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ORIGINAL

Decision No. 91495 APR 2 1980

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application No. 59269 (Filed November 13, 1979; amended November 15, 1979)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, 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 No. 63 (Filed December 18, 1979)

(Appearances listed in Appendix A.)

INTERIM OPINION
GRANTING PARTIAL GENERAL RELIEF

Introduction

On November 13, 1979, The Pacific Telephone and Telegraph Company (Pacific) filed its application with the Commission requesting authorization to increase its telephone rates to produce approximately $381 million of additional revenues and to authorize such rate increases on an interim basis in 1979. Pacific alleged in its application that such relief is necessary because of the existence of unforeseen and extraordinary circumstances, which if not alleviated by increased rates, will result in Pacific's inability to attract sufficient capital to finance its 1980 construction budget and its consequent inability to provide adequate telecommunications services.

In filing this application Pacific relies on Resolution No. M-4706 (June 5, 1979) which provides that utilities may request rate relief outside of the scope of the Regulatory Lag Plan when a sudden, significant, and unforeseen change in operating conditions exists. In its Declaration of Robert M. Joses, Treasurer, attached to the application, Pacific relies on its inability to obtain adequate rate relief, the possible tax liability to the Internal Revenue Service (IRS), the issuance of a deficiency notice by the IRS on September 27, 1979 relating to 1974, and by economic developments during the recent past that have resulted in escalating interest rates and a tightening of the availability of credit as developments constituting a sudden, significant, and unforeseen change in operating conditions.

Pacific also sets forth in its application the following reasons why a rate increase is necessary because extraordinary circumstances exist that imperil the provision of telephone service in California.

a. Despite Pacific's efforts to promote economies and cost controls throughout its operations, extraordinarily high rates of inflation have dramatically escalated the costs of providing telephone service in California far above the estimates adopted by the Commission in Decision Nos. 90642 and 90919.

b. Demand for telephone services continues to grow, requiring large amounts of additional capital in order to keep up with the service needs of California consumers.

c. In the absence of a substantial increase in rates, Pacific will be unable to attract, at reasonable costs, the necessary capital to permit Pacific to meet telephone service requirements.

d. In the absence of a substantial increase in rates, Pacific will be denied the opportunity of earning the rate of return on equity authorized by the Commission in Decision No. 90642.

e. Pacific has had to defer the sale of stock authorized by Decision No. 90652 because of the advice of the proposed underwriters that the sale would not be favorably received by the investing public.

f. Reflecting a lack of confidence in Pacific's financial condition, Pacific's bond rating has again been reduced by Standard & Poor's Corporation from A+ to A.

g. Pacific's post tax coverage for the twelve-month period ended August 31, 1979, was 1.78 as compared with 2.02 for the same period ended in 1978 and if refunds are ordered in Application No. 53587 and no rate relief is granted, post tax interest coverage is expected to be between 1.30 and 1.32 for 1980.

h. A failure to provide a sufficient rate increase will result in irreparable injury to Pacific, to California and to the entire nation in that the resultant inability to finance will injure both intrastate and interstate services.

i. Any delay in providing the rate increase requested will result in delay or failure to obtain the needed capital and will risk service failures which will be difficult to correct.

Order Instituting Investigation No. 63 (OII No. 63) was filed December 18, 1979 and consolidated for hearing with Application No. 59269. Prehearing Conference was held on December 14, 1979 and evidentiary hearings commenced on January 15, 1980 before Administrative Law Judge K. Tomita. The interim phase of the hearing was submitted on February 19, 1980 after 13 days of hearings with the oral arguments on Pacific's Motion for Immediate Interim Rate Increase. Motions in Opposition to Pacific's Motion for Immediate Interim Rate Increase were filed by Western Burglar and Fire Alarm Association and Sonitrol

Telephone Assistance. In addition to the above two protestants, General Services Administration (GSA) appearing for Executive Agencies of the United States, the Cities of San Francisco, Los Angeles and San Diego (Cities), California Interconnect Association (CIA), Sidney Webb, stockholder in Pacific, General Telephone Company of California (General), Continental Telephone Company of California (Continental), 15 small independent telephone companies, California Independent Telephone Association, and the Commission staff (staff) participated in the oral arguments on February 19, 1980.

In addition to the statements made at the public witness hearings held to date, the Commission has also received approximately 500 letters from the public relating to the application. The main areas of concern expressed were related to the proposed 95-cent a month charge for the standard rotary dial instrument when used as a main station, the elimination of the Proposition 13 credit, inability to make a connection, and the continuing reduction of the local calling area. On the opposite side, there were several customers who agreed that rate relief was necessary, if Pacific was to continue to provide good service to the public.

Although the Zone Usage Measurement (ZUM) Plan adopted in Decision No. 90642 in Application No. 58223, and the exchange access rate plan ordered in Decision No. 90861 in Application No. 55492 were not issues in this proceeding, many public witnesses appeared to oppose the Commission's adoption of ZUM and the effect of the exchange access rate plan on foreign exchange service. With respect to any service complaints, Pacific was requested to investigate such complaints and prepare a reply to the customer, together with a copy of such response to be included as an exhibit in this proceeding.

For the public witness hearings in Los Angeles, the Commission found it necessary to change the hearing site from the State Building to a nearby high school on the first day, and to the Los Angeles County Board of Supervisors building on the second day after the Commission was advised that several bus loads of senior citizens would be attending the hearings. Although Pacific was not responsible for the change of site, it did provide shuttle bus service between the State Building and Belmont High School on the first day, and between Belmont High School and the Los Angeles County Board of Supervisors building on the second day, should any party appear at the original noted site and not see the correction published in the papers. We concur with the Administrative Law Judge in denying the motion for cancellation of the hearings, and also will deny motion for rescheduling since the second phase of the hearing will be consolidated with Pacific's next general rate increase filing for which public witness hearings will be scheduled.

Summary of Opinion

This interim opinion and order authorizes a partial general rate increase of $227.2 million. For the reasons hereinafter discussed, we do not find Pacific has a financial emergency. However, we have before us a results of operations presented for test year 1980 along with the results of initial staff review. At this stage in these proceedings Pacific's and the staff's showings have been tested under cross-examination and, as such, these matters are at a juncture where partial general rate relief, subject to refund, may be authorized. Revenue requirement and rate design issues surrounding Pacific's 1980 test year showing will receive further scrutiny in later stages of these proceedings. The granting of partial general rate relief is an option built into our procedures for processing general rate increases under what is termed the Regulatory Lag Plan, adopted by Resolution No. M-4706. In this instance we adopt that procedure for these matters, involving a 1980 test year, even though they are being processed outside the Regulatory Lag Plan.

Pacific's Position

In support of its application for immediate interim rate relief of $336.9 million (modified downward from the original request of $381 million), Pacific presented eight witnesses including Mr. T. J. Saenger, President of Pacific, two witnesses from the financial community, and an economist from the University of California at Berkeley.

Policy and Operations Testimony

Mr. Saenger testified that based on the October 1979 view of 1980 on which Pacific bases its request for rate relief, Pacific expects to earn, absent any rate relief, only a 7.36 percent rate of return for 1980. Mr. Saenger further explained that in developing Pacific's October 1979 view of the 1980 budget, the operations as well as construction budget represented constrained budgets and not the normal budget used in a general rate case. The adopted capital budget levels were described as below the level engineering tests and judgment support and below the level which Mr. Saenger would recommend to the Board of Directors if the financial circumstances permitted. The funding of this constrained budget is contingent on Pacific's receiving immediate and substantial rate relief early in 1980.

Mr. Saenger testified that the financial situation called for a reduction in the capital budget from an engineering-recommended level of $2.560 billion to a constrained level of $2.312 billion. The following tabulation shows the areas of reduction and the possible impact such reduction would have on service.

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
CONSTRUCTION BUDGET

The $248 million reduction made in arriving at the current 1980 budget level introduces service risks and less efficient operations.

	$ Millions	Reduction Impact
Engineering Recommended Level	2559.5	
Customer Gain	(80.0)	Administrative adjustments Anticipates 47,500 less Customer Gain than the official forecast. Increases service risk.
Non-Equipment Buildings	(12.6)	Less efficient operations.
Electromechanical Switching Equipment Modernization	(18.7)	Less efficient operations.
Reduction and Deferral of Switching Growth Capacity	(10.7)	Minimal impact.
Trunk Circuit Purchase	(11.4)	Increased risk of Network overload.
Increases in Outside Plant Utilization	(13.4)	Increased service risk.
Motor Vehicles and Furniture	(58.3)	Less efficient operations.
Other Modernization Projects	(6.4)	Defers operating expense savings.
Outside Plant Rehabilitation	(15.0)	Increased service risks and less efficient operations.
Routine Expenditures	(10.2)	Increased service risk.
Other Projects	(11.3)	Increased service risk.
Total Reductions	(248.0)	
October 1, 1979 Budget	2311.5	

Of the $2.312 billion constrained construction budget for 1980, Mr. Saenger testified that 59.5 percent is to meet growth, 17.7 percent for customer movement, 6.1 percent for plant replacement, and 16.7 percent for modernization. The first three components are directly related to customer demand, and even capital expenditures related to modernization are closely related to growth requirements. Mr. Saenger further testified as to the various reviews, tests and analyses Pacific made to assure that it is making efficient use of capital. For instance, in evaluating a key modernization project, it uses as an analytical tool, a technique called Capital Utilization Criteria, to ensure that the cost of the project is more than offset by expense savings to produce net savings over the long run. He further explained that high plant utilization ratio compared to other Bell companies presents a higher degree of service risk than is preferable.

Mr. Saenger further testified that if Pacific is only able to obtain $450 million of financing from external sources in 1980 instead of the budgeted $1.2 billion, it would have to reduce its capital budget by $950 million, reduce employees by 4,000, and such action would have a disastrous effect on Pacific's ability to provide service. Under such circumstances held orders (unfilled orders for telephone service) at the end of 1980, are estimated to range between 130,000 to 170,000.

Although under the constrained budget for 1980 Pacific is targeting to maintain service at current levels, Mr. Saenger indicated that it would create undesirable backlogs in Pacific's modernization and replacement programs. While the constrained budgets do not allow Pacific to do what it should do in the best interest of its customers, it was the best Pacific could do under its existing financial situation. The constrained budgets were developed to minimize the impact on service.

Mr. John Dennis, Assistant Vice President-Regulatory Planning presented Pacific's results of estimated Total California and Separated Results of Operations for 1980. Mr. Dennis testified that Pacific's projected intrastate rate of return for 1980 on a Commission basis is expected to be 8.04 percent compared to the 10.25 percent authorized in Decision No. 91121. Mr. Dennis testified that $336.9 million in additional revenues are required in order for Pacific to be afforded the opportunity of earning the 10.25 percent authorized rate of return. Such revenue requirement was premised on Pacific's not contesting any of the adjustments and disallowances ordered in Pacific's last general rate case (A.58223) although Pacific did not necessarily agree with the adjustments.

Economic Impact Testimony

Pacific next presented Dr. Kenneth Rosen, Professor of Economic Analysis and Policy in the School of Business Administration at the University of California in Berkeley to testify on the impact of the reduction of Pacific's construction expenditures by approximately $950 million in 1980 on the California economy.

Dr. Rosen testified that the reduction of $950 million in construction and equipment purchases after application of a conservative 2.5 regional multiplier would have a $2.375 billion effect on state personal income and the reduction in payroll of $100.8 million after application of a 3.0 multiplier would have a $302.4 million effect on state personal income or a combined total of $2.677 billion. Dr. Rosen concluded that it would be a serious error if this Commission forced Pacific into a situation where it must curtail the telephone service which it provides to Californians.

Financial Testimony

Mr. Robert M. Joses, Treasurer, testified on Pacific's deteriorating financial condition and stated that without substantial rate relief early this year Pacific will be unable to raise sufficient capital in 1980 to fund its construction budget. Mr. Joses stated that in addition to the lack of adequate rate relief Pacific's difficulties have been further exacerbated by the IRS deficiency notice issued September 27, 1979 for $89 million plus interest relating to tax liability for 1974, by the further possible federal tax liability for the years 1975 to the present, and by the deteriorating market conditions with record level interest rates and a tightening of the availability of both long-and short-term credit.

Mr. Joses testified that Pacific's construction budget requirements for 1980 are over $2.3 billion, and over $1.2 billion will have to be raised from external sources. It was his opinion that Pacific will not be able to raise that amount of money without substantial rate relief early this year. Even with substantial rate relief, it would be difficult to raise capital because of soaring inflation and contracting credit availability. Without substantial rate relief Mr. Joses stated that Pacific's financial position will deteriorate below the level which would make such financing possible.

Mr. Joses testified that the bond ratings given by Moody's and Standard & Poor's are given substantial weight in the investment community. He further testified that Standard & Poor's in its November 10, 1979 issue of Fixed Income Investor stated that it was maintaining the "A" rating on Pacific's debenture issue while awaiting confirmation of an improved regulatory environment for the company. It was Mr. Joses opinion that there was real danger of a further downgrading to BBB/Baa if the projected 1.32 post tax interest coverage became a reality in 1980 absent substantial rate relief. Moreover, since the projected earnings per share for 1980 would fail to cover the $1.40 dividend, Pacific will be faced with either cutting dividends or reducing retained earnings and increasing borrowings by an equivalent amount. In Mr. Joses' opinion, neither option is desirable since further financing ability depends on the maintenance of the dividend rate.

Mr. Joses further stated that even should American Telephone and Telegraph (AT&T) participate in an issue of common stock, substantial immediate interim rate relief would still be necessary if the investor is to be convinced that there is a likelihood for improved earnings in the immediate future.

Mr. Joses concluded that even with a $336.9 million rate increase, Pacific's financial ratios demonstrate a need for further rate increases before adequate financial stability can be regained. Although the $336.9 million increase will enable Pacific to finance its 1980 construction budget, Mr. Joses testified that it was still substantially less than necessary to enable Pacific to regain its financial flexibility as indicated by the less than satisfactory post tax interest coverage of 1.65 and the return on average common equity of 9.63 percent on a financial reporting basis which will remain substantially lower than the 12.25 percent return found reasonable by the Commission.

Mr. Thomas A. Saunders III, Vice President of the investment banking firm of Morgan Stanley & Co., testified that the capital market is aware of Pacific's need for substantial amounts of external financing in 1980 and its lack of financing flexibility to meet those needs. Mr. Saunders testified that it was critical that Pacific maintain its A/A bond ratings if it hoped to sell $900 million of debt securities in 1980. Without the proposed interim rate relief, Pacific's 1980 fixed charge coverage levels are projected to decline dramatically to a level below those for BBB rated utilities, and would surely result in downgrading of Pacific's bond ratings.

Mr. Saunders further testified as to the need for Pacific to have access to the equity markets as it was not feasible for Pacific to raise the entire $1.2 billion of external financing in the debt market. However, in order to sell equity Pacific needs immediate and substantial rate relief so that Pacific's Board of Directors can make a positive statement that it will maintain its current dividend rate.

Mr. James K. Dobey, retired banker and former Chairman of the Board of Wells Fargo and Company, testified that without immediate rate relief, without adequate long-term funds available, and projected 1980 earnings far below the present dividends, it will be impossible for Pacific to obtain sufficient short-term borrowings to get it through 1980. Mr. Dobey testified that a short-term lender puts substantial importance on a company's bond ratings since lower ratings mean reduced access to financial markets and higher prices, therefore resulting in lessened ability to repay commercial loans.

Mr. Robert Berry, Assistant Secretary and Assistant Treasurer testified on the status of Pacific's proposed $100 million preferred stock offering. He testified that he discussed the proposed offering with Pacific's New York agent who indicated that there was significant investor resistance to the $100 million offering and that in the agent's opinion only approximately one-half of the issue could be sold. Mr. Berry indicated that the adverse regulatory climate in California together with Pacific's decline in earnings and various financial ratios were frequently mentioned as reasons for investor resistance to the proposed offering.

Rate Design Testimony

Ronald R. Banducci, Pacific's rate design witness, presented Pacific's rate design to produce the additional $336.9 million of revenues to Pacific, after settlement, on a 1980 test year basis. Mr. Banducci proposes increases in various rates and charges for basic exchange, terminal equipment services, private line, message toll service, optional calling measured service, and certain non-recurring charges. He also recommended a restructure of the basic exchange service rate for residential use by dividing the service into two rate elements: 1) Exchange access line rate, and 2) utility-provided telephone rate. Under his proposal the current exchange service rate will become the exchange access line rate and a new monthly rate of 95 cents for a standard rotary dial telephone be established. He also proposed removal of the Proposition 13 bill credit.

In support of his rate design proposal Mr. Banducci testified that the Revenue and Cost Summary by Service Category for 1980 without rate relief indicated that basic exchange, vertical services and state private line will not produce revenues sufficient to recover costs and that even under the rate relief sought by Pacific, revenues for the above three services would still be less than the cost of providing the services as shown below:

Type of Service	Revenue/Cost Without Rate Relief	Ratio With Rate Relief
Basic Exchange	.4	.49
State Private Line	.72	.84
Vertical Services	.90	.95

Mr. Banducci testified that competition in the various services must be considered in the rate design to see that rates for Pacific's product and service line produce sufficient revenues in the present and the future, to maintain and improve Pacific's financial ability to continue meeting the growth demands for basic exchange services; rates must be sufficient to earn profits from all services other than basic exchange services if low basic rates are to be maintained, and rate levels must be such that customers will select Pacific's products and services when they believe the value they receive is better or equal to what they pay in the marketplace.

He further testified that with the enactment of interconnect regulations by both the Federal Communications Commission and the California Public Utilities Commission, the telephone utilities were no longer the sole authorized providers of telephone instruments to customers. Customers today can purchase these instruments from various sources and connect their instrument to the telephone network. The proposed rate restructure recognizes this fact and separates the basic exchange service charge to an access line charge and a new instrument charge of 95 cents per month for the standard rotary telephone when used as a primary station telephone.

The additional standard rotary dial telephone set rate of 95 cents will apply to residential individual flat or measured service including so-called lifeline customers who use utility-provided standard rotary instruments. Mr. Banducci further testified that his rate restructure proposal extends to standard telephones the rate treatment which the Commission adopted for premium telephones in Decision No. 90642.

For the business basic exchange service, Mr. Banducci recommends the adoption of an exchange access line terminating on a jack without a utility-provided telephone similar to that proposed for residence service and the elimination of all usage allowances. If the business customer used utility-provided terminal equipment he would be charged an additional amount.

For terminal equipment services Pacific proposes a general 20 percent increase for virtually all terminal equipment services which have not had their rates increased since February, 1978. Pacific also proposes increases in private line rates which will increase those rates for which charges are proposed by about 30 percent. In addition, Pacific proposes increases in certain multi-element service connection charges,namely, an increase in the premise visit charge from $6 to $8 and the station handling charge from $5 to $8. Under these proposed rates, the cost of a simple residence service connection will increase from $37 to $42 and for a simple business connection from $47 to $52 (assumes that wiring and jacks have to be placed).

Pacific also proposes an increase of 1 cent for direct dial day toll rates for the initial period in all mileage steps between 0 and 30 miles, and for the additional minute rates for mileage steps between 17 and 40 miles; a 5-cent increase in the operator-assisted surcharges and increases in coin rates in all mileage steps between 13 and 25 miles. These increases are estimated to increase message toll revenues by $34.2 million annually. Optional calling measured service (OCMS) is affected by the proposed message toll rate charges and is changed to maintain the same relationships.

A summary of the estimated annual effect of Pacific's rate design proposal is shown in the following tabulation:

Estimated Annual Revenue
Effect of Proposed Rate Charges
(Millions of Dollars)
Year 1980

	Total Intrastate	Percent Increase
Basic Exchange Rates		
Residence - Utility-provided primary set charge	$49.2	11.7
Business - Utility-provided primary set charge and uniform basic business line rate and elimination of usage allowances	78.3	42.8
Terminal Equipment		
Increases certain rates and charges for Centrex, PBX, Key Telephone Service, Data Terminals, and other supplemental equipment	45.6	20.2
Non-Recurring Charges		
Increase certain service connections, and certain installation charges	21.6	8.9
Private Line Service		
Increase local loop and non-recurring charges	20.4	17.2
Message Toll Service		
Increases in message toll rates	34.2	2.2
Optional Calling Measured Service		
Increases in certain rates	.2	11.1
Proposition 13		
Residence - Eliminate bill credit	57.8	--
Business - Eliminate bill credit	29.6	--
Total	$336.9	8.3*

*Represents an 8.3 percent increase in total local and toll intrastate revenues.

Mr. Banducci also recommended that should the Commission authorize an increase in rates less than the $336.9 million requested by Pacific, the priority for rate increases and restructuring shall be as follows:

Category 1 (highest priority)

a. Elimination of Proposition 13 bill credit.

b. Increases in terminal equipment and private line service.

c. Restructure of business and residence exchange service (primary set charge) and a uniform business access line rate.

Category 2

Increases in non-recurring charges.

Category 3

Increases in message toll and OCMS.

Staff Evidence and Position

The staff presented five witnesses who testified on Pacific's request for immediate interim rate relief. Robert C. Moeck, Project Manager III, in charge of the Communications and Water Group of the Revenue Requirements Division, sponsored an exhibit on the Results of Operations and Separated Results of Operations for Test Year 1980 based on the staff investigation made on the interim phase of this proceeding.

Based on the staff review and adjustments to Pacific's estimates as shown in Table 1, Mr. Moeck estimates that Pacific, under current rates, would earn a 9.21 percent rate of return instead of the 8.04 percent rate of return estimated by Pacific. Mr. Moeck testified that this would be 1.04 percent less than the 10.25 percent rate of return found reasonable by the Commission, resulting in a revenue requirement deficiency of $157.8 million.

TABLE 1

The Pacific Telephone and Telegraph Company

SUMMARY OF EARNINGS

Present Rates

Line No.	Item	Total California: Utility 1/ (A)	Staff Adjmt. (B)	Staff Adjusted (C)	California Intrastate: Utility 1/ (D)	Staff Adjmt. (E)	Staff Adjusted (F)
	Operating Revenues						
1	Local Service Revenues	$ 2,036.2	$ -	$ 2,036.2	$ 2,033.9	$ -	$2,033.9
2	Toll Service Revenues	3,198.7	40.8	3,239.5	1,818.9	40.8	1,859.7
3	Miscellaneous Revenues	292.9	12.1	305.0	292.9	12.1	305.0
4	Less: Uncollectibles	69.7	.7	70.4	53.3	.7	54.0
5	Total	5,458.1	52.2	5,510.3	4,092.4	52.2	4,144.6
	Operating Expenses and Taxes						
6	Current Maintenance	1,361.4	(44.5)	1,316.9	994.4	(32.5)	961.9
7	Depreciation & Amortization	790.6	(4.1)	786.5	599.0	(3.1)	595.9
8	Traffic Expenses	392.1	(28.5)	363.6	308.7	(22.2)	286.5
9	Commercial Expenses	601.4	(34.0)	567.4	503.6	(28.2)	475.4
10	Gen. Office Salaries & Expenses	310.4	(15.0)	295.4	247.0	(12.0)	235.0
11	Operating Rents	47.4	-	47.4	36.7	-	36.7
12	Gen. Services & Licenses	75.8	-	75.8	57.3	-	57.3
13	Balance Other Oper. Expenses	523.5	(17.1)	506.4	401.6	(13.0)	388.6
14	Total Operating Expenses	4,102.6	(143.2)	3,959.4	3,148.3	(111.0)	3,037.3
15	Operating Taxes - Fed.Income	197.3	91.1	288.4	110.2	75.9	186.1
16	- Cal.Corp.Fr.	17.6	2.8	20.4	7.5	2.3	9.8
17	- Social Sec.	112.0	(5.3)	106.7	86.0	(4.1)	81.9
18	- Other	124.8	(.1)	124.7	94.4	(.1)	94.3
19	Total	4,554.3	(54.7)	4,499.6	3,446.4	(37.0)	3,409.4
20	Balance Net Revenues	903.8		1,010.7	646.0		735.2
	Avg.Net Plant & Working Capital						
21	Telephone Plant in Service	14,093.0	(70.7)	14,022.3	10,662.3		
22	Property Held for Fut.Tel.Use	3.0	-	3.0	2.3		
23	Telephone Plant Acquisition Adj.						
24	Working Cash	249.0	-	249.0	191.7		
25	Materials & Supplies	110.9	-	110.9	84.2		
26	Less: Depreciation Reserve	2,612.9	(2.1)	2,610.8	1,956.8		
27	Less: Reserve for Def.Taxes	1,273.1	(1.9)	1,271.2	953.3		
28	Total	10,569.9	(66.7)	10,503.2	8,030.4	(50.7)	7,979.7
29	Rate of Return	8.55%		9.62%	8.04%		9.21%

(Red Figure)

1/ Exhibit 6, pages 3 and 6.

Mr. Ermet Macario, Supervising Utilities Engineer in the Communications Division, recommended that in addition to the $157.8 million revenue requirement deficiency testified to by Mr. Moeck, Pacific should also be permitted to recover the $69.4 million additional marketing expenses by increasing rates for competitive services. In making his recommendation witness Macario considered the fact that whereas ten years ago Pacific operated in a near exclusive monopoly environment, with the initial impetus of the Carterfone case in 1968 and further actions by the FCC and this Commission, Pacific today operates in a competitive marketplace for many of its service offerings. Mr. Macario testified that this not only included practically all terminal equipment, such as PBX and Key Systems, telephone instruments, answering devices and call forwarding equipment, but also long distance voice and data transmission services which now compete with Pacific and Bell System message toll and private line services. In addition Mr. Macario stated that a number of bills have been introduced in the U. S. Congress in recent years with the principal objective to foster competition and to partially deregulate the utility communications industry which would directly affect terminal equipment and intercity services when and if they become law.

Mr. Macario noted that today the utility and the regulator are faced with changed and changing circumstances especially in the area of providing terminal equipment. The utility, to meet its unregulated competition, needs flexibility in pricing, quick response to new technology, and an aggressive marketing effort. According to Mr. Macario, each of these factors is frustrated to a large or small degree by the regulatory process. On the other hand, Mr. Macario noted that the regulator is driven primarily by concern that the utility operations in this competitive market not be subsidized by the monopoly portion of the utility operation.

Mr. Macario recommends that although the $69.4 million adjustment made by the staff to Pacific's estimated intrastate operating expenses (commercial expense of $28.2 million, maintenance expense of $32.5 million and $8.7 million of associated salary overheads) representing expenditures which are the effects of a commitment by Pacific to an increased marketing effort to meet competition should not be a part of rates for other than competitive services, Pacific should be permitted to recover such expenditures by increased rates for competitive services.

Mr. Paul Popenoe, Jr., Chief of Rates Branch in the Communications Division, offered policy testimony as to the priority in which the rate changes proposed by Pacific should be authorized if the Commission were to issue an interim order in this proceeding. The staff recommendation on priority of implementing rate increases is set forth in the following tabulation:

PRIORITY OF IMPLEMENTING RATE INCREASES
FOR
THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

The Pacific Telephone and Telegraph Company
Application No. 59269

COMMISSION STAFF RECOMMENDATION
ON
PRIORITY OF IMPLEMENTING RATE INCREASES

Rank	Item	Rate Increase	Cumulative Increase
1	Message Toll Service	$42.7	$ 42.7
2	Optional Calling Measured Service	.2	42.9
3	Terminal Equipment	45.6	88.5
4	Private Line Service	20.4	108.9
5	Non-Recurring Charges	21.6	130.5
6	Business Primary Set Charge - Phase A	3.1	133.6
7	Residence Primary Set Charge - Phase A	25.9	159.5
8	Business Access Line Rate - Phase A	38.7	198.2
9	Proposition 13 - Eliminate Business Credit	29.6	227.8
10	Proposition 13 - Eliminate Residence Credit	57.8	285.6
11	Business Primary Set Charge - Phase B	3.0	288.6
12	Residence Primary Set Charge - Phase B	23.3	311.9
13	Business Access Line Rate - Phase B	25.0	336.9

Note: Phase A and B rates set forth on Attachment B

Mr. Popenoe recommended the increase in message toll service as first priority and at an $8.5 million higher level than Pacific with a corresponding $8.5 million lower increase in business access line charges. His reasons for assigning top priority to message toll are:

a. Exhibit 6 indicates that intrastate toll operations earnings are lower than exchange operations earnings.

b. Message toll service rates are applicable throughout the state to both Pacific and the independent telephone companies. An increase in message toll rates at this time would therefore reduce the pressure for independents to seek rate increases.

c. Any increase in rates which may be authorized would be of an interim nature. Should it be later determined that the amounts authorized were excessive and refunds are in order, the higher priority item would be less subject to refund thereby making statewide refunds on toll which would be extremely complicated, less likely.

Mr. Popenoe next recommended increases in the categories of cost-based rates; terminal equipment, private line service and non-recurring charges. In the last area for increases are increases in basic rates as shown in ranks 6 through 13 in the above tabulation. Mr. Popenoe supported the unbundling of basic rates into an access line charge and a charge for telephone instrument. This unbundling of the basic rate was consistent with recent orders of the Federal Communications Commission which provide that customers may connect their own FCC registered telephones to the system. If the customer chooses to use his own equipment he should only pay the access line rate.

In connection with Mr. Macario's recommendation that Pacific be allowed to recover $69.4 million of intrastate expenses which are being incurred on increased marketing activities in the competitive areas, Mr. Popenoe recommended that Pacific be authorized to make a tariff filing for increased rates using the following guidelines:

1. Rates to be increased only in the state private line and vertical services category.
2. Only rates for competitive services should be increased. For instance, there should be no increase in exchange suburban mileage rates which is a non-competitive offering in the vertical services category.
3. No rate should be increased more than 50 percent over present rates when considered in combination with increases that may otherwise be authorized in the proceeding.

The final staff witness James D. Pretti, Principal Financial Examiner in the Revenue Requirements Division testified on the effect of the $227.2 million rate increase recommended by the staff on Pacific's 1980 financial ratios and the impact of those financial ratios on Pacific's ability to finance its 1980 construction budget. Table 2 presents the pro forma financial ratios and statistics used for Pacific's published financial report. Table 2 was prepared using the following assumptions:

a. Rates are set on a fully normalized tax basis.
b. All current regulatory decisions are reflected.
c. $300 million in common stock is issued on June 1980.
d. The composite tax rate on the $227.2 million is 50 percent.
e. Interest deduction includes $123.7 million accrued interest in 1980 on pre-1980 tax liabilities.

TABLE 2

The Pacific Telephone and Telegraph Company and Subsidiary
FINANCIAL RATIOS AND STATISTICS
Pro Forma 1980
($ Millions)

Description	Case I	Case II
Total Operating Revenue	$5,602.1	$5,829.3
Total Operating Expense	4,316.7	4,316.7
Interest Deductions	661.4	661.4
Misc. Other Income - Net	48.8	48.8
Total Operating Taxes	406.2	519.8
Net Income	$ 266.6	$ 380.2
Preferred Dividends	$ 54.3	$ 54.3
Earnings Avail. for Common	$ 212.3	$ 325.9
Avg. No. of Shares Outs.	179.1	179.1
Earnings Per Share	$ 1.19	$ 1.82
Current Dividend	$ 1.40	$ 1.40
Payout Ratio	117.6%	76.9%
Interest Coverages		
Pre-Tax	1.66x	2.00x
Post-Tax	1.40x	1.57x

Case I - Pacific's 1-14-80 outlook for 1980.

Case II - Case I with $227.2 M in rate relief.

Mr. Pretti testified that the $227.2 million rate increase will increase earnings per share from a $1.19 to $1.82 and improve the pre-tax times interest coverage from 1.66 to 2.00. He concluded that the 2.00 pre-tax interest coverage should, on an interim basis, enable the company to protect its current bond ratings and attract required debt funds.

Cities Position

Mr. Snaider arguing for the Cities of San Francisco, Los Angeles and San Diego (Cities) states that the interim relief requested in this case should be denied at this time because it is premature. Procedurally, Cities argued that this application violates the Regulatory Lag Plan provisions allowing utilities to file for rate relief only once every two years, and notes that Pacific already has rates set on a 1979 test year. In addition, Mr. Snaider argues that the Commission staff did not have the time to put forth a case of competent quality under the scheduling adhered to in this proceeding.

In connection with Pacific's allegation that sudden, significant, unforeseen changed circumstances justify emergency interim relief, the Cities argue that there simply has not been any new sudden, significant, unforeseen or changed circumstances. The only two changed circumstances that have occurred have only been favorable to Pacific according to the Cities in that the Commission has granted Pacific full use of normalized depreciation and AT&T's decision to purchase Pacific's stock. The Cities further argue that Pacific's financial problems were caused by AT&T's policy and by Pacific's imprudence and obstinacy.

The Cities argue that the $157 million increase recommended by staff Witness Moeck for Pacific is based on glaring deficiencies of time and lack of analysis. The Cities further argue that staff Witness Macario's recommendation to allow Pacific to recover $70 million of ratemaking adjustments in the area of commercial and marketing, and maintenance expenses in the form of higher rates in the competitive services is without basis. The Cities argue that the $70 million adjustment made by Mr. Moeck had only limited relation to competitive marketing and that Mr. Moeck agreed that commercial and marketing was both competitive and non-competitive but he could not break out the competitive and non-competitive marketing aspects.

The Cities conclude that there has been no staff showing to date to support interim relief and that the two alternatives available to the Commission are to allow the staff adequate time to put on its showing or to discontinue these proceedings and let Pacific proceed with a 1981 test year under the Regulatory Lag Plan.

CIA's Position

CIA argues that the record in this proceeding already shows that Pacific is failing to meet adequate standards of public service even in the vital area of providing monopoly service. CIA argues that had vertical services been fully cost priced residential rates could have been one and a half billion dollars less over the period 1972 to the present.

CIA argues that Pacific is indeed in a state of emergency, and Pacific should be required to do certain things in an emergency before giving Pacific everything it is seeking in this proceeding, such as ordering Pacific to stop making payments to AT&T. CIA claims that Pacific is losing large amounts of money in vertical services and therefore it should abandon the terminal equipment field. CIA also argues that in addition to the $70 million of excess marketing expenses, approximately $30 million of disallowed license contract expenses should be included in the amounts Pacific must charge for terminal equipment. In CIA's view such increases should be spread across the board for competitive services and not selectively as in Pacific's rate design proposals.

CIA sponsored one witness, Mr. Joel Effron, President of Scott-Buttner Communications, Inc., who testified as to the competition that exists in telephone terminal equipment in California. Mr. Effron testified that there is intense competition between the unregulated vendors who find it difficult to compete profitably because of the restrictive ceiling that the prices of equipment from the regulated utilities impose upon the market. It was Mr. Effron's opinion that competition in the terminal equipment field benefits the customer whether he buys his own equipment, or stays a customer of the telephone company, in that the customer has greater options, and the benefit of more innovations in communication equipment.

Mr. Effron recommends that rather than adopting Pacific's rate proposal for vertical services he recommends a 10 percent increase on grandfathered equipment, supplemental equipment charges and other key equipment; a 20 percent increase on ComKey and Horizon rates and a 30 percent increase on SGI/IA and Dimension, six-button and ten-button sets and associated equipment and the single line set used as a main or extension behind any PBX.

GSA's Position

General Services Administration (GSA) appearing for the Executive Agencies of the United States argue that there is nothing new or different to support the criterion for emergency rate relief sought by Pacific. GSA argues that Pacific's presentation is pretty much the same as that offered and essentially rejected by the Commission in Pacific's last major rate case (A.58223).

GSA also alleges that the staff study in this proceeding, while probably the best that could be done under the time constraints, was inadequate. GSA also faulted the rate design offered by Pacific in response to Mr. Macario's recommendation that Pacific should be allowed to recover $70 million of excess expenses by further increasing rates for vertical services. GSA claims that whereas witness Macario admitted that the type of marketing done by installers was probably more in the residential service such as extension, Princess and Trimline telephones, and probably not very much in Key telephones, PBX and Centrex, Pacific's rate proposal for this $70 million is placed entirely on private line and Key telephone service. GSA also criticized the lack of evidence in this proceeding as to where the actual competition is in the telecommunication field in California and that such competition has not indicated that it is ready, willing, and able to compete vigorously should deregulation of certain telephone company services become a fact.

Mr. Webb's Position

Mr. Webb, a stockholder in Pacific, argues that Pacific has made a prima facie showing that it needs interim rate relief of $336.9 million and that such relief should be granted subject to refund in the interim phase of these proceedings. He recommended that such rate relief should be conditioned on the fact that Pacific's 1980 financing would be comprised of the $300 million debt offering authorized by Decision No. 91327, a $100 million preferred stock offering requested in Application 59324 and an $800 million common stock sale to be derived through a rights offering. The magnitude of the common stock offering results from the fact that Pacific has had no common stock offering since 1973 and needs a large equity sale to reduce the debt ratio to 50 percent, according to Mr. Webb.

General's Position

General urges the Commission to grant the rate increase requested by Pacific. General expresses its concern about deterioration in the communications network and the potential for further deterioration. General recommends, however, that the Commission should adopt the positions set forth by staff Witness Popenoe of increasing intrastate toll by approximately $42 million or, in the alternative, increase total intrastate toll by $93 million statewide, out of which approximately $68 million would flow to Pacific rather than the $34.2 million increase recommended by Pacific.

Continental's Position

Continental supports the granting of interim emergency rate relief to Pacific. Continental argues that traditionally the Commission's policy as set forth in its various decisions is to have the more risky toll operations bear a higher rate of return than the less risky exchange services. However, under the rate design proposed by Pacific or the staff Continental argues that the evidence indicates that the rate of return on toll services is less than the rate of return on exchange services. Continental argues that the rate of return on toll service has got to be raised to at least equal Pacific's cost of money or 10.25 percent and that the record in this proceeding will support an increase in toll revenues much better than it will support an increase in vertical services.

Fifteen Small Independent
Telephone Companies' Position

The 15 Small Independent Telephone Companies, 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, Livingston Telephone Company, Mariposa Telephone Company, The Ponderosa Telephone Company, Sierra Telephone Company, Inc., The Siskiyou Telephone Company, and Volcano Telephone Company, support Pacific's request for the full $336.9 million interim rate relief and in no event less than the $227 million recommended by the staff. The small independents disagree with the low priority given by Pacific to toll revenue increases nor the 2.2 percent increase for toll compared to the overall 8.3 percent increase being requested. In fact, the small independents argue that if Pacific is to earn its 10.25 percent rate of return, intrastate toll should be earning a 12 percent rate of return and exchange operations an 8 percent rate of return.

Similar argument was made by Mr. Bob Ringman, Executive Vice President of the California Independent Telephone Association which includes 24 independent operating non-Bell Telephone Companies that serve California.

Western Burglar and Fire
Alarm Association's Position

Western Burglar and Fire Alarm Association (WBFAA) joined in by Sonitrol Telephone Assistance, opposes the granting of an immediate interim rate increase. WBFAA argues that although the Commission failed to grant any more than nominal rate relief to Pacific in Application No. 58223, in restructuring rates it, however, granted in excess of a 50 percent rate increase for private line service used by burglar and fire alarm companies. Such increases are alleged to have had a negative effect on alarm users and resulted in many having discontinued service. WBFAA argues that burglar and fire alarm service is a necessary emergency service which should be affordable to the entire population. WBFAA further argues that burglar and fire alarm services are essentially no different than the basic exchange network which has been subsidized for years.

WBFAA argues that the increases Pacific is seeking with respect to the alarm users ranging between 37 and 67 percent is unreasonable, unjust, and unconscionable. It believes that the 50 percent increase levied against the alarm users in Decision No. 90642, should be sufficient to enable Pacific to attract necessary capital and to obtain necessary credit. It recommends that Pacific's motion and application be denied.

Issues

The three issues at this stage of these proceedings are:

a. Is Pacific faced with a financial emergency sufficient to warrant interim rate relief or is there any other basis for granting a revenue increase?

b. If so, what amount of relief should Pacific be granted?

c. What rate design should be adopted to provide the necessary increase in revenues?

Discussion

Financial Emergency

Pacific, in this proceeding, claims that it is confronted with a financial emergency because of its inability to finance its constrained construction budget for 1980 without substantial rate relief. While the projected financial ratios used for financial reporting purposes indicate that earnings per share for 1980, under present rates, are estimated to be only $1.19 per share, and pre- and post-tax interest coverages 1.66 and 1.41 times, respectively, we must recognize that actions taken by Pacific, and its parent, with respect to accelerated depreciation, and the failure to issue common stock since 1973, thereby creating an unbalanced capital structure, contribute to these less than favorable figures. Also, contributing to the appearance of financial emergency is the assumption that the IRS would prevail in its assertion that the AAA, and AA ratemaking methodologies used by the Commission in Decision No. 87838 are not proper normalization methods, thereby saddling the company with substantial interest costs which aggravate the interest coverage problems of Pacific. This is demonstrated by the improved 1.84 and 1.51 pre- and post-tax interest coverages that would result if such interest liabilities did not materialize.

Although we do not agree that the claim of financial emergency has been sustained, we do agree that partial interim rate relief is in order since we are now well into the 1980 rate year, and Pacific, using staff estimates, is expected to earn only a 9.21 percent rate of return on intrastate operations in 1980 which is below the 10.25 percent return authorized in Decision No. 91121. This action is consistent with our prior decisions granting partial interim rate relief under the Regulatory Lag Plan procedure. We believe that, based on the direct testimony and cross-examination of Pacific and staff witnesses in this proceeding, the granting of partial general rate relief is in order. Such rate relief will, of course, be made subject to refund should later hearings prove that the partial general increase granted was excessive.

It should be noted that the instant proceedings are not within the filing cycle set forth in the Regulatory Lag Plan. Pacific has a 1980 construction budget that has materially increased over its 1979 budget because of customer growth and increased demand for telephone service. This circumstance led to our processing Application No. 59269. It is critical that Pacific be in a position where it can attract the large amounts of capital necessary to finance its $2.3 billion construction budget if California is to have adequate phone service for its growing population; and without this review of Pacific's 1980 results of operations, utility service could have been jeopardized. The last adopted 1979 test year results of operations have, it turns out, been shown to be not reflective of 1980's needs and requirements in that Pacific would not have come close to having the opportunity to realize the 10.21 percent rate of return which we found reasonable in December 1979 by Decision No. 91121. Pacific would have difficulty attracting needed capital for 1980 construction requirements with the 9.21 percent rate of return that would result without this partial general increase.

Amount of Interim Increase

Pacific bases its request for $336.9 million increase on a constrained outlook for 1980, and not on what it would seek in a normal rate increase filing. Pacific's figures are also developed on a decision basis (D.90642, 90919, and 91121) in order to eliminate the issue of prior ratemaking adjustments for the purpose of this proceeding although Pacific does not necessarily agree with the ratemaking adjustments in the prior decisions.

The staff, for the purposes of the interim, recommends a revenue increase of $157.8 million after making certain adjustments to Pacific's estimates. In addition, the staff further recommends that Pacific be permitted to recover approximately $70 million of maintenance, commercial and marketing expenses, and associated salary overheads which were a part of the $111 million adjustment to operating expenses made by the staff, provided Pacific filed tariffs to recover these expenses by further increasing rates in the competitive areas. The staff bases its recommendation on the ground that these excess expense levels are being increased to enable Pacific to meet the competition that exists with respect to terminal equipment and certain intercity services. The staff, therefore, recommends that recovery of these costs should be in the competitive areas, with particular attention to those services which are not now returning their full costs, namely, **intrastate private line, and vertical services.**

The staff witness in originally making adjustments for excess marketing expenses determined that in 1978 and 1979 these expenses climbed drastically over prior years due to productivity drops indirectly caused by competition. The staff considered these increases resulted from the marketing emphasis initiated in 1978 to improve Pacific's competitive position.

Staff witness Macario testified that he considered these increased marketing expenditures as legitimate expenses for ratemaking purposes, provided they are recovered from vertical competitive services rather than in non-competitive services. On cross examination witness Macario stated that even if Pacific made increased marketing expenditures which for the near term may result in a decline in rate of return, he would not consider such action to be imprudent considering the long-term picture in which competition will increase (and is increasing as various monopoly segments become deregulated). Mr. Macario concludes that as long as such expenditures are not borne by the monopoly segment of Pacific's operation they are reasonable expenditures and Pacific should be permitted to recover such increased marketing expenditures by increasing rates in competitive vertical services.

Both Mr. Moeck and Mr. Macario were cross-examined extensively as to their recommendation to initially adjust such expenditures and to subsequently restore such expenditures as a recoverable expense. In the area of marketing effort in the maintenance expense category, Mr. Macario admitted that probably the greater percentage of such increased marketing effort was directed more to the marketing of simple terminal equipment rather than the marketing of PBX, Key Telephone, Centrex, and state private line services. In the area of commercial and marketing expenses witness Macario testified that the increase in commercial and marketing expense beyond the levels that existed in a generally non-competitive era was the result of competition.

Certain parties were critical of Pacific's proposed rate design contained in Exhibit 16a, which was offered in response to the staff's proposal that $69.4 million of additional marketing expenses be recovered by raising rates for competitive vertical services. The major criticism appeared to be that the staff could not identify what portion of the additional marketing expenses related to competitive vertical services, as opposed to non-competitive vertical services, and that a substantial portion of excess maintenance expenses was geared to marketing terminal equipment in the residential market rather than in those services which the staff recommends the rates be further increased. In understanding the rationale behind this argument one must be aware that in Decision No. 90642 in Pacific's most recent rate proceeding, the Commission adopted the staff-proposed rates and charges for extensions, and premium sets which are based upon GE-100 fully allocated costs. Thus this segment of vertical services is already contributing to the overall profits of Pacific whereas other segments of vertical services offered by Pacific are still not covering the cost of providing such services. It is reasonable in such circumstance to require that rates for these services, especially those that are in the competitive area, should contribute a profit, and not burden the monopoly segment of Pacific's operations.

Although certain parties argue that no study has been made to determine whether the additional marketing expenditures will produce sufficient revenues to justify such expenditures, we do not believe that such argument should dissuade us from permitting Pacific to increase rates for competitive vertical services if, in the long run, it is management's view that such expenditures will be productive, and eventually lead to a contribution to Pacific's profits. We will therefore authorize Pacific to increase its rates by $157.8 million as recommended by staff witness Moeck, and also to increase rates for competitive vertical services by $69.4 million as recommended by Mr. Macario. We believe the $227.2 million partial general increase we are authorizing herein should enable Pacific to finance its 1980 construction budget, maintain its Single A bond ratings, and provide adequate service to the residents of the state at reasonable costs.

In connection with the $69.4 million increase in competitive vertical services, we caution Pacific that while we may authorize such rates it should be clearly understood that we are leaving it up to the judgment of Pacific's management whether to place such increases into effect. If Pacific is convinced that increased marketing expenditures are essential to meet the competition in providing vertical services, it should increase the rates for such services. In authorizing Pacific to do so, we place Pacific on notice that should such expenditures not result in corresponding offsetting revenue increases, and thereby result in a decline in the rate of return, Pacific cannot come before this Commission, and attempt to recoup such rate of return deficiency by higher rates on the monopoly segment of its operations. Both staff, and Pacific witnesses testified that increasing rates in competitive vertical services will increase competition, which we have stated in Decision No. 90642, would be desirable, and beneficial to customers.

We believe the regulatory approach of allocating expense categories that encompass competitive activity to the customers affected within Pacific's operations has desirable promise. In subsequent stages of these proceedings we expect Pacific and our staff to further analyze this approach, which, in essence, entails more refined allocation of expense from the broad expense account areas between competitive and monopoly service categories.

Rate Design

Pacific offered the only complete rate design proposal in the initial phase of these proceedings. The staff proposal was identical to Pacific's except for Message Toll service which was $8.5 million higher than Pacific's request and its Business Access Line rates were a corresponding $8.5 million lower. The staff also differed as to the priority in which the rate changes should be authorized should the Commission authorize an increase less than the full amount requested by Pacific.

The Independent Telephone Companies offered various arguments for increased toll rates varying from a minimum of $42.7 million increase recommended by the staff, General's $68 million increase for Pacific, requiring increases in toll rates so that Pacific will earn a 10.25 percent rate of return on intrastate toll operations or, better still, a 12 percent rate of return instead of the 8.4 percent rate of return estimated for 1980 on the intrastate toll operations under Pacific's proposed rate design.

We agree with the staff position that an increase in Message Toll service rates should have top priority because of the lower rates of return projected for 1980 for intrastate toll operations compared to the projected intrastate rate of return or the projected rate of return on exchange operations. By placing first priority on toll increases, it would also be the last item subject to refund should it ultimately be determined that the interim rates were excessive, and thereby making the possibility of refunding message toll revenues, which would be extremely complicated, more unlikely. We also concur with the staff priorities set forth in Exhibit No. 35 as to the balance of the rate increase relating to the $157.8 million and will basically adopt such rate design as set forth in Appendix B.

With respect to the $69.4 million additional increase in rates, we will generally adopt the proposals contained in Exhibit No. 16a, which were testified to by Pacific, as increasing competition in the area of vertical services. Appendix C sets forth the rates we will authorize with respect to the additional $69.4 million rate increase to recover increased marketing expenditures. We believe our action in allowing Pacific to recover these expenditures by increasing rates in competitive vertical services, especially where revenues from such services are not currently recovering full costs, will increase competition in these areas and which we indicated in Decision No. 90642 would be the Commission's goal.

We recognize that of the $69.4 million of expense not allowed for setting non-competitive or monopoly service rates a portion is attributible to promoting residence terminal equipment and a portion to terminal equipment used primarily in business application. However, for purposes of this interim partial general rate increase, we will allow Pacific to file tariffs (as set forth in Appendix C) to recover that amount of additional revenue primarily from business subscribers. We take this approach because many residential terminal equipment offerings were just repriced in the last general rate proceeding; further, the evidence before us indicates non-residential terminal equipment offerings are underpriced to such an extent that the $69.4 million can be readily absorbed and at the same time all competitive items, in aggregate, will still be a long way from being priced at full current cost. To ensure that none of Pacific's terminal equipment customers pay an excessive or unreasonable rate, we will require

Pacific to submit current GE-100 cost studies on the items of terminal equipment covered in Appendix C as compliance filings in these proceedings. To the extent any rate is subsequentially found to be excessive, a refund of the difference between the reasonable rate and the excessive rate will be refunded with interest.

While the WBFAA made a strong plea to exempt the alarm industry from any further increases in rates in view of the 50 percent increase imposed on the industry in Decision No. 90642, we must weigh the consequence of such request as to the burden such action would have on other ratepayers. We have, in the past, warned the alarm industry that the price for providing service to the alarm industry must be increased since such costs are being provided below cost. We are not swayed by the arguments of the alarm industry that it should be treated the same as the users of basic exchange telephone services.

The following is a summary of the gross revenues produced from the rate increases authorized herein:

Estimated Annual Revenue
Effect of Authorized Rate Changes
(Millions of Dollars)
Year 1980

Rate Change	Appendix B: Increases (a)	Appendix C Add'l Increases (b)	Total Increases (c)=(a)+(b)
<u>Message Toll Service</u>			
Increases in Message Toll Rates	$ 42.7	-	$ 42.7
<u>Optional Calling Measured Service</u>			
Increases in certain rates	.1	-	.1
<u>Terminal Equipment</u>			
Increases certain rates and charges for Centrex, PBX, Key Telephone Service, Data Terminals and other supplemental equipment	45.6	$38.2	83.8
<u>Private Line Service</u>			
Increase local loop, and non-recurring charges	15.6	-	15.6
<u>Non-Recurring Charges</u>			
Increase certain service connections, and certain installation charges	21.6	31.2	52.8
<u>Basic Exchange Rates</u>			
Business - Utility provided primary set charge	3.5	-	3.5
Residence- Utility provided primary set charge	28.7	-	28.7
Totals	$157.8	$69.4	$227.2

The Need for Further Study

In order to ensure that Pacific's competitive vertical services are adequately priced, we will require cost studies on its items of terminal equipment be prepared by Pacific for submission in later stages of these proceedings. It is reasonable to limit the studies to those items that now produce ninety-five percent of Pacific's terminal equipment revenue. The studies shall be tendered to the Commission's Communications Division on or before August 1, 1980 and Pacific shall make them available for any party requesting a copy or opportunity to inspect the studies. Although we are aware that Pacific has a multitude of competitive offerings, and that the cost analysis ordered herein will require accelerated effort on its part, this information is vital for setting rates which are in the best interests of all ratepayers, competing terminal equipment vendors, and Pacific. Pacific should confer with our staff in preparing these studies.

Staff Proposal on Second Phase

The staff in its closing argument recommended that should the Commission authorize interim rate relief in this proceeding, the second phase of this application should be consolidated with Pacific's impending NOI filing to be made some time in the first quarter of 1980. Pacific indicated it would not oppose such recommendation if Pacific was authorized to collect the full $336.9 million in increased rates on an interim basis subject to refund. Although this decision does not grant Pacific the full $336.9 million increase it is seeking in this interim order, we concur that the staff recommendation is sound. We believe we are providing Pacific with substantial rate relief in this proceeding which should clearly indicate to rating agencies, as well as investors, that we are taking positive steps to arrest the decline in various financial ratios and indicators in order to enable Pacific to obtain the necessary financing to meet its 1980 construction budget and thereby provide, maintain, and improve service to its customers.

By consolidating the second phase of this application with the NOI to be filed, we will be able to eliminate duplication of effort by Pacific, the staff, as well as intervenors, and enable the various parties to concentrate their efforts on the next general rate proceeding.

Interim Increase Subject to Refund

By allowing Pacific an interim rate increase subject to refund, we feel that the Commission's present attitude toward any future refunds that may arise should be expressed at this time.

Future refund plan hearings shall include the issue of undistributed refund disposal. We feel that the possibility of using undistributed refunds to establish a special fund for intervenors in rate case proceedings should be addressed by parties in the future.

3. Assuming an interim increase of $336.9 million effective March 1, 1980, Pacific estimates a return on average common equity for 1980 of 9.63 percent, earnings per share of $2.07 per share, and pre- and post-tax interest coverages of 2.13 and 1.65, respectively.

4. Pacific's constrained construction budget of $2.3 billion dollars for 1980 will require external financing of $1.2 billion if such construction is to be accomplished.

5. Over 80 percent of Pacific's constrained construction budget is necessary to meet expected growth and, even the 16 percent budgeted for modernization is related to growth.

6. Pacific has a Single A bond rating from both Standard & Poor's and Moody's with a possibility of downgrading unless earnings and coverages improve. Such further downgrading will make it almost impossible for Pacific to raise sufficient capital to meet its 1980 construction needs.

7. Pacific must resort to both equity and debt financing if it is to prevent further deterioration of its debt ratio and further compounding the problem of inadequate interest coverage.

8. AT&T's pronouncement that it would be willing to buy its proportionate share of a 10-million share common stock offering is a positive indication to the financial community, and should result in more favorable reception by the financial community in Pacific's future debt and equity offerings.

Findings of Fact

1. For estimated year 1980 Pacific projects an 8.04 percent rate of return on intrastate operations under present rates.

2. For financial reporting purposes, Pacific estimates its average return on common equity for 1980 at present rates will be 5.61 percent, earnings per share of $1.19 which is substantially less than the $1.40 dividend, and pre- and post-tax interest coverages of 1.66 and 1.41, respectively.

9. Using staff estimates, at present rates, Pacific will earn a 9.21 percent rate of return on intrastate operations in 1980, which is below the 10.25 percent rate of return found reasonable in Decision No. 91121.

10. Pacific's actions with respect to accelerated depreciation, investment tax credit, and failure to maintain a more balanced capital structure have contributed to Pacific's earnings and interest coverage problems.

11. Although Pacific's actions have contributed to its financing problems, it is obvious that Pacific needs rate relief if it is to finance its construction budget for 1980; however, the $336.9 million requested by Pacific is excessive for the purposes of partial general rate relief.

12. Pacific's showing meets the requirements under Resolution No. M-4706 dated June 5, 1979, which provides that utilities may request rate relief outside the scope of the Regulatory Lag Plan.

13. Under the assumptions used in Table 2 by the staff, a $157.8 million rate increase as of March 1, 1980, together with an additional $69.4 million increase in rates for competitive vertical services is estimated to provide earnings of $1.71 per share, and pre-tax interest coverage of 1.94 for estimated year 1980 on a financial reporting basis, and a 10.25 percent rate of return on intrastate operations.

14. The $227.2 million increase we find reasonable is based on the staff's adjustment to Pacific's estimates as contained in Exhibit 41, which finds a revenue requirement deficiency of $157.8 million, and the additional rate increase of $69.4 million recommended in Exhibit 42 to cover additional marketing effort to be recouped by increasing rates for competitive vertical services.

15. The additional $69.4 million increase in rates over and above the basic $157.8 million increase recommended by staff witness Moeck, will allow Pacific to be more competitive with the other providers of terminal equipment.

16. The increases in rates and charges authorized herein are reasonable for the purposes of the partial general increase, and the present rates and charges, insofar as they differ from those prescribed herein are for the immediate future unjust and unreasonable.

17. It is reasonable to place first priority on message toll service rates as such services are projected to earn a lower rate of return than Pacific expects to earn on its exchange operations.

18. It is reasonable to adopt the staff-recommended rate design priorities shown in Exhibit 35 as such rate design spreads the increase to competitive services, non-recurring charges, and reduces the revenue to cost deficiency for basic exchange services.

19. It is reasonable to spread the additional $69.4 million to recover additional marketing expenses, by increasing terminal, and non-recurring charges for those services which are not providing revenues to recover the cost of providing such services.

20. The rate design adopted in this decision will more closely match the price for service rendered to the cost of the service rendered so that each class of service will be paying the rates which will cover the fully embedded costs to render that service, with special attention to those vertical services for which Pacific has competition, using the policy consideration set forth in Decision No. 90642.

21. Basic exchange rates are residually priced and are not based upon cost.

22. The existing rates for services used by the alarm industry is below cost.

23. It is not in the public interest to exempt the alarm industry from bearing its fair share of cost for services it uses.

24. The current multi-element installation rates recover less than the cost of providing such service.

25. Residential terminal equipment rates have been revised in the last general rate proceeding.

26. Terminal equipment rates in aggregate for offerings made primarily to business subscribers are underpriced by more than $69.4 million annually on a fully allocated cost basis.

27. The $69.4 million of operating expense included in Pacific's test year showing is related to marketing competitive equipment and, together with other expenses, constitutes an abnormally high amount of expense for the purpose of setting rates on Pacific's non-competitive monopoly service.

28. There is the need for Pacific to increase its common equity ratio, and while we do not believe that it is necessary to require Pacific to issue $300 million of additional common stock in 1980 as a condition of this order, Pacific should issue, in addition to the 10 million share offering announced in its press release Exhibit 54, as many additional shares as it can sell. If Pacific does not achieve a reasonable capital structure of 50 percent debt and 50 percent equity, such a capital structure can be imputed for ratemaking purposes.

29. Rate relief in the amount of $227.2 million falls within the guidelines set forth by the President's Council on Wage and Price Stability.

30. Because there is an immediate need for rate relief in 1980, the following order should be made effective the date hereof.

Conclusion of Law

Partial general rate relief should be granted subject to refund in the amount of $227.2 million for intrastate operations. Based on the staff's estimate of revenues, expenses, and rate base, such revenue increase will enable Pacific to earn the 10.25 percent rate of return authorized by this Commission, and more importantly, enable Pacific to finance its 1980 budget of $1.2 billion, and the rates which we authorize in this decision are just and reasonable.

INTERIM ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company (Pacific) is authorized to file with this Commission, 15 days after the effective date of this order, in conformity with the provisions of General Order 96-A, revised tariff schedules with rates, charges, and conditions modified as set forth in Appendices B and C. The effective date of the revised tariff sheets shall be five days after the date of filing. The revised tariff schedules shall apply to service rendered on,and after the effective date of the revised schedules,and the charges shall be collected subject to refund pending final determination with respect to the reasonableness of the interim rates in Pacific's next general rate increase proceeding using a 1981 test year.

2. The rates authorized in this decision shall be subject to refund upon further order of the Commission.

3. Interest on amounts subject to refund shall be computed by applying the Federal Reserve Board Commercial Paper Rate, 3-Month Prime, published monthly in Federal Reserve Board Statistical Release G-13 with monthly compounding.

4. Within 90 days Pacific shall prepare,and file a costing study and recommended rates, and charges for each terminal equipment item increased in Appendix C using a 15 percent return factor. On any items where the authorized rates, and charges in Appendix C exceed indicated costs, those rates, and charges shall be reduced within 30 days by tariff filings, and refunds paid to affected customers back to date of effectiveness of the rates, and charges in Appendix C. The costing study shall be filed as a compliance filing in these proceedings and available for public inspection.

5. By August 1, 1980 Pacific shall prepare and submit to the Communications Division costing studies using a 15 percent return factor, and recommended rates, and charges on items not included in the studies required in Ordering Paragraph 4 above. Such studies shall be made only on items of terminal equipment that provide significant revenue (on the items, excluding Centrex, and single line instruments, that produce in the aggregate 95 percent of terminal equipment annual revenue), and shall be on items that have not been repriced since October 1, 1979. Such studies shall be made after consultation with the Commission staff. These costing studies shall be made available by Pacific to any party desiring to inspect such studies or their underlying work papers.

6. Further evidentiary hearings on this application will be deferred and combined with the hearings to be held relating to the general rate increase application The Pacific Telephone and Telegraph Company will file using a 1981 test year under the NOI procedure. We will determine after those hearings whether the interim rates authorized herein are excessive as well as determining the level of rates Pacific should be authorized based on test year 1981.

7. Pacific shall place advertisements in newspapers of general circulation that detail the rate increases authorized herein, at least 10 days prior to the effective date of the rates.

The effective date of this order is the date hereof.

Dated APR 2 1980, at San Francisco, California.

John E. Bryson
President

Vernon L. Sturgeon

Richard D. Gravelle

Leonard M. Grimes, Jr.
Commissioners

Commissioner Claire T. Dedrick, being necessarily absent, did not participate in the disposition of this proceeding.

APPENDIX A

LIST OF APPEARANCES

Applicant and Respondent: James S. Hamasaki, Diane B. Prescott, and Christopher L. Rasmussen, Attorneys at Law, for The Pacific Telephone and Telegraph Company.

Respondents: Dinkelspiel, Pelavin, Steefel & Levitt, by Alvin H. Pelavin, and Douglas P. Ley, 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, Livingston Telephone Company, Mariposa Telephone Company, The Ponderosa Telephone Company, Sierra Telephone Company, Inc., The Siskiyou Telephone Company, and Volcano Telephone Company.

Protestants: Richard S. Kopf, and Jose E. Guzman, Jr., Attorneys at Law, for Southern Pacific Communications Company; Paul M. Hogan, Attorney at Law, for Sonitrol Telephone Assistance; Margaret M. Dowling, for herself; William L. Knecht, Attorney at Law, for Telephone Users' League.

Interested Parties: A. M. Hart, H. Ralph Snyder, and Dale W. Johnson, Attorneys at Law, by Dale W. Johnson, for General Telephone Company of California; Orrick, Herrington, Rowley & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Continental Telephone Company of California; Robert Winchester, for Continental Telephone Company of California; Roger R. Bruhn, for the Regents of the University of California; John L. Mathews, Western Area Chief Counsel, Regulatory Law, General Services Administration, for Executive Agencies of the United States, Allie B. Latimer, General Counsel, and Spence W. Perry, Assistant General Counsel Regulatory Law; William L. Knecht, Attorney at Law, for California Interconnect Association and Parts Locator, Inc.; Gold, Herscher, Marks & Pepper, by Alan L. Pepper, Attorney at Law, for the Western Burglas & Fire Alarm Association; Robert S. Lukenbill, for the County of Los Angeles; Edward M. Goebel, Attorney at Law, for Toward Utility Rate Normalization, (TURN); Leonard L. Snaider, Deputy City Attorney, for the City and County of San Francisco, and City Attorney, George Agnost; William Shaffran, Deputy City Attorney, for the City of San Diego, and John Witt, City Attorney; Ed Perez, Deputy City Attorney, for the City of Los Angeles, and Burt Pines, City Attorney; Sidney J. Webb, for himself; Allen R. Crown, for the California Farm Bureau Federation; Bob Ringman, for California Independent Telephone Association; and James G. Shields, for himself.

Commission Staff; Timothy E. Treacy, Attorney at Law, Robert C. Moeck, Ermet Macario, Thomas Lew, and James Pretti.

RATES AND CHARGES

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

Schedules Cal. P.U.C. Nos. 4-T, 34-T, 80-T, 117-T - Primary Instrument Charge.

The following revision is authorized:

Rate does not include a utility provided non-key, single-line standard rotary dial telephone set. An additional standard rotary dial, single-line telephone rate of $.60 will apply for a utility provided set.

Schedules Cal. P.U.C. Nos. 12-T, 22-T, 24-T, 32-T, 46-T, 50-T, 83-T, 100-T, 117-T, 121-T, 135-T and 144-T - Terminal Equipment Rates and Charges.

Proposed revisions as set forth in Exhibit No. 16, pages 11 through and including page 24.

Schedules Cal. P.U.C. Nos. 45-T, 46-T, 51-T, 104-T, 115-T, 122-T, 134-T and 139-T - Private Line Services and Channels.

Proposed revisions as set forth in Exhibit No. 16-A, pages 27 through and including page 35.

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

Proposed revisions as set forth in Exhibit No. 16, page 26.

Schedule Cal. P.U.C. No. 30-T, Toll Terminal Service.

Proposed revisions as set forth in Exhibit No. 16, page 6.

Schedule Cal. P.U.C. No. 53-T - Message Toll Service.

The following revisions are authorized:

APPENDIX B

RATES AND CHARGES

	Initial Period Station (Sent Paid)		Each Additional Minute
	DIAL ϕ	COIN +	ALL CLASSES OF SERVICE
RATE MILEAGE	1-Minute DAY RATE	3-Minute ALL DAYS/ HOURS	
0- 8	$0.11	$0.20	$0.06
9- 12	.11	.20	.06
13- 16	.14	.30	.08
17- 20	.17	.40	.11
21- 25	.20	.50	.13
26- 30	.23	.60	.14
31- 40	.26	.70	.16
41- 50	.30	.85	.20
51- 70	.34	.95	.24
71- 90	.36	1.05	.26
91-110	.39	1.15	.28
111-130	.42	1.25	.31
131-150	.45	1.35	.33
151-170	.46	1.45	.34
171-195	.48	1.55	.35
196-220	.50	1.65	.36
221-245	.52	1.80	.37
Over 245	.54	1.95	.38

ϕ Operator Assisted Messages: In addition to the DIAL computed charge, the following surcharges are applicable per message for operator assistance:

Station $0.55
Person $1.55

\+ Coin Messages: On person messages paid for at a coin box, add $1.55 to the charges computed on a Station basis.

Schedule Cal. P.U.C. No. 149-T-Optional Calling Measured Service.

The following revisions are authorized:

Service Area Rate Group	Service Offerings Rate Mileages	USOC	Rate Per Service: Each Exchange or District Area Selected — Monthly Time Allowance: One Hour	Two Hours	Three Hours	Overtime Rate Per Minute Over Allowance
I	9-12¢	TBX++	$ 1.65	$ 3.30	$ 4.95	.06
II	13-16	TDX++	2.10	4.20	6.30	.08
III	17-20	TFX++	2.55	5.10	7.65	.11
IV	21-25	TGX++	3.00	6.00	9.00	.13
V	26-30	THX++	3.45	6.90	10.35	.14
VI	31-40	TJX++	3.90	7.80	11.70	.16

APPENDIX C

RATES AND CHARGES

Appendix C as herein authorized supplements Appendix B as detailed below:

The rates and charges of The Pacific Telephone and Telegraph Company are changed as follows:

Schedules Cal. P.U.C. Nos. 12-T, 22-T, 24-T, 32-T, 46-T, 50-T, 83-T, 100-T, 117-T, 121-T, 135-T, and 144-T - Terminal Equipment Rates and Charges.

Proposed revisions as set forth in Exhibit No. 16-A, pages 11 through and including page 24.

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

The following increases are authorized:

1. Section I Service Connection Charges
   All charges listed - 25%
2. Section II Move and Change Charges
   All charges listed - 25%
3. Section III In Place Connection Charges
   All charges listed - 25%

These revisions are in addition to those shown in Appendix B.

Schedule Cal. P.U.C. Nos. 12-T, 26-T and 100-T - Non-Recurring Charges

Proposed revisions as set forth in Exhibit No. 16-A, page 26B. These revisions are in addition to those shown in Appendix B.