Decision No. 92804 MAR 17 1981 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of CONTINENTAL TELEPHONE COMPANY OF CALIFORNIA, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 59936
(Filed September 15, 1980)

Orrick, Herrington, Rowley & Sutcliffe, by Robert J. Gloistein and James F. Crafts, Jr., Attorneys at Law, for applicant.

Antone S. Bulich, Jr., Glen J. Sullivan, and Allen R. Crown, Attorneys at Law, for California Farm Bureau Federation; Warren A. Palmer and Michael F. Willoughby, Attorneys at Law, for Cal-Autofone, Radio Electronics Products Corporation, Desert Mobilfone, and Industrial Communication Systems; and William Knecht, Attorney at Law, for California Interconnect Association; interested parties.

James T. Quinn, Edward W. O'Neill, Attorneys at Law, and Thomas Lew, for the Commission staff.

# INDEX

OPINION

By this application, Continental Telephone Company of California (Continental) seeks an increase in gross revenues of approximately $18,308,000 from present rates, comprised of $12,157,000 in local service revenue increases (after uncollectibles), $5,061,000 in anticipated settlement effects of intrastate toll rate increases proposed by The Pacific Telephone and Telegraph Company (Pacific) in pending Application No. 59849, as well as an additional $1,090,000 from increased service connection charges[1/] (originally estimated by Continental as $1,036,000). This total of $18,308,000 would produce a 12.46 percent rate of return on intrastate rate base and a return on equity of 16.5 percent.

After due notice, prehearing conferences were held before Administrative Law Judge (ALJ) William A. Turkish on September 30 and December 9, 1980 in San Francisco and public witness hearings were held on October 28 in Mammoth Lakes, October 29 in Victorville, November 5 in Sanger, and November 6, 1980 in Manteca. In all, 34 public witnesses testified with respect to Continental's application. The Commission staff, after examination of Continental's application and its own independent study and analysis of company records, prepared and distributed its own reports and recommendations to all parties on December 2, 1980.

1/ Authorized by Commission Resolution No. T-10296 effective July 1980.

At the second prehearing conference held on December 9, 1980, Continental indicated that it was prepared to accept the staff's recommendations and submit the application on an agreed statement of the case if the staff would agree to update its estimates of toll settlements and if some assurance could be given that a final decision could be issued in the matter on or before April 1, 1981.

The staff expressed no objection to updating its estimate of the settlement revenues to reflect more recent information, which was not available at the time the initial staff reports were prepared, if Continental agreed to the remainder of the staff recommendations on the basis set forth hereinafter. The ALJ directed the parties to submit their proposed agreement in writing and to circulate the proposed agreement to all parties of record who would then have the opportunity to comment on or to examine any witnesses they may desire to present or to cross-examine on January 7, 1981. The proceeding could then be submitted on the basis of the public witness testimony, the stipulated agreement of Continental and the staff, Continental's and the staff's reports, and any additional evidence introduced January 7, 1981. The ALJ, after consultation with the assigned Commissioner, agreed to prepare a draft decision for Commission consideration on or before April 1, 1981.

On December 19, 1980, the staff prepared and distributed revisions (Exhibit 29) to its previously prepared reports showing the effects of a lower intrastate settlement ratio and the use of the staff-recommended 11.34 percent rate of return for affiliate adjustments.

On January 7, 1981, Continental introduced and submitted Exhibits 1-18 into evidence, the staff introduced and submitted Exhibits 19-29, and they jointly introduced and submitted Exhibits 30 and 31. Exhibit 30 is an agreed statement of the case as originally prepared and distributed to the parties and Exhibit 31 is the final version of the agreed statement of the case, modified slightly, and stipulated to by Continental and the staff. Continental examined one of its witnesses to explain and sponsor Exhibit 18 after which the matter was submitted.

SUMMARY OF DECISION

On September 15, 1980, Continental filed an application to increase its rates by approximately $18.3 million annually so as to produce a 12.46 percent return on intrastate rate base and a 16.5 percent return on equity for a 1981 test year. Public hearings were held throughout the service area, and the primary issue aired at these hearings was the quality of telephone service. At the second prehearing conference, on December 9, 1980, Continental indicated that it was prepared to stipulate to the Commission staff showing if the staff would agree to update its estimate of toll settlements and in the hope that a final decision would be issued by April 1, 1981. The staff agreed to this stipulation. The decision authorizes an increase of $10,076,000 of which $1,090,000 in increased service connection charges has already been authorized by Commission Resolution No. T-10296 effective July 30, 1980. The authorized return on equity is 14.5 percent, which is in line with that authorized in other recent Commission decisions, and it will result in a rate of return on rate base of 11.34 percent. Such a rate of return will provide an approximate 2.53 times interest coverage after taxes.

It was agreed by Continental and the staff that this increased revenue requirement should be spread so as to eliminate any subsidy of Continental's competitive offerings and to avoid burdening basic exchange customers with any unrecovered costs associated with optional service offerings. Rates and charges for competitive terminal equipment and for optional equipment and services are revised to recover their full cost. The balance of the increased revenue requirement authorized by the Commission is generated through increased rates for basic exchange service. The base rate for one-party flat rate residence service is raised $2.00 from $5.00 to $7.00 per month, and for business from $12.80

to $17.50. The instrument charge of $1.00 per month is added to these new rates if the customer uses a utility-provided telephone instrument. The table below sets forth the new monthly rate and percent increase for basic exchange service for various categories of service.

Schedule No. A-1 - Network Access Line Service

The following rates are authorized:

| | Monthly Rate | % Increase |
|---|---|---|
| Residence | | |
| One-party | $7.00 | 40 |
| Two-party | 5.90 | 53 |
| Four-party | 5.90 | 69 |
| Multiparty | 5.40 | 40 |
| Multiline | 12.00 | 140 |
| Keyline | 12.00 | 33 |
| siness | | |
| One-party | 17.50 | 37 |
| Two-party | 15.00 | 49 |
| Four-party | 15.00 | 49 |
| Multiparty | 13.50 | 34 |
| Multiline | 29.00 | 127 |
| Keyline | 29.00 | 67 |
| PBX trunk | 29.00 | 5 |
| Semipublic | 17.50 | 525* |

*While this increase may appear disproportionately large, it should be noted that the line and instrument rate together for semipublic service is only increased 163 percent. The line rate alone bears the entire increase because the line rate is being revised to the level of one-party business service.

The service problems in the Victor Valley are due to central office equipment shortages. However, it is evident that a significant amount of the company's construction budget (approximately $55 million in 1980 and $60 million in 1981) has been allocated to address and rectify these problems by installations of modern digital switching systems and a considerable augmentation of the long distance trunks. The company will be directed to report monthly on its rate of progress in improving subscribers' service. Continental is also directed to submit economic studies to reflect the effects of future implementation of measured local service and directory assistance charging.

PUBLIC WITNESS STATEMENTS AND TESTIMONY

One day of public hearings each was held in Mammoth Lakes, Victorville, Manteca, and Sanger to provide Continental's customers with an opportunity to comment on the rate increase application. A total of 34 people gave either statements or testimony. At the hearing in Victorville, 24 customers elected to make statements and they all opposed the rate increases. The remainder of the 34 appeared in the three other locations and most of them spoke against the application.

At the Victorville hearing, most of those making statements concerning service problems were residents of the nearby communities of Hesperia and Apple Valley with at least one resident from Victorville itself and from the surrounding areas of Phelan, Big Bear Lake, and Newberry Springs.

The service problems encountered by most can be summarized as follows:

Unable to get dial tone at times.

Unable to get operator because of constant busy signal.

Inability to dial long distance direct.

Noise or dial tone on line during conversations.

Incorrect billing of long distance calls.

Inoperative telephone.

Difficulty getting repair service.

Phone installation delays.

Telephone employees' attitude to customers.

Interrupted service in middle of call.

In addition to the public witnesses who appeared at these hearings, approximately 11 individual letters plus letter petitions containing 14 signatures of customers from Independence, 85 signatures of customers in the Farmington area, 15 signatures of customers in Covelo, and 34 signatures of customers in the Victor Valley area were received by the Commission and have been made a part of the formal file in this matter. In general, the letters were opposed to the application and voiced the same concerns that the public witnesses expressed. We have considered all of these concerns along with the quality-of-service reports prepared by the staff. We are requiring frequent reporting on service quality by Continental to ensure that steps undertaken by Continental to solve service problems are effective.

Continental responded at these hearings to all or most of the public comments and was directed by the ALJ to investigate each complaint, to issue a written response to each public witness, and to submit a report to the Commission regarding the service problems expressed at these hearings.

## CONTINENTAL'S PRESENT OPERATIONS

Continental is a subsidiary of Continental Telephone Corporation (CTC) which owns approximately 99 percent of its common equity. It owns and operates a total of 110 central offices, 100 of which are scattered throughout California. Its sparsely settled serving areas are comprised primarily of rural agriculture, desolate desert, rugged mountains, and recreational areas. It operates in 28 of California's 58 counties, with a density of approximately 14 telephones per square mile, which compares to over 300 per square mile for Pacific and over 375 per square mile for General Telephone Company of California (General).

The application alleges the requested increases are essential to provide Continental the financial strength to obtain the significant amount of capital required in 1981 and the following years, and to refinance $25 million of bonds by January 1982, as well as to allow it to earn a reasonable return on its capital. Because of these financing requirements, Continental expects its embedded cost of debt in test year 1981 to increase from 7.15 percent in 1979 to at least 9.25 percent, or a 29 percent increase. According to Continental, the rate increases sought are necessary to maintain Continental's financial health and interest coverage to assure a continued "A" bond rating, which will produce lower interest costs for the benefit of Continental's customers. Equally as important, Continental maintains that the requested rate increases are necessary to allow it to continue to meet increased customer growth and to improve the level of service to all customers.

STIPULATED AGREEMENT

Continental has agreed to accept the staff's reports and recommendations (Exhibits 19-29). Although Continental disagrees with a number of ratemaking issues, estimates, and recommendations contained in the staff reports, it agrees to forego contesting these issues in this proceeding in the expectation of receiving rate relief substantially earlier in the test year than would otherwise be possible under the Regulatory Lag Plan (RLP) procedure. This is Continental's first application under the RLP. The application was filed on the basis of a 1981 test year. Under the RLP, Continental will not apply for general rate relief until 1982 for test year 1983. Continental will have to obtain rate relief as early as possible in the 1981 test year to have any realistic opportunity to earn its authorized return during this period, as is contemplated by the RLP. Continental states it has balanced the benefits of an early decision against the possibility that it might demonstrate a need for greater revenues after full litigation of all the issues, but receive a decision within the normal RLP time schedule on or about September 15, 1981. In addition, Continental feels that an early decision pursuant to an agreed statement would save Continental time, expense, and commitment of personnel which protracted hearings and briefs would entail.

It is understood among the parties that in agreeing to the Agreed Statement of the Case, Continental, for the purposes of this proceeding only and for the reasons noted above, will forego contesting issues raised by the staff's reports, on which Continental has disagreed in the past and continues to disagree. Continental reserves the right, however, to litigate these points of disagreement in future applications. Lastly, Continental's agreement to the Agreed Statement of the Case is contingent upon the assurance that a draft decision in this matter will be before the Commission on or before April 1, 1981.

The staff, recognizing Continental's legitimate interest in obtaining rate relief early in the test year, welcomes the opportunity to present its recommendations to the Commission on a stipulated basis thereby saving the time, expense, and commitment of personnel which full evidentiary hearings and briefing would require. The staff had no objection to updating its estimate of toll settlement revenue to reflect recent information which was not available at the time the initial staff reports were prepared. Such revisions to the staff recommendations reflecting this reevaluation of settlement revenue has been distributed, received into evidence (Exhibit 29), and is incorporated in the Agreed Statement of the Case which follows.

Summary of Stipulated Results

In this application, Continental requested an increase of $12,157,000 in local intrastate service revenues to produce a rate of return on rate base of 12.46 percent and 16.50 percent on common equity. The staff has recommended that Continental's 9.05 percent intrastate rate of return at present rates be increased to 11.34 percent, and 14.5 percent on common equity, through an increase in revenues of $10,076,000.

The staff's estimates of operating revenues are lower than Continental's by $5,026,000 (3.8 percent) due to more recent data which indicates slower growth in local revenues and settlement effects of lower staff estimates of expenses and investment.

Maintenance expense estimates of the staff are lower than Continental's by $1,226,000 (4.6 percent) as a result of lower staff estimates of costs per pole, growth in aerial cable mileage, and costs of repairing station equipment.

Traffic expense estimates of the staff are $170,000 (1.3 percent) lower than Continental's, reflecting the staff estimates of a more rapid decline in operator supervision expenses as a result of increased operator service mechanization.

The staff used later data than Continental to estimate commercial expenses and applied a different method of evaluation. The resulting estimate is $369,000 (4.3 percent) lower than Continental's.

General office salaries and expenses of the staff are $593,000 (5.8 percent) lower, reflecting the staff's opinion that Continental has not adequately justified increased amounts budgeted for 1981 over present recorded expenses.

The staff estimates of other operating expenses are lower by $870,000 (8.9 percent) as a result of adjustments for insurance premium rebates and license contract expenses.

The staff proposed additional affiliate adjustments of $257,000 in expenses and $2,759,000 in rate base primarily to reflect a reduction in earnings of affiliates to the 11.34 percent rate of return recommended by the staff.

The staff's estimates of taxes other than income are $870,000 (13.4 percent) lower than Continental's due to the staff's recognition of the lower market value determination for ad valorem taxes issued by the State Board of Equalization.

Differences in income tax estimates are primarily due to differences in Continental's and the staff's estimates of various expenses and capital costs. The staff has, however, recommended that a $4,288,733 tax deduction found acceptable by the Internal Revenue Service be amortized over 10 years, resulting in a $429,000 test-year effect.

The staff has assumed an effective incremental California corporate franchise tax rate of 1.90 percent which reduces the net-to-gross multiplier to 1.90 and consequently reduces Continental's gross revenue requirement by approximately $700,000. Continental used the statutory incremental California corporate franchise tax rate of 9.6 percent and a net-to-gross multiplier of 2.06.

The staff has excluded $7.4 million of construction work in progress (CWIP) from rate base which Continental proposed to include. An additional adjustment of $695,000 to rate base was recommended by the staff on grounds that, to date, it has not been adequately justified.

The staff's recommended rate of return on rate base of 11.34 percent is designed to produce rate of return on common equity of 14.5 percent, based on capital ratios of 45 percent common equity, 50 percent long-term debt (with an embedded cost of 8.96 percent), and 5 percent preferred stock (with an embedded cost of 6.66 percent). This return is estimated to produce an after-tax interest coverage of 2.53x.

A more detailed examination and comparison of the agreed summary of results follows.

RATE OF RETURN

The following tabulation compares Continental's requested rate of return with the rate of return recommended by the staff together with the respective capital component costs:

Continental's Requested Rate of Return

| Component | Capitalization Ratios | Cost | Weighted Cost |
|---|---|---|---|
| Long-term Debt | 50.0% | 9.25% | 4.63% |
| Preferred Stock | 5.0 | 8.06 | .40 |
| Common Equity | 45.0 | 16.50 | 7.43 |
| Total | 100.0% | | 12.46% |

Staff's Recommended Rate of Return

| | | | |
|---|---|---|---|
| Long-Term Debt | 50.0% | 8.96% | 4.48% |
| Preferred Stock | 5.0 | 6.66 | .33 |
| Common Equity | 45.0 | 14.50 | 6.53 |
| Total | 100.0% | | 11.34% |

The staff used the same capital structure as Continental for rate of return purposes. The difference in the cost factors for long-term debt and preferred stock result from the staff's estimate of Continental's 1981 capital requirements. The staff projects $15 million less long-term debt financing and $5 million less preferred stock issuances in 1981. Continental requests a common equity return of 16.50 percent whereas the staff recommends a common equity return of 14.50 percent.

We will adopt the staff's recommended return on equity of 14.50 percent as reasonable, recognizing that Continental has some service problems and will be making capital expenditures in the near future aimed at correcting those service deficiencies. This return is amply adequate to attract capital at a reasonable cost and not impair the credit of Continental. This return translates to a rate of return of 11.34 percent which provides an approximate times interest coverage after income taxes of 2.53 times for debt and a combined coverage factor for all interest and preferred dividend coverage of 2.36 times.

This return is also adopted with the requirement that any increase in intrastate toll of EAS settlement revenues which might result from a decision in Pacific's Application No. 59849 will be reflected in a billing surcharge reduction. It is not our intent here to authorize a return which might be substantially exceeded due to increases in revenues resulting from other proceedings.

We recognize that a return on equity of 14.50 percent is somewhat higher than the 14.10 percent we recently found reasonable for General in Decision No. 92366 in Application No. 59132; however, we must point out that Continental is a full flow-through company, whereas General normalizes and further, that Continental has a greater percentage of overall revenues coming from toll revenues which can fluctuate substantially. These two factors tend to make Continental a more risky company and accordingly to justify our authorization of a higher return on equity.

## OPERATING REVENUES

General Information

Continental derives revenues from local, toll, and miscellaneous services. An amount for uncollectible revenues is subtracted from the gross revenue amount to obtain net total operating revenues.

Continental's test year revenue estimates, except for toll and extended area service (EAS) revenues which are determined by settlement procedures, were arrived at by a bottoms-up type of budgeting process. The estimates were based on forecasted station growth and historical revenue trends. The base period of recorded data relied upon was from June 1978 through February 1979. The staff, in determining the reasonableness of Continental's estimates or in developing an independent forecast, reviewed essentially the same data as Continental, except that the staff had more recent recorded data to analyze. The staff used historical data from January 1978 through June 1980, and its test year revenue estimates were also based on forecasted station growth and projections of historical trends. EAS and toll revenues were also separately determined via the settlement process.

TOTAL OPERATING REVENUES

At present rates, Continental's estimate for total operating revenues of $135,791,000 exceeds the staff's estimate of $130,765,000 by $5,026,000, or 3.8 percent. These revenues are derived from local service revenues, toll service revenues, and miscellaneous revenues less uncollectible revenue.

Local Service Revenues

Local service revenues consist of subscriber station revenues, public telephone revenues, service station revenues, local private line revenues, and other local service revenues. One category of local service revenues is derived via settlements. This category is called EAS revenues, but is identified for accounting purposes as other local service revenues. Continental receives its separated cost of providing EAS plus a return on its investment allocated to this service from Pacific. These EAS settlement monies are determined similarly to toll settlement revenues described hereinafter. The staff's estimate of $31,459,000 for local service revenues at present rates is less than Continental's estimate of $32,876,000 by $1,417,000, or 4.5 percent. This difference is due to differences in estimates for subscriber station revenues and EAS revenues.

The staff's estimate of $29,281,000 for subscriber station revenues is less than Continental's estimate of $30,623,000 by $1,342,000. This difference reflects the 16 additional months of more recent recorded data available to the staff in making its estimate. This later data indicated that Continental's estimate was optimistic.

The staff's estimate of $1,252,000 for other local service revenues is less than Continental's estimate of $1,327,000 by $75,000. This difference is due to the staff's lower estimate of expenses and investment allocated to this service for EAS settlement revenue.

<u>Toll Service Revenues</u>

These revenues consist of message toll revenues and toll private line revenues. Each of these categories is comprised of interstate and intrastate portions. Continental's estimates for these revenues are based on monies estimated to be received via a statewide settlement process administered by Pacific and participated in by all California independent telephone companies. This statewide settlement process is similar to the nationwide Bell system's "Division of Revenues" method whereby each utility receives its separated costs of providing toll service plus a return on its investment allocated to toll services. This return element, determined by Pacific, is common for all participating companies and is known as the settlement ratio. Different settlement ratios are determined and used for the interstate toll portion and the intrastate toll portion. The costs and investment are allocated to the various classes of service categories by a procedure known as "Telephone Costs Separations" set out in the Federal Communications Commission's (FCC) Rules and Regulations.

Continental followed these procedures, in part, in determining its estimated separation factors and settlement ratios, and the staff, after reviewing Continental's work papers, accepted them as reasonable. The staff then used the same procedures in arriving at its toll revenue estimates for the test year based on other staff members' estimates of expenses and investments.

The staff's estimate of $91,543,000 for message toll revenues is less than Continental's estimate of $95,207,000 by $3,664,000. The difference is due to the staff's lower estimate of expenses and investment allocated to the interstate and intrastate portions of the message toll revenue category.

The staff's estimate of $4,546,000 for toll private line revenues is less than Continental's estimate of $4,675,000 by $129,000. This difference is due to the staff's lower estimate of expenses and investment allocated to the interstate and intrastate portions of the toll private line revenue category. The staff's estimate for total toll revenues is 3.9 percent less than Continental's.

The staff recommended instituting a billing surcharge with which to reflect any increase in intrastate toll or EAS settlement revenues which might result from a decision in Pacific's Application No. 59849. In the Agreed Statement of the Case (Exhibit 30) both Continental and staff agreed to defer that issue to OII 81 (consolidated with Application No. 59849) wherein the matter would be fully considered and decided and to which all telephone companies are respondents.

Notwithstanding the agreement of the parties, we believe it appropriate to resolve the issue in this proceeding and accordingly will adopt a billing surcharge to reflect any increase or decrease in intrastate toll or EAS settlement revenues which may result from our decision in Pacific's Application No. 59849.

Miscellaneous Revenues

Miscellaneous revenues consist of telegraph commission revenues, directory advertising revenues, rent revenues, general services and licenses revenues, and other revenues. The staff's estimate of $4,044,000 is more than Continental's estimate of $3,836,000 by $208,000, or 5.1 percent. The staff's and Continental's estimates differ for directory advertising revenues. The staff's estimate of $3,662,000 for directory advertising revenues is greater than Continental's estimate of $3,454,000 by $208,000. This difference reflects the additional 16 months of more recent recorded data available to the staff in making its estimate. This later data indicated that Continental's estimate was conservative.

Uncollectible Revenues

Continental arrived at its uncollectible revenue estimate by determining an historical relationship with local service revenues only and applying this relationship to its test year estimate for local service revenues. The staff determined an historical relationship between uncollectible revenues and total gross operating revenues and used this ratio to determine its test year estimate based on total operating revenues, not just local service revenues.

The staff's estimate of $827,000 for uncollectible revenues is greater than Continental's estimate of $803,000 by $24,000, or 2.9 percent. The reason for this difference is the staff had more recent recorded data on which to base its estimate. This later data indicated that Continental's estimate was conservative.

A comparison between the staff and Continental of test year revenue estimates for individual accounts is presented in Table I.

TABLE I

Continental Telephone Company of California
California Operations

COMPARISON OF OPERATING REVENUES AT PRESENT RATES

Test Year 1981

| Item | Staff | Continental | Continental Exceeds Staff Amount | Continental Exceeds Staff Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Local Service Revenues | | | | |
| Subscriber Station Rev. | $ 29,281 | $ 30,623 | $1,342 | 4.6 |
| Public Telephone Rev. | 609 | 609 | 0 | 0.0 |
| Service Station Rev. | 5 | 5 | 0 | 0.0 |
| Local Private Line Rev. | 312 | 312 | 0 | 0.0 |
| Other Local Rev. | 1,252 | 1,327 | 75 | 6.0 |
| Subtotal | 31,459 | 32,876 | 1,417 | 4.5 |
| Toll Service Revenues | | | | |
| Message Toll Rev. | 91,543 | 95,207 | 3,664 | 4.0 |
| Toll Private Line Rev. | 4,546 | 4,675 | 129 | 2.8 |
| Subtotal | 96,089 | 99,882 | 3,793 | 3.9 |
| Miscellaneous Revenues | | | | |
| Telegraph Commission Rev. | 4 | 4 | 0 | 0.0 |
| Directory Advertising Rev. | 3,662 | 3,454 | (208) | (5.7) |
| Rent Revenue | 106 | 106 | 0 | 0.0 |
| General Services & Licenses Rev. | 262 | 262 | 0 | 0.0 |
| Other Operating Rev. | 10 | 10 | 0 | 0.0 |
| Subtotal | 4,044 | 3,836 | (208) | (5.1) |
| Total Gross Operating Rev. | 131,592 | 136,594 | 5,002 | 3.8 |
| Uncollectible Rev. | 827 | 803 | (24) | 2.9 |
| Total Net Operating Rev. | $130,765 | $135,791 | $5,026 | 3.8 |

(Red Figure)

# OPERATING EXPENSES

## Maintenance Expenses

Maintenance expenses consist primarily of salaries, wages, administrative costs, and material purchases or subcontracting involved in the repair or upkeep, rearrangements, or station moves and changes in existing plant as contrasted to new construction. Maintenance costs are expensed rather than capitalized as are most construction costs. Maintenance expense includes the repair and replacement of wire, cables, and poles in the outside plant up to the customer's terminal, central office repair, and rearrangements or modification and the numerous "moves and changes" of company-owned station equipment either replaced or relocated on the customer's premises. The response to trouble reports and work necessary to locate and clear them is also a maintenance expense.

Continental's development of its operating budget, of which estimated maintenance expenses are a part, is predicated on the philosophy that operating revenues and expenditures will be planned and controlled by the many people presumably able to effect direct control over them. Thus, estimates are the responsibility of the local managers and their subordinates based upon their judgment and as approved by various supervisors in higher management, subject to planning and fiscal restraints.

This "bottoms-up" budget method gives much discretion to the local manager. The staff, not being able to look into the mind of each person making these managerial judgments, based its estimate on trends determined by review of past recorded expenses and trended to the 1980-81 period with final judgment for 1981 based upon consistency with trend line and consideration of data obtained in reviewing detailed records, field trips, and effect of growth in usage on utility planning or methods.

Account 602.1, Repair of Pole Lines, was estimated by the staff by trending the declining maintenance cost per pole and applying this unit cost to an estimate of the number of poles. The staff estimate for this account is $313,000 which is lower than Continental's estimate of $440,000 by $127,000, or 40.6 percent.

The staff estimate for Account 602.2, Repair of Aerial Cable, of $2,560,000 is lower than Continental's estimate of $2,748,000 by $188,000, or 7.3 percent. The staff's estimate was arrived at by developing a trended maintenance cost per mile and applying it to current estimates of mileage for the test year. According to the staff report, current growth in mileage has been slow.

In Account 605, Repair of Station Equipment, the staff trended the dollar expense in this account as $8,200,000 compared to Continental's estimate of $9,111,000, for a difference of $911,000, or 11.1 percent. Since there may be a trend to some customer-owned station equipment, the staff believes the maintenance of station equipment may decrease in 1981 and beyond.

In all other maintenance expense accounts, the staff's estimates either were the same as Continental's estimates or were at or below trended historical values, and were accepted by the staff. In the total maintenance expense, the staff estimate of $26,650,000 is lower than Continental's estimate of $27,876,000 by $1,226,000, or 4.6 percent. The staff and Continental estimates of maintenance expenses by major FCC accounts for the test year are shown and compared in Table II.

TABLE II

Continental Telephone Company of California
California Operations

COMPARISON OF MAINTENANCE EXPENSES
Test Year 1981

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff Amount | Continental Exceeds Staff Percent |
|---|---|---|---|---|---|
| | | (Dollars in Thousands) | | | |
| | Maintenance Expenses | | | | |
| 602.1 | Repair of Pole Lines | $ 313 | $ 440 | $ 127 | 40.6 |
| 602.2 | Repair of Aerial Cable | 2,560 | 2,748 | 188 | 7.3 |
| 602.3 | Repair of Underground Cable | 475 | 475 | 0 | 0.0 |
| 602.4 | Repair of Buried Cable | 1,639 | 1,639 | 0 | 0.0 |
| 602.5 | Repair of Submarine Cable | - | - | - | - |
| 602.6 | Repair of Aerial Wire | 335 | 335 | 0 | 0.0 |
| 602.7 | Repair of Underground Conduit | 36 | 36 | 0 | 0.0 |
| | Subtotal OSP Repair | 5,358 | 5,673 | 315 | 5.9 |
| 603 | Test Desk Work | 2,308 | 2,308 | 0 | 0.0 |
| 604 | Repair of COE | 9,680 | 9,680 | 0 | 0.0 |
| 605 | Repair of Station Equip. | 8,200 | 9,111 | 911 | 11.1 |
| 606 | Repair of Buildings | 560 | 560 | 0 | 0.0 |
| 610 | Maint. Transmission Power | 487 | 487 | 0 | 0.0 |
| 612 | Other Maintenance Expense | 57 | 57 | 0 | 0.0 |
| | Total Maintenance Exp. | $26,650 | $27,876 | $1,226 | 4.6 |

Traffic Expenses

Traffic expenses consist primarily of the salaries, wages, and administrative costs involved in handling of telephone calls by switchboard operators and by the personnel responsible for the central office switching equipment. As with the development of maintenance expenses, the local manager for each responsibility area makes the original estimate on a judgment basis which is then reviewed by each succeeding higher level of management for approval consistent with utility planning and fiscal commitment. Since traffic expense is driven by call volume, there is much less ability to arbitrarily adjust operator's hours, but some flexibility exists in training, supervision, and potential for more automated traffic measurement and efficiencies in switching and routing due to new central office equipment.

The staff estimate was based upon a detailed examination of the central office records for Accounts 624, Operator Wages, and 627, Operator Training. The other accounts were trended on past recorded expenses.

Account 621, General Traffic Supervision, trended lower than Continental's estimate for 1981 which was consistent with the reduction in personnel charging this account, between 44 to 48, as compared to 68 in 1977 and 1978. The staff estimate of $1,840,000 is based upon a supervision level comparable to 1979 to which is applied a trended annual cost per supervisor. Continental's estimate of $2,021,000 differs from the staff estimate by $181,000, or 9.8 percent. The remaining accounts were either at or below the 1981 projection and Continental's estimates for these accounts were accepted by the staff. Continental's estimate of the Total Traffic Expenses is $13,595,000 which exceeds the staff estimate for 1981 of $13,425,000 by $170,000, or 1.3 percent. These estimates for the test year 1981 are shown and compared in Table III.

TABLE III

Continental Telephone Company of California
California Operations

COMPARISON OF TRAFFIC EXPENSES
Test Year 1981

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff Amount | Continental Exceeds Staff Percent |
|---|---|---|---|---|---|
| | | (Dollars in Thousands) | | | |
| | Traffic Expenses | | | | |
| 621 | General Traffic Supervision | $ 1,840 | $ 2,021 | $181 | 9.8 |
| 622 | Customer Service Insp. | 164 | 164 | 0 | 0.0 |
| 624 | Operator Wages | 9,715 | 9,715 | 0 | 0.0 |
| 627 | Operator Training | 1,183 | 1,183 | 0 | 0.0 |
| 629 | C. O. Stationery & Printing | 87 | 87 | 0 | 0.0 |
| 630 | C. O. House Service | 212 | 212 | 0 | 0.0 |
| 631 | Misc. C. O. Exp. | 214 | 214 | 0 | 0.0 |
| 633 | Other Traffic Expenses | 10 | (1) | (11) | - |
| | Total Traffic Expenses | 13,425 | 13,595 | 170 | 1.3 |

(Red Figure)

Commercial Expenses

Commercial expenses consist primarily of salaries, wages, and administrative costs involved in the handling of customer service order contacts and the collection of revenues; developing and filing tariff schedules and other regulatory matters; the preparation and distribution of telephone directories; intercompany relations and settlements; and marketing and sales functions, including advertising.

Continental has estimated $8,875,000 for Total Commercial Expenses in test year 1981 which exceeds the staff estimate of $8,506,000 by $369,000, or 4.3 percent.

Continental developed its test year commercial expense estimates in a manner similar to the way it developed its previously discussed maintenance and traffic expense estimates. The staff based its estimates on: (a) trends determined via an analysis of ongoing and recorded expenses; (b) information and data obtained from field trips, data responses, and discussions with Continental's employees; and (c) consideration of the effects of known and planned changes in Continental's operations. The staff used later data than Continental to estimate commercial expenses and, in determining the reasonableness of Continental's various estimates, performed statistical analysis of recorded data by account. Where this test indicated a statistically significant explanation of the recorded data and the staff was aware, via other information gathered and analyzed during its investigation, that Continental's operations in the test year would be basically the same as those during the recorded years, then the staff based its estimate on a least-square-best-fit line trended into the test year.

The staff's estimate for Account 642, Advertising, is $232,000 and is $12,000 less than Continental's estimate. The reason for this difference is as follows: The staff's $12,000 downward adjustment reflects that amount which the staff determined to be for the betterment of Continental's corporate image. The basis for this disallowance is consistent with past Commission decisions concerning this issue.

The staff's estimate for Account 643, Marketing and Sales Expense, is $1,551,000 and is $220,000 less than Continental's estimate. The difference in this case is due to the different estimating methodologies as used by the staff and Continental, and the fact that the staff had an additional 16 months of recorded data to rely on which indicated that Continental's estimate was optimistic.

The staff's estimate for Account 645, Local Commercial Operations, is $3,044,000 and is $235,000 less than Continental's estimate. The difference in this account is due to different estimating methodologies between the staff and Continental and the availability of later data for the staff to analyze. The additional data indicated that Continental's estimate was optimistic.

The staff's estimate for Account 649, Directory Expenses, is $1,896,000 and is $98,000 more than Continental's estimate. Continental via a contract with Leland Mast Directory Company keeps 53 percent of all revenues derived from the sale of directory advertising and pays to the directory company, as an expense, the remaining 47 percent. The staff's estimate for directory advertising revenues was higher than Continental's; thus, the staff's related expense estimate is also higher to be consistent.

The remaining commercial expenses resulted in the same estimates by Continental and the staff. Both Continental's and the staff's commercial expense estimates are shown and compared in Table IV.

TABLE IV

Continental Telephone Company of California
California Operations

COMPARISON OF COMMERCIAL EXPENSES
Test Year 1981

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|---|
| | | | (Dollars in Thousands) | | |
| | Commercial Expenses | | | | |
| 640 | General Commercial Admin. | $1,466 | $1,466 | $ 0 | 0.0 |
| 642 | Advertising | 232 | 244 | 12 | 5.2 |
| 643 | Sales Expense | 1,551 | 1,771 | 220 | 14.2 |
| 644 | Connecting Company Relations | 211 | 211 | 0 | 0.0 |
| 645 | Local Commercial Operations | 3,044 | 3,279 | 235 | 7.7 |
| 648 | Public Telephone Commissions | 80 | 80 | 0 | 0.0 |
| 649 | Directory Expenses | 1,896 | 1,798 | (98) | (5.2) |
| 650 | Other Commercial Expenses | 26 | 26 | 0 | 0.0 |
| | Total Commercial Expenses | 8,506 | 8,875 | 369 | 4.3 |

(Red Figure)

GENERAL AND OTHER OPERATING EXPENSES

General office salaries and expenses are those operating costs incurred in performing the executive, accounting, treasury, law, personnel, engineering, and other general office functions. These costs include salaries, office supplies, and periodicals, together with traveling and other expenses of employees engaged in performing general office functions. Other operating expenses are those operating costs necessary to provide overall telephone service which are not included in the various other accounts. Mainly, these costs include insurance, employees' fringe benefits, pensions, operating rents, and general service and licenses. Some of the functions and the services for both groups of expenses are provided by affiliates, Continental Telephone Service Corporation (CTSC)-Western Region Division (Western Region) and ConTel Data Services Corporation (ConTel), of Continental.

CTSC was formed as of January 1, 1968. CTSC consists of four operating divisions: Corporate, Western Region, Central Region, and Eastern Region. The Corporate Division performs services for the entire Continental system, while the other three divisions provide services primarily to the domestic telephone operating companies within the region boundaries.

The Western Region staff, headquartered in Bakersfield, California, provides certain direct managerial and operational functions to Continental along with four other operating companies within the western half of the United States. Some of these functions are engineering, accounting, financial, revenue requirements, and budget coordination.

ConTel was created on January 1, 1974, as a result of a FCC decision in Docket No. 16979. That decision required that a separate corporation be formed for providing data processing services to affiliated telephone companies and that the separate corporation maintain its own books, have separate offices, utilize separate personnel and computer equipment, and operate in separate facilities.

ConTel provides all of the data services for subsidiaries within the Continental system which were formerly provided by CTSC. ConTel's data centers are located in six regional areas and its Bakersfield regional center provides data processing services to Continental, as well as other telephone companies within the Western Region. These services include customer billing, general accounting, payroll, traffic engineering, and general engineering.

Continental's estimates for general office and other operating expenses were developed individually for each account by applicable operating managers. Portions of these categories include management costs incurred on behalf of Continental by CTSC. The 1980 estimates contained in Continental's Report on Results of Operations for these services were based on the operating budgets for these service companies and the 1981 estimates were trended off 1980.

The staff's estimates were based on an analysis of Continental's Notice of Intention (NOI) application budget view of the estimated years 1980 and 1981 and historical data. Information was also obtained from Continental on its operations and budgeting process. As a further test a comparison was made of Continental's expense estimates for the year 1980 with six months actual 1980 expense annualized.

The staff excluded certain budgeted expenses that were either excessive or not beneficial to the ratepayers and also made adjustments to incorporate ratemaking treatments included in recent Commission decisions.

The staff's estimate for general office salaries and expenses for the test year 1981 is $10,231,000 and is $593,000 less than Continental's estimate of $10,824,000. Continental's estimate of $10,638,000 for other operating expenses for the same estimated test year exceeds the staff's estimate of $9,768,000 by $870,000.

Discussion of Differences in General and Other Operating Expenses

The staff and Continental estimates of general office salaries and expenses by main accounts are shown and compared in Table V. A comparison of other operating expenses are shown in Table VI.

The staff's 1981 test year estimate of $440,000 for the Executive Department is less than Continental's estimate of $453,000 by $13,000. The $13,000 difference is a combination of a downward adjustment of $69,000 largely offset by additional billings of $56,000 as discussed below.

Investigation by the staff revealed that Continental has included $69,000 for consulting payments to J. Ray, former owner of Redwood Empire Telephone Company (Redwood Empire),[2/] and C. Goetting, former employee of Redwood Empire. These payments, approximately $43,000 to J. Ray and $26,000 to C. Goetting, are part of the purchase agreement for the acquisition of Redwood Empire. Ratepayers receive no benefits from the annual payments to these two individuals.

The staff has included an additional $56,000 to properly reflect a reasonable expense level for the Executive Department. Continental's test year estimate does not include the proper level of Western Region billings for the Executive Department.

2/ Redwood Empire and Colfax Telephone Exchange (Colfax) merged and were acquired by Continental in December 1976.

TABLE V

Continental Telephone Company of California
California Operations

Total Company

COMPARISON OF GENERAL OPERATING EXPENSES

Test Year 1981 Estimated

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|---|
| | | (Dollars in Thousands) | | | |
| | General Office Salaries & Exp. | | | | |
| 661 | Executive Department | $ 440 | $ 453 | $ 13 | 3.0 |
| 662 | Accounting Department | 4,228 | 4,343 | 115 | 2.7 |
| 663 | Treasury Department | 94 | 94 | 0 | 0.0 |
| 664 | Law Department | 109 | 109 | 0 | 0.0 |
| | Other Gen. Off. Salaries & Exp. | 5,452 | 5,825 | 373 | 6.8 |
| | Subtotal before Adjust. | 10,323 | 10,824 | 501 | 4.9 |
| | Legislative Advocacy Adjust. | (20) | 0 | 20 | (100.0) |
| | Western Region Adjust. | (72) | 0 | 72 | (100.0) |
| | Total General Office Exp. | $10,231 | $10,824 | $593 | 5.8 |

(Red Figure)

TABLE VI

Continental Telephone Company of California
California Operations

Total Company

COMPARISON OF OTHER OPERATING EXPENSES

Test Year 1981 Estimated

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|---|
| | | (Dollars in Thousands) | | | |
| | Other Operating Expenses | | | | |
| 668 | Insurance | $ 224 | $ 224 | 0 | 0.0 |
| 671 | Operating Rents | 708 | 708 | 0 | 0.0 |
| 672 | Relief and Pensions | 8,164 | 8,599 | 435 | 5.3 |
| 674 | General Service & Licenses | 2,361 | 2,873 | 512 | 21.7 |
| 675 | Other Expenses | 229 | 229 | 0 | 0.0 |
| 677 | Exp. Charged to Construction-Cr. | (1,909) | (1,995) | (86) | 4.5 |
| | Subtotal before Adjust. | 9,777 | 10,638 | 861 | 8.8 |
| | Dues, Donations & Contr. Adjustment | (9) | 0 | 9 | (100.0) |
| | Total Other Operating Expenses | $9,768 | 10,638 | 870 | 8.9 |

(Red Figure)

The staff's estimate of $4,228,000 for the Accounting Department (Account 662) for the test year 1981 is less than Continental's estimate of $4,343,000 by $115,000.

Investigation of the six months recorded data of 1980 revealed that Continental was underrunning its 1980 budget by approximately $115,000. Continental could not justify to the staff why the variance of $115,000 has occurred during the first six months of 1980. The 1980 and 1981 test year estimates are interrelated with the likelihood that the variance in 1980 would be reflected in 1981. Continental has the burden of justifying this variance. Therefore, the staff reduced Continental's test year estimate by $115,000.

The staff's estimate of $5,452,000 for other general office salaries and expenses (Account 665) for the test year 1981 is less than Continental's estimate of $5,825,000 by $373,000.

A portion of the total difference is due to the staff's investigation of the Record Verification Program. The staff has determined that Continental has overbudgeted the remaining cost of the Record Verification Program by $168,000 for the test year 1981. The staff has disallowed $168,000 from its test year estimate as recommended in a separate audit report (Exhibit 24).

The remaining difference of $205,000 is due to staff's investigation of Continental's six months recorded data of 1980. The staff's investigation revealed that Continental was underrunning its 1980 budget by approximately $205,000. Continental could not justify why the variance of $205,000 has occurred during the first six months of 1980. The 1980 and 1981 test year estimates are interrelated with the likelihood that the variance in 1980 should be reflected in 1981. Since Continental has the burden of justifying this variance, the staff has reduced Continental's test year estimate by $205,000.

Table VI-A compares the staff and Continental estimates of individual benefits in Account 672, Relief and Pensions. The staff's estimate of $8,164,000 for relief and pensions for the test year 1981 is less than Continental's estimate of $8,599,000 by $435,000. The major difference is in the expense estimate for group medical and life insurances. The staff has accepted as reasonable Continental's estimates for workmen's compensation and other miscellaneous benefits.

The staff's estimate of $2,759,000 for group medical and life insurances for the test year 1981 is less than Continental's estimate of $3,155,000 by $396,000.

The staff assumed that Continental will obtain insurance company refunds of $230,000 in 1981 for prior year premiums. Continental has received refunds for prior year premiums averaging approximately $230,000 from its insurance company in years 1977, 1978, and 1979. As of October 27, 1980, Continental had not received any information from its insurance company on 1980 refunds for its 1979 premiums.

The remaining difference is due to the staff witnesses' estimates of total company employee requirements.

The staff's estimate of $4,290,000 for service pension premiums for the test year 1981 is less than Continental's estimate of $4,329,000 by $39,000. The difference is due entirely to the combined total of the staff estimates of total company employee requirements. The staff has reviewed Continental's methodology for service pension premiums and considers it reasonable.

TABLE VI-A

Continental Telephone Company of California
California Operations

COMPARISON OF RELIEF AND PENSIONS EXPRENSES, ACCOUNT NO. 672

Test Year 1981 Estimated

| Item | Staff | Utility | Utility Exceeds Staff: Amount | Utility Exceeds Staff: Percent |
|---|---|---|---|---|
| | | (Dollars in Thousands) | | |
| Service Pension Premiums | $4,290 | $4,329 | $ 39 | 0.9% |
| Group Med/Life Insurance | 2,759 | 3,155 | 396 | 14.4 |
| Workmen's Compensation | 518 | 518 | 0 | .0 |
| Other | 597 | 597 | 0 | .0 |
| Total | 8,164 | 8,599 | 435 | 5.3 |

The 1981 test year estimate for Account 674, General Services and Licenses, was prepared by a staff accountant and is contained in a separate report on the affiliated relationships of Continental (Exhibit 26). The differences between the staff and Continental are due to a difference in the overall expense estimate for CTSC, Corporate Division, and specific adjustments proposed by the staff. The staff estimate for test year 1981 is $2,361,000, which is $512,000 less than Continental's estimate of $2,873,000.

The staff's estimate of $1,909,000 for expenses charged to construction (Account 677) for the test year 1981 is less than Continental's estimate of $1,995,000 by $86,000. The staff has reviewed Continental's method for calculating the estimate for expenses charged to construction and considers it reasonable. The difference is due entirely to expense adjustments in executive, general accounting, other general office salaries and expenses, and relief and pensions.

The staff has excluded $9,000 for dues, donations, and contributions, as compared to zero exclusion in Continental's estimate. The Commission has adopted similar types of adjustments in Decision No. 90642 dated July 31, 1979 for Pacific and in Decision No. 92366 dated October 22, 1980 for General.

The staff has excluded $20,000 for legislative advocacy expense, as compared to zero exclusion in Continental's estimate. The Commission has excluded legislative advocacy expense in the above-mentioned telephone proceedings.

The staff has excluded $72,000 of Western Region's expenses that should not be charged to Continental. This amount represents a combination of $18,000 for the staff accountant's recommendation of aircraft billings and $54,000 for other ratemaking adjustments. The staff in a separate audit report (Exhibit 24) recommends that lessor (Airleasco), not Continental, be billed for routine aircraft maintenance expense. The other ratemaking adjustments, Western Region's dues, donations, contributions, investor interest costs, aircraft expenditures, and nonoperating expenses are consistent with the adjustments adopted in Decision No. 86802 dated January 5, 1977.

## TAXES

## TAXES OTHER THAN INCOME

### Ad Valorem Taxes

The staff's estimate of $3,220,000 for ad valorem taxes for the test year 1981 is less than Continental's estimate of $4,002,000 by $782,000. Continental prepared its test year 1981 estimate prior to receiving its revised 1980-1981 fiscal year full market value determination from the California Board of Equalization. The staff reviewed Continental's methodology for estimating ad valorem taxes and considers it reasonable.

The staff's estimate of $3,220,000 incorporates the staff's estimates of plant-in-service, plant under construction, depreciation reserve for historical cost development, as well as the revised 1980-1981 fiscal year market value. The staff utilized the 1980-1981 market value/historical cost ratio to estimate the 1981-1982 fiscal year market value, as well as the assessed value to which is applied a composite tax rate.

The staff used the latest available composite tax rate of 4.75 percent as compared to Continental's tax rate of 5.08 percent for the 1980-1981 fiscal year. The staff's 1981-1982 composite tax rate of 4.77 percent was based on a 0.473 percent increase over the 1980-1981 tax rate. Continental has also developed its 1981-1982 tax rate using this 0.473 percent growth factor.

Payroll Taxes

The staff's payroll taxes estimate of $3,259,000 for the test year 1981 is lower than Continental's estimate of $4,347,000 by $88,000. The difference is due entirely to the lower number of employees as estimated by the staff witnesses. The staff reviewed Continental's methodology for payroll taxes and considers it reasonable.

Table VII sets forth the staff and Continental estimates of ad valorem (property) and payroll taxes.

TABLE VII

Continental Telephone Company of California
California Operations

Total Company

COMPARISON OF TAXES OTHER THAN ON INCOME

Test Year 1981 Estimated

| Ac. No. | Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|---|
| | | (Dollars in Thousands) | | | |
| | Operating Taxes | | | | |
| 307.1 | Ad Valorem Taxes | $3,220 | $4,002 | $782 | 24.3 |
| | Payroll Taxes | | | | |
| 307.5 | Calif. Unemployment Insurance | 349 | 358 | 9 | 2.6 |
| 307.6 | Federal Unemployment Insurance | 93 | 96 | 3 | 3.2 |
| 307.7 | Federal Insur. Contribution Act | 2,817 | 2,893 | 76 | 2.7 |
| | Subtotal | 3,259 | 3,347 | 88 | 2.7 |
| | Total Taxes Other Than On Income | $6,479 | $7,349 | $870 | 13.4 |

## TAXES BASED ON INCOME

Taxes based on income include California Corporation Franchise Tax (CCFT) and federal income tax. Tables VIII and IX contain the development of these respective taxes at present and Continental-proposed rates.

Operating revenue, expense, and tax estimates discussed previously were used for the development of income taxes included in Tables VIII, IX, and X.

The staff reviewed and analyzed the procedures used by Continental to calculate tax depreciation estimates. The staff has used the tax depreciation procedure of Continental for this proceeding adjusted for the differences in the staff estimates for plant additions.

The staff used liberalized tax depreciation on a flow-through basis for the development of federal income tax and for the CCFT on all Continental property except that of the former Redwood Empire and Colfax companies. The tax depreciation associated with those respective properties is normalized for this proceeding.

TABLE VIII

Continental Telephone Company of California
California Operations

Total Company

CALIFORNIA CORPORATION FRANCHISE TAX

Test Year 1981 Estimated

| Item | Present Rates | Proposed Rates |
|---|---|---|
| | (Dollars in Thousands) | |
| Operating Revenues | $130,765 | $149,019 |
| Operating Expenses | 68,580 | 68,580 |
| Taxes Other Than On Income | 6,479 | 6,479 |
| Subtotal | 75,059 | 75,059 |
| Net Before Additions and Deductions | 55,706 | 73,960 |
| Additions to Taxable Income | | |
| Difference between Whole and Remaining Life Depreciation | 931 | 931 |
| Depreciation on Capitalized Expenses | 1,478 | 1,478 |
| Amortization of Plant Acquisitions and Others | 25 | 25 |
| Depreciation on Other Misc. Below-the-line Items | 21 | 21 |
| State Asset Depreciation Range Adjust. | 3,140 | 3,140 |
| Subtotal Additions | 5,595 | 5,595 |
| Deductions from Taxable Income | | |
| Staff Remaining Life Depreciation Exp. | 24,943 | 24,943 |
| Payroll Taxes Capitalized | 476 | 476 |
| Sales Tax Capitalized | 1,370 | 1,370 |
| Pensions Capitalized | 520 | 520 |
| Cost of Removal | 1,720 | 1,720 |
| Tax Over Book Depreciation | 5,482 | 5,482 |
| Ad Valorem Taxes Reach-ahead | 172 | 172 |
| Fixed Charges | 14,224 | 14,224 |
| Amort. of Loss on Ret. Vintages | 429 | 429 |
| Subtotal Deductions | 49,336 | 49,336 |
| Net State Taxable Income | 11,964 | 30,213 |
| Calif. Corp. Franchise Tax at 9.6% | 1,149 | 1,495 |
| Total Calif. Corp. Franchise Tax | 1,149 | 1,495 |

Note: Revenues at Proposed Rates differ by $18,254.

TABLE IX

Continental Telephone Company of California
California Operations

Total Company

FEDERAL INCOME TAX

Test Year 1981 Estimated

| Item | Present Rates | Proposed Rates |
|---|---|---|
| | (Dollars in Thousands) | |
| Operating Revenues | $130,765 | $149,019 |
| Operating Expenses | 68,580 | 68,580 |
| Taxes Other Than On Income | 6,479 | 6,479 |
| State Income Tax | 1,149 | 1,495 |
| Subtotal | 76,208 | 76,554 |
| Net Before Additions and Deductions | 54,557 | 72,465 |
| Additions to Taxable Income | | |
| Difference between Whole and Remaining Life Depreciation | 931 | 931 |
| Depreciation on Capitalized Expenses | 1,478 | 1,478 |
| Amort. of Plant Acquisitions and Others | 25 | 25 |
| Depreciation on Other Misc. Below-the-line Items | 21 | 21 |
| Subtotal Additions | 2,455 | 2,455 |
| Deductions from Taxable Income | | |
| Staff Remaining Life Depreciation Exp. | 24,943 | 24,943 |
| Payroll Taxes Capitalized | 476 | 476 |
| Sales Tax Capitalized | 1,370 | 1,370 |
| Pensions Capitalized | 520 | 520 |
| Cost of Removal | 1,720 | 1,720 |
| Tax Over Book Depreciation | 5,482 | 5,482 |
| Ad Valorem Taxes Reach-ahead | 172 | 172 |
| Fixed Charges | 14,224 | 14,224 |
| Amort. of Loss on Ret. Vintages | 429 | 429 |
| Subtotal Deductions | 49,336 | 49,336 |
| Federal Taxable Income | 7,675 | 25,583 |
| Federal Tax at 46% | 3,531 | 11,768 |
| Graduated Rate Benefit | (19) | (19) |
| Investment Tax Credit | (1,851) | (1,851) |
| Amort. of Previous Def. ITC | (599) | (599) |
| Federal Tax | 1,062 | 9,299 |

Note: Revenues at Proposed Rates differ by $18,254.

(Red Figure)

TABLE X

Continental Telephone Company of California
California Operations

Total Company

DEDUCTIONS FOR TAX CALCULATIONS

Test Year 1981

| Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Tax Depreciation | | | | |
| State | $26,644 | $27,752 | $1,108 | 4.2 |
| Federal | 29,784 | 30,716 | 932 | 3.1 |
| Cost of Removal | 1,720 | 1,001 | (719) | (41.8) |
| Ad Valorem Taxes Reach-ahead | 172 | 249 | 77 | 44.8 |
| Fixed Charges | 14,224 | 14,452 | 228 | 1.6 |
| Payroll Taxes Capitalized | 476 | 489 | 13 | 2.7 |
| Pensions Capitalized | 520 | 517 | (3) | (0.6) |
| Sales Tax Capitalized | 1,370 | 1,419 | 49 | 3.6 |
| Investment Tax Credit | 1,851 | 1,943 | 92 | 5.0 |
| Amort. of Previous Def. ITC | 599 | 535 | (64) | (10.7) |
| Amort. Loss on Fully Retired Vintages | 429 | - | (429) | (100.0) |

(Red Figure)

Cost of Removal

The staff estimate of cost of removal expense of $1,720,000 exceeds Continental's estimate of $1,001,000 by $719,000. The difference is due to the difference between the staff and Continental estimates of plant in service and plant retirements for the test year.

Fixed Charges

The staff estimate of average long-term debt outstanding is $159,163,000. Based on a computation of Continental's operating and nonoperating plant ratios as of January 1, 1980, the staff allocated $14,224,000 of the $14,261,000 total fixed charges expense to operating plant.

Investment Credit

The investment credit (IC) used as a reduction of the federal income tax in Table IX is a combination of the 4 percent IC currently flowed through and the amortization on a ratable flow-through basis of IC attributable to the 6 percent IC along with the entire IC attributable to the Redwood Empire and Colfax properties.

The staff estimate of IC to be flowed through currently of $1,851,000 is less than Continental's estimate of $1,985,000 because of lower estimates of plant additions by the staff. The ratable flow-through portion of the IC on a staff basis is $599,000. This amount exceeds Continental's estimate by $64,000 because of the use of the full year convention in the amortization of the IC, partly offset by the lower estimate of plant by the staff. The full year convention has been adopted by this Commission in both Pacific and General rate proceedings.

Federal Deferred Tax Reserve

The staff accountant reviewed and analyzed Continental's development of the deferred tax reserve for the Redwood Empire and Colfax properties. The staff used Continental's method as a basis for determining the deferred tax reserve. There are no differences in the estimate of deferred tax reserve between the staff and Continental.

CCFT

The CCFT is a privilege or income tax for the right to do business in California. This tax is based on the income of the preceding tax year. For rate-fixing purposes, however, the Commission has historically adopted this tax on a current-year basis consistent with other revenue and expense items.

Continental's tax liability for CCFT is not solely dependent on its California operations. Because it is part of the Continental system, the State Franchise Tax Board has taken the position that its tax liability should be determined with reference to a "Combined Report" of the Continental system. The "Combined Report" makes use of a three-factor formula which determines the relationship of California wages, revenues, and average net tangible property of all Continental system operations in California to the same three-factor formula items for the total Continental system. Because of the effect of using the "Combined Report" three-factor formula method, Continental's tax liability may be greater or less than the statutory rate of 9.6 percent of its separate taxable earnings in California, unlike utilities operating exclusively in California which incur a straight 9.6 percent CCFT tax rate on their separate taxable earnings. Consistent with Commission policy regarding utilities filing CCFT on a "Combined Report" basis, the staff computed CCFT using an effective tax rate. An analysis of the data provided by Continental indicated that its tax rate on the average was slightly less than the statutory rate; therefore, in this proceeding the staff has used the statutory rate for CCFT.

Incremental California Franchise Tax Rate

For determination of the additional CCFT liability which results when increased rates are granted to Continental, the 9.6 percent rate developed is not appropriate. Since only one of the three factors changes, namely, the revenue factor, the impact of any increase only affects that one factor, not all three, and further, only Continental's California intrastate revenues are affected by rate increases granted by this Commission. In consideration of the above factors, the staff has determined that the proper incremental tax rate for any increase in rates granted by this Commission is 1.90 percent. The development of the incremental tax rate is reasonable and consistent with past Commission policy.

Loss on Fully Retired Vintages

On its 1976 tax return, Continental claimed a deduction of $5,128,197 for "Loss from Fully Retired Vintage Accounts" of which $4,288,733 was applicable to California operations. This loss represents the debit balance (undepreciated) remaining in a tax vintage year after the property had been fully retired. Because there was a question regarding the deductibility of this item at that time, the staff and Continental agreed to defer the flow through of that tax savings until the matter was resolved. The question of deductibility has now been resolved. Therefore, for ratemaking purposes, the staff has amortized the amount attributable to California over a 10-year period with a deduction for tax purposes of $428,873 in the test year.

# TELEPHONE PLANT

## General

Continental has changed its accounting method for plant two times since June 1978. These changes relate mainly to Telephone Plant Under Construction, commonly known as CWIP, and the related Interest During Construction (IDC). Both the staff and Continental estimates were made on Continental's book basis, and all comparisons were shown on Continental's book basis. Adjustments to the book basis to reflect the staff basis are shown separately as IDC adjustments in the rate base in the Summary of Earnings Table XVIII.

## Construction Expenditures

Both the staff and Continental based their estimates of telephone plant on the same construction budget levels for the years 1980 and 1981. These construction budget levels are referred to as gross expenditures and they include the cost of removal. The Continental system uses the Construction Management System (CMS) to summarize its forecasted construction requirements and also utilizes CMS to aid the Network Design Department (engineering) in pricing the future construction needs. The gross expenditure levels used are $54.7 million for 1980 and $59.8 million for 1981.

The staff evaluation reviewed the growth history, analysis of construction expenditures by major account, and cost analysis per main telephone gain. The staff also analyzed and compared the past proposed construction budgets with actual experienced expenditures. From the above analysis the staff found that the level of Continental's construction program is reasonable for both 1980 and 1981.

Gross additions to telephone plant in service is estimated by gross expenditures less cost of removal, changes in CWIP, and adjustment for intercompany tax elimination. The following tabulations compare gross additions to telephone plant in service.

Gross Addition to Telephone Plant in Service

| Item | Year 1980 | | Continental Exceeds Staff | |
|---|---|---|---|---|
| | Staff | Continental | Amount | Percent |
| | (Dollars in Thousands) | | | |
| Gross Expenditures | $54,658 | $54,658 | $ - | - |
| Less Cost of Removal | 1,400 | 1,200 | (200) | (14.29) |
| Less Changes in CWIP | 3,100 | 869 | (2,231) | (71.97) |
| Less Adjustment for Inter-company Tax Elimination | 67 | 67 | - | - |
| Gross Addition: to 100.1 | $50,091 | $52,522 | $ 2,431 | 4.85 |

| Item | Year 1981 | | Continental Exceeds Staff | |
|---|---|---|---|---|
| | Staff | Continental | Amount | Percent |
| | (Dollars in Thousands) | | | |
| Gross Expenditures | $59,775 | $59,775 | $ - | - |
| Less Cost of Removal | 1,720 | 1,001 | (719) | (41.80) |
| Less Changes in CWIP | 3,400 | 2,154 | (1,246) | (36.65) |
| Less Adjustment for Inter-company Tax Elimination | 293 | 293 | - | - |
| Gross Addition: to 100.1 | $54,362 | $56,327 | $ 1,965 | 3.61 |

(Red Figure)

Telephone Plant Under Construction

This account includes the original cost of construction of telephone plant, other than station apparatus and station connections, that is not completed and ready for service. Continental has changed its accounting method for plant two times since June 1978.

Prior to the amendments by FCC Docket No. 21230, effective January 1, 1979, the FCC's Uniform System of Accounts for Telephone Companies states the following regarding telephone plant under construction:

> "31.100:2 Telephone Plant Under Construction.
>
> "(a) This account shall include the original cost of construction of telephone plant, other than station apparatus and station connections, that is not completed and ready for service. It shall include interest during construction, taxes during construction, and all other elements of costs of such construction work. . .
>
> "Note: There may be charged directly to the appropriate plant accounts the cost of any construction project which is estimated to be completed and ready for service within two months. There may also be charged directly to the plant accounts the cost of any construction project for which the gross additions to plant are estimated to amount to less than $10,000."

This definition has been accepted by this Commission for rate-making purposes.

Prior to June 1978, Continental charged interest on projects over $1,000 with construction period over one month. In June 1978, Continental changed its accounting method without charging interest on construction projects less than $100,000 and job orders with construction periods less than one month.

FCC's Uniform System of Accounts was amended effective January 1, 1979 by the FCC in Docket No. 21230. The amendment affected mainly two items in Account 100.2, Telephone Plant Under Construction, as follows:

a. Account 100.2, Telephone Plant Under Construction, was subdivided into construction projects designed to be completed in one year or less (Subdivision 1) and construction projects designed to be completed in over one year (Subdivision 2). Subdivision 1 would be allowed in rate base and only Subdivision 2 would accrue interest during construction.

b. The note to Account 100.2 was amended by increasing the $10,000 level for charging construction costs directly to plant in service to $25,000.

Continental changed its accounting method again beginning January 1, 1979 to reflect item a. above by not charging interest on job orders with construction period less than one year. The Commission has not adopted for rate-making purposes any of the amendments to the FCC's Uniform System of Accounts.

There is a substantial difference between Continental and the staff in estimating the operative CWIP and short-term, noninterest-bearing CWIP. The operative CWIP includes work orders under $1,000 and 30 days construction period and plant that is completed and in service but not yet closed. The following tabulation is the comparison of Continental and the staff estimates.

Construction Work in Progress

| Item | Year 1981 Staff | Year 1981 Continental | Continental Exceeds Staff Amount | Continental Exceeds Staff Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Weighted Average Operative CWIP | $16,426 | $10,510 | $ (5,916) | (36.02) |
| Weighted Average Short-term, Interest-bearing CWIP | 11,588 | 7,410 | (4,178) | (36.05) |
| Total Weighted Avg. CWIP | $28,014 | $17,920 | $(10,094) | (36.03) |

(Red Figure)

The reason for these differences is in the estimating procedure. Continental assumed that all expenditures on the job that started in any month will be transferred to the plant account four months after the job got started. This assumption is based upon the CWIP (total of operative and short-term CWIP) turn-around study which shows that the total dollar volume that passes through the CWIP account divided by the average CWIP is every four months. This assumption resulted in higher job order closings in the early part of the year which has a major impact on the weighting factor for CWIP and telephone plant in service. The above assumption by Continental has a major defect in that it does not allow for actual timing of the job order closing, and fails to recognize that CWIP does not uniformly close to plant throughout the year. The dollar volume that passes through the CWIP account is historically higher in the latter part of the year and Continental does not account for this fact. This difference in estimating procedures resulted in higher total weighted average CWIP and lower plant in service for the staff when compared with Continental estimates.

The staff estimated its total weighted average CWIP by adding weighted average additions to the beginning of year CWIP. The weighting factor used by the staff is 60 percent, and it is based on the historical weighting factors. Due to the defect in the estimating method of Continental mentioned above, its weighting factor is a negative 309 percent. The staff has also adjusted the CWIP balance to account for the cost of removal which is included in construction expenditures. The following tabulation is the comparison between the staff and Continental.

Total Construction Work in Progress

| Item | Year 1981 | | Continental Exceeds Staff | |
|---|---|---|---|---|
| | Staff | Continental | Amount | Percent |
| | (Dollars in Thousands) | | | |
| Beginning-of-Year Balance | $26,820 | $24,589 | $ (2,231) | (8.32) |
| End-of-Year Balance | 30,020 | 26,748 | (3,272) | (10.90) |
| Weighted Average Balance | 28,860 | 17,920 | (10,940) | (37.91) |
| Adjustment for Cost of Removal | (846) | - | 846 | (100.00) |
| Total Weighted Avg. CWIP | $28,014 | $17,920 | $(10,094) | (36.03) |

(Red Figure)

Telephone Plant In Service

The net addition to telephone plant in service is the net of gross addition to telephone plant in service less retirements. The staff's estimated retirements are based on analysis of retirements and gross addition. Five years of historical retirements versus constructed additions were compared and used as the basis of the staff's estimates for retirements. Continental basically used the CMS system to gather all retirement estimates from different groups with varied methods of estimating. These groups include the division staff in Victorville, central office engineer, outside plant engineer, and building and power engineers. The staff's and Continental's estimates of retirements are shown in the following tabulation.

Retirements

| Year | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|
| | | (Dollars in Thousands) | | |
| 1980 | $13,470 | $11,201 | $(2,269) | (16.84) |
| 1981 | 14,810 | 8,640 | (6,170) | (41.66) |

(Red Figure)

The comparison between Continental and the staff estimate of utility plant in service is shown in the following tabulation.

Telephone Plant in Service

| Item | 1980 Staff | 1980 Continental | 1981 Staff | 1981 Continental | Continental Exceeds Staff 1980 | Continental Exceeds Staff 1981 |
|---|---|---|---|---|---|---|
| | | | (Dollars in Millions) | | | |
| Beginning of Year | $338.3 | $338.3 | $374.9 | $379.6 | - | $ 4.7 |
| Plus Gross Addition | 50.1 | 52.5 | 54.4 | 56.3 | $ 2.4 | 1.9 |
| Less Retirements | 13.5 | 11.2 | 14.8 | 8.6 | (2.3) | (6.2) |
| Total End of Year | $374.9 | $379.6 | $414.5 | $427.3 | 4.7 | 12.8 |

(Red Figure)

Common Utility Plant (Usage and Companywide Assets Adjustment)

Common utility plant consists of the headquarters facilities in Victorville, California, which are used for companywide operations including those located in Arizona and Nevada. In addition, there are certain facilities in California (Blythe, for example) that are partially dedicated to serving subscribers in Arizona. Conversely, there are certain facilities in Nevada (Gardnerville, for example) that are partially dedicated to serving subscribers in California. The net amounts allocated to Arizona and Nevada are shown in the staff's figures in Table XI as usage and companywide assets adjustment.

IDC Disallowed

This is the adjustment for IDC which was disallowed in the prior Commission decisions that goes back to Decision No. 81896 dated September 25, 1973. This adjustment is shown in Table XI.

TABLE XI

Continental Telephone Company of California
California Operations

Total Company

COMPARISON OF TELEPHONE PLANT

Test Year 1981 Estimated

| Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Beginning-of-Year Balances Telephone Plant in Service | $374,922 | $379,663 | $ 4,741 | 1.3 |
| Weighted Avg. Net Additions Telephone Plant in Service | 18,998 | 26,299 | 7,301 | 38.4 |
| Total Weighted Avg. Telephone Plant in Service | $393,920 | $405,962 | $12,042 | 3.1 |
| Usage and Companywide Assets Adj. | (1,286) | (1,286) | 0 | 0.0 |
| IDC Disallowed | (350) | (350) | 0 | 0.0 |

(Red Figure)

Summary of Telephone Plant Amounts Carried to Rate Base

Table XI shows a comparison of the staff's and Continental's amounts of weighted average telephone plant carried forward to the rate base.

In calculating the weighted average net addition, the staff used a weighting factor of 48.00 percent of total net additions as compared to the 55.10 percent factor employed by Continental. The staff derived the 48.00 percent weighting factor by taking the average percentage of weighted average net additions to total net additions of the past five years, from 1975 through 1979, then adjusting it to take into consideration the improvement in job order closing procedures expected from the fully operational Construction Management System (CMS), Central Office Continuing Property Record (COE-CPR), and Mechanized Unit Property System (MUPS). Continental's estimating procedure, which assumed that all construction expenditures will be closed to plant in service within four months, resulted in the higher weighting factor used by it.

## DEPRECIATION EXPENSE AND RESERVE

### Background (Represcription)

Continental is currently required by the FCC to review its depreciation elements on a three-year basis. Explicit in this review is the provision for this Commission's participation in a three-way FCC-CTCC-CPUC evaluation. Straight-line remaining life (SLRL) depreciation rates used for 1980 are derived from average service lives and net salvage rates agreed to in the three-way evaluation. 1980 is a represcription year.

Late in 1979, Continental filed its annual depreciation study for review by the Commission staff for new 1980 rates. The proposed rates derived from that study were based on Continental's submitted data and experience with respect to net salvage, average service lives, remaining lives, and depreciation reserve. The Depreciation Unit of the Revenue Requirements Division reviewed this depreciation study and concurred in the proposals, except for the average service lives and net salvage rates of Accounts 212, 221, 232, 234, and 242.1. Subsequent review and discussion resulted in an agreement on the proposed depreciation elements as set forth in Table XIII. By letter dated July 30, 1980, the FCC staff concurred in the agreement.

### Depreciation Expense

Both Continental and the staff used the 1980 SLRL depreciation rate for the 1981 test year estimates of depreciation expense and reserve. Table XII shows the development of the staff estimates for depreciation expense and accrual for test year 1981. The average depreciable plant shown is the weighted average depreciable plant in service.

TABLE XII

Continental Telephone Company of California
California Operations

Total Company

STRAIGHT-LINE REMAINING LIFE DEPRECIATION ACCRUALS

Test Year 1981 Estimated

| Ac. No. | Item | Average Depreciable Plant | Depreciation Rate | Depreciation Accruals |
|---|---|---|---|---|
| | | (Dollars in Thousands) | | |
| 212 | Buildings | $ 24,343 | 3.980 | $ 969 |
| 221 | Central Office Equipment | 139,837 | 7.270 | 10,166 |
| 231 | Station Apparatus | 40,415 | 7.300 | 2,950 |
| 234 | Large Private Branch Exchanges | 9,454 | 7.410 | 701 |
| 241 | Pole Lines | 18,711 | 4.220 | 790 |
| 242.1 | Aerial Cable | 46,323 | 4.820 | 2,233 |
| 242.2 | Underground Cable | 12,526 | 2.550 | 319 |
| 242.3 | Buried Cable | 48,175 | 2.560 | 1,233 |
| 242.4 | Submarine Cable | 98 | 3.830 | 4 |
| 243 | Aerial Wire | 5,554 | 10.750 | 597 |
| 244 | Underground Conduit | 8,981 | 2.150 | 193 |
| 261 | Furniture and Office Equipment | 3,033 | 1.960 | 59 |
| | Subtotal Excluding Account 232 and Clearing Accounts | 357,450 | 5.655 | 20,214 |
| 232 | Station Connections | 30,252 | 15.820 | 4,786 |
| | Subtotal Excluding Clearing Accounts | 387,702 | 6.448 | 25,000 |
| | Through Clearing Accounts | | | |
| | Vehicles and Work Equipment | 4,648 | 2.640 | 123 |
| | Total Depreciable Plant | $392,350 | 6.403 | $25,123 |
| | Depreciation Expense | | | $25,000 |
| | Allocation of Common Plant | | | (57) |
| | Total Depreciation Expense | | | $24,943 |

(Red Figure)

TABLE XIII

Continental Telephone Company of California
California Operations

DEPRECIATION DATA

| Ac. No | Item | Average Service Life Years | Estimated Net Salvage Percent | 1980 Depreciation Rate |
|---|---|---|---|---|
| 212 | Buildings | 31.0 | (8.0) | 3.98 |
| 221 | Central Office Equipment | 18.3 | (2.0) | 7.27 |
| 231 | Station Apparatus | 11.0 | 5.0 | 7.30 |
| 234 | Large PBX | 14.0 | (5.0) | 7.41 |
| 241 | Pole Lines | 26.0 | (18.0) | 4.22 |
| 242.1 | Aerial Cable | 21.0 | (12.0) | 4.82 |
| 242.2 | Underground Cable | 35.0 | 8.0 | 2.55 |
| 242.3 | Buried Cable | 35.0 | 0.0 | 2.56 |
| 242.4 | Submarine Cable | 25.0 | 0.0 | 3.83 |
| 243 | Aerial Wire | 15.0 | (25.0) | 10.75 |
| 244 | Underground Conduit | 45.0 | 0.0 | 2.15 |
| 261 | Furniture & Office Equipment | 26.0 | 20.0 | 1.96 |
| 264 | Vehicles and Work Equipment | 10.0 | 15.0 | 2.64 |
| 232 | Station Connections* | 7.2 | (13.9) | 15.82 |

(Red Figure)

* Average service life not applicable to the calculation of the depreciation rate due to the special treatment of this account per Commission decision.

Note: The 1980 depreciation rate was used by both Continental and the staff for 1981 test year.

The allocation for common utility plant is shown as an adjustment for common usage plant similar to that as previously discussed under common utility plant.

Depreciation Reserve

Table XIV shows the comparison of the staff's and Continental's weighted average remaining life depreciation reserve estimates for the test year 1981.

The reasons for the differences in the depreciation reserve between the staff and Continental shown in Table XIV are as follows:

a. The staff estimate of beginning-of-year depreciation reserve is less than Continental's by $824,000 mainly because of the difference in depreciation expense and retirements estimated for 1980.

b. The difference in depreciation expense is mainly due to the differences in the estimated weighted average plant in service.

c. The staff retirement estimate is $6,170,000 higher than Continental's. The development of the retirement estimate was discussed previously in the section entitled Telephone Plant.

d. The staff's cost of removal estimate is $719,000 higher than Continental's. Similar to the retirement estimate, the higher cost of removal estimate results in a lower depreciation reserve estimate by that amount. The staff estimated its cost of removal by investigating the five-year historical ratio data of cost of removal to retirements. The total cost of removal was calculated by multiplying the estimated cost of removal per dollar in retirement by the total retirement. Continental estimates its cost of removal through its CMS.

e. The staff's gross salvage estimate for the test year 1980 is higher than Continental's estimate by $2,055,000. The higher estimate increases the staff's depreciation reserve by that amount. The staff again used the five-year historical ratio of the gross salvage to retirement percentages in estimating the percentage of gross salvage to retirement for the test year. This percentage was applied to the staff's retirement estimates for test year 1981 to obtain the staff gross salvage estimates. Continental estimates its cost of removal through its CMS similar to its estimates of retirements.

f. The staff's weighted additions to the depreciation reserve for the test year 1981 is lower than Continental's estimate by $3,332,000. The staff's estimate of weighted additions to reserve is 50.70 percent of its estimate of net additions to reserve. The 50.70 percent is the average of the three-year recorded percentage of weighted additions to net additions to reserve. A three-year average was used because the data of earlier years were not available by month. Continental used 52.60 percent weighting factor of weighted average additions to net additions.

TABLE XIV

Continental Telephone Company of California
California Operations

COMPARISON OF DEPRECIATION RESERVE
Estimated Year 1981

| Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Beginning-of-Year Depreciation Reserve | $104,550 | $105,374 | $ 824 | 0.79 |
| Depreciation Expense | 24,943 | 25,953 | 1,010 | 4.05 |
| Depreciation-Clearing Accts. | 123 | 124 | 1 | 0.81 |
| Retirements | (14,810) | (8,640) | 6,170 | (41.66) |
| Cost of Removal | (1,720) | (1,001) | 719 | (41.80) |
| Gross Salvage | 4,930 | 2,875 | (2,055) | (41.68) |
| Allocation of Common Plant | 57 | 57 | - | - |
| End-of-Year Depreciation Reserve | 118,073 | 124,742 | 6,669 | 5.65 |
| Net Additions to Reserve | 13,523 | 19,368 | 5,845 | 43.22 |
| Weighted Additions to Reserve | 6,856 | 10,188 | 3,332 | 48.60 |
| Weighted Average Depreciation Reserve | 111,406 | 115,562 | 4,156 | 3.73 |

(Red Figure)

## RATE BASE

The staff and Continental rate bases are shown and compared in Table XV. The various elements comprising the rate base are discussed as follows.

### Telephone Plant

Estimates of telephone plant in service, telephone plant under construction, and the weighted average additions to these items were previously discussed. The amounts shown in Table XV are brought forward from Table XI.

### Property Held for Future Use

Both Continental and the staff estimated zero balance for property held for future use for the test year 1981.

### Depreciation Reserves

The amounts shown are brought forward from Table XIV.

### Materials and Supplies

Both Continental and the staff estimated the test year 1981 materials and supplies to be $3,501,000. The staff analyzed five years of recorded weighted average balances of material and supplies versus gross expenditures and found that Continental's estimate of material and supplies for test year 1981 is reasonable.

### Deduction for Deferred Tax Reserve

This deduction represents the accumulated difference between income taxes actually paid using accelerated depreciation and the amounts that would have been paid using book depreciation. Under the normalization method of accounting for income taxes as used by both the staff and Continental, the reserve so accumulated becomes a deduction from the rate base. Continental is basically a flow-through company, but a small portion of its system that it acquired (Redwood Empire and Colfax) have normalized accounting. The deferred tax reserve shown is for these two companies.

TABLE XV

Continental Telephone Company of California
California Operations

Total Company

COMPARISON OF RATE BASE

Test Year 1981 Estimated

| Item | Staff | Continental | Continental Exceeds Staff: Amount | Continental Exceeds Staff: Percent |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Telephone Plant | | | | |
| Telephone Plant in Service | $374,922 | $379,663 | $ 4,741 | 1.3 |
| Weighted Avg. Net Additions | | | | |
| Telephone Plant in Service | 18,998 | 26,299 | 7,301 | 38.4 |
| Depreciation Reserve | (111,406) | (115,562) | (4,156) | 3.7 |
| Weighted Avg. Net Tel. Plant | 282,514 | 290,400 | 7,886 | 2.8 |
| Materials and Supplies | 3,501 | 3,501 | 0 | 0.0 |
| Working Cash Allowance | 3,190 | 1,664 | (1,526) | (47.8) |
| Normalized Tax Reserve | (210) | (173) | 37 | (17.6) |
| Subtotal before Adjustments | 288,995 | 295,392 | 6,397 | 2.2 |
| Usage & Companywide Assets Adj. | (1,286) | (1,286) | 0 | 0.0 |
| IDC Disallowed | (350) | (350) | 0 | 0.0 |
| Weighted Avg. Operative CWIP | 16,426 | 10,510 | (5,916) | (36.0) |
| Short-term Noninterest-bearing CWIP | 0 | 7,410 | 7,410 | 0.0 |
| Subtotal Adjustments | 14,790 | 16,284 | 1,494 | 10.1 |
| Total Rate Base | $303,785 | $311,676 | $7,891 | 2.6 |

(Red Figure)

<u>Working Cash Allowance</u>

Working cash allowance compensates the investors for funds provided by them which are committed to the business for the purpose of paying operating expenses in advance of receipt of offsetting revenues from its customers and in order to maintain minimum bank balances if such an arrangement is used.

The staff's working cash allowance is based on 11.30 percent rate of return.

With the exception of lag days for ad valorem taxes, the lag days used by Continental were found to be reasonable and were adopted by the staff. Both Continental and the staff used 1978 as the base year for its lead/lag study.

The difference between the staff's and Continental's estimates of working cash is mainly due to the following:

1. The major difference is due to the staff use of estimated 1981 revenues and expenses while Continental used 1978 revenues and expenses. The staff also adjusted the operational cash requirements and deductions to the 1981 level.

2. For federal income taxes the staff used the rate-making taxes estimated for 11.30 percent rate of return less any deferred taxes due to accelerated tax depreciation. Continental reduced its taxes by the unamortized investment tax credit in its lead/lag study. The unamortized investment tax credit is then included under deferred taxes and was assigned a zero lag day. The staff disagrees with this. The staff believes that the reason for a working cash allowance is to compensate investors for funds provided by them which are permanently committed to the business for the purpose of paying operating expenses in advance of receipt of offsetting revenues from its customers and in order to maintain minimum bank balances if

such an arrangement is used. What are the allowable operating expenses is the key question in this case. The staff contends that in estimating the working cash allowance for ratemaking, all allowable ratemaking expenses should be used in the lead/lag study. To reduce income taxes by the unamortized ITC in the lead/lag study is to mix ratemaking taxes and taxes as paid. The staff argues that it is not proper to use ratemaking taxes, on the one hand, and turn around and use taxes as paid, on the other. We agree with the staff.

It should be noted that this issue was the same issue in the recent General Telephone Company of California general rate proceeding, and the Commission in Decision No. 92366 dated October 22, 1980 adopted the staff's position.

3. The staff estimated the lag days for the ad valorem taxes to be 41.5 days. Continental estimated the lag days to be 29.4 days. The difference is 12.1 days and it is due to the staff's adjusting the first payment of 1978 and valorem taxes (based on taxes before the Proposition 13 property tax reduction) to the level of the second installment payment (based on post-Proposition 13 tax levels).

4. The staff-estimated deferred tax in its lead/lag study is the amount of income taxes deferred for accelerated tax depreciation for test year 1981 and does not include the taxes due to unamortized investment tax credit. On the other hand, Continental-deferred taxes used in its lead/lag study only includes the unamortized investment tax credit.

5. Continental's use of the unamortized investment tax credit as the deferred tax in its lead/lag study is improper according to the staff. The staff explains the reason for assigning zero lag days for deferred taxes due to the use of

accelerated tax depreciation with normalization; clearly zero lag days is not applicable for the unamortized investment tax credit.

The staff's computation of the working cash allowance is set forth in Tables XVI and XVII.

CWIP

Continental, in this rate proceeding, is requesting that CWIP be included in rate base.

The staff has excluded nonoperative construction work in progress from the rate base as discussed below.

The staff agrees with item (b) of the accounting change, as amended by the FCC in Docket No. 21230, relating to Account 100.2, to increase from $10,000 to $25,000 the projects that can be charged directly to plant in service. The staff does not agree with item (a) of the noted FCC amendment which is to include construction projects designed to be completed in one year or less in rate base.3/

Based on the job order listing on July 30, 1980, almost all projects (job orders) will be completed in less than a year. Based on this fact, the staff found that Continental's projection that all jobs will be completed in less than a year for the test year 1981 is reasonable. Therefore, by requesting that short-term CWIP be included in rate base, Continental is in essence requesting that all CWIP be included in rate base.

---

3/ The decision on FCC Docket No. 21230 also stated:

"It should also be pointed out that we are not in any way attempting to influence the intrastate ratemaking decisions the several state commissions make in this area.

"Of course, they are free to adopt the same ratemaking treatment for plant under construction and interest during construction as we adopted in Docket 19129, or they may prefer to follow a different treatment."

TABLE XVI

Continental Telephone Company of California
California Operations

Total Company

WORKING CASH ALLOWANCE

Test Year 1981 Estimated

Determination of Average Amount of Working Cash Supplied by Investors

| Item | Amount (Dollars in Thousands) |
|---|---|
| Operational Cash Requirements | |
| Working Funds | $ 123 |
| Miscellaneous Special Deposits | 15 |
| Miscellaneous Receivables | 491 |
| Prepayments | 33 |
| Other Deferred Credits | 185 |
| Total Gross Requirements | 847 |
| Deductions | |
| Avg. Amount Available from Collecting Revenues before Expenses | (7,001) |
| Federal, State, & City Taxes | 297 |
| Employees Withholding | 779 |
| Other Deferred Credits | 756 |
| Credit Received from Suppliers | 2,826 |
| Total Deductions | (2,343) |
| Working Cash Allowance | 3,190 |
| Development of Avg. Amount Available as a Result of Collecting Revenues before Paying Expenses | |
| Average Lag in Payments | 17.694 |
| Average Lag in Collecting Revenues | 41.500 |
| Excess of Exp. Lag Over Rev. Lag | (23.806) |
| Total Expenses, Taxes, Depreciation | 107,339 |
| Avg. Amount Available as a Result of Collecting Rev. before Paying Expense | (7,001) |

(Red Figure)

TABLE XVII

Continental Telephone Company of California
California Operations

Total Company

DEVELOPMENT OF AVERAGE LAG IN PAYMENT OF
EXPENSES, TAXES, AND DEPRECIATION

Test Year 1981 Estimated

| Item | Dollars in Thousands | Est. Avg. No. of Lag Days | Thousands of Dollars Days of Lag |
|---|---|---|---|
| Federal Income Tax | $ 5,927 | 92.000 | $ 545,284 |
| Calif. Corp. and Franchise Tax | 1,356 | 82.800 | 112,277 |
| Depreciation Expense | 24,943 | 0.000 | 0 |
| State Unemployment Insurance | 349 | 75.100 | 26,210 |
| Federal Unemployment Insurance | 93 | 74.400 | 6,919 |
| Federal Ins. Contribution Act | 2,817 | 20.000 | 56,340 |
| Ad Valorem Taxes | 3,220 | 41.500 | 133,630 |
| Public Telephone Commissions | 80 | 67.600 | 5,408 |
| General Service and Licenses | 2,356 | 12.400 | 29,214 |
| Directory Expense | 1,896 | 46.000 | 87,216 |
| Operating Rents | 708 | (27.100) | (19,187) |
| Pensions | 3,733 | 5.700 | 21,278 |
| Payroll | 45,108 | 13.000 | 586,404 |
| Insurance | 674 | (2.900) | (1,956) |
| Deferred Income Tax - Acc. Depr. | 55 | 0.000 | 0 |
| Medical & Life Insurance | 2,375 | 13.900 | 33,012 |
| Voucher Items - Goods & Services | 11,649 | 23.800 | 277,256 |
| Total at Present Rates | $107,339 | 17.694 | $1,899,303 |

(Red Figure)

Note: State and Federal Income Taxes are based on a rate of return of 11.300 percent.

Continental's proposal rejects the long-standing principle that utility plant included in rate base should be considered "used and useful". Equally central to the used and useful concept is the equitable principle that ratepayers may not be forced to pay a return except on investment which can be shown directly to benefit them. Thus, imprudent or excess investment, for example, is the responsibility and coincident burden of the investor, not the ratepayer.

A potentially serious problem arises from including CWIP in rate base in that it provides the investors an incentive to increase nonoperative plant and overinvest since the rate base is calculated by total investor-supplied capital rather than by justifying such investment as used and useful to the ratepayer. Continental is able to construct plant without risk or incentive to complete a project because CWIP will earn the same rate of return as completed plant in service. Conversely, if a possible used and useful defense of each investment project is required, Continental would have the incentive to be more careful about its investment, realizing that the fact that the investment, if made, does not guarantee the investor a return.

Adjustment to Rate Base

The staff has adjusted its weighted average depreciated rate base by the following:

(1) Adjustments in Rate Base Table XV

(a) Usage and Companywide Assets Adjustment

The amount is a negative $1,286,000 for both the staff and Continental and was discussed previously under the heading Common Utility Plant.

(b) IDC Disallowed

The amount is a negative $350,000 for both the staff and Continental and was discussed previously under the heading IDC Disallowed.

(c) Weighted Average Operative CWIP

The amount is $16,426,000 for the staff and $10,510,000 for Continental. The reason for including it in the rate base and the differences between the staff and Continental were explained under the heading Telephone Plant Under Construction.

(d) Short-term, Noninterest Bearing CWIP

The amount is zero for the staff and $7,410,000 for Continental. It is the CWIP that was discussed earlier under Construction Work in Progress.

(2) Adjustment to Rate Base in Table XVIII, Summary of Earnings

(a) Unsupported Telephone Plant Adjustment

This adjustment reflects the unsupported telephone plant acquired in the Redwood Empire merger that was recommended by the staff accountant. The amount is a negative $695,000.

(b) Adjustment for Expense Charged to Construction

This is the adjustment to rate base due to the difference between the staff and Continental estimates as explained previously (Account 677). The expense charged to construction difference is $86,000. After retirements, salvage, etc., the net effect on the weighted average rate base is a negative $21,000.

(c) Adjustment for Capitalized Payroll Taxes

This is the adjustment to rate base due to the difference between the staff and Continental estimates of capitalized payroll taxes. The capitalized payroll taxes difference is $14,000 and the net effect after retirements, salvage, etc., on the weighted average rate base is a negative $2,000. This adjustment amount is so small that the staff rounded it to zero.

(d) IDC Adjustment for CWIP

The amount is $2,291,000 for the staff and zero for Continental. This is the effect on rate base of adding back the IDC that should have been charged to CWIP on projects over $1,000 consistent with the Commission-adopted accounting method. Continental is requesting CWIP to be included in rate base and no IDC adjustment be made.

## SUMMARY OF EARNINGS

The stipulated results of operation at present rates for test year 1981, discussed heretofore in detail, are summarized in Table XVIII. In accordance with the agreement reached between Continental and the Commission staff, the Commission adopts the stipulated results of operation as reasonable.

As noted previously, the adopted results of operation include a number of ratemaking adjustments as to which Continental takes issue. However, for purposes of a future filing under the RLP, Continental will include a results of operation prepared in a manner consistent with the results of operation adopted herein, even though some issues remain in dispute.

TABLE XVIII

Continental Telephone Company of California
California Operations

SUMMARY OF EARNINGS AT PRESENT RATES
(Estimated Year 1981)

| Item | Total Company: Continental | Total Company: Staff | Stipulated/Adopted: Total Company | Stipulated/Adopted: Intrastate |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Operating Revenues | $136,594 | $131,592 | $131,592 | $ 99,803 |
| Uncollectibles | 803 | 827 | 827 | 625 |
| Revenues after Uncollectibles | 135,791 | 130,765 | 130,765 | 99,178 |
| Total Operating Revenues | 135,791 | 130,765 | 130,765 | 99,178 |
| Operating Expenses | | | | |
| Maintenance | 27,876 | 26,650 | 26,650 | 20,166 |
| Traffic | 13,595 | 13,425 | 13,425 | 10,375 |
| Commercial | 8,875 | 8,506 | 8,506 | 7,476 |
| Bal. Gen. Office Sal. & Exp. | 10,824 | 10,231 | 10,231 | 8,277 |
| Other Operating Expenses | 10,638 | 9,768 | 9,768 | 7,387 |
| Subtotal | 71,808 | 68,580 | 68,580 | 53,681 |
| Depreciation Expense | 25,953 | 24,943 | 24,943 | 19,019 |
| Property and Other Taxes | 4,002 | 3,220 | 3,220 | 2,458 |
| Payroll Taxes | 3,347 | 3,259 | 3,259 | 2,553 |
| State Income Tax | 1,138 | 1,149 | 1,149 | 683 |
| Federal Income Tax | 1,136 | 1,062 | 1,062 | (28) |
| Depr. Unsupported Plant Adj. | 0 | (30) | (30) | (23) |
| Depr. Exp. Const. Adj. | 0 | (1) | (1) | (1) |
| Depr. Payroll Tax Adj. | 0 | 0 | 0 | 0 |
| Depr. IDC Adj. - CWIP | 0 | 80 | 80 | 61 |
| Affiliated Int. Adj. | 0 | (257) | (257) | (197) |
| Net Operating Expenses | 107,384 | 102,005 | 102,005 | 78,206 |
| Net Operating Revenues | 28,407 | 28,760 | 28,760 | 20,972 |
| Rate Base | | | | |
| Account 100.1 | 405,962 | 393,920 | 393,920 | 300,719 |
| Materials and Supplies | 3,501 | 3,501 | 3,501 | 2,677 |
| Working Cash | 1,664 | 3,190 | 3,190 | 2,504 |
| Less: Depr. Reserve | 115,562 | 111,406 | 111,406 | 85,036 |
| Less: Def. Tax Reserve | 173 | 210 | 210 | 160 |
| Subtotal | 295,392 | 288,995 | 288,995 | 220,704 |
| Usage and Co. Asset Adj. | (1,286) | (1,286) | (1,286) | (453) |
| IDC Disallowed | (350) | (350) | (350) | (267) |
| Weighted Avg. Opr. - CWIP | 10,510 | 16,426 | 16,426 | 12,535 |
| Unsupported Tel. Plant Adj. | 0 | (695) | (695) | (531) |
| Exp. Charged to Const. Adj. | 0 | (21) | (21) | (16) |
| Cap. Payroll Tax Adj. | 0 | (2) | (2) | (1) |
| IDC Adj. - CWIP | 0 | 2,291 | 2,291 | 1,748 |
| Affiliated Interest Adj. | 0 | (2,759) | (2,759) | (2,107) |
| Short-term CWIP Adj. | 7,410 | 0 | 0 | 0 |
| Total Rate Base | 311,676 | 302,599 | 302,599 | 231,612 |
| Rate of Return | 9.11% | 9.50% | 9.50% | 9.05% |

(Red Figure)

RATE SPREAD

In accordance with the stipulated results of operation, adopted herein, Continental will require increased gross revenues of $10,076,000 to have an opportunity to earn the staff's recommended 11.34 percent rate of return. This will require increases in Continental's rates of $9,232,000 (of which $246,000 represents increased EAS settlement revenue credit to Pacific), in addition to the $1,090,000 increased service connection charges authorized by Resolution No. T-10296 effective July 30, 1980. It is agreed by Continental and the staff that this increased revenue requirement should be spread to eliminate any subsidy of Continental's competitive offerings and to avoid burdening basic exchange customers with any unrecovered costs associated with optional service offerings. Rates and charges for competitive terminal equipment and for optional equipment and services should accordingly be priced to cover their full cost. The balance of any revenue requirement which may be authorized by the Commission should be generated through increased, residually priced rates for basic exchange access line service. Increasing Continental's present rates by application of these rate design criteria to yield the increased revenue requirement recommended will produce the annual revenue increase from each service shown in Table XIX. Table XIX summarizes categories of rates increased and the annual amount per category.

TABLE XIX

Continental Telephone Company of California
California Operations

ADOPTED ANNUAL REVENUE INCREASE*

| Item | Amount (000's omitted) |
|---|---|
| Terminal Equipment | |
| Key Telephone System | $1,054.4 |
| Supplemental Equipment | 82.0 |
| Telephone Sets | 27.9 |
| Cords | 31.9 |
| Telephone Answering Service | 42.5 |
| Private Branch Exchange Service | 290.7 |
| Data Subset Service | 25.7 |
| Interconnect Couplers and Connecting Arrangements | 8.0 |
| Miscellaneous Equipment and Services | 11.1** |
| Foreign Exchange Service | 112.8 |
| Nonrecurring Charge | 14.3 |
| Service Connection Charges | |
| Key Telephone Installation Charges | 127.1 |
| Exchange Mileage Services | 509.0 |
| Extended Area Service | 81.2 |
| Pocket Paging Service | 6.2 |
| Personal Signaling Service System | 2.1 |
| Fire Reporting Systems | 2.3 |
| Private Line Services and Channels | 67.7 |
| Misc. Private Line Service and Equipment | 1.5 |
| Utility-provided Music Access System | *** |
| Verification/Interrupt | 7.0 |
| Basic Exchange Local Access | 6,696.0 |
| Rotary Number Service | 30.6 |
| Total | $9,232.0 |

* Based on Staff Report of Rates and Charges Appendix A-N, with modification of Appendix M as necessary to reflect the increase authorized. (Exhibit 23.)

** 25 percent increase in rates; not shown in appendices to staff report.

*** Negligible, under $1,000 annually.

The specific staff-proposed rate and charge revisions along with the methodology designed to yield the customer-billed increases shown in Table XIX are contained in Exhibit 23 and are adopted herein by reference. The staff also proposed instituting a billing surcharge with which to reflect any increase (or decrease) in intrastate toll or EAS settlement revenues which might result from a decision in Pacific's Application No. 59849 proceeding. We will adopt the recommendation for the billing surcharge so that the matter may be settled in this proceeding without deferring it to OII 81.

## STAFF-RECOMMENDED STUDIES

The Commission staff recommended the following studies be undertaken by Continental regarding rate design, to which Continental agrees. We will include them in the ensuing order.

1. A study regarding the conversion of all foreign exchange customers who are not served on a cross-boundary basis to rate-center-to-rate-center mileage measurement, with rates designed to have a zero impact on Continental.

2. The introduction of Directory Assistance Charging within Continental's serving area. This study should include, but not be limited to, the plan authorized in Decision No. 92108, and should include a schedule of implementation as well as effects in plant, expenses, and revenues.

3. Continental should continue its review of providing Optional Residential Telephone Service (ORTS) to those areas currently receiving inward ORTS service; should revise Optional Calling Measured Service (OCMS) rates if, as a result of the Pacific proceeding, intrastate toll rates are revised which affect OCMS service rates; and if Pacific's request in Application No. 59849 to establish fully measured OCMS is authorized, Continental should file by advice letter a fully measured OCMS offering on a similar basis for its then existing OCMS services.

4. In its next general rate application, Continental should file a time schedule and the revenue requirement for implementing measured local service within its service areas utilizing electronic switches capable of implementing such service during a normal five-year planning period.

CUSTOMER SERVICE

The staff considers Continental's overall quality of service adequate and improving. According to the staff reports, service problems noted in prior proceedings have been significantly reduced by modernization of plant, improved maintenance, centralization of planning and quality controls, and implementation of uniform practices and procedures.

Service problems, however, persist in Victor Valley where 50,000 customers, approximately 30 percent of the total served by Continental, reside. As previously discussed, the majority of those customers who appeared at the public witness hearings or signed letter petitions to the Commission concerning the poor level of service provided by Continental were from the Victor Valley area.

Continental has undertaken a comprehensive remedial program which should yield significant improvements in Victor Valley within the next 12 months. Some of the key components of this program are the three new digital central offices in Victorville, Hesperia, and Spring Valley Lake, a new digital toll switch in Victorville and a 1344-channel digital microwave system which will provide the necessary relief on long distance network from Ridgecrest south to San Bernardino. According to Continental, the digital central offices are presently being installed and tested before they are placed into service. The toll switch was placed into service on December 21, 1980. The first phase of Continental's cutover plan added 72 new toll circuits from Victorville to the 4A machine in San Bernardino.

The Victorville class 5 digital switch and the Spring Valley remote digital switch were scheduled to go into service on or about February 7, 1981. At the time these digital switches are cut into service, total long distance facilities out of the Victor Valley area will be increased by 169 circuits. This represents a 33 percent increase in long distance facilities.

Continental's 1981 digital microwave addition, which will add 404 toll circuits to its toll network in Victor Valley, is scheduled to be placed into service on or about October 31, 1981. Continental assures us that service levels in Victor Valley have already improved since public testimony hearings were conducted in October 1980 and that substantial improvement should be reached by the end of 1981.

Beginning with the January 1981 report, Continental will be ordered to report to the Commission, on a monthly basis, all of the Commission's General Order No. 133 service indices. This will give the Commission the ability to measure, on a monthly basis, the anticipated improvement on service level, once the digital switches are in service. These reports will continue through September 1981, provided that all service levels improve as anticipated. Thereafter, Continental may return to its original practice of reporting all General Order No. 133 service indices on a quarterly basis. Continental also will be ordered to report its dial service observation results on a monthly basis through 1981 in order to measure the effect its microwave addition in October 1981 will have on long distance call-handling capabilities. Continental is also to provide the Commission staff with a status report immediately following the cutover of its three digital switches at the end of January 1981.

## FINDINGS AND CONCLUSIONS

Findings of Fact

1. Continental is in need of additional revenues, but the requested increase of $17,282,000, comprised of $12,221,000 in local service revenue increases and $5,061,000 in anticipated settlement revenues from Pacific, is excessive.

2. Continental, in return for assurance that a draft decision in connection with this application would be on the Commission Agenda on or before April 1, 1981 so that it may obtain rate relief as early as possible, has agreed to accept the staff's report and recommendations received into evidence during this proceeding.

3. Although Continental disagrees with a number of ratemaking issues, estimates, and recommendations contained in the staff reports, Continental has agreed to forego contesting these issues in this proceeding in the expectation of receiving rate relief substantially earlier in the test year than would otherwise be possible.

4. Continental reserves the right to litigate these points of disagreement in future applications.

5. The staff's recommended rate of return on rate base of 11.34 percent designed to produce rate of return on common equity of 14.5 percent, based on capital ratios of 45 percent common equity, 50 percent long-term debt (with an embedded cost of 8.96 percent), and 5 percent preferred stock (with an embedded cost of 6.66 percent) is reasonable. Such a rate of return would provide an approximate times interest coverage after income taxes of 2.53 times.

6. A rate of return of 11.34 percent applied to our adopted intrastate rate base of $231,612,000 would require $9,232,000 of increased annual revenues, in addition to the $1,090,000 increased service connection and "unbundling" charges authorized by Resolution No. T-10296 effective July 30, 1980.

7. The stipulated and adopted estimates previously discussed herein of operating revenues, operating expenses, and rate base for test year 1981 reasonably indicate the results of Continental's operations in the future.

8. Continental's overall quality of service is adequate, although service problems persist in the Victor Valley area. The installation of digital central offices in Victorville, Hesperia, and Spring Valley Lake, which should all be in service by early February 1981, should yield significant improvement in local service calling in those areas.

9. The staff-recommended study to be done by Continental regarding the conversion of all foreign exchange customers who are not served on a cross-boundary basis to rate-center-to-rate-center mileage measurement with rates designed to have a zero revenue impact on Continental is reasonable.

10. The staff-recommended study to be done by Continental regarding the introduction of Directory Assistance Charging within Continental's serving area including, but not limited to, the plan authorized in Decision No. 92108 and to include a schedule of implementation as well as effects on plant, expenses, and revenues is reasonable.

11. The staff-proposed rate design which increases rates for terminal equipment and optional equipment and services is designed to recover costs of providing those services and is reasonable.

12. The staff-proposed increases in basic exchange service rates which are residually priced to recover the revenue requirement deficiency remaining after recovering full costs for terminal equipment and optional equipment and services are deemed reasonable.

13. The staff proposal to institute a billing surcharge to reflect any increase or decrease in intrastate toll or EAS settlement revenues resulting for our decision in Application No. 59849 is reasonable and will be adopted as an administratively convenient vehicle for disposing of this issue in the current proceeding rather than deferring it to OII No. 81.

Conclusions of Law

1. The Commission concludes that the application should be granted to the extent set forth in the order which follows.

2. The rates authorized in Appendix A are just and reasonable. Any other rates applied after the rates in Appendix A are in effect are unjust and unreasonable.

3. Continental should, within 180 days of the effective date of this order, undertake and submit studies regarding:

a. The conversion of all foreign exchange customers who are not served on a cross-boundary basis to rate-center-to-rate-center mileage measurement, with rates designed to have a zero revenue impact on Continental.

b. The introduction of Directory Assistance Charging within Continental's serving area. This should include, but not be limited to, the plan authorized in Decision No. 92108, and should include a schedule of implementation as well as effects on plant, expenses, and revenues.

4. In its next general rate application, Continental should file a time schedule and the revenue requirement for implementing measured local service within its service areas which have or will have electronic switching during a normal five-year planning period.

5. Continental should continue its review of providing ORTS to those areas currently receiving inward ORTS service, should revise OCMS rates if, as a result of the current Pacific proceeding, intrastate toll rates are revised which affect OCMS service rates; and, if Pacific's request in Application No. 57849 to establish fully measured OCMS is authorized, Continental should file by advice letter a fully measured OCMS offering on a similar basis for its then existing services.

6. Continental should report to the Commission, on a monthly basis, all of the Commission's General Order No. 133 service indices, commencing after the effective date of this order and continuing through September 30, 1981. After that time, provided that all service levels have improved as anticipated, and with the exception of dial service indices, Continental should return to its original practice of reporting all General Order No. 133 service indices on a quarterly basis. The dial service indices report should continue on a monthly basis until December 31, 1981.

7. Because the rates authorized are based on the test year 1981 and will be effective for only a portion of that year, the effective date of the order should be the date of signature.

## O R D E R

IT IS ORDERED that:

1. Five days after the effective date of this order Continental Telephone Company of California (Continental) is authorized to file the revised rate schedules attached to this order as Appendix A and concurrently to cancel the presently effective schedules. Such filing shall comply with General Order No. 96-A. The effective date of the revised schedules shall be not less than five days after the date of filing. The revised schedules shall apply only to service rendered on and after the effective date.

2. Within one hundred eighty days of the effective date of this order, Continental shall submit to the Commission staff, and serve on all appearances to this proceeding, studies, regarding:

a. The conversion of all foreign exchange customers who are not served on a cross-boundary basis to rate-center-to-rate-center mileage measurement, with rates designed to have a zero revenue impact on Continental.

b. The introduction of Directory Assistance Charging within Continental's serving area. This should include, but not be limited to, the plan authorized in Decision No. 92108, and should include a schedule of implementation as well as effects on plant, expenses, and revenues.

3. In its next general rate application, Continental shall file a time schedule and the revenue requirement for implementing measured local service within its service areas which have or will have electronic switching during a normal five-year planning period.

4. Continental shall continue its review of providing Optional Residential Telephone Service (ORTS) to those areas currently receiving inward ORTS service; shall revise Optional Calling Measured Service (OCMS) rates if, as a result of The Pacific Telephone and Telegraph Company's (Pacific) request in Application No. 59849, intrastate toll rates are revised which affect OCMS service rates; and, if Pacific's request in Application No. 59849 to establish fully measured OCMS is authorized, Continental shall file by advice letter a fully-measured OCMS offering on a similar basis for its then existing OCMS services.

5. After the effective date of this order, Continental shall report to the Commission, on a monthly basis, all of the Commission's General Order No. 133 service indices to allow the Commission the ability to measure any improvement of service levels in the Victor Valley area. These reports shall continue to September 30, 1981 with the exception of the dial service indices report which shall continue until December 31, 1981. After which time, providing that all service levels have improved to a satisfactory level, Continental may revert to its original practice of reporting service indices on a quarterly basis.

6. Continental shall report its dial observation results on a monthly basis through 1981 in order to measure the effect its microwave addition, to be installed in October 1981, will have on long distance call-handling capabilities. Thereafter these reports may revert to a quarterly reporting basis.

7. Continental shall reflect any increase in intrastate toll or EAS settlement revenues which result from our decision in Application No. 59849 in its billing surcharge.

The effective date of this order is the date hereof.

Dated MAR 17 1981, at San Francisco, California.

President

Commissioners

RATES AND CHARGES

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

Schedule No. A-1 - Network Access Line Service

The following rates are authorized:

| Residence | Monthly Rate |
|---|---|
| One-party | $ 7.00 |
| Two-party | 5.90 |
| Four-party | 5.90 |
| Multiparty | 5.40 |
| Multiline | 12.00 |
| Keyline | 12.00 |
| **Business** | |
| One-party | 17.50 |
| Two-party | 15.00 |
| Four-party | 15.00 |
| Multiparty | 13.50 |
| Multiline | 29.00 |
| Keyline | 29.00 |
| PBX trunk | 29.00 |
| Semipublic | 17.50 |
| Rotary Number Service | 0.75 |

In addition to the rates shown above standard Special Rate Area increments, Zone increments, and the proposed Extended Area Service increments as set forth in Exhibit No. 17, page 18 will apply where appropriate.

Schedule No. A-2 - Outside Plant Facilities

Proposed revisions as set forth in Exhibit No. 17, pages 20, 21, and 22.

Schedule No. A-3 - Telephone Sets

Proposed revisions as set forth in Exhibit No. 23, Appendix B, Part II.

Schedule No. A-9 - Telephone Answering Service

Proposed revisions as set forth in Exhibit No. 23, Appendix C.

Schedule No. A-10 - Key Telephone System Service

Proposed revisions as set forth in Exhibit No. 23, Appendix A, Parts I and II.

RATES AND CHARGES

Schedule No. A-12 - Data Subset Service

Proposed revisions as set forth in Exhibit No. 23, Appendix D.

Schedule No. A-13 - Interconnect Couplers and Connecting Arrangements

Proposed revisions as set forth in Exhibit 23, Appendix E.

Schedule No. A-15 - Supplemental Equipment

Proposed revisions applicable to special cords as set forth in Exhibit No. 17, page 30 and proposed revisions as set forth in Exhibit No. 23, Appendix B, Part I.

Schedule No. A-17 - Foreign Exchange Service

Proposed revisions as set forth in Exibit No. 23, Appendix G, except that non-recurring charges shown on Sheet 2 of 2 shall be applicable to all grades of service.

Schedule No. A-28 - Fire Reporting Systems

Proposed revisions as set forth in Exhibit No. 23, Appendix J.

Schedules Nos. G-1, G-2, and G-4 - Private Line Services and Channels; Miscellaneous Private Line Services and Equipment; Utility-Provided Music Access Systems

Proposed revisions as set forth in Exhibit No. 23, Appendix K.

Schedules Nos. L-2 and L-3 - Pocket Paging Service and Personal Signaling Service System

Proposed revisions as set forth in Exhibit No. 23, Appendix H.

Schedule No. X-2 - Obsolete Service or Equipment

Proposed revisions as set forth in Exhibit No. 23, page 2-9 and Appendix F, Parts I, II, III, IV.

Schedule No. Z - Billing Surcharge

Proposed revisions as set forth in Exhibit No. 23, Appendix O.

Verification/Interrupt

Proposed revisions as set forth in Exhibit No. 23, Appendix L.