For many years the FCC prescribed depreciation rates using the "Straight-Line Total Life" (SLTL) method. This is the conventional method by which depreciation rates are commonly calculated.

In D.50258, dated July 6, 1954 (In No. 33935 (53 Cal. PUC 275, 330) this Commission ordered PT&T to maintain memorandum depreciation records according to the Straight-Line Remaining Life (SLRL) depreciation method and, since 1954, the Commission has used that method for California jurisdictional rate setting purposes.

Some 26 years later, in 1980, the FCC, by its "Report and Order" in Docket 20188, permitted the use of SLRL and PT&T adopted that method for its books. Because of the differing Federal and lower state depreciation methodologies over the 26-year period, there was a difference between the book and memorandum reserves.³

Remaining life depreciation, by taking into account the depreciation already accumulated and the life remaining to the property, insures that the total depreciable cost of the property will be recorded over the life of the property.

Because of the difference in depreciation reserves accumulated over the 26-year period that the Federal and California depreciation methodologies were different, the book and memorandum record depreciation rates will be different, even though the same remaining lives and salvage values are used.

The FCC prescribes depreciation rates at three-year intervals. Prior to prescription, it is customary for PT&T to submit proposed changes to the FCC and California Commission staffs. After a detailed review of the telephone company's initial proposal the staffs suggest any changes that they consider appropriate and then meet jointly with the company to discuss the depreciation

³ On December 31, 1981 the book reserve, accumulated using SLTL, was \$3,048,763,942. The corresponding SLRL memorandum record reserve was \$2,836,860,034.

proposals and, if possible, to agree on all depreciation factors. Upon agreement, the California Commission staff would recommend approval of the depreciation factors to the Commission by a draft resolution. If agreement cannot be reached, PT&T may then request approval by an application.

Represcription for PT&T, according to the three-year cycle, came up on 1982 and on May 10, 1982, PT&T requested changes which would have increased accruals by \$427,943,000 or 53.8%. After 1981 reviews and counter proposals, the FCC and CPUC staffs met with PT&T in San Francisco on July 12, 13, and 14, 1982, and agreed on proposed depreciation changes that would increase total company accruals by \$227,477,000, or 28.6%.

The large increase was necessitated by technological obsolescence of switching equipment, introduction of fiber optics in transmission plants, and by reduced lives for terminal equipment because of deregulation. Depreciation Application A.82-11-07

Because of the magnitude of the change, the staff recommended that PT&T request approval by means of an application rather than a resolution. PT&T thereupon filed A.82-11-07 which, because of the pendency of the general rate case, was subsequently consolidated with 83-01-22.

By A.82-11-07, PT&T asked that California intrastate revenues be increased, on a 1981 test-year base, by \$165,800,000, not including the effects of settlements. This proposed intrastate increase was made up of three parts:

1982 represcription of 1981 base \$156,728,000

Elimination of calculation lag \$7,450,000

Rounding Rates to one decimal place 1,669,000

\$165,847,000

Prior to the filing of A.82-11-07 PT&T had made the request to eliminate the calculation lag and rounding of depreciation rates

1982 represcription of 1981 base \$156,728,000
Elimination of calculation lag \$7,450,000
Rounding Rates to one decimal place 1,669,000
\$165,847,000

to one decimal place in the continuation of the last general rate increase A.59849. The depreciation issues in A.59849, as will be explained below, were not resolved in D.93367, but deferred to a later decision in that application.

PT&T has indicated that it will not begin charging the increased intrastate depreciation associated with the new depreciation factors, either on the books or in the California memorandum records, until the new depreciation factors are approved by the Commission. It has charged the higher depreciation on its interstate plant, however.

Following the consolidation of A.82-11-07 with A.83-01-22, PT&T distributed prepared testimony by Joseph P. Tami, district staff manager - capital recovery, financial management. In this testimony Tami updated the total California depreciation accrual increase by approximately \$3 million, from \$239,194,000 to \$241,957,000. Since increased depreciation has an offsetting effect on income taxes, the revenue requirement effect of the updating would be somewhat less than \$3 million accrual increase.

Tami, who represented PT&T in the triennial rescription meetings, was responsible for PT&T's depreciation proposal to the

The Revenue Requirements Division was represented at the triennial rescription and at the hearings by Michael F. Yee, PE, an Associate Utilities Engineer.

Yee presented a comprehensive report (Exhibit 76A) which gave a complete history of the controversies incident to reaching the rescription agreement and he recommended acceptance of the agreed depreciation factors by the Commission. As mentioned earlier, because of estimating differences on other areas than depreciation factors, the PT&T memorandum record depreciation expense estimate is \$9,015,000 higher than the staff's. Because of the truly enormous size of depreciation expense, this is only a 0.37% difference in depreciation expense levels.

Effect of D.83-08-031 was to reauthorize the rate base adjustment for "stranded investment" and D.93367 ordered further hearings on depreciation issues which arose in A.59849 et al. and, on August 3, 1983, the Commission issued D.83-08-031 in these proceedings. D.83-08-031 made a \$19 million rate base adjustment for "stranded investment" and allowed \$45,000,000 in increased rates to allow for higher depreciation, prior to reflecting the rescription rates in this decision. D.83-08-031 expressed the intention that the \$19 million rate base adjustment be included as part of this general rate case proceeding.

D.83-08-031 was issued after the taking of evidence in the first phase of this proceeding had been concluded. None of the results, therefore, reflect the order in D.83-08-031. The changes necessary will be grouped as "Recast 4" and will be included in the final calculation of any revenue increase required.

Single decimal rounding was used to calculate results in D.83-08-031 but neither that issue nor the elimination of calculation lag was specifically addressed in that decision. These issues will be resolved in this one.

Opposition to Rescription Results

The implementation of the rescription life and salvage factors was opposed by Towards Utility Rate Normalization (TURN), and a "Users Group" composed of American Broadcasting, CBS, California Clearing House Association, and Tele-Communications Association, and by the Commission Staff Counsel (but not by the technical staff).

TURN presented Ida B. Pound, Ph.D. as its depreciation witness. Dr. Pound, an accounting educator at College of Alameda, has taught accounting for 14 years and has participated actively in accounting professional associations.

Dr. Pound was generally critical of the rescription process. She explained that the proper matching of revenues, costs, and expenses is necessary to avoid distortion of net income.

Accordingly, she said, the simplest and most logical method of depreciation accounting is to distribute the cost of property in a reasonable and consistent manner to all the accounting periods related to its use. A frequent reexamination of the asset lives and salvage factors violates this principle and causes net revenues to be subject to the vagaries of estimates upon estimates upon estimates of remaining lives. The resulting change in the bases for determination of net income thus appears to run counter to such qualitative accounting concepts as comparability, consistency, reliability and verifiability.

Another contention of Dr. Pound was that the frequent represetation of service lives lends itself to a charge of abuse and manipulation in order to justify a rate increase. Internal controls must be clearly established and publicly recognized to avoid even the suspicion of abuse and manipulation for financial expediency.

Additionally, she testified, Generally Accepted Accounting Principles while not perfect, strive for the use of objective data in the reporting of results of operations and financial position of an entity. In the triennial reexamination of asset lives and salvage factors, objectivity is non-existent. In fact, this case, the doctor said, amounts to gazing into a crystal ball to forecast advancing technology and other factors that may lead to obsolescence of the asset. Making decisions based on the opinions of the tri-partite committee of the FCC, the CPUC and PT&T engineers, with seemingly a common interest to give the company more revenues, is thus decision making, or revenue producing, based on speculation.

Dr. Pound was concerned that encouraging dubious use of depreciation accounting as a device for seeking rate increases could place the CPUC in an embarrassing anti-public posture that would be a signal to other utilities to adopt the same practice to the detriment of users. The CPUC would be legitimizing what, in her view, is an inappropriate manipulation of asset lives and salvage factors to

increase the depreciation expense and thus justify an increase in revenues.

According to TURN's witness, most enlightened businesses would normally dispose of assets that become prematurely obsolete assets through exchange, sale, or abandonment and, if necessary, incur losses as a result. Such losses also result in tax savings as some measure of compensation, however any such losses would be the burden of the company, i.e., flow through to the stockholders, and might affect rate of return.

In the case of PT&T, should losses due to obsolescence result in a lower rate of return, net of tax savings, the company would have a more objective basis for seeking a revenue readjustment. In other words, Dr. Pound believed, this type of factual basis would be a more appropriate predicate for a revenue increase than recurring subjective shortening of service lives and salvage factors to accomplish this purpose.

TCA Group's Depreciation Position

American Broadcasting Company, Inc., CBS Inc., California Banks Clearing House Association, and the Tele-Communications Association (TCA Group) sponsored testimony prepared by Lee L. Selwyn, PhD. Dr. Selwyn was retained by the TCA group to offer testimony on affiliated relations, divestiture and rate design. Since his testimony dealt only incidentally with depreciation, the parties stipulated that he need not travel from his headquarters in Boston to sponsor the exhibit in person.

Dr. Selwyn was active in the last general rate case and his contributions regarding depreciation as related to migration strategy are discussed extensively in D.83-08-031.

In this proceeding Dr. Selwyn was concerned that increased depreciation would cause PT&T ratepayers to pay increased depreciation on plant assets scheduled to be transferred to AT&T, and AT&T would then pay less as the net book value at which they are to

be transferred would be less. Dr. Selwyn alleged that PT&T adopted remaining life for this very purpose. Dr. Selwyn also said that, by increasing depreciation rates, PT&T was attempting to recover stranded investment through higher depreciation expenses.

Gibbons' Comments on Depreciation

At the invitation of the ALJ, the Assistant Director, Finance, of the Revenue Requirements Division, John J. Gibbons, commented on Dr. Pound's testimony. Gibbons is the Commission's chief advisor in accounting matters.

Gibbons testified that while he generally agreed with Dr. Pound's testimony, he thought there was some misunderstanding on her part of the differences in accounting for utilities and non-utilities.

He explained that in unregulated businesses, fixed assets and depreciation are far less important than they are for utilities. In nonregulated businesses, major assets are typically inventories and receivables. Depreciable assets would ordinarily be buildings, for which service lives could be selected and continued unchanged until sold or disposed of. At the time of disposition the enterprise would report a gain or loss on the sale of the assets, and that would be that.

For a utility to follow this practice would be undesirable because it would tend to assign losses on retirement to the wrong generation of customers. Should an asset with a 40-year estimated life be retired after only 30 years, as under Dr. Pound's proposed accounting treatment, the entire burden of the undepreciated cost would be borne by the customers at the 30th year when it was retired. If, on the other hand, as a result of continuing reexamination of asset lives, it could be determined at the end of the 15th year, that the asset was only going to last 30 years, the undepreciated balance could be spread over the remaining years and that practice would be much fairer to the utility customers.

He pointed out that frequent review of utility depreciation rates was commonplace, not only in California, but in other states, and not only for telephone companies, but for all kinds of utilities. Major utilities are audited by CPAs who give unqualified opinions, in most circumstances, so there was no question in Gibbons' mind that they felt as he felt.

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Staff Counsel's Position on Depreciation

The Revenue Requirements Division, having participated in the rescription process, and having presented witness Yee to support the results, naturally recommended their adoption. Staff Counsel, however, had a different position. The pertinent part of the staff brief with respect to the A.83-11-07 depreciation request is quoted verbatim as follows:

"Some controversy surrounds the triennial rescription application. The history of the rescription process and the Commission staff's participation in the current triennial rescription is discussed in Exhibit 76. It is significant to note that throughout its entire history, at no time has this Commission, or any other commission, been presented with a demand for accelerated capital recovery and a consequent increase in revenue requirement on the order of the amount requested herein (\$166 million).

Resistance to this major request has appeared in many state commissions. PT&T has indicated they will not begin booking the expense until it is authorized by this Commission.

"On January 6, 1983, the FCC released its memorandum opinion and order (FCC 82-581) in CC Docket No. 789-105 RM-3017, which, in effect, reversed its earlier policy of allowing each state to determine its own depreciation rates for intrastate ratemaking. In its January order, the FCC provided that state commissions are henceforth precluded from departing from depreciation rates set by the FCC. This Commission has appealed the preemption aspect of the order.

"Notwithstanding the appeal by this Commission of the attempted preemption by the FCC, the staff recommends that the company be required to continue maintaining separate memorandum accounts on an intrastate basis. The Commission should not act upon the requested \$166 million until there is a final decision in the court appeal which is not subject to further review."

At the oral argument staff counsel clarified that, in this passage of the brief, the word "staff" referred to staff counsel, and not to the technical staff.

Depreciation Discussion

Though dispelled to a great extent by the agreement reached as a result of the represcription process, some confusion remains in the two major depreciation issues to be reached on this case, namely the appropriateness of the remaining life method and the use of the prescribed depreciation factors in determining revenue requirement in this case.

The straight-line remaining-life method was adopted 30 years ago by all major California utilities, with the exception of PT&T.

At that time remaining-life was conceived as a measure to enable the ratepayer to receive a benefit for depreciation accruals

accumulated during World War II when plant replacement was greatly curtailed. Now, because of the accelerating rate of obsolescence affecting many things associated with electronics, remaining

depreciation discussion

depreciation life provides a reassuring protective blanket to communications utilities, and the Bell System has embraced it with the fervor typical of recent converts. The merits of the method are unchanged, however, regardless of the fact that the telephone company no longer opposes it. As Dr. Pound testified, recognition in a rate proceeding of faster depreciation rates gives the company more revenues. The straight-line remaining life method has a built-in self-correcting mechanism to compensate for the errors inherent in estimates of asset lives and salvage.

As to Dr. Selwyn's objections, this decision will not become effective until after divestiture. The effect of any increased depreciation expense will be moot, and the problem of stranded plant was allowed for in D.83-08-031.

The Commission, in D.83-08-031, used single decimal place rounding, and PT&T's request that this practice be formally recognized is reasonable.

We will eliminate the one-year lag in the review process, and use remaining lives, plant, salvage and reserve balances applicable for the year in which remaining life depreciation rates are set. Such an arrangement would benefit all concerned.

It is unfortunate that rate increases associated with faster depreciation rates have been proposed at a time when rates are increasing for other reasons. However, we believe changes in depreciation rates are required at this time to reflect rapid changes

in technologies and the resulting obsolescence of much existing equipment. The depreciation expense recommend by staff is reasonable and will be adopted.

We adopt the staff number because it is reasonable not because it results from a "deal" struck between staff, the utility and the FCC staff. The Commission is not bound by the informal process of represcription. Further, the appropriateness of that process is not an issue to be decided in this proceeding.

In response to staff's concerns, we note that our action here is not a concession to the FCC on the issue of state jurisdiction over the establishment of depreciation rates for

intrastate plant and intrastate ratemaking. In spite of the pendency of the Commission's suit over the matter of jurisdiction, we must rule in the meantime on the technical aspects of depreciation expense.

Traffic Expenses

Traffic expenses consist of salaries, wages, and administrative costs incurred in the handling of telephone calls by switchboard operators, and the costs associated with administering the utilization and performance of the switching network.

The estimate that PT&T made for this category of expenses exceeds the staff estimate by \$39,283,000 or 10.2%. A comparison of the two estimates is shown in Table 7:

Table 7

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

RESULTS OF TOTAL CALIFORNIA OPERATIONS

A-83-01-22 ESTIMATED YEAR 1983

TRAFFIC EXPENSES THROUGH RECAST #3

(\$000)

Item	PT&T	Staff	PT&T-Exceeds Staff
Account 621 General Trf. Supvr.	\$ 58,084	\$ 55,564	\$ 2,520
622 Service Inspec. and Cust. Instr.	6,720	7,701	(981)
624 Operator's Wages	295,008	269,288	25,720
626 Rest and Lunch Rooms	161	0	161
627 Operator Employment Training	10,869	6,870	3,999
629 C.O. Stationery & Print.	8,041	4,772	3,269
630 C.O. House Service	4,782	4,184	598
631 Misc. C.O. Expense	41,049	37,679	3,370
632 Public Tel. Expense	902	475	427
Wage Overlay	485	0	485
Subtotal	\$426,101	\$386,816	\$39,285
Adjustment			
CI-II			
Depr-SL-RL	(16)	(16)	0
Recast #1, #2, #3 Total	\$424,501	\$385,218	\$39,283
SL-RL Adjustment added back		16	
		\$385,234	

(Red Figure)

Traffic Expenses are labor intensive and approximately 70% of the category consists of Ac. 624, Operators' Wages.

PT&T's estimates were based on its 1982 NOI "View" of the 1983 test year based on a higher level of economic activity than that of the staff. The economy did not perform as anticipated and, in its brief PT&T stated that, while it had reservations concerning the consistency of the methodology used throughout the staff report (Exh. 28), the staff evaluation of Traffic Expenses appeared to be internally consistent and the utility had no reservations about the staff estimate.

The PT&T showing was presented by Vice President King, and the staff study by Arthur J. Nettles, PE, an Assistant Utilities Engineer in the Commission's Communications Division.

Because Nettles' excellent work, although differing significantly from the company's results, received practically complete acceptance by PT&T, the Commission will adopt his recommendation of \$385,218,000 as a reasonable 1983 test year allowance for Traffic Expenses.

Commercial Expenses - Overview

Commercial Expenses consist of salaries, wages and administrative costs for handling customer service order contracts, the field collection of revenues, marketing and sales functions including advertising, and the expense associated with the preparation and distribution of telephone directories.

PT&T's 1983 test year estimate of \$808,990,000 for this category exceeds the staff estimate of \$711,778,000 by \$97,212,000 or 13.7%.

The derivation of the two estimates is shown in Table 8:

Table 8

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

RESULTS OF TOTAL CALIFORNIA OPERATIONS

A.83-01-22 ESTIMATED YEAR 1983

EXPENSES THROUGH RECAST #3

(\$000)

Item	PT&T	Staff	PT&T Exceeds Staff
Account			
640 Gen. Coml. Adm.	\$174,744	\$172,426	\$2,318
642 Advertising	33,828	33,302	526
643 Sales Expense	142,729	141,335	1,394
644 Conn. Company Rel.	1,111	1,101	10
645 Local Commercial Ops.	394,043	359,529	34,514
648 Public Tel. Comm.	17,331	17,058	273
649 Directory Expense	171,743	169,038	2,705
650 Oth. Coml. Exp.	60	60	0
Sub-Total before adjustments	\$935,589	\$893,849	\$41,740
CII	(115,308)	(163,407)	48,099
Ratemaking Adjustments			
CI-II-COLA & CPI Adja	0	(7,978)	7,978
Advertising	(4,025)	(4,355)	350
Multi-State Marketing	(3,753)	(3,753)	0
Sale of CPE	(3,400)	(2,465)	(935)
Depr. SL-RL	(86)	(86)	0
Dues and Donations	(27)	(27)	0
Recast #2, #3, Total	\$808,990	\$711,778	\$97,212
SL-RL Adjustment		711,891	
Dues and Donations added back			
(Red Figure)			

As can be seen from the table, the major difference is in the estimate of the effects of CI-II. The second major difference was in Ac. 645, Local Commercial Operations.

PT&T's estimate was sponsored by Vice President King and the staff's by Associate Utilities Engineer Gerald H. Busch, P.E., of the Commission's Communications Division.

Commercial Expenses,
BAU and CI-II Differences

After reviewing PT&T's CI-II overlay to its 1983 BAU estimates of commercial expenses, Busch concluded the utility's CI-II overlay method did not consider all the major changes that needed to be made to its normal operating practices, resulting in overstatement of commercial expenses before applying the CI-II overlay. The staff, therefore, made its own estimate, using productivity and volume estimates, which affected Ac. 645, Local Commercial Operations, and different COLA and Consumer Price Index (CPI) factors, which affected all of the BAU Commercial Expense accounts.

Busch's Ac. 645 expense estimate was lower than the utility's because he estimated lower volumes and better productivity than the utility did for the Business Service Center (BSC) and Residence Service Center (RSC) offices. He found that the utility estimated lower productivity for the RSC's processing of service orders and live collections for 1982 than actually occurred. This underestimation contributed to the difference between the 1983 staff and utility BAU estimate of Ac. 645 offices expenses. The above adjustments resulted in \$31,030,000 of the difference in Ac. 645, Local Commercial Operations expense.

The staff 1983 BAU commercial expenses are also less than the utility's because of the use of COLA and CPI estimates which are less than the utility's. Busch used COLA and CPI factor estimates provided by the Revenue Requirements Division. The staff's COLA and CPI reduced the labor and other expense in each commercial account by 2.0% and 1.6%, respectively, resulting in a \$15,822,000 difference between the staff and the utility. The \$15,822,000 is not shown separately but was apportioned to each commercial account proportionate to the account's amount of labor and other expenses.

Differences in the PT&T and staff's Commercial Expense Base estimates are difficult to reconcile because of the format adopted for this decision, which was adapted from the sequence of events transpiring during the company's preparation of its case. The company used a CI-II overlay to its BAU showing, whereas the staff has estimated a one-piece 1983 showing, using the CI-II guidelines. The differences between the parts of the makeup cannot be identified on the previous table but are spread out among the items.

The differences between the various accounts, on a CI-II basis, as explained by the staff, are as follows:

Ac. 640, General Commercial Expenses

PT&T's estimate of Ac. 640 on a CI-II basis of \$144,596,000 exceeds the staff's estimate of \$143,512,000 by \$1,084,000 or 0.8%. The difference is due to the staff's reduction of the utility's \$6,451,000 PhoneCenter expenses charged to this account by \$1,084,000 or 16.8%. An explanation of this reduction is discussed under Ac. 645 because it is directly proportional to the large reduction in PhoneCenter expenses proposed by the staff in that account.

Ac. 643, Sales Expense

PT&T's estimate of Ac. 643 on a CI-II basis of \$84,403,000 exceeds the staff's estimate of \$42,546,000 by \$41,857,000 or 98.4%. The difference is due to the staff's reduction of the utility's estimate of Marketing Sales force in Business Services. Marketing Sales' salaries and expenses represent the major portion of this account. The staff contends that, because of CI-II, a larger sales force will not be required because PT&T no longer will have an inventory to sell, especially of the larger PBX systems such as Dimension and Horizon.

PT&T contended that the sales force will concentrate on sales of Centrex, a system that relocates switching functions of a PBX back to the utility's central office. Also, the sales force will

would put more emphasis on wide area telephone service and other network and toll stimulation. The difference in effecting was not significant.

It appeared to the staff that PT&T does not follow upon the economic justification on these offerings to determine if they are profitable.

The staff recommended what it considered to be a sufficient sales force to serve the utility's business premise equipment needs of customers, to market Centrex, to sell network services, and to manage PT&T's existing business customer accounts. This would be 945 people as compared to the 1,600 proposed by PT&T.

Ac. 645, Local Commercial Operations

The staff's estimate of test year 1983 Ac. 645 expense is \$334,438,000 and the utility's 1983 CI-II estimate is \$379,652,000. The utility's estimate exceeds the staff's by \$46,214,000 or 13.8%. Of that difference \$7,708,000 is in BSC expenses, \$23,490,000 is in RSC expenses, and \$15,016,000 is in Phone Center Store (PCS) expenses.

PT&T maintains BSC offices where its business customers can place telephone service orders, make billing adjustments, and register questions, complaints and other inquiries with the utility. BSC offices process service orders for entry to the utility's appropriate computer or order processing systems, and they perform bill collection activities.

The lower staff BSC estimate was based on recorded data from through November 1982, as compared to the telephone company's March 1982 data. The later data indicated to the staff that 1983 BSC activities would be lower, and its estimate of BSC expenses of \$121,978,000 was \$7,708,000 lower compared to PT&T's 16.3% higher overall estimate of \$129,686,000.

The RSC offices of the utility perform essentially the same duties as the BSC offices except they are for residence customers. The lower staff estimate of RSC expenses was caused by the unavailability of November 1982 data by the staff's lower forecasted

work volumes, by improvements in productivity expected by the staff, and by the transfer of PCS to AT&T.

The staff estimate allowed for the effects of several advanced business information projects coming on line which will greatly facilitate street address location and assignment of outside plant.

The transfer of the PCS to AT&T required the RSC offices to assume the utility related functions formerly performed by the PCS. This CI-II impact caused PT&T to assign an additional 1,206,000 person-hours to RSC. The staff considered 889,000 person-hours to be more appropriate.

PT&T estimated 1983 test year RSC person hours at 12,359,000. The staff thought 10,789,000 a more likely figure. Their PT&T 1983 expense estimate for RSC office expense was \$207,639,000, which was \$23,490,000 a 12.8% higher than the staff estimate.

Before CI-II, the PCS were the utility's familiar retail outlets. PT&T positioned, through its advertising and other methods, the PCS as the place for residence customers to go to obtain the utility's products and services. In addition to meeting the customers' terminal equipment needs, the PCS initiated orders for local access lines and any desired network services.

In addition to PCS, the utility maintained and still maintains Bell Customer Service Centers (BCSC). The BCSC are leased, spaced locations that provide only defective equipment replacement program and return services. They are typically located in small towns which PT&T deemed could not support a PCS operation anywhere a PCS location actually closed due to declining activity. The BCSC, however, perform no order activity as do the PCS. Additionally, they are typically open only from 10 a.m. to 2 p.m., Monday through Friday.

The staff reviewed the workpapers by which PT&T made its 1983 PCS and BCSC estimates and initiated a series of inquiries. Not

being satisfied that the company estimate adequately took the many new ramifications of CI-II into account, the staff proceeded to make its own independent estimate for these activities.

The staff also, in the field, reviewed the activities of the PCS's and BCSC's. Beginning in January of 1983, the PCS's were being renamed "PTSC" (Pacific Telephone Service Centers), and the emphasis shifted from sales of terminal equipment to service. The staff estimated that 80% of the 3,410,000 service orders that it estimated for 1983 would be transferred to RSC's. The staff also determined that orders would be processed more efficiently at the RSC's because no time would not be spent in lengthy sales presentations for telephone equipment. Moreover, the calling card campaign of 1982 required credit checks while the customer was placing his order.

A field inspection of a BCSC, and a review of the operating records of others, revealed to the staff that for relatively high net operating rent, these facilities experienced small set replacement and return activity.

The PT&T management told Busch that essentially all plans for residence telephone set distribution came from AT&T in New York and New Jersey. AT&T was undertaking field trials into alternate set distribution systems that could be more cost-effective than PCS or BCSC. These systems included contracting with service agents who could perform multiple activities including set recovery, order pickup, and dropoff. Additionally, the utility was considering expanding its contract with PhotoMat so that a customer, in addition to telephone set drop off or return, could also arrange pre-arranged negotiated set pickup and/or defective equipment exchange.

Rate-making Adjustments

Both PT&T and staff reduced their CI-II estimates for rate-making adjustments. The staff Advertising adjustment eliminates \$330,000 that was budgeted for PT&T's Olympic Sponsorship Program. The staff considered this institutional advertising. The Multi-State

Marketing over which there was no disagreement, was the portion the MSM benefiting AT&T Long Lines. The COLA and CPI adjustments are to reflect the staff CI-II estimates of these items. As explained earlier, the differences in BAU, COLA, and CPI rates are included in each of the BAU accounts.

Commercial Expenses - Rebuttal and Surrebuttal

PT&T Vice President King responded that PT&T must stimulate and generate additional revenues and it is imperative that PT&T retain its current revenue stream and minimize competitive vulnerability. PT&T must remain responsive to customer demands in order to meet its obligation to serve all customers. To that end it is essential for PT&T to maintain its customers' confidence by having an aggressive, professional sales force well positioned to serve its customers. King did not consider the staff's 945-person premise sales force adequate to meet PT&T's own revenue estimates for 1983 or the staff's estimates.

King questioned the staff's 14-minute production time per RSC order, based on the actual experienced 1982 time requirements. In the NOI estimate PT&T used 20 minutes and King said that the 1982 experienced value was atypical. In 1982 80% of the "inward" (new customer) orders were taken at the PCS. These take the longest to complete and will impact 1983 RSC order production time because of their transfer to RSCs. Also, the 1983 Single Line Sales program will impact customer contact time, since this program was not in effect for most of 1982. Also, in 1982, PT&T initiated a one time "calling card" (credit card) sales campaign. During the approximately 8 months of this campaign, order production time decreased to 8 minutes. After the campaign, it rebounded to 21 minutes.

King criticized the sample of 40 orders that Busch took to validate his 14-minute estimate. Considering the 9 million RSC

orders processed in 1982, 40 was clearly not a large enough sample to produce a valid judgment.

King said that the staff's methodology was used to estimate an allowance of 236,072 person-hours for all work activities other than order negotiation in PTSC. He said there would continue to be significant activity in the area of set returns, set replacements, set distribution and payments collection work activities.

In response, Busch contended that the high, 21-minute order processing time at the end of 1982 was caused by the transfer of PCS to AT&T and the reassigning of PT&T personnel from the stores to RSC. During the transition time orders were handled jointly by the PCS and RSC. He introduced as an exhibit a sheet from a PT&T training manual which indicated from role-play studies and an actual shared contact trial that this shared contact program would take service representatives an average of 22 minutes for a new connection and 15 minutes for a transfer. Busch verified this by monitoring contacts in field visit to a PT&T office.

Busch also said that the calling card campaign involved postcard replies, use of an 800 number, and PCS, as well as RSCs. Where an RSC contact was involved, time requirements were increased, because the sales reps were selling credit cards as part of a total package involving "inward" orders and transfer orders.

Busch concluded by repeating his assertion that PT&T was aggressively selling services regardless of their profitability, in order to achieve revenue goals, and gave Dataphone Digital Services (DDS) as an example. DDS had been cited by Mr. King as one of the profitable services for which PT&T's account executives would be taking a very aggressive and "proactive" role in finding solutions for its customers' business problems. Busch presented an exhibit showing DDS had realized negative or very low annual rates of return since its inception; when the provisional DDS tariff expired in November of 1982, PT&T did not renew it.

Discussion of Commercial Expenses

From a careful evaluation of the record concerning Commercial Expenses, the Commission concludes that the staff estimate is a reasonable allowance of an amount necessary to fund PT&T's customer service, marketing and sales functions for the test year 1983. The staff's estimates are based on later data and a realistic appraisal of the effects of CI-II on sales activities. We will, however, make one revision in the staff estimate. We agree with Pacific that the staff estimate of Account #645 is in error because the staff not only reduced new order volumes in Phone Center stores by 80% to reflect their transfer to Residence Service Centers, it also reduced other order volumes in Phone Center stores by 80%, even though these latter volumes were not transferred elsewhere. The effect of this revision is to increase the staff's commercial expense level by \$7.8 million.

The Commission will find that \$719,957,000 is a reasonable allowance for Commercial Expenses on a Recast 3 basis. This amount should be more than sufficient for PT&T to field a prudent level of sales and marketing effort commensurate with its transition to an independent utility.

General Office Salaries and Expenses

General Office Salaries and Expense includes those operating costs incurred in performing the executive, accounting, treasury, legal, personnel, public relations and other general office functions.

Although the staff's estimated General Office Salaries and Expenses were \$16,774,000 less than PT&T's, the company contested only the staff allowance for Ac. 664, Law Department, which was \$682,000 lower than the utility, and a reduction of \$125,000 in Ac. 665, Other General Office Salaries and Expenses, which represented cost of anti-trust litigation.

This category of expenses was presented by PT&T's Vice President King, and by the Commission staff's Randall C. Chinn. Chinn was also responsible for the category "Operating Rents", and for "Balance Other Operating Expenses", except Ac. 672, Relief and Pensions, and also for the Business Information Systems portion of Ac. 675, Other Expenses.

The development of the General Office Salaries and Expenses category is shown on Table 9:

General Office Salaries and Expenses

Table 9 (continued) 1983
PACIFIC TELEPHONE AND TELEGRAPH COMPANY
RESULTS OF TOTAL CALIFORNIA OPERATIONS
A.83-01-22 ESTIMATED YEAR 1983
GENERAL OFFICE SALARIES AND EXPENSES THROUGH RECAST #3
 (\$000)

Item	PT&T	Staff	PT&T Exceeds Staff
Account			
661 Executive	\$ 3,044	\$ 3,044	
662 Accounting	198,320	198,320	\$ 5,448
663 Treasury	11,930	11,930	
664 Legal	10,645	9,963	682
665 Other	259,044	252,257	6,787
Wage/Salary	220	0	220
Subtotal	\$483,203	\$470,066	\$13,137
Adjustments			
CI-II	(8,557)	(9,190)	633
Net CI-II	474,646	460,876	13,770
MIPP		(2,333)	2,333
Subtotal	\$474,646	\$458,543	\$16,103
Ratemaking			
Citizenship	(12)	(12)	-
Legislative	(481)	(481)	-
Dues & Donations	(246)	(246)	-
Antitrust	(75)	(200)	125
Shareholder	(99)	(99)	-
Subtotal Ratemaking	(913)	(1,038)	125
Recast #1 Subtotal	473,733	457,505	16,228
Sale of CPE		(546)	546
Recast #2, #3 Total	473,733	456,959	16,774
Dues & Donations Removed		(27)	27
		\$456,932	
	(Red Figure)		

The legal expense adjustment was based on the staff's elimination of five new positions in the Legal Department proposed to handle a claimed 50% increase in workload. Chinn was not able to secure adequate justification of this staffing increase from PT&T in time to complete his report and so removed the five positions.

The record is not clear whether the five positions were at the clerical, para-legal or professional level. Even assuming they are all lawyers, \$136,400 per position is not cheap. A fundamental budgeting rule for submitting requests for new positions is that each of the positions must be fully justified by adequate workload statistics. Lacking specific justification, new positions cannot be authorized. The Commission will accept Chinn's estimate which excludes the five new positions.

Chinn's elimination of \$125,000 is part of an overall antitrust adjustment prepared by staff accountant Jimmie G. Low. For reasons that will be discussed under the heading "Antitrust Expenses", the Commission will not make this adjustment. Adopted General Office Salaries and Expenses, through Recast #3, are therefore \$457,084,000.

Service Measurement

Daljit Singh, P.E., conducted an extensive review and analysis of PT&T's telephone service quality and prepared a report which was received as an exhibit.

Singh concluded that PT&T's overall service performance is in the standard service range. He believed the level of telephone service to be generally satisfactory and adequate.

Singh explained the uniform standards established by the Commission's General Order 133, Rules Governing Telephone Service and reported very favorable performance by PT&T as measured by these standards.

Singh reviewed PT&T's internal service quality indicators and was not impressed by two of the telephone company's customer opinion service surveys, the Telephone Service Attitude Measurement (TELSAM) and Telephone Consumer Attitude Measurement (TELCAM).

TELSAM measures customer satisfaction with PT&T's service after a contact by the customer with one of the company's service activities, such as installation and repair service centers, PhoneCenter stores, business offices, etc. A sample of such customers are contacted and are subjected to a structured interview in order to obtain the customers' appraisal of the quality of the company's service. To insure objectivity, the interviews are conducted by outside public opinion specialists.

Singh, while satisfied with the sampling procedures, thought that the TELSAM questionnaires were designed to obtain a high percentage of favorable customer responses. He considered them to be more a measure of the courtesy of PT&T's employees rather than of basic telephone service. Singh testified that his analysis showed that TELSAM results cannot be substituted for basic telephone measurements, such as those required by GO 133.

Also, according to Singh, extensive revisions on the TELSAM questionnaire destroyed the validity of many of the measurements for comparison purposes in observing specific trends.

The staff recognized that courtesy and responsiveness are essential for good service, but recommended that, instead of monthly, TELSAM surveys should be done only twice a year, with additional surveys for an additional three months for 10% of the entities reporting the lowest overall customer satisfaction. PT&T estimated \$2,431,000 for the 1983 TELSAM program while Singh recommended that \$559,000 be included for TELSAM in the staff's estimate for Ac. 665, Other General Office, Salaries, and Expenses.

TELCAM was introduced by PT&T's Public Relations Department to determine the customers' attitude to PT&T's corporate image and to provide a focus for future public relations activities intended to

produce an environment supportive of, or at least neutral to, the company's objective. The 1983 cost of TELCAM is estimated to be \$50,000.

The staff concluded that TELCAM provided no benefit to the customers and the staff's estimate for Ac. 662, Accounting, does not include an allowance for TELCAM.

The staff service report also contained recommendations for revision of GO 133. Revision of GO 133 is beyond the scope of this proceeding and will not be considered.

The PT&T brief argued that the Staff's TELSAM recommendation was not statistically valid, and the results would reduce the confidence level of the survey and increase sampling costs. The Commission recognizes that some other sampling method may be preferable to that recommended by Singh, but it will adopt his proposed allowance. The TELSAM survey as being conducted has the aspects of self-reinforcement and self-approval by the company. The level of expenditure recommended by Singh, together with the GO 133 measurements, should be more than sufficient to identify customer dissatisfaction.

The company did not contest the staff TELCAM treatment and apparently recognizes that its image building purposes are not appropriate expenditures to be paid by the customers. The Commission's adopted results will likewise not contain a TELCAM allowance.

Operating Rents

Staff witness Chinn reviewed Operating Rents. This category includes rental costs for administrative space occupied by work groups or equipment. Examples would be leased administrative quarters, business offices, and operating service centers. Also included are a few minor items such as circuit rentals and the costs of rights of way. The development of this category is shown in Table 10:

Table 10: Development of Operating Rents

Table 10

PACIFIC TELEPHONE & TELEGRAPH COMPANY
 RESULTS OF TOTAL CALIFORNIA OPERATIONS
 A.83-01-22 ESTIMATED YEAR 1983
 OPERATING RENTS THROUGH RECAST #3
 (\$000)

Item	PT&T	Staff	PT&T Exceeds Staff
BAU Operating Rents	\$83,234	\$60,015	\$23,219
Adjustments CI-II	(4,851)	(4,862)	11
Ratemaking (Antitrust)	(62)	(62)	0
Recast #3 Operating Rents	78,321	55,091	23,230

Chinn's review of this account revealed a 124% increase for the 5-year period through the end of 1983. Because of this rather dramatic rise the staff directed particular attention to this account.

The staff did not question whether the utility's operating rents budgeting process reasonably approximates its expenditures. Rather, the staff focused on the question of whether those expenditures were just and reasonable. To answer this the staff considered two indicators: cost per square foot of leased space and average leased square footage per employee. The first indicator was to test whether the price was reasonable; the second, if the amount of space was reasonable.

To obtain cost per square foot of the leased space the staff simply divided the total California operating rents expense by the average California leased square footage. From 1979 to 1983 the utility's cost of leased space increased from \$3.48/sq. ft. to \$5.78/sq. ft., a 66% rise. Information received from real estate brokers and property managers throughout the state indicated to the staff that this increase was reasonable.

The staff found a relatively stable level of average square footage of leased space per employee from 1978 to 1981. In 1982, however, this level increased 26% over the 1978-1981 average and the 1983 level was 37% above the average. The company's level is shown below.

Year	1978	1979	1980	1981	1982	1983
Average Leased Square Footage Per Employee	95	94	98	105	124	134

When asked by Chinn for an explanation of this sudden, dramatic rise, the utility responded that the primary cause was the Business Service Center/Residential Service Center (BSC/RSC) consolidation. The staff agreed that paradoxically, consolidation can require extra space on a temporary basis. As the utility consolidates into a new location, the old locations might not be productively reused. Also, it may not be possible to terminate the old leases economically. The utility could, therefore, be burdened with surplus space until old leases expire. The staff adjusted for this effect, as represented by the BSC/RSC consolidation, by subtracting the new leased square footage required for the consolidation from the yearly average leased square footage. Despite this correction, the data clearly indicated that the unusual escalation persisted, as shown below:

Year	1978	1979	1980	1981	1982	1983
Adjusted Average Leased Square Footage Per Employee	95	94	97	104	122	130

PT&T offered the advent of Phone Center Stores in 1980 as a secondary explanation for the increase in average leased square footage per employee. The staff's analysis, however, showed this had no effect.

As PT&T could not explain the change in the average leased square footage per employee indicator, the staff concluded that the amount of space leased by the utility was unsupported.

For its estimate, the staff started with the average of the last 5 years leased space per employee figures. The figure for 1982 was excluded for being unreasonable and unexplained. Multiplying this average by the 1983 forecasted force, and then adjusting for the BSC/RSC consolidation, the staff arrived at a leased space requirement of 11,000,000 sq. ft. Multiplying this by the utility's average rate per square foot the staff determined its 1983 operating rents expense of \$63,594,000.

To check the estimates reasonableness, the staff used a formula employed by the utility's real estate department in its long-range planning: By dividing the number of employees by two and then multiplying the result by 200 sq. ft., the utility determines an estimate of its long-range requirements. The results of this formula applied to 1978-1981 were very close to the actual averages, confirming the reasonableness of the starting point for the staff's estimate. In 1982 the result was significantly below the actual value. Applying the formula to the 1983 work force, the resulting requirements are 10.8 million square feet, very much different from the utility's forecast of 14.4 million sq. ft. but very similar to the staff's projection of 11.0 million sq. ft. Chinn asserted that the utility's own forecasting technique confirmed the reasonableness of the staff estimate.

The staff noted that the Utility realizes it can function with less space per employee. During April 1982 PT&T issued a revised standard space allocation procedure. This revision should result in a 20%-30% reduction of space requirements when compared to the utility's prior standard.

PT&T, in its brief, argues that the staff's purported rationale for this "disallowance" is deficient for several reasons:

First of all, it totally ignores the most recent actual data available, 1982, because staff's witness felt it was not indicative of historical data and it was not adequately explained to anyone. It is clear, according to PT&T, that the staff witness was arbitrarily selective in his use of recorded data. He did not look at data prior to 1978 because he wanted to take as close a look as possible at the current time frame. He excluded 1982, however, the most current year's data available, because he judged it to be out-of-line with historical trends. This most recent data obviously should have been considered since it is more representative of 1983, the company argues.

Further, PT&T contends, although the staff's estimate is completely reliant on a selected parameter of floor space per employee, it completely ignores the selective method it utilizes to derive the impact of CI-II on rent expense. Instead, the staff adopted the company's CI-II estimate, which it admitted more accurately identified expected rental expenses. In addition, the staff totally failed to account for the floor space and employees transferred under CI-II and the obvious impact this action would have on the remaining "average". This interjected even further inconsistencies into the staff's footage per employee rationale.

Apparently, PT&T speculates, the staff witness chose to ignore the fact that most of the rent expense being added in 1983 is for consolidations of company operations, which are cost-efficient even if the old space cannot be reused or terminated.

Finally according to PT&T, the staff's basis for its operating rent expense level is impacted heavily by its inordinately low estimate of PT&T 1983 work force level. This factor further demonstrates the staff's failure to justify its conclusion that PT&T's operating rents expenses are neither justified nor reasonable.

In its brief, the staff argued that it evaluated every reason PT&T gave to justify the leased square-foot per employee

increase in 1982 and estimated 1983. In each instance the reason given was inadequate in the staff's opinion. The staff examined the last 5 years and (excluding 1982 as unreasonable, inadequately explained and therefore unjustified) arrived at a reasonable estimate of leased square footage per employee. This led to an estimate of a reasonable operating rents expense.

The drastic increase in space per employee claimed by PT&T for 1983 required rigorous demonstration, particularly when a recently adopted company policy calls for a reduction in allocated space. A rigorous demonstration for the need for more floor space per employee was not forthcoming, and a competent investigation by a staff engineer more than cast doubt on the company's claim.

The work force levels to which the staff's average space per employee were applied is consistent with the expense levels being adopted by this decision. The staff estimate of operating rents of \$55,091,000 will be accepted.

STAFF ENGINEER'S REPORT & RECOMMENDATIONS
 ON THE PROPOSED 1983 BUDGET
 BY STAFF ENGINEER
 DATE: 11-10-82
 TO: THE BOARD OF DIRECTORS

LINE	AMOUNT	DATE	REMARKS	DATE
100.00	100.00	100.00	100.00	1
100.00	100.00	100.00	100.00	2
100.00	100.00	100.00	100.00	3
100.00	100.00	100.00	100.00	4
100.00	100.00	100.00	100.00	5
100.00	100.00	100.00	100.00	6
100.00	100.00	100.00	100.00	7
100.00	100.00	100.00	100.00	8
100.00	100.00	100.00	100.00	9
100.00	100.00	100.00	100.00	10

STAFF ENGINEER'S REPORT & RECOMMENDATIONS
 ON THE PROPOSED 1983 BUDGET
 BY STAFF ENGINEER
 DATE: 11-10-82
 TO: THE BOARD OF DIRECTORS

General Services and Licenses

The Revenue Requirements Division's affiliation investigation team presented its findings and recommendations with respect to the affiliated relationships of PT&T and AT&T general department, Bell Telephone Laboratories, Inc. Business Information Systems Organization, and the Western Electric Company in the staff's Exhibit 30. The history of these ratemaking adjustments is contained within the report. The procedure for these adjustments has become routine in recent years and has been the subject of major discussion in briefs up to this rate case. No new major issue was presented in that regard in this proceeding, and PT&T did not, for the purposes of this proceeding, contest the general concept. The utility did, however, contest the General Services and License portions of Antitrust Expenses and Business Information Systems. These items will be considered under separate headings. The details are shown in Table 11.

Table 11

PACIFIC TELEPHONE & TELEGRAPH COMPANY
RESULTS OF TOTAL CALIFORNIA OPERATIONS
A.83-01-22 ESTIMATED YEAR 1983
GENERAL SERVICES & LICENSES THROUGH RECAST #3
(\$000)

<u>Line</u>	<u>Item</u>	<u>PT&T</u>	<u>Staff</u>	<u>PT&T Exceeds Staff</u>
1	GS&L	\$184,681	\$182,164	\$2,517
2	Adjustments CI-II	40,874	46,880	(6,006)
3	Ratemaking	72,202	69,455	2,747
4	Recast #1	71,605	65,829	5,776
5	Sale of CPE	800	0	800
6	Recast #2, #3	70,805	65,829	4,976

PT&T did not contest, except as noted, the general staff figure, which will be adopted in the amount of \$65,829,000.

Balance "Other Operating Expenses"

The makeup and difference in the category "Balance Other Operating Expenses" is shown on Table 12:

Table 12

PACIFIC TELEPHONE & TELEGRAPH COMPANY

RESULTS OF TOTAL CALIFORNIA OPERATIONS

A.83-01-22 ESTIMATED YEAR 1983

BALANCE OTHER OPERATING EXPENSES THROUGH RECAST #3

(#000)

Item	PT&T	Staff	PT&T Exceeds Staff
Accounts			
668 Insurance	\$ 1,157	\$281,157	
669 Accidents & Damages	34,650	3,606	\$ 1,044
672 Relief & Pensions	790,547	730,636	59,911
675 Other Expenses	79,001	74,701	4,300
677 Expenses Charged Const. CR	(20,484)	(16,890)	(3,594)
Wage/Salary	<u>11,755</u>	<u>0</u>	<u>11,755</u>
Total	<u>\$866,626</u>	<u>\$793,210</u>	<u>\$73,416</u>
CI-II	<u>27,680</u>	<u>(29,972)</u>	<u>2,292</u>
Net CI-II	<u>\$838,946</u>	<u>\$763,238</u>	<u>\$75,708</u>
Adjustments			
Rate-making			
Legislative	(106)	(106)	
Dues & Donations	(926)	(926)	
Depreciation SL-RL	(79)	(79)	
Antitrust	(1)	(106)	105
BIS	(2,742)	(2,800)	58
Shareholder	(13)	(13)	
Recast #1 Subtotal	<u>\$835,079</u>	<u>\$759,208</u>	<u>\$75,871</u>
Sale of CPE	<u>(4,900)</u>	<u>(2,171)</u>	<u>2,729</u>
Recast #2 Subtotal	<u>\$830,179</u>	<u>\$757,037</u>	<u>\$73,142</u>
Triennial Represcription	<u>(5,073)</u>	<u>(5,177)</u>	<u>104</u>
Recast #3 Total	<u>\$825,106</u>	<u>\$751,860</u>	<u>\$73,246</u>
SL-RL Adjustment			
Added Back		<u>79</u>	
		<u>\$751,939</u>	

(Red Figure)

1907-1912 1913-1914 1915-1916 1917-1918 1919-1920 1921-1922 1923-1924 1925-1926 1927-1928 1929-1930 1931-1932 1933-1934 1935-1936 1937-1938 1939-1940 1941-1942 1943-1944 1945-1946 1947-1948 1949-1950 1951-1952 1953-1954 1955-1956 1957-1958 1959-1960 1961-1962 1963-1964 1965-1966 1967-1968 1969-1970 1971-1972 1973-1974 1975-1976 1977-1978 1979-1980 1981-1982 1983-1984 1985-1986 1987-1988 1989-1990 1991-1992 1993-1994 1995-1996 1997-1998 1999-2000 2001-2002 2003-2004 2005-2006 2007-2008 2009-2010 2011-2012 2013-2014 2015-2016 2017-2018 2019-2020 2021-2022 2023-2024 2025-2026 2027-2028 2029-2030 2031-2032 2033-2034 2035-2036 2037-2038 2039-2040 2041-2042 2043-2044 2045-2046 2047-2048 2049-2050 2051-2052 2053-2054 2055-2056 2057-2058 2059-2060 2061-2062 2063-2064 2065-2066 2067-2068 2069-2070 2071-2072 2073-2074 2075-2076 2077-2078 2079-2080 2081-2082 2083-2084 2085-2086 2087-2088 2089-2090 2091-2092 2093-2094 2095-2096 2097-2098 2099-2100 2101-2102 2103-2104 2105-2106 2107-2108 2109-2110 2111-2112 2113-2114 2115-2116 2117-2118 2119-2120 2121-2122 2123-2124 2125-2126 2127-2128 2129-2130 2131-2132 2133-2134 2135-2136 2137-2138 2139-2140 2141-2142 2143-2144 2145-2146 2147-2148 2149-2150 2151-2152 2153-2154 2155-2156 2157-2158 2159-2160 2161-2162 2163-2164 2165-2166 2167-2168 2169-2170 2171-2172 2173-2174 2175-2176 2177-2178 2179-2180 2181-2182 2183-2184 2185-2186 2187-2188 2189-2190 2191-2192 2193-2194 2195-2196 2197-2198 2199-2200 2201-2202 2203-2204 2205-2206 2207-2208 2209-2210 2211-2212 2213-2214 2215-2216 2217-2218 2219-2220 2221-2222 2223-2224 2225-2226 2227-2228 2229-2230 2231-2232 2233-2234 2235-2236 2237-2238 2239-2240 2241-2242 2243-2244 2245-2246 2247-2248 2249-2250 2251-2252 2253-2254 2255-2256 2257-2258 2259-2260 2261-2262 2263-2264 2265-2266 2267-2268 2269-2270 2271-2272 2273-2274 2275-2276 2277-2278 2279-2280 2281-2282 2283-2284 2285-2286 2287-2288 2289-2290 2291-2292 2293-2294 2295-2296 2297-2298 2299-2300 2301-2302 2303-2304 2305-2306 2307-2308 2309-2310 2311-2312 2313-2314 2315-2316 2317-2318 2319-2320 2321-2322 2323-2324 2325-2326 2327-2328 2329-2330 2331-2332 2333-2334 2335-2336 2337-2338 2339-2340 2341-2342 2343-2344 2345-2346 2347-2348 2349-2350 2351-2352 2353-2354 2355-2356 2357-2358 2359-2360 2361-2362 2363-2364 2365-2366 2367-2368 2369-2370 2371-2372 2373-2374 2375-2376 2377-2378 2379-2380 2381-2382 2383-2384 2385-2386 2387-2388 2389-2390 2391-2392 2393-2394 2395-2396 2397-2398 2399-2400 2401-2402 2403-2404 2405-2406 2407-2408 2409-2410 2411-2412 2413-2414 2415-2416 2417-2418 2419-2420 2421-2422 2423-2424 2425-2426 2427-2428 2429-2430 2431-2432 2433-2434 2435-2436 2437-2438 2439-2440 2441-2442 2443-2444 2445-2446 2447-2448 2449-2450 2451-2452 2453-2454 2455-2456 2457-2458 2459-2460 2461-2462 2463-2464 2465-2466 2467-2468 2469-2470 2471-2472 2473-2474 2475-2476 2477-2478 2479-2480 2481-2482 2483-2484 2485-2486 2487-2488 2489-2490 2491-2492 2493-2494 2495-2496 2497-2498 2499-2500 2501-2502 2503-2504 2505-2506 2507-2508 2509-2510 2511-2512 2513-2514 2515-2516 2517-2518 2519-2520 2521-2522 2523-2524 2525-2526 2527-2528 2529-2530 2531-2532 2533-2534 2535-2536 2537-2538 2539-2540 2541-2542 2543-2544 2545-2546 2547-2548 2549-2550 2551-2552 2553-2554 2555-2556 2557-2558 2559-2560 2561-2562 2563-2564 2565-2566 2567-2568 2569-2570 2571-2572 2573-2574 2575-2576 2577-2578 2579-2580 2581-2582 2583-2584 2585-2586 2587-2588 2589-2590 2591-2592 2593-2594 2595-2596 2597-2598 2599-2600 2601-2602 2603-2604 2605-2606 2607-2608 2609-2610 2611-2612 2613-2614 2615-2616 2617-2618 2619-2620 2621-2622 2623-2624 2625-2626 2627-2628 2629-2630 2631-2632 2633-2634 2635-2636 2637-2638 2639-2640 2641-2642 2643-2644 2645-2646 2647-2648 2649-2650 2651-2652 2653-2654 2655-2656 2657-2658 2659-2660 2661-2662 2663-2664 2665-2666 2667-2668 2669-2670 2671-2672 2673-2674 2675-2676 2677-2678 2679-2680 2681-2682 2683-2684 2685-2686 2687-2688 2689-2690 2691-2692 2693-2694 2695-2696 2697-2698 2699-2700 2701-2702 2703-2704 2705-2706 2707-2708 2709-2710 2711-2712 2713-2714 2715-2716 2717-2718 2719-2720 2721-2722 2723-2724 2725-2726 2727-2728 2729

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ing Adjustment

Antitrust Expense	168,000
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Other Expenses

BIS Costs (Including \$58,000)

BIS "Rate-making" Adj.)	4,400,000
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Relief and Pensions

1% Poor Performance Penalty	24,100,000
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\$29,605,000

Antitrust Expenses

In addition to the \$125,000 adjustment for antitrust expenses included in Ac. 665, General Office Salaries and Expenses, the staff is proposing an adjustment of \$937,000 in Ac. 669, Accidents and Damages, and \$168,000 in "Rate-making Adjustments" for costs associated with 1982 antitrust litigation.

In D.93367, the Commission excluded 50% of the costs of two antitrust suits, Litton and the Department of Justice (DOJ) suit. Accordingly, Pacific did not seek recovery of 50% of those costs in this application. The staff through witness Low proposed in this case to exclude 50% of the costs of all antitrust suits, including over \$900,000 that was incurred in 1982 and not included in Pacific's 1983 budget.

A.82-11-07 et al.

Business Information System

Since 1981 Bell Labs has been working on a program of research and development in the area of business information systems.

The staff also proposed exclusion of \$937,000 in antitrust settlement costs by applying the staff nonlabor inflation rate to \$923,000 actually incurred in 1982.

The staff did not investigate whether the antitrust costs proposed to be excluded were included in PT&T's 1983 estimated results and the utility contends in its brief that the \$937,000 was not.

We believe the company's request is reasonable and will adopt it.

Costs of the business information system were \$1.2 million in 1982 and \$1.3 million in 1983. The staff has accepted the company's request to exclude \$937,000 of antitrust settlement costs from the 1983 operating expenses. The staff has also accepted the company's request to exclude \$923,000 of antitrust settlement costs from the 1982 operating expenses. The staff has also accepted the company's request to exclude \$937,000 of antitrust settlement costs from the 1983 operating expenses. The staff has also accepted the company's request to exclude \$923,000 of antitrust settlement costs from the 1982 operating expenses.

For the estimated costs of the business information system, the staff has accepted the company's request to exclude \$937,000 of antitrust settlement costs from the 1983 operating expenses. The staff has also accepted the company's request to exclude \$923,000 of antitrust settlement costs from the 1982 operating expenses. The staff has also accepted the company's request to exclude \$937,000 of antitrust settlement costs from the 1983 operating expenses. The staff has also accepted the company's request to exclude \$923,000 of antitrust settlement costs from the 1982 operating expenses.

Business Information Systems

Since 1967 Bell Labs, in conjunction with AT&T and BOCs, has been undertaking a program of research and development on Business Information Systems (BIS). These systems are essentially software packages prepared by Bell Labs for use by the BOCs to allow them to gather and analyze data concerning their day-to-day operations, to allow them to administer more efficiently their operations, and to plan for future operations and services. The development costs of these specific programs are charged directly to the BOCs through the BIS agreement. The fundamental research on BIS priorities, feasibility studies, and planning of future BIS programs is charged to AT&T which in turn bills the BOCs through the License Contract.

Costs of the BIS program have increased exponentially since its inception at a 20% to 25% rate and for 1983 PT&T budgeted \$30.8 million as its share applicable to California utility operations. The total Bell System BIS budget for 1983 was \$280 million, a \$55 million increase over the 1982 budget of \$225 million. The staff witness, Kevin P. Coughlin, P.E., was not satisfied with the cursory explanation he received for this item so used AT&T's 1982 budgeted amount and applied the staff allocation factor to arrive at the staff's 1983 estimate of PT&T's share of \$26.4 million.

For the estimated test year to function successfully, the utility must be able to justify its estimates with solid data and logic. The Commission has examined the AT&T memo that PT&T furnished to justify the total Bell System BIS budget of \$280 million and it is indeed superficial. The staff report on affiliated relations Exh. 30 does describe in detail the BIS budgetary activities and budget controls. We will adopt the staff number.

Relief and Pensions

Maurice F. Crommie, a Research Analyst in the Revenue Requirements Division, recommended a 1% penalty reduction in the normal cost rate used for pension accruals purposes for the test year. This would amount to a penalty of \$24,100,000 or approximately 5.4% of the pension expense requested by PT&T for the test year. The penalty was based on what the staff considered to be a less than adequate performance of the utility's pension investment fund for the period 1974-1981.

To evaluate the performance of PT&T's pension fund, Crommie compared the return on investment of five major California utilities with a norm composed of median averages for a sample of 100 large investment plans with investments greater than \$100 million each, as published by the investment advisory firm of A.G. Becker. Crommie found that four of the five utilities studied have been earning one or two percent less than the selected norm consistently over the last 5 to 8 years. PT&T's pension fund had the worst performance of all.

	1974	1975	1976	1977	1978	1979
PT&T	1.2	1.1	1.0	0.9	0.8	0.7
PG&E	1.3	1.2	1.1	1.0	0.9	0.8
SDG&P	1.4	1.3	1.2	1.1	1.0	0.9
SWP&S	1.5	1.4	1.3	1.2	1.1	1.0
Norm	1.6	1.5	1.4	1.3	1.2	1.1

The results of the comparison are shown in the table above. The results show that PT&T's pension fund has the lowest return on investment of the five utilities studied. The results also show that the norm is consistently higher than the returns of the five utilities. The results indicate that PT&T's pension fund has not performed as well as the other utilities and the norm. The results also indicate that the norm is a reasonable benchmark for comparing the performance of the five utilities. The results suggest that PT&T's pension fund may need to be re-evaluated and that the norm may need to be adjusted.

Exhibits and Tables

The relative performance of the California utilities are shown on the following tables.

Annual Rates of Return on Pension Investment Funds

Year	PG&E	SCE	SCG	SDG&E	PT&T
1974	(29.8)	(14.7)	(19.5)	(25.8)	(16.1)
1975	29.8	19.6	24.4	26.4	21.9
1976	15.8	15.0	18.0	15.8	17.5
1977	(8.3)	(1.4)	(0.6)	(7.5)	(2.5)
1978	7.6	7.2	7.3	4.7	6.2
1979	21.9	11.0	17.6	16.8	12.0
1980	28.5	24.4	32.4	16.7	17.8
1981	(6.4)	3.2	(2.7)	6.8	0.6

(Red Figure)

Compounded-Linked Annualized Rates of Return on Pension Investment Funds

Period	PG&E	SCE	SCG	SDG&E	PT&T	Large Plan
1974-1981	5.4	7.4	8.4	5.5	6.5	6.3
1975-1981	11.7	11.0	13.1	10.9	10.2	11.0
1976-1981	9.0	9.6	11.4	8.5	8.3	9.0
1977-1981	7.7	8.5	10.1	7.1	6.6	7.5

In rebuttal to Crommie, PT&T presented its Director-Investment Management, Richard E. Holmes.

Holmes took exception to Crommie's statistical methods and to the inferences that Crommie drew. He also disagreed with the use of the Becker universe. Only Becker clients are included. Very large corporate plans, such as the Bell System, General Motors and General Electric are excluded. Furthermore, the Becker data includes profit sharing and savings plans, including the Bell System plan which is composed only of common stock and reserves.

To evaluate the consistency and predictability of returns over time, Holmes determined the standard deviation of the 1974-1981 annual compound returns of Crommie's five California utilities and the Becker Norm. Statistically, the lower standard deviation the more consistent are the returns over time. Holmes divided the annual compound returns by the standard deviations to determine another measure, which he designated "return per unit of risk". The higher this number, the more return that has been achieved per unit of risk. Holmes' returns, standard deviations, and return per unit of risk are shown in the following table.

Eight-Year-Date-1974-1981

Company	Annual Compound Return	Standard Deviation	Unit of Risk
	(a)	(b)	(a-b)
PG&E	5.4%	19.5%	0.28
SCE	7.4	11.7	0.63
SCG	8.4	15.7	0.54
SDG&E	5.5	15.6	0.35
PT&T	6.5	11.9	0.55
Becker	6.3	14.1	0.45

To Holmes, the use of these standard evaluation tools reveals that PT&T had the second lowest standard deviation and second highest return per unit risk of the funds shown, indicating it is well above average in these areas when compared to the other California utilities utilized by the staff in their evaluation. PT&T also outperformed the Becker median.

Discussion of Pension Fund Penalty

The assessment of a penalty for inadequate performance of pension fund investments is tantamount to imputing better performance. The Commission in the past has used a higher actuarial interest rate than used by PT&T in its pension calculations. In D.67369, dated June 11, 1964, in C.7409 (62 Cal PUC 775, 841-848) the

A.82-11-07 et al.

Commission imputed a 3-1/4% actuarial interest rate in place of the 3% being used by PT&T. That adjustment was made, however, on the basis that the actual earnings on the pension fund had, for many years, consistently exceeded 3%.

At that time, pension fund management was merely a matter of selecting a proper mix of yield and maturity of high grade bonds. Now pension funds typically also invest in common stocks and real estate. The element of volatility that changed investment policy has injected into fund management is clearly evident in Crommie's table of annual rates of return, where in 1974, all California utilities suffered large negative rates of return, followed by a rebound to even larger positive rates of return in 1975.

The staff did not challenge Holmes' calculation of return per unit of risk. That analysis purports to show that, considering the risks assumed, PT&T is not doing too badly.

The Commission will not impose the pension performance penalty. By rejecting the staff proposal, the Commission does not intend to discourage staff efforts along this line. The Commission would welcome the staff, as part of its continuing studies of employee benefits, formulating a standard definitive test that it could apply to determine pension expense. Such a test would enable the utility to know in advance what results were expected of it, and to take such steps as it could to achieve such results.

Adopted "Balance Other Operating Expenses"

The Commission, having resolved all of the contested aspects of "Balance Other Operating Expenses" in favor of PT&T, except for the Business Information System estimate, will add \$25,205,000 to the staff Recast #3 total for a total of \$783,458,000 adjusted for other adopted expenses.

Early Retirement Incentive Plans

In May of 1982, PT&T accelerated its offerings of early retirement incentive plans because of "rapid advances in technology" and "unanticipated declines in the economy", among other reasons. During 1982, a total of 2,515 managers accepted Pacific's Management Income Protection Plan (MIPP) and 574 nonmanagement personnel took advantage of the Supplemental Income Protection Program (SIPP). Essentially, these plans provide incentives equal to 1-year's salary over a 2-year period for managers (MIPP) and up to a 4-year period for nonmanagers (SIPP). There were two MIPP offerings; one was booked in July and the other in October. The SIPP booking took place in December.

These expenses averaged \$36,000 for each Pacific employee who took advantage of the plan. PT&T's incentives were considerably higher than other companies. For example, General Telephone Company of California offered only a half year's salary plus \$500 a month until age 62 and \$250 a month thereafter until age 65.

On its books, which PT&T maintains in accordance with the Uniform System of Accounts prescribed by the FCC, the company charged the entire \$98 million relating to these incentive plans to the various expense and plant accounts to which these retired employees had been charging their salaries.

For California intrastate ratemaking purposes, however, PT&T deferred \$56.4 million, representing the intrastate operating expenses portion of these early retirement incentive expenses "off book" by debiting Ac. 139, Other Deferred Charges, and crediting Ac. 675, Other Expenses.

The company amortized the intrastate portion of these expenses monthly starting in July 1982 on a "cash basis" when the first MIPP payments were made by charging Ac. 675, Other Expenses, "off book". As of the end of 1982, a total of \$11.4 million of these early retirement incentive expenses had been amortized.

Approximately \$2.275 million will be amortized monthly off-book in 1983 for a total of \$27.3 million. This amortization will continue in 1984 and 1985 until the remainder has been completely amortized.

The MIPP and SIPP programs were reviewed for the Commission staff by John S. Kupiec, CPA, Financial Examiner IV.

Kupiec recommended that the amortization of these early retirement incentive plan expenses should not be allowed for ratemaking purposes for the following reasons:

1. These expenses are "one time" abnormal expenses which should not be considered in an annual rate case test year. (These expenses are not similar to on-going vacation pay and merit awards which are treated on a "cash basis" for "off book" ratemaking purposes.)
2. Accounting Principles should be consistently applied for ratemaking. PT&T should not be allowed to pick and choose between alternative accounting methods. In 1982, PT&T wrote off these expenses for book purposes, for tax purposes, for interstate revenue purposes, and for intrastate plant accounting purposes. PT&T, therefore, should not be allowed to amortize a portion of these expenses beyond 1982 for its own intrastate expense accounting purposes. There is no future benefit to California ratepayers for these expenses and they should not be included for ratemaking purposes.
3. The resulting savings from having 3,077 fewer employees on PT&T's payroll will have covered all of the costs associated with these incentive plans by June 1983. To require California ratepayers to pay for these expenses in future years after these terminated employees have been off their payroll for many months is unfair and unreasonable.

Kupiec recommended, therefore, that these early retirement incentive plan expenses not be considered for ratemaking purposes in the test year. In its application PT&T included the amortization of the first MIPP offering for the calendar year 1983 in its 1983 staff estimates. These MIPP costs were charged to various operating expense accounts and totaled \$20,193,000. Pacific did not include any amortization of the second MIPP offering in October and the SIPP offering in December because Pacific did not anticipate them when it prepared its application. Kupiec recommended, however, that all the costs of Pacific's early retirement incentive plans be considered expensed in 1982 and that none of these expenses be amortized for ratemaking purposes in 1983 and later years. The staff estimates for those accounts to which PT&T had charged the costs associated with the first MIPP offering do not include the early retirement incentive plans expenses.

The total amount of MIPP and SIPP in question, amounts to \$20.1 million in operating expenses and \$5.1 million in plant, all of which is attributed by PT&T to California intrastate operations, the interstate portion not being shown in the Total California Operations.

In cross-examination Kupiec conceded that MIPP and SIPP resulted in savings of about \$40 million in test year 1983. Kupiec contended, however, that the retired employees were surplus and implied that their employment costs would not be properly included in a 1983 results of operations.

If we were to accept PT&T's proposal, we would be agreeing to a form of retroactive ratemaking. We do not think it fair that PT&T receive the benefits of its early retirement program of \$40 million, and ask ratepayers to fund \$20 million in costs. PT&T cannot have it both ways. We will adopt the staff proposal.

OPERATING TAXES
Tax Differences

PT&T did not dispute the tax methodology employed by the Commission staff, although it did not agree with the absolute level of the staff's taxes. The tax differences are attributable to differences in other elements of the results of operations, such as revenues, expenses, and construction levels, some of which are contested.

California Corporation Franchise Tax

Because of the use by California of the "unitary method" of assessing corporation income taxes, PT&T's California Corporation Franchise Tax (CCFT) is determined by means of a "combined report" of the Bell System. The combined report allocates the Bell System taxable income to California by means of a three-factor formula which compares the relationship of California wages, revenues, and average net property of all California Bell System operations to the total Bell System.

This formula operates so that PT&T's 1983 effective tax rate is estimated to be 21.3%. Because of the small incremental effect that a PT&T rate increase would have in the entire Bell System, however, the incremental CCFT rate is only 1.40%. Any rate increase would affect only one Bell System factor, revenues, and only the California intrastate portion of those. Bell System wages and property will be unchanged.

The 1.40% incremental CCFT rate is used to calculate the 1.901 net-to-gross multiplier used to calculate any revenue increase required.

When divestiture becomes effective on January 1, 1984, PT&T will be an independent company and, except for its relatively small operations in Nevada, will be paying the statutory 9.6% rate. The staff suggests that the Commission consider adopting the 9.6% tax rate for telephone rates scheduled to become effective January 1, 1984.

The staff witness for taxes based on income was Cherrrie A. Conner, Financial Examiner III.

Proper CCFT Rate for 1983

The Commission will not reduce the 21.3% rate to 9.6% nor raise the 1.40% rate used to calculate the net to gross multiplier. By accepting a 1983 test year and applying the BAU concept to determine results of operations, it becomes inevitable that a great many factors, both plus and minus, impinging on PT&T in 1983 will not be carried over after divestiture. The study of PT&T as divested is the subject of the second phase of this case and since a 9.6% CCFT rate will only apply after divestiture, the use of a 9.6% rate will be considered in that phase.

Adopted Taxes

Taxes adopted as reasonable for Total California Operations are:

Federal Income	\$513,705,000
Calif. Corp. Franchise	281,169,000
Social Security	187,019,000
Other	166,080,000

CUSTOMER PREMISE
EQUIPMENT SALES

Nature of CPE Issue

This issue arises out of the sale of customer premise equipment (CPE) required by the CI-II decision. On August 4, 1982 the California Commission issued D.82-08-017 in A.59849 et al. which decision authorized an advice letter proposal by PT&T to implement a

plan for the direct sale of the six major lines of single line terminal equipment. PT&T requested \$42,028,000 in additional annual revenues. A.83-01-22 to offset the revenue loss that PT&T estimated would be occasioned by the direct sales program. 3005 3000000 11.30

PT&T's CPE proposal was investigated by a team of cost accountants and engineers from the Commission's Revenue Requirements Division. The team's report of investigation was presented by Gregory P. Johnson.

The 1983 revenue requirement effect of sales of CPE is made up of two general components. The sale of the telephone sets will reduce rentals from month-to-month service and there will be a gain or loss on the sale of the sets themselves. The CPE sales team has confined its investigation to the gains and losses, leaving the effect of removing sets from month-to-month service to be covered in the staff R/O report (Exh. 28).

The staff review developed that the \$42 million revenue requirement was based upon an estimated sales volume of 6,200,000 "Big 6" sets.⁶

The net gains or losses on the sales are equal to the net proceeds from the sales less the book value of the CPE sold and the associated tax consequences. The staff found that, based on PT&T's original view of CPE sales effects, the company estimated that it would generate \$34.1 million in gross gains, less \$29.5 million in taxes, for a net gain of \$4.6 million. In late February PT&T informed the staff team that a later view had reduced these figures to \$14.2 million less \$9.0 million for a net gain of \$5.2 million. The corresponding revenue requirement effects were reduced from \$42,028,000 to \$15,196,000, based on sales of 3,800,000 Big 6 sets.

6. The "Big 6" are the rotary dial and touchtone versions of the three common telephone sets; the 500 type, Princess, and Trimline.

Ordinary and Extraordinary Retirement Accounting

The reason PT&T was forecasting a profit on the sale of CPE and also asking for \$15.2 million to offset an estimated CPE revenue loss is to be found in the retirement accounting used. PT&T accounts for the sale of CPE equipment by means of "normal retirement accounting", adding the gains to the reserve for depreciation, where they are deferred and written off over the remaining life of the plant remaining in the account.

The staff contends that normal retirement accounting is not always appropriate. For example, should a large portion of a utility's assets be destroyed by fire, normal retirement accounting would defer this loss over the remaining life of the remaining assets and not allow the utility a speedy recovery to provide for the replacement of the assets. In such instances FCC accounting regulations permit "extraordinary retirement accounting" whereby such losses are removed from the depreciation reserve and amortized separately over a shorter period.

FCC extraordinary retirement accounting addresses only extraordinary losses, but the team knew of no reason why it should not also include extraordinary gains. The team speculated that the historical limitation of extraordinary retirement accounting to losses only is probably explained by the fact that up until now, telephone utilities have not experienced any extraordinary gains.

Johnson testified that there should be no doubt that the retirement of 35% of PT&T's single line sets in one year is an extraordinary event. There should be even less doubt that the deferring and spreading the gains on these sales over the life of the remaining assets is totally inappropriate.

Should PT&T prevail in its accounting recommendation, the gross gain on sales would be credited to the station apparatus portion of the depreciation reserve where they would decrease the net book cost of the remaining station apparatus. If this station

apparatus were to remain with PT&T, the ratepayers would receive the benefits of these gains over time through reduced station apparatus depreciation expenses.

According to the staff team, the problem is that the station apparatus will not remain with PT&T because these assets are scheduled to be retained by AT&T when AT&T divests PT&T. Because the transfer will be conducted on a net book cost basis, AT&T and not the ratepayers would receive the benefit of an accounting method which reduces the net book cost of unsold sets.

The FCC, in Docket 19129, stated that gains or losses from the sale of property sold from or previously included in a rate base account should flow to the ratepayers. The California Commission has also stated its desire that all gains or losses from the sale of CPE should be borne by the ratepayers. Should Pacific's accounting proposal be adopted, both the FCC's and this Commission's policies would be frustrated, the team declared.

The team recommended that, consistent with extraordinary retirement accounting, gains or losses on the sale of CPE by PT&T should be removed from the depreciation reserve and credited to Ac. 609, Extraordinary Retirements, immediately upon recognition. The team saw no point in deferring recognition of these gains beyond 1983 because all the other effects of CPE sales were to be recognized immediately, and PT&T is not likely to be in the CPE business on a regulated basis after 1983.

In the staff's original Results of Operation Report, Exh. 28, each staff witness was responsible for presenting the effects of CPE sales on the individual accounts for which they were responsible. Because of coordination problems, however, some staff recommendations were omitted from Exh. 28 and some which were included required revision. As a result, Johnson submitted Exh. 67, to show a revised staff negative revenue requirement estimate of

\$27,804,000. The areas of difference between the staff's revised estimate in Exh. 67 and PT&T's estimate are summarized below:

Income Accounts	PT&T	Staff	Staff	Witness
Maintenance	(27,586)	(30,756)	(3,170)	Mirza
Commercial	(3,754)	(2,465)	(1,289)	Busch
Extrd. Retirements	-	(47,199)	(47,199)	Johnson
CCFT	10,242	11,859	(1,617)	Johnson
FIT	(14,726)	7,197	(21,923)	Johnson
<u>Plant Accounts</u>				
Deprec. Reserve	(30,437)	(44,760)	(14,323)	Johnson
Dfd. Tax Reserve	(27,490)	(24,903)	(2,587)	Johnson
		(Red Figure)		
<u>Tax Effects</u>				

The treatment of the sale of CPE as extraordinary retirements would affect federal income taxes. Because state tax effects are flowed through for ratemaking, there is no effect on CCFT but, because normalization of federal income taxes (FIT) is required by federal law, the federal tax allowance computed for regulatory purposes must be consistent with book accounting. The federal tax effect of the CPE gain must therefore be computed. For this purpose the team recommended that the federal capital gains rate be used, and calculated the FIT effect at \$14,651,000.

After considering rebuttal testimony by PT&T witness Gueldner that the CCFT effect of the reduction in CPE revenue requirement was wrong in that the staff team used the 16.60% effective CCFT rate that the PT&T had used in its CPE sale computation, instead of the 21.37% used by the staff in its Results of Operations report, the staff agreed that the company was correct. The team accordingly recomputed its calculation of the effects of CPE sales on PT&T's taxes based on income and, since CCFT is a deduction of FIT, a change in CCFT affects FIT.

A comparison of the effects on the staff's recommended taxes based on income is shown below:

	<u>Old Amount</u>	<u>New Amount</u>	
	(\$000)	(\$000)	
CCFT	(4,726)	(2,579)	
FIT	(7,997)	(9,150)	
	(Red Figure)	-	

In testimony prior to the correction, Johnson had indicated that the team had computed the tax on the sale of telephone sets the according to the methodology employed by the company in its estimate submitted on February 25, 1983. At that time he also stated that the should PT&T respond to the team's calculations by recommending that a higher CCFT tax rate be used, the team would want to reassess PT&T's entire methodology for computing the tax effect of sales. the

Upon receipt of Gueldner's prepared rebuttal, the team proceeded with its reassessment. During the reassessment, the team discovered that the Bell System is treating sales of telephone sets as ordinary retirements on its tax returns and that PT&T had filed a preliminary tax return using the ordinary retirement treatment. By use of ordinary retirement accounting, \$47,199,000 in gains accruing from the CPE sales would be transferred to AT&T on divestiture. This is because station apparatus will be transferred to AT&T at net book cost at divestiture and ordinary retirement accounting will tend to reduce net book cost. The revenue effect of the team's revised recommendation would be a negative \$58,475,000.

In rebuttal to the team's accounting recommendations, PT&T called upon John A. Gueldner, division staff manager-service costs. Gueldner testified that the extraordinary retirement accounting recommended by the staff was not consistent with the FCC's Uniform System of Accounts. He said that the FCC is very specific on the procedures for recognizing extraordinary losses in service value of a telephone plant retired.

As rebuttal witness on the tax aspects, PT&T presented David James Snell, district staff manager. Snell handles PT&T's taxes and has spent extensive time researching the tax consequences of sale of single line sets. He has taught classes to other Bell System companies on the tax consequences of the sale of CPE and how to compute taxes and how to accrue the taxes on the books of accumulated account. The methods that he developed have been adopted in time by the Bell System and are used currently in the Bell System instructions for the consolidation of the 1982 tax return.

Snell maintained that PT&T would be required to follow the IRS' Revenue Ruling 80-37 (RR 80-37). He said that the staff's argument for capital gains treatment, based on a liquidation of CPE, was not realistic because the CPE sales will not be considered as extraordinary by the IRS. He observed that, "You cannot have an ordinary retirement and a capital gain at the same time."

In its brief, PT&T cited three cases to support its prediction that the Bell System will be denied capital gains treatment for sale of CPE and prophesied that the most likely IRS position will be to follow RR 80-37.⁷

Refurbishment

The staff claimed that PT&T proposed charging the new depreciation reserve for \$15.4 million estimated cost of 228 prior refurbishment of sets prior to their sale but the company has not decreased its BAU maintenance by a similar amount, thereby requesting recovery of the same costs twice.

PT&T did not deny this contention but alleged in its brief that later data that the company has obtained shows its refurbishment costs are relevant and should be included. Our adopted figures will reflect the staff position.

PT&T also claimed that the staff's position is inconsistent with the IRS' position in RR 80-37, which states that the cost of depreciation should be based on the original cost of the property, not on the cost of replacement.

⁷ RR 80-37 deals with sales of depreciable property in the ordinary course of business.

Nondisposition Material

Nondisposition materials are items which are too numerous, and inexpensive to individually track and account for, so for tax retirement purposes they are "loaded" onto items like telephone sets. As a set is removed from service, a proportionate amount of nondisposition materials are simultaneously retired.

The staff team asserts that the fact that nondisposition materials are not individually tracked for accounting purposes tends to disguise the fact that many of these items are individually inventoried and charged for on a month-to-month basis. Although ownership of these items will not pass upon the sale of CPE sets and in many cases PT&T will continue to collect monthly rents for these items, the company proposes that a proportionate amount of the cost of these assets should be factored in as a component of net book costs of sets sold by recommending inclusion of the nondisposition material in the calculation of gains and losses. PT&T is effectively requesting full and immediate capital recovery for items it will not in fact sell.

The team estimated that only 13% of the nondisposition materials included in PT&T's loadings represent actual materials which will be sold and retired as sets are sold retired. The remaining 87% are recommended to be excluded from the net book cost calculations. PT&T's rebuttal witness, Guelchner, stated that use of the staff's loading factor would not reflect the retirements which will be made on the company's books and should be rejected. Our adopted figures will reflect the staff position.

Discussion of CPE Sales

In its brief PT&T recommends that the issue of single-line sales be considered in further hearings in A.59849 but should the Commission choose to decide the CPE issue in this proceeding, it should accept PT&T's \$15.2 million proposal with the provision that

any necessary adjustments be made in further hearings in A-59849 regarding a CPE balancing account.

PT&T believes that the CPE sales effects should reflect the utility's actual experience and not a series of estimates based on a supposition.

We do not agree with PT&T that ratemaking treatment of CPE sales should not be prospective and permanent, and will adopt the staff's position. Recognizing that the CPE sales program is a unique business situation to which ordinary accounting principles and rulings are probably not applicable, the Commission will assume that the staff's position regarding tax treatment is likely to prevail. We also agree that extraordinary retirement accounting is appropriate in this instance, and that FCC rulings do not appear to prohibit such treatment, particularly for purposes of ratemaking by state authorities. Without such treatment, PT&T's ratepayers would not see the gain from the CPE sales program, since upon divestiture PT&T will transfer equipment and accounts to an AT&T affiliate. We have found that PT&T's ratepayers should see this gain since they have borne the risk of the CPE investment. Under the circumstances, we see no reason to delay this decision to another proceeding.

1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043	2044	2045	2046	2047	2048	2049	2050	2051	2052	2053	2054	2055	2056	2057	2058	2059	2060	2061	2062	2063	2064	2065	2066	2067	2068	2069	2070	2071	2072	2073	2074	2075	2076	2077	2078	2079	2080	2081	2082	2083	2084	2085	2086	2087	2088	2089	2090	2091	2092	2093	2094	2095	2096	2097	2098	2099	2100	2101	2102	2103	2104	2105	2106	2107	2108	2109	2110	2111	2112	2113	2114	2115	2116	2117	2118	2119	2120	2121	2122	2123	2124	2125	2126	2127	2128	2129	2130	2131	2132	2133	2134	2135	2136	2137	2138	2139	2140	2141	2142	2143	2144	2145	2146	2147	2148	2149	2150	2151	2152	2153	2154	2155	2156	2157	2158	2159	2160	2161	2162	2163	2164	2165	2166	2167	2168	2169	2170	2171	2172	2173	2174	2175	2176	2177	2178	2179	2180	2181	2182	2183	2184	2185	2186	2187	2188	2189	2190	2191	2192	2193	2194	2195	2196	2197	2198	2199	2200	2201	2202	2203	2204	2205	2206	2207	2208	2209	2210	2211	2212	2213	2214	2215	2216	2217	2218	2219	2220	2221	2222	2223	2224	2225	2226	2227	2228	2229	2230	2231	2232	2233	2234	2235	2236	2237	2238	2239	2240	2241	2242	2243	2244	2245	2246	2247	2248	2249	2250	2251	2252	2253	2254	2255	2256	2257	2258	2259	2260	2261	2262	2263	2264	2265	2266	2267	2268	2269	2270	2271	2272	2273	2274	2275	2276	2277	2278	2279	2280	2281	2282	2283	2284	2285	2286	2287	2288	2289	2290	2291	2292	2293	2294	2295	2296	2297	2298	2299	2300	2301	2302	2303	2304	2305	2306	2307	2308	2309	2310	2311	2312	2313	2314	2315	2316	2317	2318	2319	2320	2321	2322	2323	2324	2325	2326	2327	2328	2329	2330	2331	2332	2333	2334	2335	2336	2337	2338	2339	2340	2341	2342	2343	2344	2345	2346	2347	2348	2349	2350	2351	2352	2353	2354	2355	2356	2357	2358	2359	2360	2361	2362	2363	2364	2365	2366	2367	2368	2369	2370	2371	2372	2373	2374	2375	2376	2377	2378	2379	2380	2381	2382	2383	2384	2385	2386	2387	2388	2389	2390	2391	2392	2393	2394	2395	2396	2397	2398	2399	2400	2401	2402	2403	2404	2405	2406	2407	2408	2409	2410	2411	2412	2413	2414	2415	2416	2417	2418	2419	2420	2421	2422	2423	2424	2425	2426	2427	2428	2429	2430	2431	2432	2433	2434	2435	2436	2437	2438	2439	2440	2441	2442	2443	2444	2445	2446	2447	2448	2449	2450	2451	2452	2453	2454	2455	2456	2457	2458	2459	2460	2461	2462	2463	2464	2465	2466	2467	2468	2469	2470	2471	2472	2473	2474	2475	2476	2477	2478	2479	2480	2481	2482	2483	2484	2485	2486	2487	2488	2489	2490	2491	2492	2493	2494	2495	2496	2497	2498	2499	2500	2501	2502	2503	2504	2505	2506	2507	2508	2509	2510	2511	2512	2513	2514	2515	2516	2517	2518	2519	2520	2521	2522	2523	2524	2525	2526	2527	2528	2529	2530	2531	2532	2533	2534	2535	2536	2537	2538	2539	2540	2541	2542	2543	2544	2545	2546	2547	2548	2549	2550	2551	2552	2553	2554	2555	2556	2557	2558	2559	2560	2561	2562	2563	2564	2565	2566	2567	2568	2569	2570	2571	2572	2573	2574	2575	2576	2577	2578	2579	2580	2581	2582	2583	2584	2585	2586	2587	2588	2589	2590	2591	2592	2593	2594	2595	2596	2597	2598	2599	2600	2601	2602	2603	2604	2605	2606	2607	2608	2609	2610	2611	2612	2613	2614	2615	2616	2617	2618	2619	2620	2621	2622	2623	2624	2625	2626	2627	2628	2629	2630	2631	2632	2633	2634	2635	2636	2637	2638	2639	2640	2641	2642	2643	2644	2645	2646	2647	2648	2649	2650	2651	2652	2653	2654	2655	2656	2657	2658	2659	2660	2661	2662	2663	2664	2665	2666	2667	2668	2669	2670	2671	2672	2673	2674	2675	2676	2677	2678	2679	2680	2681	2682	2683	2684	2685	2686	2687	2688	2689	2690	2691	2692	2693	2694	2695	2696	2697	2698	2699	2700	2701	2702	2703	2704	2705	2706	2707	2708	2709	2710	2711	2712	2713	2714	2715	2716	2717	2718	2719	2720	2721	2722	2723	2724	2725	2726	2727	2728	2729	2730	2731	2732	2733	2734	2735	2736	2737	2738	2739	2740	2741	2742	2743	2744	2745	2746	2747	2748	2749	2750	2751	2752	2753	2754	2755	2756	2757	2758	2759	2760	2761	2762	2763	2764	2765	2766	2767	2768	2769	2770	2771	2772	2773	2774	2775	2776	2777	2778	2779	2780	2781	2782	2783	2784	2785	2786	2787	2788	2789	2790	2791	2792	2793	2794	2795	2796	2797	2798	2799	2800	2801	2802	2803	2804	2805	2806	2807	2808	2809	2810	2811	2812	2813	2814	2815	2816	2817	2818	2819	2820	2821	2822	2823	2824	2825	2826	2827	2828	2829	2830	2831	2832	2833	2834	2835	2836	2837	2838	2839	2840	2841	2842	2843	2844	2845	2846	2847	2848	2849	2850	2851	2852	2853	2854	2855	2856	2857	2858	2859	2860	2861	2862	2863	2864	2865	2866	2867	2868	2869	2870	2871	2872	2873	2874	2875	2876	2877	2878	2879	2880	2881	2882	2883	2884	2885	2886	2887	2888	2889	2890	2891	2892	2893	2894	2895	2896	2897	2898	2899	2900	2901	2902	2903	2904	2905	2906	2907	2908	2909	2910	2911	2912	2913	2914	2915	2916	2917	2918	2919	2920	2921	2922	2923	2924	2925	2926	2927	2928	2929	2930	2931	2932	2933	2934	2935	2936	2937	2938	2939	2940	2941	2942	2943	2944	2945	2946	2947	2948	2949	2950	2951	2952	2953	2954	2955	2956	2957	2958	2959	2960	2961	2962	2963	2964	2965	2966	2967	2968	2969	2970	2971	2972	2973	2974	2975	2976	2977	2978	2979	2980	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TELEPHONE PLANTTelephone Plant - Overview

As shown on Table 2 in the article entitled "Estimated 1983 Results of Operations", 0.22% of the 1.26% difference between PT&T and staff estimates of realized 1983 rate of return for California Intrastate Operations is attributable to differences in rate base.

Of this, 0.19% comes from differences in estimates of weighted average plant estimates.

A spread of the differences, arranged according to the agreed PT&T-staff format, is shown in Table 13.

Table 13 shows the differences in

The Pacific Telephone and Telegraph Company

Results of Total California Operations

A.83-01-22 Estimated Year 1983 Weighted Average

Account 100.1 Telephone Plant in Service Through Recast #3

(\$000)

Item	PT&T Exceeds Staff		
	PT&T	Staff	Staff
100.1 Plant in Service (BAU)	\$19,501,750	\$19,132,117	\$369,633
CI-II	(198,144)	(185,600)	(12,544)
Subtotal	19,303,606	18,946,517	357,089
Recast #1 Adjustments			
without WECO Price Adj.	104,666	104,700	(34)
WECO Price Adj.	(176,014)	(169,474)	(6,540)
Recast #1 Subtotal	19,232,258	18,881,743	350,515
Direct Sale CPE	(128,200)	(128,028)	(172)
Recast #2 Subtotal	19,104,058	18,753,715	350,343
Recast #3 Adjustments	(1,772)	0	(1,772)
Recast #3 Total	19,102,286	18,753,715	348,571
Per Staff's format.			
WECO Price Adjustment			
added back		169,474	
		18,923,189	

(Red Figures)

The actual experienced 1983 BAU beginning-of-year plant in service turned out to be \$152,200,000 lower than forecasted by PT&T in the NOI. PT&T is not contesting the later figure.

The buildup of the PT&T and staff BAU figures for weighted average plant is shown below:

Item	Plant in Service "Business as Usual"		PT&T Exceeds Staff	
	PT&T	Staff	PT&T	Staff
	(Dollars in Millions)		(Dollars in Millions)	
Beginning-of-Year Balance				
Telephone Plant in Service	\$18,645.5	\$18,504.3	\$141.2	\$141.2
Weighted Average Net Additions	886.3	627.9	258.4	258.4
Total Weighted Average				
Telephone Plant in Service	19,501.8	19,132.2	369.6	369.6

PT&T's Plant in Service Estimate

PT&T's plant estimate was based on its capital budget and the budget process was explained by Vice President King.

According to King, the 1983 BAU capital budget is \$2,643.5 million, a 5.5% increase over 1982. These dollars were forecasted to engineer, purchase, and install new telephone equipment to meet customer demand and to support the utility's work force with tools and equipment. The capital budget for 1983 was developed by five major capital categories: COE, Station Equipment, Outside Plant (OSP), General Equipment, and Land & Buildings.

PT&T's estimates, as of the time of the NOI, adjusted for CI-II, are as follows:

BAU Total was Impact and CI-II
(Dollars in Millions)

Land & Buildings	\$ 205.2	\$ (8.8)	\$ 196.4
Central Office Equipment	1,006.6	-	1,006.6
Outside Plant Equipment	745.1	-	745.1
Station Equipment	524.7	(383.2)	141.5
General Equipment	161.9	(11.2)	150.7
Total	\$2,643.5	(403.2)	\$2,240.3

(Red Figures)

The Land & Buildings category includes the cost of all land and buildings, including all permanent fixtures and appliances installed.

The COE category provides for the engineering, purchase, and installation of the majority of the exchange and toll network. The category is broken down and analyzed in terms of four major subcategories: Manual, Circuits, Radio, and Dial Switch.

Manual, which has virtually been eliminated, includes all manual switching equipment. Circuits and Radio provide interlocal and long distance communication paths. The final subcategory, Dial Switch, represents switching equipment expenditures for both local and toll traffic.

Station Equipment is grouped into two main categories: station apparatus and large PBX. The apparatus subcategory contains all the equipment located on the customer premises. In addition, a portion of the former station connections account remains capitalized and is included in the Station Equipment total. Large PBX consists of business customers' on-premises switching systems.

The OSP category includes all expenditures associated with providing customer access to the exchange and toll network as well as some of the network trunking requirements. This category covers the engineering, purchase, and installation of telephone poles, manholes, cables, and conduit, including costs of trenching and repaving associated with installation.

The General Equipment category includes expenditures for furniture and office equipment, motor vehicles, and tools.

King described PT&T's capital budgeting process as consisting of tiers of activities designed to assure efficient utilization of corporate capital investment. He said that the process is a dynamic one, with changes in forecasts triggering a new cycle of updated requirements, management review, and analyses. In addition, the utilization of standard engineering criteria assures that capital expenditures provide telephone plant in the right place at the right time and in a cost-effective manner.

The utility's capital budget guidelines specify that the company will:

1. Meet forecasted demand for services.
2. Plan a modernization program in accordance with corporate objectives.
3. Replace worn-out equipment as required.

To develop the budget, each capital account is analyzed in terms of formulas or ratios, which, when examined over a period of time, can provide a reasonableness check for capital expenditures. Proposed unit costs are compared with historical cost trends.

Specifically, some of the ratios analyzed are Dial Switch dollars per main and equivalent main telephone gain, as well as Station Apparatus dollars per inward movement. For OSP, Subscriber Line dollars per main and equivalent main telephone gain is tested. In the Land & Buildings category, the ratio of Land & Building dollars to COE expenditures provides a check on reasonableness.

General Equipment requirements are reviewed for alignment with overall force additions, as well as testing the project costs against those of similar projects.

The budget process begins with a new volume forecast. The forecast is used as the basis of budgetary COE and OSP. The Station Equipment budget is based on forecasted quantities of the various types of terminal equipment. General Equipment requirements are based on field requests for force projections, project needs, and forecasted replacements. These requests are reviewed by PT&T's capital and budget group for alignment with overall force additions as well as testing the project costs against those of similar projects.

Land & Buildings category projects are triggered by related COE projects, operations requirements, or administrative needs. Building engineers account for all existing owned and leased space before proceeding with economic studies for new sites. Land & Buildings requirements are reviewed by the segment budget groups charged with overall management of the account. They check that requirements are justified by forecasts, timed to meet in-service dates, and are priced in relation to trends and averages.

King described the efficiencies that derive from PT&T's modernization programs. Should the company find it necessary to defer these programs, PT&T would still make capital expenditures to expand on older technology. The utility would continue to incur higher operating expenses and work force levels. And for many of the programs, it would miss an opportunity to expand the service offerings available to the consumer with a commensurate loss in revenue opportunity.

If more funds were to become available, and all other needs were to be met, King said that there was absolutely no question that he would spend the money on more modernization. By taking advantage of improved technology and introducing greater efficiency in PT&T's

operation, the company would more than pay for these expenditures with future expense savings.

King also explained the budgeting of contingency allowances, which PT&T defines as "Corporate Held Funds." These allowances are not included in the field budgets, and their dimension is not known by nor is it available to field budget groups. The corporate held funds currently contain \$30.6 million for 1982 and \$77.4 million for 1983, representing 1.2% and 2.9% of the identified budgets, respectively. As specific requirements are identified in subsequent view processes, PT&T intends to distribute these funds within the field budgets as appropriate.

Staff Plant in Service Estimate

The staff's estimate of Telephone Plant was prepared and presented by Senior Utilities Engineer David H. Weiss, P.E., of the Commission's Revenue Requirements Division.

On a Total California Operations Basis (Table 1) the staff Recast #3 estimate of Telephone Plant in Service for estimated year 1983 is \$348,571,000 lower than the telephone company. The difference is primarily the result of the staff having later information than the utility and the use of different estimating procedures. The utility had access to recorded data up to December 31, 1981, while the staff had access to much recorded data through December 31, 1982.

The staff estimates for weighted average Telephone Plant in Service are less than the utility's estimates by \$348.5 million for estimated year 1983. The principal reason for the difference is the estimates of construction expenditures where the staff estimates are less than the utility by \$416.3 million. Two basic factors leading to the staff's lower estimates of construction expenditures are staff's estimates of telephone access line gain (ALG) and capital expenditures required for each unit of ALG.

In discussing the staff estimates of construction expenditures, Weiss followed the utility practice of identifying components of the construction budget by subdividing it into categories. The differences, by category, between the utility and staff, on a Recast #1 (adjusted for CI-II), basis are:

Category	PT&T	Staff	Exceeds Staff
	(Dollars in Millions)		
Land & Buildings	\$ 196.4	\$ 189.1	\$ 7.3
Central Office Equipment	1,006.6	841.6	165.0
Outside Plant	745.1	531.6	213.5
Station Equipment	441.5	411.0	30.5
General Equipment	150.7	136.8	13.9
Total	2,240.3	1,810.1	430.2

The lower staff estimates were mostly caused by the following factors.

1. Volumes Estimates - PT&T ALG exceeded staff by 84,200 lines. That is, the staff estimate is 27% below that of the utility.
2. Corporate Held Funds - PT&T included \$77,400,000 in its CI-II budget for a contingency fund of 3.5% of estimated expenditures. The staff did not include anything for that purpose.
3. Inflation Factors - The staff used the latest estimates of inflation for each individual category as reflected in the most current Bell System Telephone Price Index (BSTPI). On a gross basis, PT&T used a composite BSTPI of 2.72 while the staff used 2.58.
4. Method of Estimating Central Office Equipment and OSP Categories - The staff used different methods of calculation and the lower staff ALG estimate.
5. Method of Estimating Station Equipment - The staff did not accept the utility's most

recent CI-II estimate because of a lack of recorded data and no approved policy for handling expenditures. The staff selected appropriate NOI and December 1982 view estimates.

6. Method of Estimating Land & Buildings and General Equipment - The staff used its lower inflation rate.

There were other differences between the utility and the staff estimates because of staff's use of different gross additions as a percent of gross construction expenditures, deferred taxes, beginning-of-year plant in service, and minor ratemaking adjustments.

In preparation of its estimate, the staff used utility definitions which explained the purposes of the expenditures made in each of the five capital categories used by PT&T in its budgeting process. These purposes were:

Growth

Modernization

Customer Movement

Plant Replacement

The staff referred to combined Customer Movement and Plant Replacement by the old term, Standing Still. The staff's analysis therefore consisted of a review of each of the five principal plant categories in terms of the three purposes of the expenditures: Growth, Modernization, and "Standing Still".

The staff estimate started with a company document which the utility develops and publishes twice each year, usually in April and October, which is entitled "Construction Budget Summary Analysis." It contains recorded data from the previous year plus forecasts for the current year and two years into the future and is commonly referred to as a "view." For the purposes of the current proceeding, the April 1982 view was further modified by the utility's headquarters staff in order to present a prudent budget for the current application. The budget summarizes the expenditures required

to carry out literally thousands of individual projects ranging in cost from thousands to tens of millions of dollars.

The staff analysis of the budget was based upon extensive discussions with the utility, supplemented by some 50 data requests which were responded to expeditiously by the utility. Based upon that information, the Commission staff attempted to develop relatively simple and reasonable methodologies to test COE and OSP, the major portion of the budget. The staff feels that the use of those methodologies should yield reasonable estimates of capital expenditures needed to achieve the utility's construction goals in those areas. The remaining areas, Land & Buildings, Station, and General Equipment, were reviewed using more conventional approaches.

COE and OSP expenditures constitute over 78% of PT&T's proposed 1983 budget.

According to the staff report, Exhibit 28, the utility has, in recent years, overestimated annual growth, as measured by ALG, and thus has placed into service more facilities than were required. As a result when the recorded costs of such facilities, or parts of them such as COE, are divided by a typical recorded quantity measuring need, a "driver," such as ALG, very high unit costs are recorded. Such unit costs would have been considerably lower had the forecast and recorded volumes matched each other. The utility typically uses unit costs, e.g., Dial Switch Dollars divided by ALG, to measure the reasonableness of its proposed capital expenditures. In the course of explaining this use of unit costs, the utility implied that it did not have the ability readily to change COE capital expenditures after detailed engineering is carried out about 1-1/2 years prior to use.

The staff found another example of this situation by dividing the historic, normalized cost of COE by recorded ALG to obtain unit costs. For the NOI, the utility figures indicate a unit cost for COE of \$2,227. The unit cost based upon recorded figures

turned out to be \$3,555 while the average for the 1970-1982 period is \$1,188. The increase in unit costs appears to come about when COE is ordered in proportion to a certain ALG forecast but when the equipment is installed, the ALG is much smaller. Dividing the relatively high COE dollars by a smaller ALG than was planned results in a larger unit cost than was envisaged at the time of forecast preparation. The staff declares that undue reliance upon the use of recorded information during periods of volatile access line estimates may be misleading in estimating COE and OSP which categories constitute together the major portion of the utility's proposed CI-II construction budget.

The staff therefore sought out another means of estimating the COE and OSP portions of the budget and concluded that the use of the utility's own view forecasts which were developed in conjunction with its own estimates of need such as ALG, etc., would provide the most reliable indication of what recorded unit cost data is most valid. The staff found several years for which recorded expenditures and ALG were close to the average of forecasted expenditures and ALG; thus, the effects of the use of missed ALG estimates with committed expenditures has been minimized. To guide the selection of those years, the forecast periods had to first be established.

The utility in justifying engineering force additions in its previous general rate application, A.59849, had pointed out that exchange and tandem switching replacement programs must be engineered up to two years prior to when capacity is placed into service. In response to a data request, PT&T confirmed that the COE and OSP categories were generally ordered via firm commitments approximately 1-1/2 and 1 year prior to use although it then said there is some ability to shorten those time intervals. Data from those time periods were used to obtain averages of forecasted values of budget dollars, ALG, and Access Line Inward Movement (ALIM). The sum of ALIM and access line outward movement is ALG. (Inward movement is

connecting a customer to receive telephone service. Outward movement is disconnecting a customer.)

The staff found several stable data reference years, the years in which the conditions were such that the forecasts of dollar expenditures and their associated drivers approached recorded values. The staff further examined the data for each year and determined that 1978 was the year closest to 1983 which generally showed decreasing unit costs with increasing ALG. The year 1978 was therefore selected as the reference year.

The staff felt that it was important to separate out the effects of growth, as growth was the major cause of the enlargement of the budget over the last ten years. To account for price charges, the staff used the BSTPI. The complete budget is based not only upon the element of growth but also upon the Modernization and Standing Still elements. Modernization for COE most often refers to replacement of existing COE equipment such as step-by-step with the more modern electronic equipment when a central office is enlarged to meet growth requirements. Some modernization is, however, carried out irrespective of growth needs. Standing Still refers to simple plant replacement with similar equipment and also to changes brought about by customer movement.

The Modernization and Standing Still (Customer Movement and Plant Replacement) portions of COE and OSP were handled separately, with the underlying basis of the utility's projections being adopted. However, since most expenditures for modernization result directly from customer growth requirements, the portion of modernization that was considered independent of growth was fully credited to the budget while the part of modernization that is proportional to growth was credited only in proportion to growth volume. The Standing Still part was fully credited to the budget.

For OSP, the staff used the same basic method as for COE, but the staff considered the shorter lead time required to purchase

OSP components. Also, ALIM was selected as the driver, since OSP must be provided to handle inward movement of customers irrespective of changes in ALG. Based on the selection of shorter lead time and of ALIM as the driver, the staff selected 1977 as the reference year.

The major portion of OSP is Exchange Lines and Aerial Wire. Discussions with the utility indicated to the staff that, as a general rule, approximately half the cost of Exchange Lines and Aerial Wire arises from the need to supply feeders which are a function of ALG while the balance of such costs are the result of adding distribution facilities which are driven by ALIM. The staff developed an equation for OSP which assumed that half its cost was a function of ALG while the other half was a function of ALIM. Since the structures part of the "Other" subcategory is basically underground facilities for distribution purposes, the entire Other dollars were assumed driven by ALIM. That assumption appears reasonable as feeders are built to provide for customer growth in a particular region whereas the distribution plant is required to bring the customers' individual lines to a particular feeder point and thus is a function of ALIM. That is to say, there may be no customer growth, but the movement of customers from one part of a region to another may require additional distribution plant.

The staff made a check by varying the ratio of the fraction of dollars attributed to Feeders vs. Distribution plus Other but no significant changes were observed and therefore the 50-50 split was accepted.

The Station Equipment category consists of Apparatus (such as telephones), Connections, and Large PBX. Of all categories, it will be the most heavily impacted by CI-II. PT&T estimated that 21.9% of its BAV Apparatus dollars would be required under CI-II when the FSS takes over the CPE function.

PT&T was unable to satisfy the staff as to any sound basis for its 21.9% estimate. The staff therefore modified the utility's

original NOI estimate of \$77.3 million for apparatus, the December 1982 view estimates of \$28.1 million for Connections and \$8.2 million for Large PBX to conform with the staff-adopted BSTPI and used \$75 million, \$27.9 million, and \$8.1 million, for a total of \$111 million.

The staff's review lead it to conclude that PT&T's estimates for the Land & Buildings and General Equipment were reasonable. Throughout the development of the staff's budget estimates, discussions were held with utility personnel which resulted in the staff's final lower BSTPI value than those used in the NOI. The staff's estimates, including those for Land & Buildings and for General Equipment, reflect this lower BSTPI value.

The staff did not allow for Corporate Held Funds because it believes that this is a redundancy. The staff found the budget already has contingency built into it, and the staff's experience is that PT&T has been over-optimistic in its forecast of growth. Weiss thought that expanding technology should yield lower, not higher, capital requirements.

Property Held for Future Telephone Use

The instructions for FCC Account 100.3, Property Held for Future Telephone Use, require that:

- "(a) This account shall include the original cost of property, other than station apparatus, owned and held for imminent use in telephone service under a definite plan for such use."

In the course of their audit, the staff accountants found vacant real estate in an amount of \$777,000 for which PT&T had no planned future use. This vacant property was being carried in Account 100.1, Telephone Plant in Service, and the accountants recommended its transfer to Account 103, Miscellaneous Physical Property, a nonrate-base account. Weiss, following this

recommendation, inadvertently removed the approximately \$800,000 from Account 100.3, rather than Account 100.1.

Were it not for this adjustment, PT&T and staff estimates for Account 100.3 would have been identical. Since the \$800,000 would have been removed from rate base in any event, there was no effect on the staff's overall results.

Plant Estimate - Rebuttal,
Rejoinder, and Briefs

Vice President King, as rebuttal to Weiss' plant estimate, took exception to Weiss' selection of 1978 as a reference year for the deviation of unit costs for COE growth expenditures. King stated that COE growth expenditures in 1978 were not sufficient to provide for all the growth requirements, as evidenced by the service levels and held orders that the company experienced. Since service levels and held orders in 1978 indicated that PT&T was not meeting quality of service standards, because not enough COE was being provided, 1978 was an inappropriate year to derive unit cost figures for COE. The unit costs thus obtained understate growth requirements.

Similarly, King said that 1977 was not an appropriate year to base a unit cost analysis for OSP growth expenditures because not enough OSP was being provided and the quality of service was not being met in 1977.

King also testified that Weiss, at transcript page 1179, recommended that \$37.1 million of Station Equipment (SE) be expensed rather than capitalized but the staff made no provision for the \$37.1 million in any expense account.

In rejoinder the staff addressed only the alleged failure to expense SE. Weiss testified that he had made no recommendation that any \$37.1 million be expensed.

"Q Now, I ask you, did the staff make any recommendation regarding the disposition of the 37.1 million?

"A No. I think the staff did not recommend either capitalizing or expensing that amount.

Instead, I believe if you look at Volume 10, page 1180, line 17-19, plus Exhibit 28, chapter 13, page 13-30, Table 13-E, apparatus subtotal of 75 million, compared to an NOI value of 77.3 million, if you look at that, we made no recommendation that this item be expensed. Instead, it was my feeling that the company should try to get by with the 75 million while carrying out the recommendation we made in Volume 10, page 1179, line 18-19, which was to provide some sort of inventory of the existing amount of equipment before proceeding in the purchase of additional equipment.

"I still can't quite understand how one can decide to purchase additional equipment when one does not know how much equipment he already owns." (TR 2867.)

In its brief, PT&T disputes the staff's use of a factor of 0.48, based on a 1978-1982 average, to be applied to estimated capital expenditures to get the weighted average net additions. PT&T contends that the figure should be 0.50, representing a uniform rate of expenditure throughout the year. The use of a uniform rate and a 0.50 factor would raise the staff's rate base by \$18.3 million.

Also in the brief, PT&T alleges that Weiss made a \$40 million error in COE and admitted the error but declined to correct it.

Another point that PT&T makes in its brief is that Weiss was not consistent in his selection of the NOI estimate for SE Apparatus and the December 1982 view for SE Connections and Large PBX.

Evaluation of Plant Estimates

The formulation of a reasonable allowance for the plant portion of PT&T's rate base depends not only on the plant estimating techniques used by the utility and the staff, but also on whether PT&T is being induced by the level of authorized rate of return to invest for the purpose of producing a return on the investment, rather than investing for the purpose of meeting a real demand by the public for additional or improved utility service.

The evaluation must also depend on the contention of the staff that PT&T's plant is already overbuilt, and plant costing in excess of \$600,000,000 is not being utilized.

The 1983 capital expenditures budgeted by PT&T are massive, \$2,240,300,000, or \$218 for each of the company's 10,275,000 telephones. The \$1,810,100,000 recommended by the staff is not exactly a parsimonious allowance, it would still amount to \$176 per customer, 81% of the amount being advocated by PT&T. Such enormous capital expenditures must bear careful examination.

Commission Staff's Position

First, regarding King's contention that the 1978 level of expenditures for COE was insufficient, the Annual Report of PT&T filed with this Commission (FCC Form M) shows that in 1978, additions to Ac 221, Central Office Equipment amounted to \$426,487,394, a 23% increase over the prior year's additions of \$345,310,556. The 1978 additions were 10.5% of the beginning of year plant. During 1978 PT&T issued \$900,000,000 in debentures, \$106,650,000 in non-voting preferred, generated \$149,674,000 in retained earnings, accumulated \$195,098,000 in "deferred taxes" and charged depreciation accruals of \$697,411,264. The year 1978 was not a year in which PT&T was starved for funds available for capital expenditures nor were the gross additions to COE insignificant.

As for 1977, the staff base year for OSP additions, PT&T added \$370,355,000 to \$2,805,836,000 of outside plant, a 13.2% gross

addition rate. This rate, while dwarfed by PT&T's present spending levels, is a respectable rate of gross additions.

After considering the recorded data for the base years selected by the staff, and the distortion in unit costs provided by the utility's method, the Commission concludes that Weiss' estimating methods for COE and OSP are sound.

The Commission cannot accept PT&T's contention made in its brief that consistency demands the staff accept the utility's December 1982 view for the SE category in its entirety. Weiss, in defending his use of the original NOI estimate, explained on cross-examination at Transcript Page 1178:

"Q Okay. Why don't you tell me where I was wrong.

A It goes beyond that. I was, first of all, suspicious when the company made the statement that -- and I will read from paragraph 38 on page 13-16, and the company said:

'The utility obtained its CI-II figures by estimating that 21.9 percent of its BAU apparatus dollars would be required under the CI-II condition.'

"I questioned the company on where the 21.9 percent came from, and I was told it was a management decision.

"I was not able to find out who in management estimated 21.9 percent.

"Furthermore, I wasn't able to find out really where the 21.9 percent came from.

"The only impression I got was that someone sat back and said, 'I think it is about 21.9 percent.'

And, after an interruption by staff counsel, at Tr. 1179 and 1180:

"Anyway, that sounded awfully funny to me. I just couldn't imagine how anybody would make that kind of management estimate.

"I was further surprised and appalled, frankly, that company, with over 100,000 employees, would not know how many telephones it used in its own operation.

"And based upon those two factors, I became suspicious that there was no real sound basis for coming up with a number.

"I discussed with your company the fact that it seemed to me, without a record of equipment on hand, that maybe the most prudent thing to do would be to go forward with a zero budget for station equipment, and during the next year or so, try and find out how much equipment you owned.

"And due to the fact also that you were centralizing a lot of offices, possibly you wouldn't need more than you already had.

"Because of this, your staff furnished some additional information, Data Request, I think it is 1117, which contained a list of equipment.

"And then we got into a discussion of what was the basis of procuring that equipment and why did you need that equipment, and your people furnished us with a series of guidelines.

"And as I have indicated here, these guidelines, none of them were actually in use, and they were the subject of discussion.

"I then asked our fiscal people, our accounting people, to come in and give me some advice.

"And the net result of my discussion with Mr. Galvin and others was that they felt many of these items should be expensed, and the whole thing seemed very cloudy.

"So, I think to sort of sum it up, in paragraph 43, where I say that I think there is a lack of firm guidelines, there are reductions of growth in customer movement, at least as a result of CI-CII, and a reduction in work force, centralization of operations, plus a lack of an historic background.

"So I went along with your original dollars, and frankly, I thought, you know, that didn't really seem right.

"I hesitate to recommend a budget, in all honesty, when I feel nobody knows what is out there in the first place."

Without some kind of justification for PT&T's Apparatus budget figure, the Commission will select Weiss' estimate.

Nor does the Commission have any difficulty with the staff's use of a weighting factor of 0.48 instead of 0.50. It is not disputed that the factor is based on five years' experience data. Upon reflection, the reason becomes obvious. Budgeted expenditures tend to bunch at the end of the year, when the December 31 expiration date comes. Plant additions rarely are at a uniform rate and for this reason the Commission has traditionally used a weighted average rate base. Were the net additions not to be weighted, the plant in service would not be weighted. Without weighted average plant, the rate base would not be weighted. Weiss was merely following the longstanding practice of the agency and his recommendation for a 0.48 weighting factor will be accepted.

The Commission has attempted to verify the company's contention, as made in its brief, that Weiss acknowledged a \$40 million miscalculation in its estimate of COE circuits, but declined to correct for it. PT&T refers to transcript page 1194 but it did not specify how the \$40 million was determined. The development is not shown in the brief nor is it clear from a reading of the transcript that an error of anywhere near that magnitude was made. Weiss only admitted to the possibility of small errors, and indicated that they probably would be compensating.

Of the \$348,571,000 difference between the PT&T and staff estimates of weighted average telephone plant in service, \$111.2 million is due to the staff's opportunity to have a later view of the beginning of year 1983 BAU plant. The remainder is due to the

estimating differences for weighted average net additions that have just been reviewed. For the reasons given, the Commission believes that the staff estimate of plant in service is reasonable and will adopt the figure of \$18,753,715,000 for 1983 Total California Estimated 1983 Operations.

Similarly the Commission will adopt the staff estimate \$55,100,000 for Plant Held for Future Use, recognizing that, in so doing, Telephone Plant in Service will be overstated by \$777,000 and Plant Held for Future Use understated by the same amount. Plant Underutilization Adjustment Proposal

In the course of this investigation of PT&T's plant investment, the staff plant witness Weiss concluded that the utility has, in recent years, consistently failed to adjust expeditiously its rate of expenditures for decreased growth needs. As a result of this failure, Weiss believes that PT&T has placed in service more facilities than are currently required.

Weiss predicted that, for the period 1983-84, there will be average underutilization of plant to the extent of \$652,700,000. Should 1982 expectations be considered, the value of underutilized plant would be even higher.

On behalf of the Revenue Requirements Division, Weiss proposes an adjustment be made in annual California jurisdictional revenues of \$93,700,000, to allow for the portion of rate bases comprised of underutilized plant. Weiss proposed no adjustment to plant in service, per se, but instead proposed that the underutilized plant be recognized by his gross revenue adjustment. All the plants in service figures discussed in the preceding consideration of Telephone Plant in Service including the staff estimate include the "underutilized plant."

... ..

The staff witness appraised plant utilization in terms of Central Office Utilization (COU)⁸ and Outside Loop-Fill (LF)⁹ percentages. These ratios are prescribed by AT&T for use in its Construction Budget Summaries.

Comparing probable 1982 COU and LF to historical averages, Weiss concluded that serious plant underutilization exists. He developed the dollar amount of unused plant by taking the average COU and LF for the 1983-84 period and applying facility unit costs to them to determine an amount of \$652,700,000 of underutilized plant facilities. The staff recommends that no rate of return be allowed on the underutilized plant and that the gross revenue requirement be reduced by \$93,700,000. The staff is proposing no adjustment to rate depreciation expense, ad valorem taxes or other expenses associated with the underutilized plant, however.

The staff proposal is mitigated by a further recommendation that two years be allowed for the elimination of the excess plant and the adjustment terminate at the end of 1984. Should the utility not utilize the plant before the end of 1984, it should petition the Commission to revise its rates to reflect inclusion of underutilized plant in rate base.

⁸ COU is the percent of the Central Office Capacity (COC) that is being used at the end of the year. It is determined by dividing the number of year-end operating lines by the COC.

⁹ Loop Fill is the percent of outside plant loops that are operational or used compared to those that are available for use. A loop is a pair of wires between the subscriber and central office, which is connected or may be connected to a telephone or other apparatus. Loops may also be called access lines.

"A I think you can only surmise what Pacific should have done by looking at the previous charts in concert with this. And that is the reason why the cross-hatch line is in the lower left side.

"So, if you take these charts apart and lay the cross-hatched area one on top of the other, you would get an idea of what the company knew, for example, in 4/82. But that has been improved upon by the last chart, where we can look at 1982.

"And if you'll turn to the last chart, and you'll draw a line up, say, the middle of 1982, and then take a piece of paper and lay it on the right hand side so you do not know what the future holds, you can see what the company knew as of early 1982. And there you can see the company knew in the past that its access line gain forecasts were all dropping for all of these years, for 1981 plus 1982.

"They could also see where their central office line and equipment budgets had either increased or remained essentially level.

"And that information, combined with their service information as to the quality of service being better than it need be, and if the audit information was available as to errors, plus I guess if you went back to their history of discussions with AT&T where the company admits that people in the field were misplacing the timing errors and other things of that sort, the company should have been guided to be much more cautious and maybe undertaken emergency effort to see where it was in the construction budget business, especially since complaints were being made that it was very difficult to raise money with the high interest rates that existed at that time."

PT&T Vice President King testified in rebuttal to Weiss's proposed adjustment. He claimed that the utility's construction of

programs for 1981 and 1982 were prudent and based on the best economic forecasts available at the time. He also said that Weiss' methodology was incorrect.

King said that, since 1979, many leading forecasters had failed to predict the course of the economy and Pacific's forecasts were comparable to those made by the leading forecasters. He described the costs and difficulties of canceling ordered switching equipment and the practical inability of transferring ordered equipment from one area of the system to another.

Finally, King said that Weiss had incorrectly applied the COU values. Had the staff applied them correctly, Weiss' estimate of underutilized plant would be reduced by \$354,100,000.

King, in his rebuttal testimony, made no mention of Weiss' reference to the many warnings that AT&T had issued to PT&T concerning PT&T's optimistic projections of construction expenditures.

Staff counsel objected strenuously and repeatedly to King's rebuttal reference to economic forecasts, on the grounds that Weiss had not relied in any way on such types of techniques. Counsel for PT&T replied that the economic forecasts were part of the total information available to the management at the time it made its plant investment decision and are absolutely vital for the evaluation of whether PT&T acted reasonably in making its plant investment decisions. The ALJ denied the staff's motion to strike King's testimony concerning economic forecasts, with the reservation that the Commission understood that Weiss had not relied on such forecasts in formulating his proposal.

Underutilized Plant - Discussion

It is clear from the record that during the test year 1983 a substantial portion of PT&T's plant will be underutilized. PT&T did not argue that there is no underutilization, although it challenged the methods used by staff for estimating the amount of underutilized plant, and associated costs. We believe that the staff's estimates are reasonable and will adopt them for purposes of this proceeding. PT&T has \$483.5 million in intrastate rate base for plant that will be underutilized in 1983.

PT&T's overinvestment in plant occurred at least in part from questionable management judgment. Hindsight is not required to see that PT&T's aggressive construction program should have been reconsidered before 1982. The company received repeated warnings from AT&T's budgetary experts, and ignored standard service indices developed by the Bell System. PT&T argued that its reliance on reputable economic forecasts was reasonable, and that it made its investment decisions on the basis of those forecasts. However, as staff argued, the company appears to have relied on those forecasts in spite of the fact that the company's own indicators of plant use were declining.

Even though management should have reconsidered the pace of its construction program, we agree with PT&T that its decision-making environment was volatile and did not provide clear signals during the period in question. The effects of recession surely contributed to the lower growth of access line gain. The extent and duration of the recession were unprecedented since the 1930s. As evidence of the unpredictability of the economy at the time, PT&T points to staff projections of access line gain in the last rate case. Those estimates were substantially higher than the line gain that actually occurred. Further, PT&T did curtail its construction program as the recession continued into 1982.

Under the circumstances, we believe staff's ratemaking treatment is too harsh. Instead, we believe that ratepayers and shareholders should share the risk of the underutilization, which occurred partly as a result of economic volatility, and partly as a result of poor management. Therefore, we will find that the effective rate of return on the plant at issue should be 6.35%. PT&T may ask to have this penalty removed as provided herein. We

will consider a normal rate of return on this plant if and when PT&T can show that it is in use.

Our action today should serve as a warning to PT&T that we will not automatically pass through to ratepayers the costs of future construction projects. We believe that in the future PT&T should be more attentive to the demand for its facilities and services. We also note that our routine authorization of PT&T's securities issues in no way binds this Commission as to the reasonableness of the company's construction budgets. Contrary to PT&T's assertions, nothing in those decisions implies a finding of reasonableness. Our Commission staff resources do not permit a thorough review of construction budgets every time a utility requests authority to issue securities; requests may number in the hundreds annually. Under current regulatory practices, it is the responsibility of PT&T management to make decisions regarding additions to plant. We have not reviewed, in general rate cases, the prudence of those decisions for purposes of ratemaking.

PT&T's construction program is a long-term program. It is not a short-term program. It is a program that is designed to provide for the future needs of the company. It is a program that is designed to provide for the future needs of the company. It is a program that is designed to provide for the future needs of the company.

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RATE BASE

Rate Base Determination is a comprehensive audit procedure as applied to the Rate-base is the net valuation of that property of a public utility that is devoted to public service. It is composed, not exclusively, principally of the weighted average depreciated original cost of various plant and equipment used and useful in serving the public. In addition the rate base includes an allowance for working cash and materials and supplies. If there is a reserve for so-called "deferred taxes", the amount, the accumulated difference between the amount of income taxes allowed for ratemaking and the amount actually paid to income tax agencies, of "deferred tax" reserve is deducted as being funds provided by the ratepayers.

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<u>1960-61</u>	<u>1959-60</u>	<u>1958-59</u>	
1,000,000	1,000,000	1,000,000	Telephone Plant in Service
100,000	100,000	100,000	Property Held for Future Use
100,000	100,000	100,000	Working Cash
100,000	100,000	100,000	Materials & Supplies
100,000	100,000	100,000	Depreciation Reserve
100,000	100,000	100,000	Reserve for Deferred Taxes
1,000,000	1,000,000	1,000,000	Rate Base

(Sample Page)

The rate base reported for each year is based on the rate base determined by the Department of Public Works and the Department of Finance. The rate base is based on the original cost of the property, less depreciation, and plus the reserve for deferred taxes. The rate base is based on the original cost of the property, less depreciation, and plus the reserve for deferred taxes.

The rate base is based on the original cost of the property, less depreciation, and plus the reserve for deferred taxes. The rate base is based on the original cost of the property, less depreciation, and plus the reserve for deferred taxes. The rate base is based on the original cost of the property, less depreciation, and plus the reserve for deferred taxes.

In this proceeding the only contested item in ratebase was the plant in service. The differences in the other items, such as working cash, materials and supplies, depreciation reserve, and reserve for deferred taxes, are either the result of the staff's having later information, or the result of the impact of other elements of the cost of service.

The differences between the components of PT&T and staff total California rate bases, on a Recast 3 basis, are:

Table 14

THE PACIFIC TELEPHONE & TELEGRAPH COMPANY
TOTAL CALIFORNIA RATE BASE
A.83-01-22 ESTIMATED YEAR 1983
(\$000)

RECAST 3

	<u>PT&T</u>	<u>Staff</u>	<u>PT&T Exceeds Staff</u>
Telephone Plant In Service	\$19,102,286	\$18,753,715	\$348,771
Property Held for Fut. Tel. Use	55,877	55,100	777
Working Cash	219,936	123,255	96,681
Materials & Supplies	148,369	103,930	44,439
Depreciation Reserve	(3,447,992)	(3,427,486)	(20,506)
Reserve for Deferred Taxes	(2,257,858)	(2,209,957)	(47,901)
Rate Base	\$13,820,618	\$13,398,557	\$422,061

(Red Figure)

The rate base adopted for this decision, before Recast 4, the depreciation adjustment mandated by D.83-08-031, is the staff rate base adjusted for the effects of adopted expenses. That figure is \$13,404,497,000.

Adopted Results of Operations

The table which follows summarizes the results of operations at present rates adopted by the Commission on a Total California basis and that portion allocated to California Intrastate through the separations process. The higher realized rate of return for Total California illustrates the profitability of the interstate toll service.

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
RESULTS OF OPERATIONS

A.83-01-22 ESTIMATED YEAR 1983

(\$000)

RECAST #3

	Total California	Intrastate
<u>Operating Revenues</u>		
Local Service Revenues	\$ 2,977,964	\$ 2,974,384
Toll Service Revenues	4,846,735	2,653,157
Miscellaneous Revenues	442,134	442,134
Uncollectibles	(110,716)	(72,631)
<u>Total Operating Revenues</u>	<u>\$ 8,156,117</u>	<u>\$ 5,997,044</u>
<u>Operating Expenses and Taxes</u>		
Current Maintenance	\$ 1,949,895	\$ 1,404,830
Depreciation & Amortization	1,217,998	897,324
Traffic Expenses	385,218	309,060
Commercial Expenses	719,578	598,708
Gen. Office Salaries & Expenses	457,084	355,866
Operating Rents	55,091	42,767
Gen. Services & Licenses	65,829	48,760
Other Oper. Expenses	783,458	588,560
<u>Total Operating Expenses</u>	<u>\$ 5,634,151</u>	<u>\$ 4,245,875</u>
Operating Taxes - Federal Income	513,705	335,649
- Cal. Corp. Franch.	281,769	181,800
- Social Security	187,019	140,586
- Other	166,080	123,015
CPE Gain After Net Adj.	(47,199)	(47,199)
CPE Gain Tax Effect	14,651	14,651
<u>Total Oper. Expenses & Taxes</u>	<u>\$ 6,749,576</u>	<u>\$ 4,994,377</u>
<u>Net Revenues</u>	<u>\$ 1,406,541</u>	<u>\$ 1,002,667</u>
<u>Rate Base</u>		
Telephone Plant in Service	\$18,753,715	\$13,857,679
Property Held for Fut. Tel. Use	55,100	40,967
Working Cash	129,195	97,542
Materials and Supplies	103,930	75,817
Depreciation Reserve	(3,427,486)	(2,489,285)
Reserve for Deferred Taxes	(2,209,957)	(1,645,655)
<u>Total Rate Base</u>	<u>\$13,404,497</u>	<u>\$ 9,937,065</u>
Rate of Return	10.49%	10.09%

(Red Figure)

Background

Realized rate of return is the ratio of the adopted net revenue at present rates to the adopted rate base.

The adopted rate of return is a percentage which, when multiplied by the rate base, determines the net revenue that the utility is to be allowed an opportunity to earn. A reasonable return should be sufficient to enable a utility to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed. (Federal Power Commission et al. v Hope Natural Gas Co. (1944) 320 US 591, 605, 88 L ed 333, 346.)

Frequent reference was made in prepared testimony and briefs to the Bluefield case, where the U.S. Supreme Court said:

"A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally."

(Bluefield Water Works and Improvement Company v West Virginia Public Service Commission (1923) 262 US 679, 692, 693; 67 L ed at 1176.)

As the Bluefield case specified, the rate of return is applied to "the value of the property which (the public utility) employs for the convenience of the public," yet the rate of return is determined by examining the capital structure of the utility, without reference to the rate base, the "value of the property" of the Bluefield case. Thus, the rate base is found by examining and adjusting the left side of the balance sheet, whereas the rate of return is obtained by independently determining the cost necessary

to pay interest on debt and provide an allowance from which to pay dividends on stock and to invest in the business as retained earnings.

In its original application, PT&T requested a 14.31% rate of return representing an embedded cost of debt of 10.16% and a return on common equity of 19.00%. In prepared testimony distributed on April 15, 1983, PT&T's financial policy witness, former Vice President and Treasurer Robert M. Joses lowered these figures to a 13.49% rate of return, representing an embedded cost of debt of 9.95% and a return on equity of 17.5%. PT&T's other witnesses revised their prepared testimony as they testified to conform to Joses' revision. This revision was made to reflect changes in the capital market between the filing of the NOI in August 1982 and the date of the hearings in May 1983.

the date of the hearings in May 1983.			DATE	TIME	LOCATION	REMARKS
1	1983	1983	1983	1983	1983	1983
2	1983	1983	1983	1983	1983	1983
3	1983	1983	1983	1983	1983	1983
4	1983	1983	1983	1983	1983	1983
5	1983	1983	1983	1983	1983	1983
6	1983	1983	1983	1983	1983	1983
7	1983	1983	1983	1983	1983	1983
8	1983	1983	1983	1983	1983	1983
9	1983	1983	1983	1983	1983	1983
10	1983	1983	1983	1983	1983	1983
11	1983	1983	1983	1983	1983	1983
12	1983	1983	1983	1983	1983	1983
13	1983	1983	1983	1983	1983	1983
14	1983	1983	1983	1983	1983	1983
15	1983	1983	1983	1983	1983	1983
16	1983	1983	1983	1983	1983	1983
17	1983	1983	1983	1983	1983	1983
18	1983	1983	1983	1983	1983	1983
19	1983	1983	1983	1983	1983	1983
20	1983	1983	1983	1983	1983	1983
21	1983	1983	1983	1983	1983	1983
22	1983	1983	1983	1983	1983	1983
23	1983	1983	1983	1983	1983	1983
24	1983	1983	1983	1983	1983	1983
25	1983	1983	1983	1983	1983	1983
26	1983	1983	1983	1983	1983	1983
27	1983	1983	1983	1983	1983	1983
28	1983	1983	1983	1983	1983	1983
29	1983	1983	1983	1983	1983	1983
30	1983	1983	1983	1983	1983	1983
31	1983	1983	1983	1983	1983	1983
32	1983	1983	1983	1983	1983	1983
33	1983	1983	1983	1983	1983	1983
34	1983	1983	1983	1983	1983	1983
35	1983	1983	1983	1983	1983	1983
36	1983	1983	1983	1983	1983	1983
37	1983	1983	1983	1983	1983	1983
38	1983	1983	1983	1983	1983	1983
39	1983	1983	1983	1983	1983	1983
40	1983	1983	1983	1983	1983	1983
41	1983	1983	1983	1983	1983	1983
42	1983	1983	1983	1983	1983	1983
43	1983	1983	1983	1983	1983	1983
44	1983	1983	1983	1983	1983	1983
45	1983	1983	1983	1983	1983	1983
46	1983	1983	1983	1983	1983	1983
47	1983	1983	1983	1983	1983	1983
48	1983	1983	1983	1983	1983	1983
49	1983	1983	1983	1983	1983	1983
50	1983	1983	1983	1983	1983	1983
51	1983	1983	1983	1983	1983	1983
52	1983	1983	1983	1983	1983	1983
53	1983	1983	1983	1983	1983	1983
54	1983	1983	1983	1983	1983	1983

...the 1983 year-end capital structure of PT&T
 ...to be the \$82 million of 6% voting preferred stock of
 "AT&T"

...the 1983 year-end capital structure of PT&T ...
 ...the 1983 year-end capital structure of PT&T ...
 ...the 1983 year-end capital structure of PT&T ...
 ...the 1983 year-end capital structure of PT&T ...

Capital Structure

Except for the federal government showing, the capital structures in the preceding table represent the witnesses' understanding of what the 1983 year-end capital structure would be. That of staff witness Mowrey reflected PT&T's financing plans as of April 8, 1983. PT&T contemplates no new debt or nonvoting preferred stock issues in 1983 and AT&T has announced that it would provide PT&T with \$600 million of common equity in 1983; \$300 million in May and an additional \$300 million later in the year. This equity is a conversion of outstanding short-term advances from AT&T. In addition to the common equity, AT&T has also agreed to assume five specific debt issues totaling \$850 million at the time of divestiture as well as advance an additional \$86 million in 1983 to PT&T which will be used by PT&T to retire high cost long-term debt currently outstanding.

The capital structures used by Joses, Mowrey, and Kroman are to a minor degree fictitious capital structures in that they impute a 6% cost to the \$82 million of PT&T 6% voting preferred stock that was converted to common equity as a result of the merger transaction by which PT&T became a wholly owned subsidiary of AT&T. In D.82-05-007, dated May 4, 1982, in A.61045, the Commission authorized the acquisition of the minority holding of PT&T's stock by AT&T.

"...subject to the condition that in applicant's subsequent next general rate proceeding (and in subsequent proceedings, for so long as is appropriate)

PT&T's actual capital structure shall be amended to impute a 6% cost to \$82 million of common equity..."

As he did in the last PT&T's general rate case, witness Langsam used the 50-50 equity - senior security ratio he considers appropriate for the Bell System as a whole.

Six Percent Equity

The Commission described above how the hypothetical "6% equity" became part of PT&T's ratemaking capital structure. Sidney J. Webb urged that the practice of imputing this hypothetical element of PT&T's be discontinued so that PT&T could start out as an independent utility and not carry forward a nonexistent stock. According to Webb, most of the stock had been issued at a discount and the minority part was bought back at \$60 a share.

The Commission agrees with Webb that it would be nice for the new company not to be burdened with an imputation of nonexistent phantom stock. Elimination of the phantom stock would raise the fraction of common equity by 0.60% and the recommended rate of return by 0.06%. (Using staff figures, common equity ratio would rise from 47.70% to 48.30%. Overall recommended range of rate of return would go from 12.52%-12.76% to 12.58%-12.82%.)

PT&T is starting out with the excess baggage of the Western Electric adjustment for plant purchased from its old affiliate, but this adjustment will gradually disappear as plant is retired. The effect of the 6% equity adjustment would continue indefinitely. The Commission notes that the staff's rate of return recommendation has a range of 0.24%, a width four times the amount of the effect of the 6% equity on rate of return.

Considering the relative lack of precision in determining rate of return and the desirability of embarking PT&T free from nagging insignificant phantom element to its capital structure, the Commission will accept Webb's recommendation and will no longer require the imputation of the 6% equity.

Meyer for PT&T

The first witness to testify for PT&T was Eugene W. Meyer, a vice president and director of Kidder, Peabody & Co. Incorporated, New York. Meyer is manager of the Utility Corporate Finance Department and is also a member of Kidder, Peabody's Executive Committee.

Meyer concluded that the 17.5% return on equity being requested by PT&T is within a reasonable range. Meyer declared the purpose of his testimony to be to compare the company's requested return on equity with the costs of new capital as determined by today's capital marketplace. PT&T needs to provide financial results which are sufficient to attract capital on an ongoing basis especially in light of the anticipated divestiture. After the divestiture, PT&T will stand on its own in the marketplace. Should the utility be unable to improve its financial posture, it will be unable to attract new capital at a reasonable cost.

Meyer said that his key role in utility financing is that of underwriter. The underwriting function is performed by buying new securities from an issuing corporation at a price determined either by negotiation or through competitive bidding and reselling the issues to the public immediately at a price slightly higher than that paid to the corporation. If the issue is successfully resold to the public market, the difference between the price paid by the underwriting group and the price paid by the public market is the underwriter's spread, or compensation. If the underwriter misjudges the level at which investors will commit their savings, it will be unable to market the issue except at a lower price than anticipated. It is the substantial risk which underwriters run during the offering period, combined with the need to keep both the issuing company and the investor as clients, which disciplines the underwriters' market judgment.

Of all the services provided by investment bankers, the ability to judge the market and correctly price an issue is of the greatest benefit to the issuing company and investor alike. In pricing new bond and preferred issues, Meyer considers, first, the yield levels of the money market and the competition for capital. Consideration is then given to the security ratings of the new issue and the ability of the company to maintain or improve such ratings.

The strength and trend of the company's capitalization and interest coverage ratios are also important considerations. A company facing ongoing construction expenditures requires higher equity and interest coverage ratios in order to continue to have access to the capital markets. These factors, credit ratings and interest coverage ratios, are dependent upon the earnings stature of the company.

Another factor is the amount of outstanding securities. PT&T has over \$6.0 billion outstanding debt. Many institutions holding these securities may require investment limitations in the securities of one corporation. This means that the market for new securities is reduced and may result in a higher cost of new capital.

Further, Meyer said, in the case of a regulated company, the regulatory environment is a very important factor in determining the cost of new capital. Regulatory lag and rate of return allowances which do not reflect the true cost of capital have a negative impact on the cost of a new issue.

Meyer testified that financing of new corporate issues over the last ten years has exceeded a half of trillion dollars. Public utilities, including the communications sector, accounted for 36% of the new corporate issues during this period. State and local governments have accelerated their borrowing, and thus increased the competition for capital and made the availability of capital funds more uncertain. There also has been a tremendous increase in the net borrowings of the U.S. government and its agencies.

It has become more difficult to price and market utility securities. In addition to the increased competition for new capital, investors have seen the quality of utility senior securities deteriorate significantly over the past few years. Bond ratings have been reduced in many instances and the fear of more downgrades is still present. The greater the risk, the higher return the investor will demand, resulting in higher capital costs for the issuing corporation. A further contributing factor to higher capital costs is the smaller market for securities of greater risk.

The principal financial measures providing that the interest or dividend will be paid during the term of the security, that investment quality will be maintained, and that, in the case of bonds or debentures, the principal will be repaid when due, are the adequacy of earnings to cover the fixed charges of interest and preferred dividends, the soundness of the capital structure and the regulatory environment.

Meyer said that the regulatory environment is very important to investors. The first step taken in an evaluation for investment in a regulated utility is a review of the Commission orders setting the utility's authorized return on equity. The investor or investment analyst would determine:

- the authorized return on equity;
- test period lag, if any; and
- disallowances, if any.

Should the order be based on an unadjusted historic test period and/or contain disallowances which would prevent the utility from earning the authorized return on its book equity, the investor will lower his estimate of future actual earnings and, in turn, lower the price he is willing to pay for the utility's securities. By lowering the price, the investor increases the yield on his investment, thereby compensating him for the higher risk.

While there are many important factors such as the nature of a company's business, its management and its regulatory environment, the key measurements in the evaluation of the quality of senior securities are fixed charge coverages and capital structure, Meyer said. This evaluation affects the interest rate or preferred dividend rate which the securities must offer to be attractive to investors.

Meyer did not consider PT&T's current bond ratings to be satisfactory. If PT&T is to raise capital on its own over the years, it must improve its credit ratings. Ideally, PT&T should be a AAA/Aaa rated company; practically, it will be unable to achieve AAA/Aaa bond ratings in 1983. At the very least, the company must immediately strengthen its present ratings and strive to achieve AA/Aa bond ratings as early as possible.

In order to do this, PT&T must improve its financial ratios. The selected criteria for S&P's AA bond ratings are:

Rating	Consistent Pretax Interest Charge Coverage	Total Debt	Minimum Total Equity	Minimum Common Equity
		Total Capital	Total Capital	Total Capital
AA-	3.7x - 4.3x	46-48%	52-54%	47%
AA	4.0x - 4.5x	45-47%	53-55%	48%
AA+	4.3x - 4.7x	40-45%	55-60%	50%

In Meyer's opinion, the objective capital structure should be 45% to 50% debt and 50% to 55% equity for now. The long-term objective should be 40% to 45% debt or less and 55% to 60% equity. He considers these objectives to be prudent and in the best interests of customers and investors.

Meyer explained his theory for determining the level of long-term interest rates. Specifically, long-term interest rates include a portion for the use of money, a portion to offset the

expected loss of purchasing power through inflation, and a portion to offset the higher risk of companies with lower bond ratings. The charge for the use of money remains unchanged over time in the range of 2.5% - 3.0%. The remainder of the interest rate is required to offset inflation and allow for a credit risk differential.

In his judgment, during April of 1983, a new issue of PT&T bonds rated A3 by Moody's and by S&P would require a yield in the 11.14% to 13.61% range. Meyer's experience in the investment business has consistently indicated that common stock investors require a total return some 300-500 basis points higher than the return available on the same company's long-term debt securities.

Meyer emphasized the need for investors to regard PT&T's stock as a good investment after divestiture. Should, PT&T be perceived by investors as being an unhealthy company, a sell-off in the utility's common shares could occur almost immediately. In this event, the market for PT&T's shares could be severely depressed, and almost immediately after divestiture, the stock could trade at a low market-to-book ratio and preclude PT&T from being able to sell additional equity at book value for quite some time.

When new equity capital must be sold at market prices below book value, dilution of earnings per share and assets per share occur. When such a situation continues it becomes ever more difficult to issue new shares except at even lower price levels, thus extending the downward cycle. The sale of stock at prices below book value requires ever larger rate increases as an offset. The sale of common stock below book value requires a higher rate of return on equity just to stay even, let alone meet the requirements of the marketplace.

For a company to issue new shares yielding net proceeds equal to book value per share, it is necessary that the market price of the shares prior to the issuance be sufficiently above book value to allow for the costs of issuance, including underwriter's

compensation and other issuance expenses, as well as any downward market pressure on the price of the stock brought about by the announcement of the new issue. In addition, since a utility must raise capital when needed to fulfill its public service obligation, the cost of equity must reflect the possibility that the utility will be required to issue new shares of common stock during unfavorable market conditions. Meyer thinks that a 20% premium to book value would enable a utility company to sell new common at or above book value during most market conditions.

Meyer said a company could avoid the issuance of new common stock at prices below book value should the market value of its common stock be below book value. The most obvious way is to reduce capital expenditures to levels justified by internally generated funds. This is the course undertaken by virtually all of American business. The utility industry is a notable exception to this rule, he said. It is a utility's responsibility to provide services to its customers on demand. If the utility's construction programs were to be geared to its ability to pay for new plant rather than to the needs of the people it serves, in a very short time service would deteriorate and eventually the utility would be unable to satisfy those needs. This unnecessary hardship will be avoided, according to Meyer, if the company is able to earn the return that will attract new capital at reasonable rates.

Meyer concluded his testimony by agreeing that PT&T's requested return of 17.5% equity approximates the cost of equity capital in the marketplace. As he said previously, his experience in the investment business indicated to him that common stock investors require a total return of some 300 to 500 basis points (3 to 5%) higher than the return available on the same enterprise's long-term debt. On that basis the 17.5% return on equity requested by PT&T is within the range of reasonableness as determined by the marketplace.

... ..

Litzenberger for PT&T and a second set of M&A and to re-examine

Robert H. Litzenberger, Ph.D., a professor of Finance at the Stanford Graduate School of business, was PT&T's second witness.

Litzenberger again used the four approaches, Discounted Cash Flow (DCF), Capital Asset Pricing Model (CAPM), market price to book value ratio, and comparable earnings, that he used in the last case. As a result of his studies, he reached the conclusion that a reasonable range of fair returns on equity is from 16.9% to 18.1%.

Litzenberger's DCF approach is a market oriented approach which estimates the firm's cost of equity capital as the rate which makes the discounted present value of all future cash flows expected by investors equal to the current price of the firm's stock. The future cash flows expected by investors can either be specified as a stream of expected dividends over a finite investment horizon and the expected stock price at the end of that horizon (the finite horizon DCF model), or an infinite stream of expected dividends (the infinite horizon DCF model).

Litzenberger's DCF approach as a whole indicated that PT&T's cost of equity capital is between 15.9% and 16.7%.

His CAPM, also a market oriented approach, was characterized by Litzenberger as a risk premium approach. He defined the risk premium, sometimes called the expected excess rate of return, as the additional expected return that investors require from a risky investment over and above the return on a safe investment.

Under the CAPM, investors are assumed to hold diversified portfolios and, therefore, are only concerned with the portion of the risk of individual stocks that they are unable to eliminate through diversification. The portion of the risk of an individual security that cannot be eliminated by diversification is the risk which is related to the stock market as a whole, called the stock's "systematic risk," and is measured by its beta. The central and

implication of the CAPM is that expected rates of return on risky investments are commensurate with their systematic risk, or beta; i.e., stocks that have higher betas require higher risk premiums, and

Litzenberger indicated that his estimate of the cost of equity capital must be translated into a fair rate of return on book value that, were PT&T's stock publicly traded, would result in a fair market value for PT&T's equity. For a starting point, he reasoned that, the nature of the competitive system is such that, for nonregulated firms, competitive forces assure that in the long run the average ratio of the aggregate market value of these firms to the aggregate replacement cost of their assets is close to 1.0. He also said empirical evidence that in the long run, the average economy-wide ratio of market value to replacement cost has approximated 1.0. In the 1982 Economic Report of the President, revised estimates of the ratio of the aggregate market value, equity plus debt, of nonfinancial corporations to the replacement cost of their assets were published for each of the last 26 years, 1955 through 1980. This ratio is called "q" and is a well-known concept in economics.

For the entire 26-year period, these ratios averaged 0.905. The average ratio is below 1.0 because of the abnormally low q ratio estimates over the last seven years. For the 19-year period, 1955 through 1973, these ratios varied between 0.784 and 1.257, averaging exactly 1.000. However, since 1974, these ratios have varied between 0.531 and 0.746, averaging only 0.633.

Various issues of the report noted that these abnormally low ratios made it more profitable to invest in financial assets rather than tangible plant and attributed them to unsettled economic conditions. Litzenberger asked the Commission to note that these economic factors affect regulated as well as nonregulated firms. Unlike a nonregulated firm, a regulated firm must continue to invest when its q ratio is below 1.0. For the regulatory process to

properly mirror the effect that competition has on the value of an unregulated firm the professor believes that, in the long run, the market value of the equity of a public utility should equal the value of its equity at replacement cost.

The Commission may, however, properly allow short-term deviations, in either direction, of the value of the company's equity from the value of its equity at replacement cost to mirror actual competitive forces in the nonregulated marketplace. A short-term target market-to-book ratio for a public utility that would result in a q for PT&T ratio equal to the economy-wide q ratio should, by that standard, be considered just and reasonable. Litzenberger calculated the value of PT&T's equity at current cost using data from its 1981 annual report and determined that the target market-to-book value ratio (T) that would result in a q ratio for PT&T equal to the economy-wide q ratio of 0.69 given in the 1983 Economic Report of the President is 1.85. As an intermediate step towards achieving a q ratio for PT&T equal to the economy-wide q ratio, he recommended that a target market-to-book value ratio of 1.42 be used in the current case. To achieve such a target ratio, returns on equity of from 16.9% to 18.1% are required.

Litzenberger used the comparable earnings approach because it provides a historical perspective on the fair return on equity for a public utility by measuring the past aggregate rate of return on book equity for a sample of nonregulated enterprises having corresponding risks. The rate of profitability of nonregulated firms is determined in the market place by competitive forces. In the long run, the actual and potential entry of competitors should limit the profits earned by nonregulated firms. Conversely, competitive forces should also exert pressure on nonregulated firms to leave unprofitable industries and to discontinue unprofitable product lines.

Litzenberger considered it quite reasonable to compare the earnings of regulated and nonregulated firms. The purpose of the comparable earnings approach is to determine the profitability of competitive firms of comparable risks where that profitability is constrained by marketplace competition. Because most regulated utilities face only limited competition, a proper comparable earnings standard must be based on a sample of nonregulated firms. While nonregulated firms have different economic characteristics than regulated utilities, there are two risk measures that are sufficient to summarize the interaction of various economic characteristics on the risk faced by investors. For a large shareholder holding a widely diversified portfolio of common stocks, an individual stock's beta would be an appropriate measure of the contribution of that security to the variability of the rate of return on his portfolio. For small investors, whose portfolios may consist of shares in only a small number of firms, the portion of the variability in the rate of return on a stock that is unrelated to stock movements in the market is important. The component of the variability of an individual stock that is attributable to movements in its rate of return that are unrelated to movements in the stock market is called its nonsystematic risk. A firm's risk of insolvency and its ability to attract capital may be defined, in part, by its beta and its nonsystematic risk. Litzenberger submits that these two measures determine the total variability of the firm's rate of return.

There were 12 firms that were comparable to PT&T:

American Brands Inc.	Int. Business Machines Corp.
Borden Inc.	Minnesota Mining & Mfg. Co.
Campbell Soup Co.	Philip Morris Inc.
Coca-Cola Co.	Procter & Gamble Co.
CPC International Inc.	Reynolds (R.J.) Inds.
Exxon Corp.	Weis Markets Inc.

Because 12 firms is a relatively small comparison group, the 50 firms having the lowest BARRA beta were also analyzed.

The result of this analysis is as follows:

	1977-1981 Five-Year Average	12-Comparable Firms	50 Lowest Firms
Aggregate ROE	19.5%	18.3%	18.3%
Mean ROE	18.8	18.8	18.8
Median ROE	19.0	19.0	19.0
Truncated Average ROE	19.4	18.8	18.8

Litzenberger concluded his testimony by pointing out that his recommended fair rates of return on equity of 16.9% to 18.1% were consistent with his comparable earnings study. Joses for PT&T

Robert M. Joses was vice president and treasurer of PT&T until his retirement on March 31, 1983. He testified as a consultant for PT&T. Joses recommended that PT&T be allowed to earn 17.5% on equity and 13.49% on rate base.

In his prepared testimony, Joses said that he considered the overall rate of return to be a function of an appropriate capital structure, the embedded costs of debt and preferred stock, and a fair and reasonable rate of return on equity. To estimate a fair and reasonable rate of return on PT&T's common equity he relied on the Hope and Bluefield case guidelines.

Joses reviewed his concept of both current and expected economic conditions, as well as their impact on financial markets and opined that investors are now extremely reluctant to provide long-term capital and tend to shy away from less sound companies such as PT&T.

According to Joses, although uncertain economic conditions add to the risk of both utilities and industrial companies, the impact is greater for utilities such as PT&T. As a regulated utility, PT&T is not able to reprice with the rapidity, flexibility

Jones said PT&T's construction program has increased even in terms of constant dollars, and this capital need has been compounded by inflation. PT&T must be well positioned to compete effectively with both corporate and government borrowers.

Jones acknowledged that the Commission's decision in August 1981 in PT&T's last general rate case helped arrest further declines in the utility's financial condition; certain financial indicators even improved slightly in 1981. He considered the Commission's decision to be a strong signal to the investment community of the Commission's intent and desire to have PT&T regain a sound financial footing. Unfortunately, a severe and lengthy economic slowdown set in shortly after the Commission decision and as a result of that and competition, much of the gains intended by the Commission's decision in the last general rate case have been eroded. Thus, despite the August 1981 rate decision and substantial amounts of equity infusion since 1980, Jones expects key financial indicators to remain well below substandard without further rate relief.

To determine his fair return on equity, Jones used three approaches: risk premium, interest coverage, and comparable earnings based on DCF analysis.

His risk premium approach was based on the concept that investors expect a higher return for undertaking riskier investments. Since equity investments are generally perceived to be more risky than debt investments, it is possible to add to the present cost of debt an appropriate risk premium to arrive at the required return on common equity.

Jones' risk premium approach estimated PT&T's cost of common equity by imputing the implied equity risk premium that the Commission has allowed PT&T in the past. These returns are then compared with the yield-to-maturity of PT&T's most current bond issue at the time of the filing of each application requesting a change in the allowed return on common equity since 1972.

Jones' analysis showed, he claimed, that from 1972 onward, the Commission has authorized PT&T to earn on its common equity an average premium of 3.77 percentage points over the yield-to-maturity of PT&T's most current bond issue at the time of filing the application. Using PT&T's requested return on common equity, the premium has averaged 5.60 percentage points. Based on this difference between PT&T's authorized return on common equity and the yield-to-maturity on its bond issues, it is possible to project PT&T's cost of common equity going into the future.

PT&T's most recent bond issue was sold in September of 1981 and in order to attract investors, had a yield-to-maturity of 16.34%. However, interest rates have declined somewhat since then and the company's bond issues are presently trading at a price which produces a yield-to-maturity of about 13.00%. Therefore, using this approach, in order for the utility to attract common equity capital in the future, Jones asserts that the required return on common

equity must be at least 3.77 percentage points greater than the 13.00% present cost of PT&T's debt. Based on the utility's prior return on common equity requests, the required return would be as much as 5.60 percentage points greater than PT&T's current debt cost. Thus, the company's cost of common equity at present ranges from 16.77% (13.00% + 3.77%) to 18.60% (13.00% + 5.60%).

The derivation of this equity risk premium is shown on the following table:

[illegible]

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A.82-11-07 et al. ALJ/bg

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Required Return on Common Equity
Based on PT&T's Cost of New Debt
At the Time of Filing

Date	Application	Cost Of New Debt*	Return on Common Equity		Equity Risk Premium	
			Commission Adopted**	PT&T Requested	Commission Adopted	PT&T Requested
9-19-72	53587	7.42%	11.00%	12.64%	3.58%	5.22%
7-14-78	58223	9.57	12.25	14.50	2.68	4.93
8-1-80	59849	12.35	17.40	19.00	5.05	6.65
Average Equity Risk Premium Since 1972					3.77%	5.60%
Add: Present Cost of PT&T Debt					13.00	13.00
Required Return on Common Equity					16.77%	18.60%

* Yield to maturity at filing date of most recent PT&T bond issue.

** Mid-point where range was requested.

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The second method that Jones used, the interest coverage approach, was predicated on the assumption that PT&T should have sufficient return on common equity to provide a total coverage (debt interest plus preferred dividends and earnings on common) equal to three times the interest charges. (This formula actually gives more than a three times coverage since taxes based on income also provide a margin of safety for debt coverage.)

Using the interest coverage method, Jones came up with an overall 14.2% rate of return as necessary to provide the assumed required 3.0 times after tax interest coverage. This worked out to a 19.14% return on equity.

19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%
19.14%	14.2%	19.14%	14.2%	19.14%	14.2%	19.14%	14.2%

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Joses' interest coverage calculation is shown on the following table:

The Pacific Telephone and Telegraph Company
Computation of Required Return on Equity
Based on Post-Tax Interest Coverage Requirement

- Step 1: Compute weighted cost of debt.
- Debt as a percent of total capital = 47.8%
- Embedded cost of debt = 9.95%
- Wtd. cost of debt = $47.8\% \times 9.95\% = 4.76\%$
- Step 2: Compute overall rate of return required to derive the post-tax interest coverage of 3.0 per D-83162.
- Overall return + Wtd. cost of debt = Post-tax interest coverage or, rearranging the above equation.
- Overall return = Post-tax interest coverage x Wtd. cost of debt
- $= 3.0 \times 4.76\%$
- $= 14.28\%$
- Step 3: Compute weighted cost of common equity.
- Wtd. cost of common = Overall return - Wtd. cost of debt
- $= 14.28\% - 4.76\% = 9.52\%$
- $= 9.17\%$
- Step 4: Compute required return on common equity.
- Required return on common = Wtd. cost of common +
- Common equity as percentage of total capital
- $= 9.17\% + 47.9\%$
- $= 19.14\%$

*Per D.82-05-007, includes weighted cost of 6% Preferred Stock that was considered common equity as a result of the PT&T/AT&T merger.

The 3.0 after tax coverage level that Joses used is the midpoint of the S&P's indicated range for a double A rating and can also be viewed as the minimum requirement for a triple A rating.

Joses' DCF approach utilizes the concept that the return an investor expects from an investment in common stock consists of a dividend yield plus a growth expectation. Mathematically, the investor's required rate of return is that discount rate at which the present value of the stream of expected future cash returns is exactly equal to the current market price of the stock.

The DCF analysis is represented by the following formula:

$$K = D_1/P_0 + G$$

where: K = Required market return.

D₁ = Dividend expected one period ahead.

P₀ = Current market price of the stock.

G = Expected growth rate in dividends anticipated by investors.

Applied properly, Joses said, the approach relies heavily on market evidence thus minimizing the need for personal judgment. Consequently, it is an appropriate and widely accepted method of determining the cost of equity and has both academic and practical validation.

In his opinion, the average risk of electric utilities is less than the risk for a telephone company. Further, because of PT&T's poor financial condition, he considered its risk to be far greater than the risk of other operating telephone companies. Thus, he said that the results of his analysis using the electric utilities as a composite group must be viewed as a floor below which the required return on common equity for PT&T cannot fall.

The following computations derive Jones' DCF return on equity:

$$\text{Market Cost of Equity} = \frac{\text{Expected Dividend } (D_1) + \text{Growth } (G)}{\text{Market Price } (P_0)}$$

1982 Dividend for composite group of electrics (D_0) = \$2.16

1982 Market Price (P_0) for composite group of electrics = \$20.77

Growth Rate for composite group of electrics = 5.2%

Then, Expected Dividend ($D_1 = D_0 \times (1 + G)$)

$$= \$2.16 \times 1.052$$

$$= \$2.27$$

Proceeds from Stock Issue = Market Price - Underpricing Allowance

Accepting an Underpricing Allowance of 10.0%,

Proceeds = Market Price - (10.0% x Market Price)

$$= 90.0\% \times \text{Market Price}$$

Therefore, Book Rate of Return is:

$$\text{Book Return} = \frac{\text{Expected Dividend}}{90.0\% \times \text{Market Price}} + \text{Growth}$$

$$= \frac{\$2.27}{90.0\% \times \$20.77} + 5.2\%$$

$$= 12.14\% + 5.2\%$$

$$= 17.34\%$$

Based on the range determined by his three different studies, Jones recommended a return on equity of 17.5%. He said that this value was at the lower end of the range for his three studies and is the midpoint of the range determined reasonable by Lutzenberger. Using this required cost of common equity in conjunction with the estimated capital structure and debt and equity preferred costs at December 31, 1983 resulted in his recommended overall rate of return of 13.49%. Terry R. Mowrey of the Commission Staff

Terry R. Mowrey, a Financial Examiner IV in the Revenue Requirements Division, testified on rate of return for the Commission staff.

Mowrey recommended an earnings allowance on common equity ranging between 15.75% and 16.50%, a rate of return on rate base of 12.52% to 12.76%, with an after tax interest coverage implied by the midpoint of his range of 2.55 times. Although there were minor differences in Mowrey's and Joses' capital ratios and cost of debt, as shown on Table 16, the primary difference was between their recommended returns on equity.

Mowrey's capital rates are different than Joses' for two reasons. Mowrey recognized the \$86,000,000 that AT&T will advance to PT&T for the purpose of retiring high coupon long-term debt by reducing the face value of such debt by \$70,000,000. (The \$16,000,000 difference being the premium that Mowrey anticipates PT&T will be required to pay.) He also had the advantage of knowing that PT&T would not realize the amount of retained earnings that Joses had anticipated. The lower retained earnings reduced common equity by \$750,000,000, which amount was more than enough to offset the reduction in debt and Mowrey thus had a slightly lower equity and higher debt rates.

Mowrey's lower cost of debt came from his estimate of the cost of two 52-month bank term loans which are not priced at fixed-term interest rates. The two loans, one for \$200 million issued in August 1981 and the other for \$250 million issued in May 1982, are priced at floating interest rates based on a variety of short-term interest rate benchmarks. PT&T computed the cost for these two issues based upon the average cost of each from issuance through August 1982, whereas Mowrey computed his embedded cost of long-term debt using the recorded average cost of these issues through December 1982 and then made a projection of the rate PT&T will pay during 1983. The interest rates on these loans are tied to the lower of a variety of short-term rates, adjusted daily. One of the rates upon which the loans can be based is the Federal Funds (Fed Fund) rates plus 5/8%.

Mowrey reviewed Data Resources Inc.'s (DRI) projections of the Fed Fund rate in 1983, as well as the most recent six-month and three-month averages, and noted that the projections have been decreasing for 1983, and the most current projection is that the Fed Fund rate will average 8% in 1983. Based upon these projections he believed that 9% would be representative of PT&T's interest rate on these loans in 1983.

Mowrey based his rate of return recommendation on the 1983 capital structure and capital costs at December 31, 1983 because rates are not expected to go into effect until January 1, 1984 and because of the uncertain consequences of divestiture. Because of the use of year ending capital structure, Mowrey is not recommending any financial attrition for 1984.

Mowrey's recommended range of return on common equity resulted from the consideration of many factors, both quantitative and qualitative. He considered the results produced by studies of interest coverage, comparable earnings, risk premium, and discounted cash flow.

He realized that reliance cannot be placed entirely on these quantitative methods and that the resulting recommendation is of necessity a judgment determination which considers the needs and requirements of the individual utility.

As is the wont of his craft, Mowrey formulated these guidelines:

1. The return to the equity holders be commensurate with returns on investments in other enterprises having similar risks.
2. The return be sufficient to enable the utility to attract capital at reasonable rates while ensuring confidence in the utility's financial integrity.
3. The return balance the interests of both the investors and ratepayers.

His recommendation was expressed in the form of a range to recognize the fact that rate of return determinations are not matters of absolute precision and that a range of reasonableness exists. No particular methodology can guarantee an end result with pinpoint accuracy, he declared.

Mowrey studied PT&T's past earning performance and its financial history, together with the ratings of its debt securities by the two leading rating agencies, and concluded that S&P's A+ rating was more reflective of PT&T's financial status than was Moody's A3.

The midpoint of Mowrey's range of rate of return provides for an implied after-tax interest coverage of 2.55 times. Mowrey believed this to be consistent with a solid single A rating and an improvement over PT&T's prior years' recorded coverages. Because the weighted cost of debt is now lower because of a lower debt ratio and a lower embedded cost of debt, Mowrey's recommendation produces a higher post-tax coverage than that provided by PT&T's last decision, even though his rate of return recommendation is lower.

For an additional guide on determining cost of common equity, Mowrey compared PT&T's financial performance with that of other regulated utilities in a comparable earnings study. He cautioned, however, during periods of unprecedented inflation, historical results must be tempered accordingly. He compared PT&T's recorded earnings performance with two groups of companies which he believed provide an appropriate basis for comparison with PT&T. The first group was comprised of 25 companies selected from the 50 largest electric utilities based on revenues and include only those companies which are rated the equivalent of either S&P A or AA by both rating agencies and which have Value Line betas ranging between .60 to .75. All the companies' common stock is publicly traded and all are regulated public utilities.

The second group of comparable companies which he used in his analysis is comprised of five telecommunication companies having bond ratings ranging from BBB to AA and Value Line betas ranging from .60 to .80. These companies are engaged in a similar business pursuit as PT&T, are regulated, or have subsidiaries which are regulated, and have common stock which is publicly traded. Some now realize a portion of their earnings from non-regulated communications activities, thus causing investors to view them as riskier investments than totally regulated entities.

Mowrey believed that these two groups of companies provide a reasonable selection for comparability purposes. He recognized that, while it is true that PT&T is not engaged in the same line of business as the electric utilities, PT&T's risks are changing with the deregulation of the communications industry and, in his opinion, the company will be considered a riskier investment than it was when it was part of the Bell System, all other things being equal. The electric utilities he chose have Value Line betas which are similar to the betas of the utilities in the communication field and therefore Mowrey believed that it can be concluded that even though the two groups are engaged in different businesses, the investors' perception of the risk of both groups relative to the market as a whole is similar. PT&T is not currently analyzed by Value Line since its common stock is not publicly traded. Prior to AT&T's acquisition, however, Value Line assigned a beta of .70 to PT&T, a ranking in the midpoint of Mowrey's comparable companies.

Another reason why he believed it is appropriate to make an analysis based on electric utilities is because PT&T's request is partly predicated on a comparison with electric utilities.

The results of his comparable earnings analysis averaged over the five years 1977-1981 are as follows:

Item	PT&T	25 Electric & Combination Utilities	5 Telephone Utilities
Times Interest Earned After Income Taxes	1.85	2.37	2.51
Average Common Equity Ratio	40.45%	36.77%	37.05%
Earnings Rate on Average Common Equity	9.12%	9.93%	9.59%
Earnings Rate on Average Total Capital	9.51%	9.39%	10.20%
Dividend Payout Ratio	75.46%	72.92%	57.17%

Mowry Recast PT&T's results to show how they would have looked had the tax remand liability not existed for 1981 and 1982.

As a result of his comparable earnings analysis, Mowrey concluded that:

1. PT&T's coverage levels have consistently remained below that of the other companies, even on the restated basis.
2. PT&T's average common equity ratio declined over the period to a level approximating that of the comparable utilities, but on a restated basis PT&T's equity ratio has increased dramatically in the last two years and is now at a level exceeding those of the other utilities.
3. PT&T's recorded earnings rate on average common equity was consistently below that recorded by the other companies and PT&T's restated 1981 and 1982 earnings were substantially below that of the group of telephone companies but more in line with the electric utilities.
4. On both the recorded basis and on the restated basis, PT&T's earnings on total capital are comparable with those earned by the other two groups of companies.

5. PT&T's dividend payout ratio approximates that of the electric group and far exceeds that recorded by the telephone group. On a restated basis, however, PT&T's payout ratio is actually comparable with the telephone group.

The risk premium definition adopted by Mowrey for his risk premium approach was essentially the same as used by PT&T's Joses.

To determine risk premium, Mowrey calculated the risk premium which investors in his comparable electric utilities, telephone utilities, and PT&T required over A-rated utility bonds for the period 1973 through 1982. Composite earnings-price ratios were determined for the two groups of utilities and also PT&T. Negative premiums were evident in 1981 and 1982 when significant changes in interest rate levels were experienced. Affecting the 1980 and 1981 results for PT&T, were announcements in both years that AT&T would purchase the approximately 10% outstanding shares of PT&T's common stock. This drove the market price of PT&T's stock up and resulted in earnings-price ratios not reflective of investors' expectations of PT&T's earnings level, but rather investors' expectations of AT&T's offer price for PT&T's common stock.

Investors in Mowrey's composite electric group demanded premiums ranging from 177 to 377 basis points (1.77% to 3.77%) excluding 1981 and 1982 when the market experienced dramatic swings in interest rates and averaged 290 basis points over the period 1973 to 1980. Investors in the group of telephone stocks required premiums ranging from 130 to 493 basis points over the years 1973 to 1980 and averaged 256 basis points for the period. Investors in PT&T experienced premiums ranging from 158 to 354 basis points over the period 1973 to 1979 and averaged 254 basis points. Mowrey excluded 1980 and 1981 from consideration due to the impact AT&T's stock purchase announcements had on PT&T's market price. 1982 was not considered because PT&T's common stock ceased trading in April 1982.

Mowrey interpreted the data to show that the average premium required by investors in PT&T was consistent with that demanded by investors in the other telephone utilities while investors in electric utilities demanded somewhat higher premiums over the period. Consistent with his opinion that PT&T is now a riskier investment than it was during the 1970s and would now be viewed as an investment with risks equating to the riskier electric utilities, he believes a reasonable risk premium for PT&T is within the range of 250 to 350 basis points.

This premium must be added to an estimate of PT&T's cost of long-term debt to derive the required return on common equity. Since PT&T is not planning on issuing any long-term debt during the test year, an estimate must be made of the interest rate which PT&T would be required to pay were it to issue debt securities. For this he used DRI's projections of utility bond issue costs for 1983 through 1985. It was Mowrey's opinion that a reasonable interest rate projection for inclusion in his risk premium analysis would be 13.0%.

Combining a risk premium of 250 to 350 basis points with his projection of 13.0% as the cost of PT&T's long-term debt gave a required return on common equity within the range of 15.50 and 16.50.

Another market-oriented method he relied upon to estimate the total return required by investor in PT&T's common equity was DCF.

The combined results of Mowrey's DCF showed that required returns on equity ranged from 15.65% to 16.49% for his group of electric companies and 15.09% to 16.33% for his telephone companies. The midpoints of the results were 16.07% and 15.71%, respectively.

After considering the results of his studies, the fact in terms of debt rating PT&T could be considered a riskier investment than the average telephone company, and that the uncertainty

surrounding the impending break-up of the Bell System and the deregulation of the communications industry also tends to make PT&T a riskier investment, Mowrey concluded that a 15.75% to 16.25% return on common equity was fair and reasonable to PT&T and its customers. That range recognizes the investors' perception of the risks associated with PT&T at this time. It provides a return consistent with what investors require as compensation for investment in comparable utilities and provides an interest coverage sufficient to acquire and maintain a solid single-A bond rating.

Mowrey recognized that his recommendation in this proceeding as to the fair and reasonable return on equity is lower than the 17.4% which was last authorized PT&T in August 1981, but he believed it to be warranted. He noted the increased business risks which PT&T will face upon divestiture but in his opinion these are tempered by PT&T's improved financial condition; its higher equity ratio, improved cash flow generation, higher interest coverages, and S&P's recognition of these improvements in its recently revised bond ratings for PT&T. The primary contributing factor to a lower return on equity in this proceeding than that which PT&T was last authorized is, in his opinion, the significant declines in inflation and interest rates which have occurred and are projected to continue or be maintained during the test year.

The range in return on equity recommended by Mowrey would provide for return on rate base of from 12.52% to 12.76% when pressed on cross-examination by counsel for the City of Los Angeles, Mowrey gave 12.58% as his "best figure."

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Kroman for the City of Los Angeles

The City of Los Angeles presented Manuel Kroman, P.E., as a witness on the subject of rate of return.

As a result of his investigations, Kroman recommended an assumed post-divestiture condition of 47% long-term debt carrying an average embedded cost of 9.5%, a 15.33% return on common equity for an overall rate of return of 12.27%, providing an after-tax interest coverage of 2.75 times.

He gave as bases underlying his recommendations:

1. They are entirely consistent with the principles governing the fair rate of return as enunciated by the Hope and Bluefield cases;
2. The recommended returns on common equity:
 - a. Fairly reflect applicant's higher equity ratio and reduced financial risk as compared with the situation when D.93367 was issued;
 - b. Properly give effect to the vastly improved financial and economic climate (e.g. lower interest rates and lower inflation rate) now obtaining as compared to the time when D.93367 was issued;
 - c. Are fully commensurate with the most recent returns authorized for other Bell System companies; and
 - d. Are far in excess of the achieved returns on equity of other telephone, electric, and combination gas and electric utilities.
3. The recommended overall rates of return provide for an after-tax interest coverage:
 - a. Well in excess of the achieved coverage of A-rated utilities;

- b. Well in excess of virtually all of North American
Moody's 24 utilities - even those
with the highest ratings;
 - c. Consistent with the latest after-tax interest coverage
coverage of Bell System companies, which are
recently rated AA-, AA, and AA+ by
S&P; and
 - d. Fully adequate to provide for a
solid investment grade bond rating, according to S&P's rating
criteria.
4. They attempt to balance the interest of both
investors and ratepayers, providing neither
extravagantly high returns to the former nor
a "free ride" to the latter.

Most of Kroman's direct testimony consisted of a detailed
critique of the methods used by PT&T's witness. He believed he had
shown it to be clear that methods such as risk premium, CAPM, DCF,
predetermined post-tax interest coverage and comparable earnings
based upon industrials' earnings, all produce results which are
determined not by the inherent validity of the various approaches but
by the inputs selected by the persons making the presentations.

Having analyzed PT&T's principal quantifiable bases of its
requested rate of return, and having concluded that such methods as
risk premium, CAPM, DCF, predetermined post-tax interest coverage and
comparable earnings based upon industrials' earnings, all produce
results which are determined not by the inherent validity of the
various approaches but by the inputs selected by the persons making
the presentations, Kroman declared that fairness requires that other,
more even-handed analyses be relied upon.

Kroman espoused the basic principle, as enunciated in the
Hope and Bluefield cases, that the return to the equity owner should
be commensurate with returns on investments in other enterprises
having corresponding risks. Obviously, he said, the most nearly

comparable risk enterprises are other telephone utilities. To broaden the field while staying with the regulated sector, one may also give consideration to the earnings of other utility groups, such as the electric and gas energy utilities, but the previous discussion regarding the extraordinary risks of electrics engaged in nuclear power generation must be recognized, as well as their higher financial risk due to leverage. An additional consideration is to provide PT&T with the opportunity to earn at a level which will permit it to raise needed additional capital on reasonable terms. An additional guide to the general level of what rate of return may be appropriate is provided by the rates of return most recently authorized by other state regulatory commissions, particularly for the telephone operations of the Bell System utilities.

A study by Kroman of the recorded return on equity, together with the associated equity ratios, for each of the Bell System principal telephone subsidiaries, for the years 1980, 1981, and 1982 gave median returns on equity of 11.70% for 1980, 12.00% for 1981, and 12.20% for 1982. Of the 44 returns on equity tabulated for 1980 and 1981, in only two instances did that figure exceed 14%, with the highest return being 14.90%. The median returns for prior years were 11.35% for 1977, 12.15% for 1978, and 12.46% for 1979. For GTE subsidiaries, the rate of earnings on equity is generally about one one-half percentage points higher than for the Bell System companies, but the equity ratios are lower. (For 1980, the median was 13.19%; for 1981, it was 14.43%.) Prior year median returns were 12.88% for 1977, 13.20% for 1978, and 13.56% for 1979.

Moody's group of 24 utilities achieved generally a lower rate of earning than both the Bell System and the GTE subsidiaries despite Moody's lower equity ratios. In only four instances did the return on equity exceed 15%, the medians were 10.61% for 1980, 12.10% for 1981, and 13.46% for 1982. Moody's 24 utilities are primarily

the nation's largest electric utilities. Although they do include five combined gas and electric companies, there are no wholly gas distribution companies or gas pipeline companies.

Dow Jones' 15 utilities include three combined gas and electric companies, three integrated gas utilities, a gas pipeline company, and eight electric companies. The median returns on equity were 11.41% for 1980, 13.32% for 1981, and 13.93% for 1982. The Dow Jones group had higher returns because of the higher earnings of the natural gas companies. Kroman excluded straight natural gas utilities except where they appear as part of the Dow Jones group of 15 utilities, because of the particular economic conditions under which such companies operate. The highest median return on any of Kroman's Utility groups was 13.93%.

Kroman used a 47% debt ratio because of AT&T's commitment to reduce PT&T's debt ratio to 47%. The ratio was not intended to be precise and he recommended that the most recent data be used. His 9.50% cost of debt was predicated on similar assumptions.

To determine his recommended return on equity, Kroman assessed PT&T's risks. He considered risk in the context of rate of return to be a combination of financial risk, a function of leverage in the capital structure, and of business risk, the effect of possible loss-inducing factors such as incompetent management, competition, loss of market, inability to qualify for credit, etc.

Kroman reviewed the changes in capital structure since D.93367 and concluded that the increased equity ratio distinctly lowered the financial risk.

As to business risk, Kroman saw divestiture as a positive future. Rather than seeing the "Bell System umbrella" as a risk-reducing relationship, it may have had the opposite result, e.g. a long history of rate base and expense disallowances based upon

affiliated relationships, a distorted capital structure because of AT&T's reluctance to provide additional equity investments, and possibly, PT&T's intrasigence with respect to adopting liberalized depreciation methods and the problems which resulted from that decision.

Kroman noted Jose's recitation of the risk-reducing various developments since D-93367, e.g. favorable resolution of the back-tax liability problem, the lack of need for further debt or preferred stock financing through 1983, and increased cash flow resulting from the single-line sales plan and from other capital recovery items.

Kroman also reviewed favorable factors upon which the S&P has recently commented in its appraisals of the Bell System Operating Companies (BSOC) in general and of PT&T in particular. These include for the BSOPs in general:

- Exceptionally strong credit worthiness
- Minimal risk associated with the industry
- Advantage over potential competitors who must invest significant amounts of capital even to begin competing
- Fundamentally strong management
- Enhanced capital recovery procedures that should reduce the need for outside financing
- Dividend reinvestment plans which should aid in financing flexibility

As to PT&T, S&P saw a more manageable level of capital expenditures.

Kroman concluded his testimony by saying that he believed that he had given the Commission the relevant data and information necessary for it to be able to exercise its independent judgment, free of erroneous, or misleading theories and relationships. He opined that perhaps this is the most that should be expected of a rate of return witness. His own view, after giving consideration to

A.82-11-07 et al.

EXHIBIT 10 to 70-11-88.A

all the material presented, was a 16.00% return on common equity, for an overall rate of return of 12.51%, providing for an after-tax interest coverage of 2.55 times.

Langsam for U.S. Government

Mark Langsam testified on rate of return on behalf of the U.S. Department of Defense and the other Federal Executive Agencies.

Langsam derived an appropriate composite rate of return for the Bell System as a whole based on an assumed 50-50 capital structure and a Bell System combined cost of debt and preferred of 8.90%. Langsam reasoned that the cost of capital to PT&T for regulatory purposes within the State of California is in fact the same as the overall cost of capital to the Bell System.

Langsam recommended a 13% to 14% return on the Bell System's equity and an overall cost of capital of 11.0 to 11.4%. The midpoint of this range would provide interest coverage of 2.5 times.

Langsam said that, because prior to divestiture, PT&T will be part of the Bell System, individual costs of capital cannot be computed or applied until immediately after divestiture.

Discussion - Rate of Return

In PT&T's last general rate case decision (D.93367), the Commission allowed PT&T an overall rate of return of 12.91% and a return on equity of 17.4%. The Commission noted that PT&T was in poor financial condition at that time, and stated AT&T's refusal to purchase any of PT&T's common stock between 1973 to 1980 was a contributing factor to PT&T's poor debt ratio and poor financial condition. The Commission declared that it hoped that PT&T would be able to reach three goals. The first was that PT&T experience a massive infusion of equity capital and to achieve a 50-50 debt equity ratio within 18 months. The second was to see an upgrading in PT&T's debt offerings. The third was an increase in PT&T's common stock dividend which would be attributable to increased investment by AT&T in PT&T's stock.

Substantial progress has been made towards these goals. A 50-50 debt-equity ratio for PT&T has very nearly been realized. In September 1981, PT&T sold over \$369 million in common, of which 91% was purchased by AT&T.

In May 1982, PT&T became a wholly owned subsidiary of AT&T by means of exchange of AT&T stock for the minority held shares of PT&T. All outstanding shares but one were cancelled. AT&T contributed in 1982 over \$662 million of common equity to PT&T. In May 1983, AT&T converted \$300 million of short-term advances to equity and the holding company has announced that it will convert an additional \$300 million by the end of 1983.

Total infusion of equity, including employee stock ownership plan fundings since the date of D.93367 will have amounted to over \$1.6 billion by the end of 1983.

In addition to supplying common equity, AT&T has also agreed to assume five specific debt issues totalling \$850 million upon divestiture. It will also advance an additional \$86 million to PT&T for the purpose of retiring high cost long-term debt.

By the end of 1983, the debt ratio had been reduced to 52% and it will have declined to below 48% by the end of 1983, according to staff's estimates.

Very substantial progress has also been made towards the second goal, that of upgraded debt ratings. At the time of D.93367, PT&T's long term debt ratings were Moody's A and S&P's A-. In March 1983, Moody's downgraded every Bell company in anticipation of divestiture. PT&T was included in this downgrading and was assigned a Bell rating. S&P, however, revised upward its Bell ratings. In April 1983, Moody's restored its PT&T rating to A3.

The goal to increase dividends had not been met as of the date of submission. In spite of this, PT&T stock which will be distributed according to the divestiture plan will be a much more attractive investment than it would have been prior to D.93367.

The Commission in D.93367 also based its return on equity decision in part on the volatile economic setting that prevailed. The following table compares a set of generally accepted economic indicators for the purpose of evaluating the economic setting of D.93367 with that of the 1983 test period.

The Financial Climate at the Time
D.93367 Was Issued on August 4, 1981
vs. Current Conditions

	August 4, 1981	March 15, 1983
Prime interest rate	20-1/2%	10-1/2%
Discount rate	14 %	8-1/2%
Federal funds market rate	19-1/2%	8-7/8%
Three-month Treasury Bills	15.674%	8.256%
Six-month Treasury Bills	15.571%	8.264%
Bankers Acceptances, 60-89 days	17.45 %	8.60 %
Certificates of Deposit, 150-179 days	17.25 %	8.35 %
Small-saver certificate rate	15.8 %	9.70 %
Money market funds, 30-day yield	17.1 %	7.77 %
Moody's corporate bond composite	15.40 %	12.78 %
Yield on newly-issued "AA" 30-year utility debt	17.6 %	12.2 %
P-E Ratio, Moody's 24 utilities	5.9 X	6.6 X
Yield, Moody's 24 utilities	12.3 %	10.61 %
Inflation rate (CPI)	10.4 %	3.8 %

As the table demonstrates, PT&T's economic environment has improved very significantly. The cost of capital and the inflation rate have fallen over the past two years, and there is no evidence demonstrating that these indicators will not remain stable throughout the test period.

The improved health of the company and the economy since PT&T's last general rate case indicate to us that 17.4% return on equity is no longer required to attract capital at a reasonable cost. The presentations and analyses of the parties support this conclusion. One very important uncertainty has arisen, however, for PT&T and its investors. Divestiture and accompanying changes in the telecommunications industry complicate PT&T's outlook for the near future. We are concerned that PT&T be divested from AT&T as an attractive investment, and have considered in reaching our decision on rate of return the risks related to divestiture.

Considering the general financial and regulatory environment, and the events transpiring since the last general rate case, the Commission finds that 16% is a reasonable return on equity and that 12.7% is a reasonable rate of return on intrastate rate base. The Commission finds that return to be the minimum needed to attract capital at a reasonable cost. A 12.7% rate of return in that portion of capital ascribed to intrastate rate base would provide an approximate interest coverage, before income taxes, of 4.36 times, and 2.73 times after taxes.

The 12.70% rate of return is determined using staff capital ratios adjusted to eliminate imputation of the phantom 6% Preferred as follows:

	Ratio	Cost	Weighted Cost
Long-Term Debt	47.90%	9.70%	4.6463
Preferred Stock	3.80	8.45	0.3211
Common Stock	48.30	16.00	7.7280
Total	100.00		12.6954

NET-TO-GROSS MULTIPLIER

The adopted net-to-gross multiplier for the 1983 test year California intrastate operations is 1.901. This means that a change of \$1,901 in gross revenues would be required to produce a change of \$1,000 in net revenue. The net-to-gross multiplier is calculated as follows:

Gross Operating Revenues	1.0000
Uncollectibles at 1.19%	(0.0119)
	0.9881
CCFT @ 1.40%	(0.0138)
	0.9743
FIT @ 46%	(0.4482)
Net Operating Revenues	0.5261
Net-to-Gross Multiplier	

$$\frac{1.0000}{0.5261} = 1.901$$

INCREASED REVENUE REQUIREMENTMethod of Determining Revenue Increase Required

The increased revenue requirement is determined by applying the difference between the adopted reasonable rate of return and the rate of return at present rates to the adopted rate base and multiplying the result by the net-to-gross multiplier. The resulting requirement is on a Recast 3 basis and must be adjusted for the depreciation effects of D.83-08-031, called "Recast 4".

Revenue Increase Required

The calculation of the revenue increase required is as follows:

1200-5-02

Need for Rate Relief

In D.83-04-021, the Commission established the test that PT&T would be required to meet for rate relief to be considered in December, 1983. There it stated:

"... The Commission decision to proceed to examine the R/O as filed should not be construed as a predetermination that rate relief will be granted. Our primary goal is to provide a base line R/O to account for the effects of divestiture and access charges, as discussed previously. The following discussion of the mechanics of implementing rate relief should not be misunderstood; we merely intend to keep the option of granting rate relief open in the event PT&T sustained its burden and demonstrates overriding financial need for rate relief. Assuming that PT&T sustains this heavy burden we will then have the flexibility to act."

PT&T has consistently and repeatedly contended that not only should interim rate relief be granted, but that such relief should be expedited. The history and details of these contentions described in D.82-04-021 and in D.83-09-006.

The staff, Cities, Sonitrol Security, Inc., and the Farm Bureau all opposed relief on the grounds that PT&T had not sustained its burden of proof in showing its overriding financial need for rate relief.

In the past, we have granted interim increases to a utility, when a financial emergency exists, before establishing a final revenue requirement. PT&T requested such treatment in this proceeding. It asked the Commission to consider interim emergency relief effective July, 1983, before the submission of the R/O phase of the proceeding. We denied consideration of such relief in D.83-04-021. In that decision we imposed on PT&T the burden of demonstrating "overriding financial need" before we would grant rate relief. We also referred to granting rate relief if required on December 7, 1983 as an interim decision. In retrospect, that choice of words was unfortunate because it created the impression that partial rate relief would be forthcoming only under the traditional standard for such relief, i.e.,

that of financial emergency. That is not the case here. A final R/O for test year 1983 has been established, that phase of the proceeding is submitted and we do not contemplate continued examination of this R/O in the further hearings scheduled for this proceeding. While an order issuing at this point is not a final order in the sense that it closes the proceeding, it is final with respect to the 1983 R/O. For this reason, we have denoted the order as the Third Opinion and Order on 1983 Results of Operations, rather than Interim Order. It is "interim" only in the sense that we are keeping the proceeding open to investigate the effects of divestiture on PT&T's 1984 operations, to determine costs and revenues accordingly and to establish a comprehensive rate design. Accordingly, PT&T is not required to establish a financial emergency to justify rate relief now, but it was required to demonstrate an overriding financial need before we would authorize rate relief.

The revenue requirement adopted by this order shows that, at existing rates, PT&T will earn a 10.09% intrastate rate of return. Under normal circumstances, this rate of return would not be cause for alarm, although it would certainly warrant a rate increase under the standards set by the Hope and Bluefield decisions.

The circumstances PT&T faces, however, are not normal. Divestiture, which takes place on January 1, 1984, creates a great deal of uncertainty for PT&T, its shareholders, management and ratepayers. As a result of divestiture PT&T will no longer have the financial umbrella provided by AT&T. Its post-divestiture operations and associated staffing and management needs are unclear in spite of extensive analysis and speculation on the part of the company, our staff and federal policy makers.

Because of the uncertainty that looms in 1984, PT&T may be denied an opportunity to become a viable independent utility if it does not set out with a solid financial foundation. Without assuming more about the effects of divestiture, we find that PT&T has

demonstrated an overriding financial need for rate relief in the amount of \$445,450,000 beginning January 1, 1984. Attrition is the decline in earnings caused by expenses and investment costs increasing faster than revenues.

In this proceeding, the prepared testimony of David M. Craig, PT&T's vice president of financial management, included an attrition proposal. Benny Y. B. Tan, a Senior Utilities Engineer of

who prepared this proposal said he was based on the assumption that the rate of attrition would be 1.5% per year. He said that the rate of attrition would be 1.5% per year because of the increase in the cost of maintenance and the increase in the cost of depreciation.

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EXHIBIT A

EXHIBIT A

1. The rate of attrition would be 1.5% per year because of the increase in the cost of maintenance and the increase in the cost of depreciation.

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5. The rate of attrition would be 1.5% per year because of the increase in the cost of maintenance and the increase in the cost of depreciation.

6. The rate of attrition would be 1.5% per year because of the increase in the cost of maintenance and the increase in the cost of depreciation.

7. The rate of attrition would be 1.5% per year because of the increase in the cost of maintenance and the increase in the cost of depreciation.

the Commission's Revenue Requirements Division staff, reviewed PT&T's attrition, proposed and modified it to recognize revenue growth and the elements of results of operation that would be adopted in this decision.

The Commission has considered the question of an attrition allowance based on this decision and has concluded that none is appropriate for purposes of ratemaking in this phase of the proceeding. On January 1, PT&T will start operations as an independent company. The second phase of this proceeding will develop the regulatory framework to deal with PT&T's new status. A decision in the second phase is scheduled to be issued in May, 1984.

Any attrition mechanism to devise rates effective after January 1, 1984, must recognize changes taking place following divestiture. It would be unwise to establish in this decision a mechanism predicated on 1983 BAU conditions. The establishment of a method for calculating an attrition allowance will be resolved in the decision on the divestiture phase. By this order, however, we find that the establishment of an attrition mechanism is reasonable and necessary.

OTHER MATTERS

Affirmative Action

By D.82-12-101 issued December 22, 1982, in C.10308 (filed April 12, 1977), the Commission directed major utilities, including PT&T, to include information regarding costs and programs for doing business with female and minority business enterprises (F/MBE) in their next rate case NOI filing. On January 31, 1983, PT&T filed a report in compliance with D.82-12-101.

Stuart Q. Cannon, division staff manager - procurement, presented PT&T's D.82-12-101 report and testified concerning the utility's F/MBE program.

Wyman G. Low, a research analyst from the Revenue Requirements Division, in response to the company presentation,

recommended long-term procedures for a consistent method of reporting and monitoring PT&T's accomplishments in the F/MBE program. A substantial amount of cross-examination took place, including examination of the form to be filled out by those vendors qualifying as F/MBE wishing to do business with PT&T. After some discussion, it was concluded that the differences between the company and staff could best be worked out through informal conferences and that some common resolution better could be reached outside of the adversary hearing process.

We intend to address the F/MBE issues in the divestiture phase. Staff should report on the status of its discussions with Pacific and present any resolution on the record at that time.

The parties should not interpret our deferral of this matter as a lessening of our commitment to ensure equal opportunity in Pacific's F/MBE program. Last December, we established a procedure for reviewing such programs in the context of each utility's general rate case. Pursuant to this procedure, we are now examining the programs for Pacific Gas & Electric Company, San Diego Gas & Electric, Pacific Power & Light Company, and General Telephone. We intend to do the same for Pacific Telephone.

The Service Employees
International Union, Local 87

During the course of the proceeding, the Service Employees International Union, Local 87 (SEIU) made an appearance for the purpose of establishing in the record that PT&T appeared to be

SEIU contended PT&T sought to reduce its costs for

At the direction of the ALJ, the staff has requested copies

STANDARD FORM NO. 64 (REV. 5-22-64) PREVIOUS EDITIONS ARE OBSOLETE

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SURCHARGE DESIGN

Surcharge Design Considerations

In D.83-04-021 the Commission provided that if it were found necessary to authorize interim rate adjustments in this proceeding, such adjustments would be made on a surcharge basis. The Commission set forth the following primary issues relative to surcharge design:

1. Which classes of service should bear the surcharge.
2. Whether the surcharge should be a uniform percentage increase in the rates or charges for the various classes of service affected.
3. Whether any simple exceptions to such a uniform percentage surcharge are feasible and, if so, what they should be.
4. To what extent and in what ways the impending divestiture must necessarily be taken into account in fashioning interim surcharges.
5. Whether the impending divestiture necessitates negative interim surcharges with respect to rates or charges for any classes of service.

D.83-04-021 specifically instructed PT&T to include in its surcharge design proposal "alternative designs addressing the issue of whether it is practical to apply an interim surcharge to intrastate message toll services (intraexchange and/or interexchange) and, if so, how such a surcharge should be set."

Hearings on surcharge design were held at the end of June, with testimony by witnesses for PT&T; the staff; TASC; Western Burglar and Fire Alarm Association (WBFAA); and a group of large customers comprising American Broadcasting Companies, Inc., CBS, Inc., California Bankers Clearing House Association, and the Telecommunications Association (Users Group). The issue of surcharge design was addressed in briefs filed by PT&T, the staff, TASC, WBFAA, the California Farm Bureau Federation (Farm Bureau), and Sonitrol Security, Inc. (Sonitrol), and in oral argument on behalf of the Users Group.

Positions of the Parties

PT&T proposes to apply a uniform percentage surcharge to all recurring charges for residential and business exchange access and similar services including foreign exchange, Centrex, and private line services. (Exhibit 50T, Attachment I.) No other rates, such as those for local and toll usage, installation services, or CPE, would be surcharged.

The staff proposes a much broader surcharge, which consequently would be of much lesser magnitude. The staff proposes to apply a uniform percentage surcharge to all of PT&T's present services except intrastate coin message toll, local coin, and directory advertising services. The staff-proposed surcharge would incorporate and replace two existing surcharges - a 5.4% surcharge on certain services including CPE, private line, exchange mileage, service connection and Centrex, and a 6.66% general surcharge on all recurring monthly rates.

According to PT&T's witness, its surcharge proposal was consistent with the primary thrust of PT&T's pending rate design filing that basic exchange rates should cover a greater portion of their costs and with PT&T's perceived need to reduce its dependence on toll revenue. He did not object to extending the surcharge to service connection, mileage, and terminal channel charges, but did oppose its extension to toll or local usage rates.

PT&T contends that its proposal is preferable to the staff's,

"because it is far more likely to produce revenues equal to those the Commission has found necessary for Pacific since the exchange access services to which the surcharge would apply are services to be retained by Pacific after divestiture."

"However, the proposal by the staff team and intervenors is critically deficient because it fails to grapple with the key Commission-posed

issue of the effect of divestiture on an interim surcharge. At divestiture certain services, notably interLATA toll and embedded customer premises equipment, will no longer be Pacific's to provide. Interim rate relief in the form of a surcharge on services Pacific will not provide is no rate relief at all."

The staff witness, on the other hand, objected to PT&T's proposal as imposing "an unfair, unreasonable, and unwise temporary burden" on certain customers, because neither PT&T's nor the staff's detailed rate design proposals contemplate increases of like magnitude to the surcharge. The witness warned that this up and down "yo-yo" movement in rates would create substantial confusion and discontent among customers and so should be avoided.

The staff witness estimated that to recover \$820 million in added revenues (roughly what PT&T requested in its application) would require an 18.3% surcharge by the staff's method but a 95.8% surcharge on the basis proposed by PT&T. A \$300 million interim increase (roughly the staff's recommendation) would require a 9.1% surcharge by the staff's method and a 35.0% surcharge by PT&T's.

The witness for TASC asserted that it would be inappropriate to impose any interim surcharge on private line rates applicable to telephone answering services. TASC is concerned that such a surcharge would have an immediate impact on customer demand for such services, which the Commission has recognized as an "essential public service."

The witness for WBFAA offered three criteria to govern establishment of an interim surcharge: simplicity, avoidance of prejudging rate design issues, and minimization of dollar impact on subscribers both in aggregate and individually. He criticized PT&T's proposal on all these counts, recommending instead a surcharge on the entire intrastate portion of each customer's bill. In effect, WBFAA has endorsed the staff's surcharge proposal. This proposal is

likewise supported by Sonitrol on similar grounds. Farm Bureau agrees, except that it would exempt intraLATA toll rates from the surcharge out of concern to shield PT&T from the risk of bypass.

The Users Group also supports the staff proposal. Its witness testified that an interim surcharge should preserve PT&T's existing rate structure, avoiding major changes which should be fully considered in the pending rate design phase of this proceeding. He criticized PT&T's proposal as constituting a major revision of rate structure unsupported by information as to the costs of affected services. He testified that:

"The surcharge should be applied to customer bills in the manner that Mr. Shantz suggests, as a separate line item to a customer's total intrastate billing including both recurring and nonrecurring charges."

Discussion

The criteria proposed by WBFAA to govern surcharge design offer useful guidance for our decision on this issue. In view of its interim character, a surcharge should be simple to apply and to

explain to customers. It should be set in a manner which avoids prejudging detailed rate design issues not yet subject to evidentiary hearing. And, in view of its provisional nature, it should be structured to avoid drastic impacts on any group of customers. This last criterion also will protect against the "yo-yo" effect which concerns the staff.

PT&T's proposal does not meet these criteria. Simplifying as though it be, it prejudges complex rate design issues and would drastically affect the bills of many customers - not the "average" customers whose bills PT&T's witness analyzed, but the millions of customers whose bills consist predominantly of recurring monthly charges.¹⁵

PT&T's proposal appears to reflect two major concerns - that increases in usage-based charges will encourage bypass and that all surcharge revenues should flow to PT&T despite its impending transfer of important lines of business to AT&T. Although, as we will discuss in the context of access charges, uneconomic bypass may be a serious long-term risk, we do not believe that a moderate rate surcharge imposed for a clearly limited interim period preliminary to the detailed study of rate design issues will create any significant incentive for such bypass. As for PT&T's concern about losing surcharge revenues arising from services it will no longer offer in 1984, for reasons stated below the surcharge that we will adopt today will not lead to such a result.

As a result of the surcharge, we expect that the number of calls made by residential customers will increase. This increase will be offset by a corresponding decrease in the number of calls made by business customers. The net result will be a slight increase in the total number of calls made. This increase will be offset by a corresponding decrease in the number of calls made by business customers. The net result will be a slight increase in the total number of calls made. This increase will be offset by a corresponding decrease in the number of calls made by business customers. The net result will be a slight increase in the total number of calls made.

¹⁵ A late-filed exhibit sponsored by the PT&T witness reveals that the most common bill among residential customers - whether flat-rate, measured-rate, or lifeline - includes no toll or local usage charges whatsoever. (See Exhibit 508, Item III).

We will adopt the staff proposal, endorsed by most interested parties, that the surcharge be spread over as many services as is practical, including all intrastate toll and local services. We will, however, make three revisions in the staff approach. First, we will maintain the existing 5.4% surcharge as a separate charge. As noted in D.93367, this surcharge is really a part of the rate spread adopted in Pacific's last general rate increase and was only put in surcharge form because of the costing and rate problems associated with the services covered by the surcharge, which were not completely resolved at the time of the general rate decision. The 6.66% surcharge, adopted in D.93728, has no such significance, and, following the staff proposal, this will be incorporated into the new surcharge associated with the present interim increase.

As a second modification of the staff proposal, we will exempt CPE rates from any change at this time. The staff proposal would have actually created a slight decrease in CPE rates. This would have led to a greater revenue requirement burden on other services and it would not have provided any real CPE rate relief, given that CPE prices will be determined in 1984 by the FCC order gradually detariffing such services. We here take official notice of this recent FCC action on November 23, 1983 in Docket 81-893.

Finally, we will modify the staff proposal to exempt lifeline rates from any increase at this time. This will contribute to the maintenance of universal service and meet the requirements of AB 1348.

We also note that our accompanying decision on access charges issued today provides that surcharge revenues on intrastate interLATA toll will flow to Pacific through an access charge premium. This is necessary to constrain AT&T's return on intrastate interLATA operations to their authorized level.

The surcharge adopted today is responsive to the impending divestiture that will heavily impact Pacific. As noted earlier, the

increased revenues flowing from the surcharge have been shown in this proceeding to be necessary to provide the divested Pacific company with a solid financial foundation. At the same time, this increase in revenue requirement is borne broadly and equitably by customers in a manner that protects universal service goals.

The Commission has also considered the relative impact of the surcharge on different classes of service. The Commission has found that the surcharge is not unduly burdensome on any class of service and that it is necessary to provide the divested Pacific company with a solid financial foundation.

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There shall be applied to each of PT&T's customer bills for intrastate services, except for CPE services, monthly lifeline service, intrastate coin message toll service, local coin service, and directory advertising service, a uniform percentage surcharge which will yield \$384,444,000 (interim rate relief) of annual revenues at the 1983 level of interstate business. We envision the surcharge being shown on customers' bills just above the total amount due, as a surcharge on the entire intrastate portion of the bill.

PT&T shall file, coincident with the advice letter filing to implement the above surcharge, the derivation of the uniform percentage surcharge to be applied to PT&T's intrastate customer billings. Such derivation shall include the 1983 annual PT&T intrastate customer billing bases for each of PT&T's tariff schedules. No repression effects shall be considered in the development of the surcharge. Such filing shall be open for public inspection and a copy of the filing shall be provided to each of the parties of record in this proceeding.

The uniform percentage surcharge on PT&T's intrastate customer billings is not based on any allocation of increased costs of operations to any particular services, nor does it constitute an increase in the rates for any particular underlying services. Thus, we are not recognizing any specific increase in the costs associated with intrastate toll services or extended area services, nor are we authorizing any increases in the applicable rates. Therefore, the uniform percentage surcharge should have no effect upon the assignment of settlement revenues to the various independent telephone companies (ITCs) in California. This is appropriate in view of the temporary character of the uniform percentage surcharge and the present uncertainty as to whether the final decision in this proceeding will authorize any permanent increases in rates for intrastate toll services or extended area services.

What we are authorizing amounts to a "bill and keep" treatment of PT&T's increased revenues from the uniform percentage surcharge. A "bill and keep" approach is particularly justified at this time because of the pendency of rate decisions for General and several other ITCs. Application of routine settlement procedures in this context would result in a complex array of cross-payments among companies to the greatest disadvantage of those ITCs which have come before us seeking rate relief. We will reexamine whether to apply the traditional settlement procedures in the context of our final decision in this proceeding.

In D.83-10-092 issued recently in Citizens Utilities Company of California's (Citizens) telephone rate increase in A.82-09-52, we calculated and authorized the appropriate billing increase for an intrastate message toll billing surcharge on a "bill and keep" basis, but we calculated and authorized the billing increase for extended area service on a basis reflecting "the usual settlement arrangements." We ordered Citizens, subsequent to issuance of the present decision for PT&T, to file for rate adjustments to "recognize any inward revenue flow from Pacific due to improved settlements should Pacific receive an interim increase." Because of the "bill and keep" procedure we are adopting for PT&T, Citizens will receive no such inward revenue flow. However, for the sake of consistency, we will by separate resolution authorize Citizens to apply the "bill and keep" procedure to the increased revenues from extended area service resulting from D.83-10-092, thereby reducing Citizens' outward revenue flow due to settlement procedures.

FINDINGS AND CONCLUSIONS

Findings of Fact

1. By these consolidated proceedings, PT&T is requesting: first an annual increase in California intrastate jurisdictional revenues of \$837,900,000.

2. The proceedings have been bifurcated into two phases, a "business as usual - surcharge phase" and a "rate design - post-divestiture phase."

3. A variance was granted from the Rate Case Plan to bifurcate the proceeding.

4. OIR 83-04-02, A.82-11-07, and A.83-06-65 were consolidated with A.83-01-22.

5. Fifteen properly noticed public hearings have been held throughout the state to afford the public an opportunity to participate.

6. Twenty-nine days of evidentiary hearings were held on results of operations and surcharge design.

7. At present rates, for the test year 1983, a reasonable estimate of PT&T's Total California and California Intrastate Results of Operations is:

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
 ADOPTED RESULTS OF OPERATIONS
 A.83-01-22 ESTIMATED YEAR 1983
 (\$000)

RECAST #3

	California	Intrastate
Operating Revenue		
Local Service Revenues	\$ 2,977,964	\$ 2,974,384
Toll Service Revenues	4,846,735	2,653,157
Miscellaneous Revenues	442,134	442,134
Uncollectibles	(110,716)	(72,631)
Total Operating Revenues	\$ 8,156,117	\$ 5,997,044
Operating Expenses and Taxes		
Current Maintenance	\$ 1,949,895	\$ 1,404,830
Depreciation & Amortization	1,217,998	897,324
Traffic Expenses	385,218	309,060
Commercial Expenses	719,578	598,708
Gen Office Salaries & Expenses	457,084	355,866
Operating Rents	55,091	42,767
Gen. Services & Licenses	65,829	48,760
Other Oper. Expenses	783,458	588,560
Total Operating Expenses	\$ 5,634,151	\$ 4,245,875
Operating Taxes		
- Federal Income	\$ 513,705	\$ 335,649
- Cal. Corp. Franch.	281,169	181,800
- Social Security	187,019	140,586
- Other	166,080	123,045
CPE Gain After Net Adj.	(47,199)	(47,199)
CPE Gain Tax Effect	14,651	14,651
Total Oper. Expenses & Taxes	\$ 6,749,576	\$ 4,994,377
Net Revenues (Carried forward)	\$ 1,406,541	\$ 1,002,667
Rate Base		
Telephone Plant in Service	\$ 18,753,715	\$ 13,857,679
Property Held for Fut. Tel. Use	55,100	40,967
Working Cash	129,195	97,542
Materials and Supplies	103,930	75,817
Depreciation Reserve	3,427,486	2,489,285
Reserve for Deferred Taxes	2,209,957	1,645,655
Total Rate Base	\$ 23,680,383	\$ 18,127,945
Rate of Return	10.49%	10.09%

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EXHIBIT 00 TO STUBBS 070004
000000000000 00-10-88.1

8. A reasonable rate of return to be applied to PT&T's California intrastate rate base is 12.70%.

9. A 12.70% return on that portion of PT&T's capitalization ascribed to the California intrastate rate base adopted in this decision would yield approximately 16.0% on California ascribed common equity.

10. PT&T's rates subject to the jurisdiction of this Commission should be increased by \$384,444,000 which increase excluding the underutilized plant adjustment should produce a 12.70% rate of return on PT&T's California intrastate rate base for the estimated test year 1983.

11. A 12.70% rate of return on California intrastate rate base would provide an interest coverage of 4.36 times before taxes on income, and 2.73 times after taxes.

12. A net-to-gross multiplier of 1.901 is reasonable for the year 1983.

13. The staff's proposed surcharge, as modified by this decision is a reasonable method of recovering the revenue increase authorized by this decision.

14. The surcharges authorized by this decision are just and reasonable; the present rates and charges, insofar as they do not contain the surcharges prescribed by this decision are for the future, unjust and unreasonable.

15. PT&T has demonstrated overriding financial need for interim rate relief.

16. The straight-line remaining life depreciation method is a reasonable method to use to determine a reasonable allowance for depreciation expense.

17. The "represcription" average service lives, remaining lives, and estimated future net salvage, as agreed to by PT&T and the staffs of the FCC and of this Commission, are reasonable and should be adopted for the purposes of this decision and for PT&T's depreciation memorandum records.

18. The use of single-decimal depreciation rates is reasonable.
19. The use of remaining lives, plant, salvage, and reserves balances applicable for the year in which remaining life depreciation rates are set is reasonable.
20. There should be no further delay in recognizing changed depreciation rates.
21. PT&T's request for anti-trust expense is reasonable.
22. PT&T's request for costs of Business Information System is not appropriate.
23. A penalty should not be applied to Account 672, Relief and Pensions.
24. The costs associated with early retirement incentives in 1982 as claimed by PT&T are not reasonable and should not be included in the adopted results of operations.
25. The use of the effective Bell System CCFT rate of 21.37% for calculating PT&T's tax liability at present rates is reasonable.
26. The use of the incremental Bell System CCFT rate of 1.40% for calculating additional tax liability resulting from increased revenues from adopted rates is reasonable.
27. The regulatory treatment of the sales of CPE should not be kept open in this proceeding. Extraordinary retirement accounting and the tax treatment assumed by staff are reasonable. Staff's estimate of gains from CPE sales is reasonable.
28. The staff productivity assumptions for Accounts 604 and 605 are too optimistic. A 10% assumption, equivalent to 1975-80 trend, is reasonable.
29. PT&T's 1983 Total California Estimated Plant includes plant in an amount of \$652,700,000 that is in excess because of underutilization.
30. The underutilization of plant results in part from imprudent management and in part from the effects of the economy.
31. PT&T should be authorized a reduced return on rate base for that portion of intrastate plant which is underutilized.
32. In its next general rate case or sooner on application and showing by the company, PT&T may apply to have the rate of return on the underutilized plant changed, based on the usage of that plant.

33. Substantial progress has been made towards the financial goals set by D.93367 including that of a 50-50 debt-equity ratio.

34. The operating expenses adopted by this decision are reasonable.

35. The revenue and sales volume estimates adopted by this decision are reasonable.

36. The economic setting is presently considerably less volatile and difficult than it was when D.93367 was issued.

37. The imputation of a 6% cost to \$82 million of common equity required by D.82-05-007 should be discontinued.

38. On a recast 3 basis gross revenues should be increased by \$445,450,000 after adjustment for underutilized plant.

39. The revenue effect ordered by D.83-08-31 in the amount of \$61 million should be applied to the revenue requirement found reasonable by this decision.

40. No attrition allowance should be established in this first phase of this proceeding.

41. The establishment of an attrition allowance for PT&T is reasonable. The method of determining such an allowance is appropriately the subject of the second phase of this proceeding.

42. Consideration of affirmative action and female and minority business enterprises should be deferred to the second phase of this proceeding to allow for possible informal resolution.

43. Consideration of adequacy of PT&T's compliance with PU Code 465 and 466 of the PU Code should be deferred to the second phase of this proceeding in order to permit the staff to gather necessary information.

44. The surcharges authorized by this order should become effective January 1, 1984.

Additional Findings of Fact

45. PT&T has demonstrated a need for additional revenues based on a 1983 rate base.

46. A baseline results of operations (R/O) developed from current data is required to assess the impacts of divestiture and access charges.

47. The proceeding is submitted on the 1983 R/O and no continued examination of the 1983 R/O is expected in the further hearings on this proceeding.

48. Because of the uncertainty that PT&T faces in 1984 it may be denied an opportunity to become a viable independent utility if it does not set out with a solid financial foundation.

49. Although characterized as interim in the sense that other orders will follow before the proceeding is closed, this order is not interim in the traditional sense where partial rate relief is granted prior to the final order because of financial emergency.

50. This order is final with respect to the 1983 R/O.

51. A financial emergency is required to justify an interim rate increase prior to establishing final R/O for the test year.

52. A financial emergency is not required to justify a rate increase based on a final R/O.

53. Overriding financial need is not identical to a financial emergency but is a lesser standard.

Conclusions of Law

W 30/10/84, 12 to 170-11-28.A

1. Based on the foregoing findings of fact and under PU Code §§ 451 and 454, the Commission should grant PT&T authority to apply surcharges to its present rates as provided in the following order to enable PT&T to earn additional annual revenues of \$384,444,000.

2. PT&T should be authorized to revise its California memorandum record depreciation rates and practices to reflect:

a. Current FCC prescription depreciation factors.

b. Single decimal rates.

c. Elimination of the one year lag in the review boundaries process.

3. The above, \$384,444,000 increase, is in addition to the \$61,006,000 previously authorized in D-83-08-031.

THIRD ORDER

IT IS ORDERED that:

1. PT&T is authorized to file with this Commission, 7 days after the effective date of this order, in conformity with the provisions of General Order 96-A, revised tariff schedules with surcharges as set forth in Appendix B. The effective date of the revised tariff sheets shall be January 1, 1984. The revised tariff schedules shall apply to service rendered on and after the effective date of the revised schedules.

2. PT&T is authorized, effective January 1, 1984, to revise its California memorandum record depreciation rates and practices to conform with Conclusion of Law 2 above.

3. PT&T and the staff need not, in future rate proceedings, impute a 6% cost to \$82 million of common equity as formerly required by D.82-05-007.

This order is effective today.

Dated December 7, 1983, at San Francisco, California.

I will file a concurring opinion.

LEONARD M. GRIMES, JR.

President

/s/ LEONARD M. GRIMES, JR.

Commissioner

VICTOR CALVO

PRISCILLA C. GREW

DONALD VIAL

WILLIAM T. BAGLEY

Commissioners

I dissent in part.

/s/ PRISCILLA C. GREW

Commissioner

I concur and dissent in part.

/s/ VICTOR CALVO

/s/ PRISCILLA C. GREW

Commissioners

CERTIFY THAT THIS DECISION

WAS REVIEWED BY THE ABOVE

COMMISSIONERS TODAY

Joseph E. Bodevitz, Executive Director

...has been filed and has been filed ...
...has been filed and has been filed ...
APPENDIX A

Page 1

700-20-28.2

List of Appearances

Applicant: Paul H. White, Daniel J. McCarthy, Randall E. Cape, and
Marlin D. Ard, Attorneys at Law, for The Pacific Telephone and
Telegraph Company.

Protestants: Herman Mulman, for Seniors; Edward Duncan, for himself; and Burt Wilson, for California
Association for Utility Service Equality.

Interested Parties and Respondents: George Agnost, City Attorney, by
Leonard Snaider, Deputy City Attorney, for the City and County
of San Francisco; Kerry Barnett and Harvey Rosenfield, Attorneys
at Law, for California Public Interest Research Group; Morrison &
Foerster, by James P. Bennett, Attorney at Law, for Telephone
Answering Services of California; McKenna, Wilkinson & Kittner, by
James S. Blaszk, Attorney at Law (Texas and District of
Columbia), for American Broadcasting Companies, Inc. and CBS,
Inc.; Joseph DeBode, for Stanford University Telecommunications;
Brobeck, Phleger & Harrison, by William H. Booth and Richard C.
Harper, Attorneys at Law, for California Bankers Clearing House
Association and Tele-Communications Association; Allen R. Crown,
Antone Bulich, and Charlotte Adams, Attorneys at Law, for
California Farm Bureau Federation; Orrick, Herrington & Sutcliffe,
by Robert J. Gloistein, Attorney at Law, and Richard Pfeiffers,
for Continental Telephone Company of California; Public Advocates,
by Robert Gnaizda, Attorney at Law, for League of United Latin
American Citizens, San Francisco Black Chamber of Commerce,
Chinese for Affirmative Action, the Sacramento Urban League, and
OCCUR; Sharon E. Hilliard and Carl Hilliard, Attorney at Law,
for VIA/NET Companies; Kenneth Edwards and William L. Knecht,
Attorneys at Law, for Communications Consultants, Inc.; William
L. Knecht, Attorney at Law, for California Interconnect
Association; H. Kendrick Kresse, Attorney at Law, for Deaf
Counseling Advocacy & Referral Agency; Pelavin, Norberg, Harlick &
Beck, by Alvin H. Pelavin and William R. Haerle, Attorneys at
Law, for Calaveras Telephone Company, Capay Valley Telephone
System, Inc., Dorris Telephone Company, Ducor Telephone Company,
Evans Telephone Company, Foresthill Telephone Company, Happy
Valley Telephone Company, Hornitos Telephone Company, Kerman
Telephone Company, Livingston Telephone Company, Mariposa County
Telephone Company, Pinnacles Telephone Company, The Ponderosa
Telephone Company, Sierra Telephone Company, Siskiyou Telephone

APPENDIX A

Page 2

Company, and Volcano Telephone Company; Morrison & Foerster, by Preston Moore, Attorney at Law, for MCI Telecommunications Corporation; Gold, Herscher, Marks & Pepper, by Alan L. Pepper, Attorney at Law, for Western Burglar and Fire Alarm Association; Glenn M. Rudd, for Communication Resources Company; Sylvia M. Siegel and Jon F. Elliott, Attorney at Law, for Toward Utility Rate Normalization; Cecil O. Simpson, Jr., Attorney at Law (Maryland and Washington, D.C.), for Department of Defense and all other Executive Agencies of the Federal Government; Palmer & Willoughby, by Michael F. Willoughby, Attorney at Law, for ICS Communications; Robert H. Wyman and Richard M. Cahill, Attorneys at Law (New York, Maryland, Florida, and Hawaii), and Richard E. Potter, Attorney at Law, for General Telephone Company of California; Sidney J. Webb, for himself; John Witt, City Attorney, by William Shaffran, Attorney at Law, for the City of San Diego; Patricia A. Tilley, for the University of California; Stewart Weinberg, Attorney at Law, for Service Employees Union, Local 87; Ira Reiner, City Attorney, by Ed Perez, Deputy City Attorney, for City of Los Angeles; Milton Morris, Randolph Deutsch, and Richard A. Bromley, Attorneys at Law, for American Telephone and Telegraph Company; Graham & James, by Thomas J. MacBride and James Squeri, Attorneys at Law, for U.S. Tel, Inc., Combined Network, Inc., and CALTEL (California Association of Long Distance Telephone Companies); John E. Dennis, for Bell System California Interexchange Organization; Charles J. Beck, Attorney at Law, and Daniel R. Loftus, Attorney at Law (Tennessee), for Sonitrol Security, Inc.; Morrison & Foerster, by Leigh R. Shields, Attorney at Law, for Telephone Answering Services of California; Steve Vogelsang, for himself and Southern California Section Professional Golfers Association of America; Lawrence P. Keller, for The Western Union Telegraph Company, Thomas Vargo, for Jay Randolph McPherson, Office of General Counsel, Code 105, Defense Communications Agency; William G. Irving, for the County of Los Angeles; Ann C. Pongracz and Mitchell F. Brecher, Attorneys at Law, for GTE Sprint Communications Corp.; August A. Sairanen, for State of California, Department of General Services; Robert Bell, Attorney at Law (Washington, D.C.), for Satellite Business Systems; Lloyd I. Krause, for himself; Steven H. Nemerouski, Attorney at Law (Illinois), for Combined Network, Inc.; C. Lee Coulter, Attorney at Law (Washington), for West Coast Telephone Company; Robert Brylawski, for himself; Harry M. Snyder, Carol Barger, and Robert Nichols, Attorneys at Law, for Consumers Union

APPENDIX A

Page 3

of U.S., Inc.; Edmund John Wells, for Xerox Computer Services; Ron Herrold, for B&W Electronics; and Dinkelspiel, Donovan & Reder, by David M. Wilson, Attorney at Law, for Direct Marketing Association.

Commission Staff: Rufus G. Thayer, Attorney at Law, Robert C. Moeck, Michael Galvin, Louis G. Andrego, J. Douglas Dade, and Dean Evans.

(END OF APPENDIX A)

APPENDIX B
Rates and Charges

There shall be applied to each of PT&T's customer bills for intrastate services (including intraLATA and interLATA toll), except for lifeline, Customer Premises Equipment, intrastate coin message toll service, local coin service, and directory advertising service, a uniform percentage surcharge which will yield \$384,444,000 of additional annual revenues at the 1983 level of business. The 5.4% surcharge shall be retained in the customer billing base to be surcharged for affected services except Customer Premises Equipment. Except for Customer Premises Equipment services and lifeline services, the present surcharge of 6.66% shall be removed and the present revenue from this surcharge shall be recovered from the uniform surcharge in addition to the \$384,444,000. Customer Premises Equipment services shall retain the present 5.4% surcharge and the 6.66% present surcharge, and the uniform percentage surcharge will not be applied to these services.

The basic monthly rate for lifeline service shall retain the present 6.66% surcharge and shall not have the uniform percentage surcharge applied.

PT&T shall file, coincident with the advice letter filing to implement the above surcharge, the derivation of the uniform percentage surcharge to be applied to PT&T's intrastate customer billings. Such derivation shall include the 1983 annual PT&T intrastate customer billing bases for each of PT&T's tariff schedules and the portion of the authorized increase associated in terms of customer billing and revenue with each of PT&T's tariff schedules. No repression effects shall be considered in the development of the surcharge. Such filing shall be open for public inspection and a copy of the filing shall be provided to each of the parties of record in this proceeding. The filings should reflect the effects of advice letters approved in 1983.

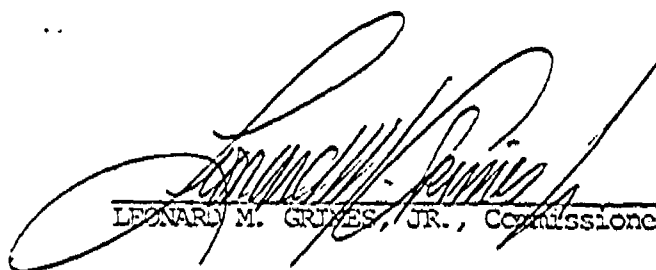
(END OF APPENDIX B)

A.82-11-07 et al
D.83-12-025

COMMISSIONER LEONARD M. GRIMES, JR., Concurring:

I concur in all aspects of today's decision but write separately to express my reservations concerning the adopted surcharge design. This Commission and each Commissioner serving on it is strongly committed to preserving the affordability of basic telephone service in California. Undoubtedly, this is the greatest challenge now facing this Commission. To meet this challenge, I believe our approach must be both balanced and farsighted. While we must be concerned about keeping basic monthly rates within reach of low and moderate income consumers, we must also recognize that the emergence of competition and threat of bypass limit our ability to impose charges on long distance users.

With this balance in mind, I would have preferred to retain the existing surcharges and impose a uniform 7.75% surcharge on all of Pacific Telephone's intrastate services except for CPE, lifeline service, coin telephone service, and directory advertising. By imposing an equal burden on local and long distance service, my method would have yielded a slightly higher basic monthly rate and slightly lower long distance rates pending the development of a final rate design in May.



LEONARD M. GRIMES, JR., Commissioner

December 7, 1983
San Francisco, California

PRISCILLA C. GREW, Commissioner, dissenting in part:

In addition to dissenting on the surcharge design, I also disagree with two other points of the majority's decision:

(1) the rate increase to cover a level of maintenance expenses higher than that proposed by our staff; and (2) the invitation to the company to file for another rate increase on presently underutilized plant before the next general rate case.

On the issue of maintenance expenses, the majority decided to revise the staff maintenance expense forecast upward to increase the staff's recommended "maintenance expense level by \$29.255 million" (mimeo at 40). One reason advanced by the majority for this increase is that they think the 15% to 18% labor productivity rates assumed by staff were too high. I disagree, and think staff's assumptions were reasonable, since elsewhere we have heard the company's very large investments in the latest telecommunications equipment justified on the grounds that they will substantially increase labor productivity. Second, the majority says it is increasing maintenance expenses with the intent of reversing the decline in the company's maintenance efficiency. To me it does not make sense to reward the company with higher rates for lower productivity and simultaneously expect that this will make the company improve its efficiency.

According to the majority's logic, the less efficient the company becomes the higher its rate awards will be. I would instead have adopted staff's maintenance estimates, predicated on higher productivity, as an incentive for improved maintenance efficiency in the company.

I also dissent on the majority's language which provides the company an opportunity to apply for a rate increase on a revision in plant before its next general rate case:

"31. In its next general rate case, or sooner upon application and showing by the company, PT&T may apply to have the rate of return on the underutilized plant changed, based on the usage of that plant."

The Commission uses a general rate case plan which allows each major utility to apply for rate relief every two years. Furthermore, in this decision we state that PT&T will be allowed an attrition increase in the second year. Between rate cases, the utilities may incur higher or lower expenses than have been authorized for a given account. It is our policy not to allow recovery of expenses retroactively. Nor do we take away from the utilities the benefits they may accrue through cost savings experienced during the two year period.

For example, in Decision 83-12-002 today, we denied a petition by TURN which argued that we should reduce PT&T's rates to reflect an alleged \$120 million in labor costs which the company may have saved during a 1983 strike. We refused even to analyze TURN's cost allegations, because if we did so,

"we could be opening the door to utilities coming in with similar petitions for each expense item on which there had been an increase over the test year estimate."
Decision 83-12-002 mimeo at 2.

In Decision 83-12-025, the majority indicates a willingness to increase rates and change PT&T's return on \$483.5 million of its intrastate rate base as more plant comes into full use during the next two years. But the Commission in Decision 83-12-002 in effect says that rate decreases to track reduced company costs during the two year intervals between rate cases are off limits. I fear that these two decisions when considered together give the unfortunate impression of a double standard. For that reason I would have let the test year return on PT&T's underutilized plant stand until the company's next general rate case.


PRISCILLA C. GREW, Commissioner

December 7, 1983
San Francisco, California

COMMISSIONERS CALVO AND GREW, concurring and dissenting in part:

While we concur in today's decision granting Pacific an interim revenue increase, we must strongly dissent from that portion of the decision which preferentially allocates the majority of the increase to intrastate toll service. At the same time the majority decided to increase the rates for basic exchange service only slightly and customer premises equipment (CPE) not at all.

Before discussing the merits of the adopted surcharge proposal, we wish to emphasize that each and every one of the surcharge proposals under serious consideration by the five commissioners were designed with the express goal of preserving universal telephone service. Not one of the proposals would have placed more than 58¢ on the basic exchange rate. The fact that we dissent from the adopted surcharge proposal in no way should be construed as a lack of our stated commitment to the goal of preserving universal service. Our decision on access charges issued today clearly demonstrates our continued commitment to this goal.

Our dissent is triggered by two important aspects of the adopted surcharge proposal which we cannot accept. The first, and most serious in our view, is that the proposal assigns practically all of the revenue increase to toll service. The second is that it foregoes any increase to CPE.

Unlike the ALJ's neutral surcharge proposal which would have increased rates to all types of service on a uniform percentage basis until a final rate design is determined next May, the majority instead chooses a rate design policy now. We are troubled by the majority's decision to adopt a rate design at this stage of the proceeding, since it is contrary to our stated intent and sound practice to wait until a full evidentiary record is developed. But more to the point, the majority's adoption of this particular rate design seriously restricts the wide flexibility we would otherwise have in choosing a final rate design in May. In contrast, the ALJ's neutral proposal would have preserved, rather than limited our options.

The majority is concerned that basic exchange rates must not increase dramatically. We share this concern and are deeply committed to the goal of maintaining affordable telephone service in California. At the same time, however, we believe it is necessary and prudent to mesh this vital concern, to the greatest extent possible, with national telecommunications policy favoring lower toll rates. If we do not demonstrate at least some degree of sensitivity towards this policy, and instead load virtually all revenue increases onto toll service, we seriously risk the eventual loss of very substantial toll service revenues altogether because of bypass. Of course we recognize that significant bypass is not likely to occur in the next five months prior to our final decision on rate design. However, the strong message sent today by the majority is their intent that California toll rates will continue to bear the brunt of further rate increases which may be necessary.

Moreover, at a time when national policy favors reductions in toll service, we are uncomfortable with such a strong policy message to the contrary. We are acutely aware that Congress is currently considering important telecommunication policy issues, including state jurisdiction over intrastate toll service. As a Commission we have all agreed that retention of intrastate toll jurisdiction is the very key to our ability to maintain low basic exchange rates, and hence, universal service in our state. Our fear is that continued state jurisdiction, however, may be less assured if this Commission announces policies which are completely out of step with national trends.

The second aspect of the adopted proposal which troubles us is the decision not to place any increase on CPE service. The ALJ's proposal would have increased CPE rates by the same percentage as other rates, notwithstanding the fact that the revenue increase from CPE would have gone to AT&T after January 1, 1984. This proposal was consistent with our intent to adopt a 1983 revenue requirement based on a business as usual approach. The added revenues of about \$80 million which will now flow to Pacific, in our view, have not been adequately justified on this

record. More importantly, the added revenues have unnecessarily exacerbated this decision's rate impact on toll service. And ironically, the very rates which the majority is attempting to keep low, namely, the basic exchange rates, are unnecessarily increased as well. Due to the FCC's decision to deregulate the CPE which Pacific will be transferring to AT&T, AT&T will be free to increase CPE rental rates substantially. Thus, under the majority's surcharge design, Pacific's ratepayers will be forced, in effect, to pay two increases in their CPE rental rates, one to Pacific and one to AT&T.

The majority justifies this aspect of the proposal on the basis that Pacific will eventually "need" these revenues in the second phase of its rate proceeding. In the absence of a sufficient evidentiary basis to substantiate this "need", we are not prepared to assume it at this time.

In sum, we simply are not willing to make a strong rate design policy statement today without a complete understanding and appreciation of the broad policy ramifications of various proposals currently being developed in Pacific's rate proceeding. For the reasons given above, we must dissent.


VICTOR CALVO, Commissioner


PRISCILLA C. GREW, Commissioner

December 7, 1983
San Francisco, California

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
ADOPTED RESULTS OF OPERATIONS
A.83-01-22 ESTIMATED YEAR 1983
(\$000)

RECAST #3

Total Operating Revenues
California Intrastate

<u>Operating Revenue</u>		
Local Service Revenues	\$ 2,977,964	\$ 2,974,384
Toll Service Revenues	4,846,735	2,653,157
Miscellaneous Revenues	442,134	442,134
Uncollectibles	(110,716)	(72,631)
Total Operating Revenues	\$ 8,156,117	\$ 5,997,044
<u>Operating Expenses and Taxes</u>		
Current Maintenance	\$ 1,949,895	\$ 1,404,830
Depreciation & Amortization	1,217,998	897,324
Traffic Expenses	385,218	309,060
Commercial Expenses	719,578	598,708
Gen Office Salaries & Expenses	457,084	355,866
Operating Rents	55,091	42,767
Gen. Services & Licenses	65,829	48,760
Other Oper. Expenses	783,458	588,560
Total Operating Expenses	\$ 5,634,151	\$ 4,245,875
<u>Operating Taxes</u>		
- Federal Income	\$ 513,705	\$ 335,649
- Cal. Corp. Franch.	281,169	181,800
- Social Security	187,019	140,586
- Other	166,080	123,015
CPE Gain After Net Add.	(47,199)	(47,199)
CPE Gain Tax Effect	14,651	14,651
Total Oper. Expenses & Taxes	\$ 6,749,576	\$ 4,994,377
Net Revenues (Carried forward)	\$ 1,406,541	\$ 1,002,667

Rate Base

Telephone Plant in Service	\$ 18,753,715	\$ 13,857,679
Property Held for Fut. Tel. Use	55,100	40,967
Working Cash	129,195	97,542
Materials and Supplies	103,930	75,817
Depreciation Reserve	3,427,486	2,489,285
Reserve for Deferred Taxes	2,209,957	1,645,655
Total Rate Base	\$ 13,404,497	\$ 9,937,065

Rate of Return 10.49% 10.09%
(Red Figure)

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8. A reasonable rate of return to be applied to PT&T's California intrastate rate base is 12.45%.

9. A 12.45% return on that portion of PT&T's capitalization ascribed to the California intrastate rate base adopted in this decision would yield approximately 15.5% on California ascribed common equity.

10. PT&T's rates subject to the jurisdiction of this Commission should be increased by \$384,444,000 which increase excluding the underutilized plant adjustment should produce a 12.45% rate of return on PT&T's California intrastate rate base for the estimated test year 1983.

11. A 12.45% rate of return on California intrastate rate base would provide an actual total company financial reporting basis interest coverage of 4.21 times before taxes on income, and 2.60 times after taxes.

12. A net-to-gross multiplier of 1.901 is reasonable for the year 1983.

13. The staff's proposed surcharge, as modified by this decision is a reasonable method of recovering the revenue increase authorized by this decision.

14. The surcharges authorized by this decision are just and reasonable; the present rates and charges, insofar as they do not contain the surcharges prescribed by this decision are for the future, unjust and unreasonable.

15. PT&T has demonstrated overriding financial need for interim rate relief.

16. The straight-line remaining life depreciation method is a reasonable method to use to determine a reasonable allowance for depreciation expense.

17. The "represcription" average service lives, remaining lives, and estimated future net salvage, as agreed to by PT&T and the staffs of the FCC and of this Commission, are reasonable and should be adopted for the purposes of this decision and for PT&T's depreciation memorandum records.